Principle 1: Scope of the Principles

1. These Principles deal with the effects and the enforceability of close-out netting provisions that are entered into by eligible parties in respect of eligible obligations.

Explanation and commentary

INTRODUCTION

1. Financial institutions and other financial market participants in their daily operations use a number of mechanisms designed to reduce their risk exposure. Amongst other things, first, they provide to each other security or collateral. In addition, they may agree that close-out netting shall apply to the contracts into which they enter with each other. Both mechanisms, security/collateral on the one hand and close-out netting on the other hand, serve the same purpose, that is, to ensure that one party’s exposure to the other parties’ solvency and to considerable changes in the value of the relevant assets is kept at manageable levels. Both mechanisms are capable of independently mitigating counterparty risk as well as market risk. However, in practice, their functions are intimately linked: where collateral and netting mechanisms are used cumulatively, netting reduces the exposure in the sense that much less collateral has to be put up. Taken together, security/collateral and close-out netting are one of the primary tools of risk management in the financial market.

2. The notion of close-out netting is a relatively new addition to the legal terminology and it is not particularly well-defined. Broadly speaking, close-out netting is often understood as resembling the classical concept of set-off applied upon default or insolvency of one of the parties. Traditionally, the concept of set-off applies only to parties with mutual debts that are already...
2. Set-off occurs by contract or by operation of law, the parties’ existing debts are offset against each other, such that the party with the smaller debt owes nothing, and the party with the larger debt owes only the difference between the two obligations. However, close-out netting, however, encompasses many additional elements and is functionally and conceptually different from traditional set-off. A close-out netting mechanism comes into operation either by a declaration (‘close-out’) of one party when a pre-defined event occurs, in particular default or insolvency of its counterparty (‘termination event’), or it is triggered automatically when such an event occurs (‘automatic termination’). The mechanism extends to a number, often hundreds, of contracts outstanding transactions between the parties that are contractually included in a netting provision. Upon close-out or automatic termination, generally all such transactions that are covered by the close-out netting provision contracts covered are terminated and the market’s value of each is determined for each under a pre-defined valuation mechanism, which may also take into account, inter alia, the identity and credit standing of the party responsible for this determination and any existing credit support and other material terms of the parties’ agreement. The sum value of all such transactions contracts is then aggregated resulting in one single payment obligation (‘net amount’). The net amount remains the only obligation to be settled and is generally due immediately after being determined even though no debts may have been due under the transactions covered by the close-out netting provision prior to the operation of the close-out netting mechanism.

3. Close-out netting provisions are widely used in the financial market by private sector entities, in particular banks, but also private non-financial institutions. In the public sector, entities such as, especially, central banks and supranational financial institutions such as development banks make use of netting provisions. Close-out netting is typically applied to transactions such as derivatives, repurchase and securities lending agreements, and other kinds of transaction that tend to carry a high counterparty and/or market risk.

4. Regulatory authorities (most recently, the Financial Stability Board (FSB) and the Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision) strongly encourage the use of such close-out netting provisions (alongside collateral) because of their beneficial effects on the stability of the financial system. The reason is that if in the event of default of the counterparty market participants would be referred for their claims on a gross basis to the position of a normal unsecured creditor in insolvency instead of being a creditor for the net amount only, the non-defaulting party might be exposed to levels of credit risk and market risk that are difficult to estimate and manage. The situation would be further exacerbated by the fact that there may be for the relevant types of transactions rapid changes in market values and uncertainty regarding the risk of repudiation of contracts during the insolvency proceeding, against which the non-defaulting party might not be able to protect itself without being able to terminate the contracts and rehedge the position on the basis of its termination rights under the close-out netting provision referring market participants’ claims in the event of default of the counterparty to regular insolvency proceedings on a gross basis instead of on a net basis might expose the non-defaulting party to levels of credit risk and market risk that are difficult to calculate and manage for the relevant types of contract due to rapid changes in market values and uncertainty regarding the risk of repudiation of contracts during the proceeding.

