



**EN**

**UNIDROIT Committee of governmental experts  
on the enforceability of close-out netting  
provisions  
First session  
Rome, 1 – 5 October 2012**

UNIDROIT 2012  
C.G.E./Netting/1/W.P. 6  
Original: English  
September 2012

**Draft Principles regarding the  
enforceability of close-out netting provisions**

**COMMENTS**

*(submitted by Governments and Organisations)*

**INTRODUCTION**

Subsequently to the comments (C.G.E./Netting/1/W.P. 3, W.P. 4 and W.P. 5) on the text of the UNIDROIT Draft Principles regarding the enforceability of close-out netting provisions (C.G.E./Netting/1/W.P. 2 and Addendum) for consideration by the Committee of Governmental Experts on the enforceability of close-out netting provisions at its first session from 1 to 5 October 2012, the UNIDROIT Secretariat received comments from the World Bank. These comments are reproduced hereunder.

**COMMENTS SUBMITTED BY ORGANISATIONS**

***World Bank***

1. We support the development of a set of internationally recognized principles on close-out netting. However, some aspects of the current version of the Draft Principles raise a few concerns about the scope of the Principles and their compatibility with developing guidance on national legislation for the effective resolution of systemically important financial institutions. We believe these can be effectively addressed through modest drafting changes. Set out below are our key concerns.

**Executive summary**

2. The Mandate of the project is to focus on the enforceability of close-out netting provisions; the Draft Principles appear to go beyond these specific concerns to reach into other areas of set off, which should remain the province of SIFI resolution principles that are currently being developed at the national and international levels. In particular:

a) the functional definition of close-out netting provision seems to encompass a mere set-off provision without sufficiently identifying and analyzing the implications to the over-all resolution process of this broad approach; and

b) the insolvency immunity envisaged by the Draft Principles seems to have conflated the close-out netting process with the *validity of the underlying obligations* that may be subject to close-out netting.

3. The scope of the proposed insolvency immunity for close-out netting goes beyond the established EU policies, and some of the purported justifications for disapplying general insolvency law appear insufficient in light of the critical importance of the need for the safe harbor to fit effectively within the larger resolution framework.

4. The conflict of laws analysis, in allowing the governing law of a close-out netting clause to determine the scope of transactions entitled to insolvency immunity, may lead to an unworkable result. It also seems to contradict the provision in the Draft Principles relating to the effectiveness of national laws that govern the substantive law of contract.

### **Introduction**

5. Para 3 states that "close-out netting ... is functionally and conceptually different from traditional set-off". This appears to have overstated the distinction between close-out netting and set-off. It is true that close-out netting involves a number of steps, such as acceleration and termination of contractual obligations followed by valuation, that are not necessary elements of set off. But the final step of close-out netting to produce a net amount is essentially a set-off process:

"Close-out netting is a process intended to reduce exposures on open contracts if one party should become insolvent or a like event occurs before the settlement date. As in this case, the agreement typically provides that, on an event of default in relation to one party, the other party can terminate all outstanding contracts between the parties, calculate the losses and gains on each contract and then *set them off* so that only a balance is owing": *Revenue and Customs Commissioners v Enron Europe* [2006] EWHC 824 (Ch); [2006] STC 1339 at [20] (emphasis added).

"A feature of all standard-form share lending agreements, which is shared with other agreements in the financial market (e.g. sale and repurchase agreements, currency and interest rate swaps), is that they make provision for close-out netting in the event of default. Close-out netting is the process by which contractual obligations are converted into money obligations which can then be *set off* against each other to arrive at a net amount payable by one party to the other": *Re Opes Prime Stockbroking* [2008] FCA 1425 at [3] (emphasis added).

6. In fact para 28 acknowledges that the close-out netting process involves the aggregation of claims which "is functionally the same result as the outcome of classical set-off of all valued and payable obligations". In these circumstances, is the document internally inconsistent by saying on the one hand that close-out netting is functionally different from set-off and on the other that the close-out netting process creates functionally the same result as the outcome of set-off?

7. It is important to maintain the conceptual clarity of close-out netting in order to:

a) delineate the proper scope of the Draft Principles and the justifications for the Draft Principles; and

b) avoid ambiguity in respect of the interaction with the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011) and national regimes for the resolution of financial institutions including SIFIs.