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5. **However, these beneficial effects can be particularly felt in the event of the insolvency of a party. In that case, the use of close-out netting assumes that the legal effects stipulated to that end by the parties (the close-out netting provision) will be recognised by and be enforceable under the applicable insolvency law. However, the current situation is that, even if about 40 jurisdictions** recognize netting in insolvency, the extent to which they do so and the scope and legal effects of close-out netting provisions differ significantly. Furthermore, some jurisdictions do not clearly recognize netting, and the legal practice in such jurisdictions often resorts to the principles governing set-off, failing to recognize the fundamental differences between the two mechanisms. This global ‘patchwork’ is unsatisfactory in cross-jurisdictional situations, since it exposes the financial market participants’ risk management to unnecessary legal uncertainty and may even jeopardise it.4

6. An additional aspect of the enforceability of netting provisions has come to the fore since the beginning of the recent financial crisis: regulatory authorities, while underlining the usefulness of netting, have contemplated the need for a brief stay on the netting mechanism in pre-insolvency or insolvency certain situations (especially pre-insolvency) affecting a financial institution, so as to allow the regulator the time needed to decide if and how to resolve an ailing financial institution in an orderly fashion so as to mitigate risks to financial stability. The FSB has recently provided guidance as to how the regulatory intervention should be reconciled with financial institutions’ and its regulators’ needs to rely on the enforceability of close-out netting for risk management and mitigation purposes.

7. The emerging international regulatory consensus regarding the interplay between close-out netting and bank resolution is set out in the FSB report on bank resolution.5 However, this newly developing regulatory approach has to deal with a patchwork where the relevant legal mechanisms in which close-out netting is embedded are not compatible or comparable across borders. Therefore, the sensitive connection of, on the one hand, regulatory measures such as stays on termination or portfolio transfers and, on the other hand, the essential insolvency and commercial law framework might fail in certain cases. Notably, stays might achieve a better cross-jurisdictional effect on the basis of harmonised legal principles. Equally, legal uncertainties arising in the context of asset transfers to domestic or foreign bridge banks can be more effectively mitigated on the basis of a more consistent international picture of the underlying commercial and insolvency law. This situation calls for a more harmonised and streamlined framework regarding close-out netting on which market participants and regulatory authorities can rely across all financial markets.6

8. First steps have already been taken towards an international consensus on the legal cornerstones regarding enforceability of close-out netting provisions. The Geneva Securities Convention sets out an optional framework for the protection of collateral transactions. This protection extends to netting provisions provided they are concluded as part of a collateral

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3 According to a list regularly updated by the International Swaps and Derivatives Association (ISDA), the following jurisdictions have accommodated close-out netting in their law: Andorra, Anguilla, Australia, Austria, Belgium, Brazil, British Virgin Islands, Canada, Colombia, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Japan, Luxembourg, Malta, Mauritius, Mexico, New Zealand, Norway, Peru, Poland, Portugal, Romania, Russia, Slovakia, Slovenia, South Africa, South Korea, Spain, Sweden, Switzerland, United Kingdom and the United States. According to the same list, netting-friendly legislation is under consideration in the following jurisdictions: Argentina, Chile, Pakistan and Seychelles. Source: http://www.isda.org/docproj/stat_of_net_leg.html.

4 Cf. for a detailed analysis UNIDROIT 2012 - S78C - Doc. 2, 1st Part, in particular pp. 32 et seq.

5 Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, part 4, in particular para. 4.3.

6 Cf. for a detailed analysis UNIDROIT 2012 - S78C – Doc. 2, 2nd Part, in particular pp. 68 et seq.
transaction. The Convention therefore contains a definition of close-out netting and a key rule on enforceability.\textsuperscript{7}

9. Furthermore, netting has also been recognised in the work of other International Organisations. Notably, the UNCITRAL Legislative Guide on Insolvency Law refers to the enforceability of netting as a feature to be considered when designing insolvency law, and advises that netting should be allowed under the applicable insolvency procedure.\textsuperscript{8} Moreover, the EU Member States have implemented a partly harmonised legal framework for close-out netting provisions.\textsuperscript{9}

10. The aim of these following Principles is to provide detailed guidance to national legislators seeking to revise or introduce national legislation relevant to the functioning of close-out netting. These Principles are designed to improve the enforceability of close-out netting, especially in cross-jurisdictional situations, in order to provide a sound basis, in commercial and insolvency law terms, for risk management and mitigation by financial institutions and for the application of regulatory policies in the international context.

11. Concerning the limitations of the scope of the Principles, it should be noted that the Principles propose a minimum field of harmonisation, where the enforceability of close-out netting provisions within the scope of the Principles should be ensured, whereas they acknowledge, without precluding further harmonisation, that beyond this minimum field, each implementing State may regard the enforceability of close-out netting provisions as an issue of its public policy.

12. In view of the preceding paragraph, the Principles allow for a certain measure of discretion for determining the scope of netting-specific legislation (see Principles 3(c) and 4(e)). Factors that each implementing State may wish to take into consideration in the exercise of its discretion include notably:

\begin{itemize}
\item the importance of the protection against systemic risk and the relevance for the functioning of the respective markets of the use of close-out netting provisions as an instrument of counterparty risk management;
\item the relationship between close-out netting and the system of insolvency priorities in the implementing State in general;
\item the predictability of results and certainty in commercial transactions;
\item the general principle that the law should not treat similar situations unequal without justification and the specific principles against discrimination between domestic and foreign creditors in insolvency (see UNCITRAL Model Law on Cross-Border Insolvency, Art. 13); and
\item whether this discretion to extend or restrict these terms is exercised for the purposes of the application of all or only some of the provisions of the Principles, or for their application in general or in situations outside insolvency only.
\end{itemize}

\textsuperscript{7} UNIDROIT Convention on Substantive Rules for Intermediated Securities, adopted in Geneva on 9 October 2009; in particular Article 31(3)(j) and Article 32(3).

\textsuperscript{8} UNCITRAL, 2004 Legislative Guide on Insolvency, Recommendations 7(g) and 101-107.

\textsuperscript{9} Cf. UNIDROIT 2012 - S78C - Doc. 2, p. 24-25 for a brief description of the various rules in place.
Principle 24: Definition of ‘close-out netting provision’

A ‘close-out netting provision’ means a contractual provision relating to eligible obligations between eligible parties under the basis of which, upon the occurrence of an event predefined in the provision a predefined event in relation to a party to the contract one of the parties, the respective due and undue obligations owed by the parties to each other of the parties that are covered by the provision are reduced to or replaced by a single net obligation, whether by way of novation, termination or otherwise, representing the remaining value of the combined obligations, which is then payable by one party to the other. Depending on the contractual agreement and applicable law, close-out netting occurs automatically by operation of the contractual agreement or may occur at the election of one of the parties.

Key considerations in respect of this definition

- The definition of close-out netting provision should be broad so as to encompass different types of provision which achieve a functionally identical result.
- It should not privilege one or the other legal method to achieve the result that may exist in different jurisdictions and in different standard market contracts.
- The definition exclusively relates to contractual close-out netting. It does not address close-out netting to the extent that its functionalities are achieved under statutory provisions, nor does it address truly multilateral netting.

Explanation and commentary

‘Close-out netting’

Close-out netting is best described in functional terms, i.e. by reference to a result. The process, in practical terms, is the following. A bundle of transactions with mutual obligations between the parties is contractually covered by a netting provision. Upon the occurrence of a predefined event, all non-performed obligations covered by the netting provision cease to be treated individually. Upon the occurrence of a predefined event, their aggregate value is computed so as to result in one single net payment obligation. This obligation is owed by the party which is ‘out of the money’ to the party which is ‘in the money’. This obligation remains the only obligation (which may include incidental fees, costs or other expenses) to be settled and is generally due shortly after being determined.

Operation of a close-out netting provision

The Principles follow a broad and functional approach concerning the various aspects of the taking effect of a close-out netting provision. All aspects, from the creation and formal validity, to the effectiveness against third parties, admissibility in evidence and enforceability in insolvency are covered by the Principles. Where the Principles seek to ensure the enforceability of close-out netting provisions, this concerns all these aspects which can be summed up as the operation of the close-out netting provision. The term ‘operation of a close-out netting provision’ is therefore used throughout the Principles as a functional, shorthand reference to the various aspects described above and replaces the need to refer to the more specific terms who are not necessarily sufficiently precisely defined in an international context.
'Contractual Provision'

12-15. This definition covers contractual close-out netting, as opposed to statutory rules that may achieve an identical or similar result.

13. Where the result of close-out netting is achieved through a combination of statutory rules with contractual rules (e.g., the right to terminate is statutory, acceleration, valuation and aggregation are arranged for contractually), these Principles exclusively cover the contractual part, cf. infra, paragraph 22.