8. If a functional definition is to be used, we think it more appropriate to state the key elements of close-out netting, namely the happening of the following upon a specified event: (i) an automatic or discretionary termination of the relevant contractual obligations; (ii) the calculation of the termination values of the obligations; and (iii) the netting of the termination values so that only a net cash amount becomes payable.<sup>1</sup>

### Principle 1

9. It appears that the definition of "close-out netting provision" is merely a description in functional terms by reference to a result. Is having a mere outcome-based definition consistent with the purpose of the project? A mere outcome-based definition risks expanding the notion of close-out netting to such an extent that it encompasses all forms of netting in a manner that falls outside the project's terms of reference. Such implicit expansion of the safe harbor (based on the existence of a set-off provision) would require careful and informed policy debate on substantive policies and powers governing resolution of financial institutions and the scope of authority of resolution authorities and regimes:

"The Study Group agreed ... to focus on close-out netting. It decided to clarify either in the preamble or the commentary to the future instrument that the limitation to close-out netting agreements was without prejudice to the protection of *other forms of netting* or other risk-mitigation techniques."<sup>2</sup>

10. Does the present functional description of "close-out netting provision" not cover all forms of netting as well as mere contractual set-off? Paras 27 and 28 seem to implicitly recognize that the functional description is unable to distinguish itself from other forms of netting such as novation netting.

11. Market-standard examples of pure contractual set-off that nevertheless appears to fall within the functional definition of "close-out netting provision" are section 6(f) of the 2002 ISDA Master Agreement and para 11.8 of the 2010 Global Master Securities Lending Agreement:

"6(f). Set-Off. Any Early Termination Amount payable to one party (the "Payee") by the other party (the "Payer"), in circumstances where there is a Defaulting Party or where there is one Affected Party in the case where either a Credit Event Upon Merger has occurred or any other Termination Event in respect of which all outstanding Transactions are Affected Transactions has occurred, will, at the option of the Non-defaulting Party or the Non-affected Party, as the case may be ("X") (and without prior notice to the Defaulting Party or the Affected Party, as the case may be), be reduced by its set-off against any other amounts ("Other Amounts") payable by the Payee to the Payer (whether or not arising under this Agreement, matured or contingent and irrespective of the currency, place of payment or place of booking of the obligation). To the extent that any Other Amounts are so set off,

---

<sup>1</sup> Cf. Section 5 of the Australian Payment Systems and Netting Act 1998.

<sup>2</sup> UNIDROIT Study Group on principles and rules on the netting of financial instruments – Report (July 2011), para 7 (emphasis added). See also para 15 of the Preliminary draft Report on the need for an international instrument on the enforceability of close-out netting in general and in the context of bank resolution (March 2011) which also confirms that the purpose of the Draft Principles is to delineate "close-out netting" from other mechanisms that produce the same result (such as novation netting).

those Other Amounts will be discharged promptly and in all respects. X will give notice to the other party of any set-off effected under this Section 6(f).”

“11.8. Set-off. Any amount payable to one Party (the Payee) by the other Party (the Payer) under paragraph 11.2(b) may, at the option of the Non-Defaulting Party, be reduced by its set-off against any amount payable (whether at such time or in the future or upon the occurrence of a contingency) by the Payee to the Payer (irrespective of the currency, place of payment or booking office of the obligation) under any other agreement between the Payee and the Payer or instrument or undertaking issued or executed by one Party to, or in favor of, the other Party.”

12. It is well established that Section 6(f) is a mere set-off provision, not a close-out netting provision: *Lehman Brothers Commodity Services v Credit Agricole Corporate and Investment Bank* [2011] EWHC 1390 (Comm); [2012] 1 All ER (Comm) 254. ISDA has also received legal opinion confirming the same.

13. If the Draft Principles are indeed intended to cover a mere contractual set-off right such as that in section 6(f) of the 2002 ISDA Master Agreement and para 11.8 of the 2010 Global Master Securities Lending Agreement, it raises at least three fundamental questions:

a) If there are a bundle of unconnected financial contracts and each of them is already subject to a close-out netting provision, why does a further set-off between the fixed close-out sums arising from the contracts deserve special insolvency protection? To say that set-off is important to one party for risk-management purposes seems to be question-begging. It assumes that his set-off right deserves special insolvency protection and other creditors' interests deserve to be subordinated. The Draft Principles do not appear to present a policy justification for this position, in light of the potential impact on other stakeholders.

b) If indeed mere contractual set-off is to be given special insolvency protection, it requires justification as to why only set-off in respect of certain transactions deserves special insolvency protection. The Draft Principles' focus is on financial market participants (see para 1) and they have proceeded from the position that only set-off rights in financial and commodity contracts should be protected. What about other sectors of the world economy? For example, should set-off clauses in construction contracts be given a special insolvency privilege? If the answer is that such concerns fall outside the scope of the Draft Principles, then this argues for clarifying the definition of close-out netting so that the Draft Principles do not have the effect of making implicit policy choices by extending insolvency immunities to other set-off mechanisms. The Draft Principles should perhaps highlight that the longer the list of 'privileged' contracts, the more likely that all stakeholders (including the supposedly privileged parties) become worse off. For example, a solvent party would have merely an unsecured claim in respect of the post-close-out net balance owed by the debtor. If many other parties are also able to assert set off (thereby significantly diminishing the estate), the value of the post-close-out net balance would abate accordingly. Moreover, losses suffered by unsecured creditors may ultimately be borne by taxpayers generally.

c) Is it intended that the Draft Principles suggest that trust assets (e.g. client money) should be susceptible to contractual set-off? If so, there should be clear justifications, given that the trust assets are generally not to be set off against the personal obligations of the trustee. The

regulatory implications should also be explained, as this approach would undermine other essential aspects of effective resolution principles for financial institutions.<sup>3</sup>

14. The sentence in the definition beginning “Depending on the contractual agreement and applicable law” seems tautologous and may create confusion. Given that a close-out netting provision is already a “contractual provision”, its operation per force depends on the terms of the agreement. The reference to “applicable law” may capture a situation where close-out netting happens by operation of law, but such statutory netting should fall outside the scope of the Draft Principles.

15. Paras 11 and 24 refer respectively to “bundle of contracts” and “termination of contracts”. Cross-product close-out netting is possible, but most close-out netting in practice concerns transactions within the same agreement. It seems more appropriate to replace “contracts” with “obligations”.

16. In terms of terminology, if the Draft Principles are intended to cover a mere contractual set-off right, is it not more appropriate for the title of the Draft Principles to be amended accordingly so that it is clear that the Draft Principles cover more than close-out netting?<sup>4</sup> In terms of substance, we believe this may go beyond the mandate of the exercise and would enter into the realm of substantive policies on the resolution of financial institutions which are under discussion in other national and international fora

### **Principle 3**

17. The discussion in paras 64-68 regarding the proposal to include loans and deposits in the list of eligible obligation demonstrates that the definition of “close-out netting provision” is apt to encapsulate mere contractual set-off. It also shows that if the definition of “close-out netting provision” is meant to capture all functional equivalents of netting, the policy justifications for giving insolvency priority to the expanded notion of close-out netting need to be properly debated.

### **Principle 7**

18. The reference to the enforceability of close-out netting *before* the commencement of insolvency proceedings merits further debate, as it has direct implications limiting application of specific national policies on the formation and validity of contracts. Before the commencement of insolvency proceedings, the enforceability of a close-out netting provision (a contract) should be a purely contractual matter, the realm of the governing law of the contract. The applicable law reflects the relevant national policies with regard to the formation and validity of contracts. To single out close-out netting for special protection requires proper debate and careful attention to all the underlying policies. Imagine the following scenario: A master stock lending agreement between A and B governed by Ruritanian law contains a set-off clause providing that all claims and cross-claims between A and B pursuant to any commodities contract are to be settled net. Under Ruritanian law, the master stock lending agreement is unenforceable. Why should the set-off clause be nevertheless enforceable? To simply say that “the enforceability of close-out netting is crucial ...

---

<sup>3</sup> “An effective resolution regime ... should ... ensure the rapid return of segregated client assets”: Financial Stability Board’s Key Attributes of Effective Resolution Regimes for Financial Institutions (October 2011), p. 3.

<sup>4</sup> Originally, “[t]he Study Group agreed to change the heading of the instrument to reflect that it only dealt with close-out netting”: UNIDROIT Study Group on principles and rules on the netting of financial instruments – Report (July 2011), para 37.

outside insolvency” does not appear to be a sufficient justification; it suggests the enforceability of close-out netting is more important than the enforceability of the master stock lending agreement.

19. In this connection, it may be helpful to note that while the enforceability of close-out netting provisions within a financial collateral arrangement is crucial before the commencement of insolvency proceedings, Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (“EU Financial Collateral Directive”) does not seek to regulate the pre-insolvency contractual position. Article 7(a) of EU Financial Collateral Directive provides merely that “a close-out netting provision can take effect in accordance with its terms notwithstanding the commencement or continuation of winding-up proceedings or reorganization measures in respect of the collateral provider and/or the collateral taker”.

20. Moreover, in the EU context, contractual validity is reserved for national law to cater for local policies (see Regulation (EC) No 593/2008 of the European Parliament and of the Council on the law applicable to contractual obligations (“Rome I Regulation”).<sup>5</sup> Close attention has to be paid to the question if the Draft Principles in respect of the pre-insolvency enforceability of close-out netting is consistent with the policies of the Rome I Regulation.

21. If it remains desirable to refer to the enforceability of close-out netting before the commencement of insolvency proceedings, perhaps it may be made clear that it is without prejudice to general national rules or policies regarding the formation and validity of contracts generally, such as ultra vires issues.

22. Principle 7(c)(i) regarding ‘cherry picking’ by an insolvency administrator seems outside the project’s mandate. The facts in *Lehman Brothers Commodity Services v Credit Agricole Corporate and Investment Bank* [2011] EWHC 1390 (Comm); [2012] 1 All ER (Comm) 254 may be used to illustrate the point. The case concerns set-off, pursuant to Section 6(f) of the ISDA Master Agreement, between a close-out sum and a sum due under a letter of credit. Imagine the insolvency of the letter of credit provider and that the letter of credit is ordinarily susceptible disclaimer or rejection under national insolvency law. The effect of Principle 7(c)(i) appears to be that, just because the letter of credit is covered by a set-off clause, it becomes immune from disclaimer or rejection. If the national insolvency law’s policy is that the letter of credit is generally not immune from disclaimer or rejection, it is hard to see why the mere fact of the letter of credit being covered by a set-off clause should entail the privilege of immunity.

23. Taken to its logical conclusion, Principle 7(c)(i) implies that all other unenforceable obligations should become enforceable just because they are covered by a close-out netting provision. But this would be outside the scope of the Draft Principles (see paras 93-96).

24. Indeed the logic of Principle 7(c)(i) does not sit easily with the explanation given to the definition of close-out netting. Para 14 states that “the term ‘close-out netting provision’ covers only those parts of an agreement that actually implement the close-out netting mechanism itself, and nothing else.” But Principle 7(c)(i) seeks to disapply insolvency policy regarding the enforceability of underlying obligations, not just the implementation of close-out netting. In other words, Principle 7(c)(i) appears to conflate the close-out netting process with the validity of the underlying obligations that may be subject to close-out netting. If all eligible obligations under Principle 3 are to be given insolvency immunity, they should be separately considered, perhaps in a different project.

---

<sup>5</sup> For example, Article 10(1) of the Rome I provides that “[t]he existence and validity of a contract, or of any term of a contract, shall be determined by the law which would govern it under this Regulation if the contract or term were valid”.

25. Principle 7(c)(iii) also appears unjustified as a matter of policy. It seeks to disapply insolvency avoidance rules with respect to preference. The purported justification provided in paras 106 and 107 is this:

“[A]t the time when they enter into the close-out netting provision, parties do not know who will be ‘in the money’ or ‘out of the money’ at any given point in time in the future. However, the domestic law can impair the operation of a close-out netting provision should there be qualifying elements, going beyond the mere fact of entering into the close-out netting provision. Such qualifying facts can consist, in particular, of the parties’ knowledge of the imminent insolvency of one of their number at the time they entered into the close-out netting provision”.

We have a number of concerns with this justification:

a) Whether the parties know, at the time of entering into a close-out netting provision, who will be in or out of the money is a question of the parties’ transactions. It is too sweeping to say that the parties are always in the dark. A principle cannot be based on this assumption.

b) Insolvency avoidance provisions reflect national insolvency law’s policy choices. As regards preference, some insolvency laws incorporate a mental element (such as a desire to prefer) and some are based simply on the fact of preferential treatment (subject to an ordinary-course-of-business defense). Preference laws that incorporate a mental element in effect use the mental element as a proxy for an ordinary-course-of-business defense. As drafted, Principle 7(c)(iii) appears to take a one-size-fits-all approach by disapplying insolvency policies without considering their underlying rationale.

c) In fact para 89 seems inconsistent with Principle 7(c)(iii). It states that “close-out netting provisions would never be allowed to trump certain other fundamental rules, such as the rules relating to misrepresentation and fraud to the detriment of the counterparty, its creditors or the insolvent estate”. But isn’t preference a form of fraud on creditors?

d) The protection of close-out netting provision within the EU Financial Collateral Directive does not go as far as disapplying preference provisions. Nor is there any protection against any anti-deprivation principle referred to in para 105.<sup>6</sup> Does Principle 7(c)(iii) not conflict with the EU Financial Collateral Directive’s policy?

26. As regards Principle 7(c)(iv), the explanatory remarks in paras 108 and 109 assert that “[n]either the close-out netting provision nor any obligations covered by it should be subject to such avoidance rights”, despite the fact that the avoidance rules are to “avoid unjustified preference of one or more creditors”. Our concerns here are similar to the points made above regarding Principle 7(c)(i). Specifically:

a) Principle 7(c)(iv) appears to conflate the close-out netting process with the validity of the underlying obligations that may be subject to close-out netting. That latter is outside the scope of the Draft Principles. If all eligible obligations under Principle 3 are to be given insolvency immunity, the immunity should be separately considered and not simply tagged on to the protection of close-out netting.

---

<sup>6</sup> If the reference to anti-deprivation principle is meant to reflect the English common law concept, it would appear mistaken as the English anti-deprivation principle does not work to prejudice bilateral set-off: *Belmont Park Investments v BNY Corporate Trustee Services* [2011] UKSC 38; [2012] 1 AC 383.

b) The justification given in para 111 is as follows:

"[P]arties cannot know at the time when they enter into a netting provision which of them, if any, might subsequently default. Equally, they cannot know which party will be 'in the money' at the time of the potential default of one of the parties. Thus, entering into a close-out netting provision is neutral from the outset and equally beneficial or disadvantageous to the risk carried by both sides. Hence this situation is different from receiving payments or property or taking new or additional collateral which decreases the credit risk of only one of the parties. As a result, entering into a close-out netting provision should not be subject to avoidance merely on the grounds that it took place before insolvency proceedings commenced."

The above justification is not necessarily apt in all circumstances. For example, a debtor on the brink of insolvency may be commercially forced to enter into a master netting agreement entitling the lender to act unilaterally and in his discretion to bring about netting. In the event of the debtor's insolvency, the invocation of such netting right benefits only the lender, to the detriment of the debtor's estate. Put another way, the entry into of a netting provision is not necessarily neutral from the outset. An example is *Lehman Brothers Holdings v JPMorgan Chase Bank, N.A. (In re Lehman Brothers Holdings)*, 469 B.R. 415 (Bankr. S.D.N.Y. 2012) where shortly before Lehman's collapse, JP Morgan used its strong bargaining position and obtained an expansive set-off right which was designed to improve JP Morgan's position only.

27. As drafted Principle 7 does not appear to contain any safeguard against post-insolvency claims trafficking, namely where, after the debtor's insolvency, a solvent party acquires debts from a third party and applies the close-out netting provision to these newly acquired debts. It may be helpful to note that post-insolvency claims trafficking for set-off purposes is not protected by Council regulation (EC) No 1346/2000 on insolvency proceedings, nor by the UK implementation of the EU Financial Collateral Directive.

### **Principle 9**

28. Principle 9(2) appears flawed. Consider a situation where a close-out netting provision is sought to be enforced in Ruritania (which has implemented the Draft Principles) and the close-out netting provision is expressed to be governed by English law. If Principle 9(2) applies, the following concerns arise:

a) If Ruritanian law differs from English law with regard to eligible parties and contracts, the application of Principle 9(2) would mean that English law trumps Ruritanian law. If so, what is the purpose of Principles 2 and 3 in allowing the relevant State (in this case Ruritania) to determine the scope of eligible parties and contracts in accordance with local policies? Does Principle 9(2) not undermine Principles 2 and 3?

b) If English law has not implemented the Draft Principles, how would English law supply the definition of eligible parties and contracts to be used in Ruritania? As a matter of conflicts principle, why should English law determine the scope of insolvency immunity under Ruritanian law?

c) The justification for Principle 9(2) is stated in para 126: "The integrity of the netting set would be destroyed and the risk-mitigation effect of close-out netting nullified if the contractual coverage of a close-out netting provision were to vary according to the jurisdiction in which enforcement of the close-out netting provision is sought." This justification seems paternalistic and

misplaced. If States have implemented the UNIDROIT principles, this problem of 'nullification' should not arise. It is true that not all States will implement the UNIDROIT principles in precisely the same way, but that is the whole purpose of each State's legislative autonomy envisaged by the principles.

29. Contrary to the suggestion in para 126, it does not follow from the parties' autonomy to choose the governing law of a close-out netting provision that the autonomy also determines the scope of insolvency immunity.

30. In this connection, it may be helpful to contrast the conflict of laws principles under the UK implementation the EU Financial Collateral Directive. While a security arrangement may be governed by foreign law, it is for English law to decide whether the foreign-law governed security arrangement falls within the English notion of financial collateral arrangement.

31. As regards Principle 9(4), consideration should also be given to the situation where both parties are insolvent and subject to insolvency proceedings in different countries.