14-16. In practice, a clause allowing for close-out netting between the parties may be included in standard master documentation (such as the ISDA Master Agreement), or be part of a tailor-made framework agreement, or be an entirely self-standing agreement. These Principles therefore refer to the term 'close-out netting provision', rather than to 'arrangement' or 'agreement', so as to encompass these various possibilities. However, 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. Definitions, schedules and annexes that the parties may have related to their agreement are covered only to the extent that their content is necessary for the proper operation of the close-out netting mechanism. For certain clauses (walk-away clauses, wait-and-see periods) that are often used in connection with close-out netting provisions, but are not covered by the Principles, see below paragraphs 35 and 37.

17. Where the result of close-out netting is achieved through a combination of statutory rules with contractual rules (e.g., the right to terminate is statutory, acceleration, valuation and aggregation are arranged for contractually), the Principles only cover the contractual part. To the extent that the parties have relied upon the application of statutory rules, the operation of the close-out netting mechanism under those statutory provisions is not an issue of the enforcement of the contractual agreement.

18. The internal rules of clearing, settlement and payment systems, as well as central counterparties are also contemplated by this definition. Despite the fact that they are usually approved by the relevant regulatory authority, the character of the relationship between the system and its participants is, or in any case is treated by this instrument as, one of commercial law (membership agreement, by-laws) as regards the treatment of the assets to be settled in the system. Thus, the close-out netting operation takes effect 'on the basis of' a contractual provision as envisaged by this definition.

15-19. The definition covers also contractual provisions that are not contained in the clauses of a single agreement, but in several interrelated arrangements, especially master-master agreements (to the extent that the underlying obligations covered by the various master agreements are eligible obligations under Principle 4).

'Relating to eligible obligations'

16. Cf. relevant definition.

'Between eligible partiesObligations owed by the parties to each other'

17-20. Cf. relevant definition. Contracts Transactions concluded between two parties may be settled either bilaterally, between the parties themselves, or through a central entity interposed between the parties. Close-out netting is equally important in both scenarios.

18-21. Bilateral settlement between the parties is the standard case and covered by these Principles.
These Principles also cover ‘central clearing’ mechanisms which are ultimately also built on bilateral relationships. Central clearing is used as a collective term for the functionalities of central counterparties, net payment systems and clearing and settlement systems in general. Central clearing applies by virtue of contractual agreements between market participants or as a legal requirement. The arrangement usually works by interposing a central entity between the parties to every contract, so that it becomes ‘buyer to every seller and seller to every buyer’. In other words, the bilateral settlement obligations that exist between the system’s participants are entirely replaced by bilateral obligations between each participant and the central clearing entity. As a consequence, the net risk exposure is calculated on a bilateral basis, so that each participant’s exposure exists exclusively against the central entity. Thus, given that, from a legal point of view, central clearing breaks down to strictly bilateral relationships, considerations in respect of bilateral close-out netting generally apply to central clearing. This applies both inside and outside insolvency of the participants and the system. Therefore, legal certainty requires also that the conversion of the original contractual relationships between the clearing participants into bilateral relationships between each participant and the central clearing entity is insolvency-proof.

Truly multilateral close-out netting is probably an exceptional case. Under such a scheme, more than two parties compute their mutual exposure on a multilateral basis, employing functionalities similar to those used in close-out netting. A mechanism similar in concept to multilateral netting is sometimes used as a tool to circumscribe the exposure of one market participant vis-à-vis a multitude of other market participants, typically a bank managing its risk exposure under one single netting provision against several entities belonging to the same group of companies (hence this form of netting is also called ‘cross-affiliate netting’). The recognition of a multilateral netting provision by the applicable insolvency law depends in part on whether the law is able to accommodate the lack of mutuality of the relevant contracts or on whether the ‘mutuality’ created through cross-guarantees, cross-collateralisation agreements or similar arrangements is recognised. Truly multilateral close-out netting is not covered by the above definition.

The event that usually triggers the application of the netting provision (the occurrence of the event that is ‘predefined in the provision event’) is commonly referred to in the relevant documentation as the ‘termination event’, ‘enforcement event’, ‘specified event’ or ‘default event’. Close-out netting can occur both in situations where both parties are solvent and in the event of the insolvency of either, since it is the parties to the netting provision themselves that determine the trigger for the operation of the mechanism. This event may consist, for example, in one of the parties defaulting on one or more of its obligations, or in its filing for insolvency, in the appointment of a state administrator or a similar intervention by the public authorities, or in the opening of an insolvency proceeding or an administration, resolution or restructuring procedure. Often, parties additionally agree to include external circumstances as termination events, such as the objective impossibility of performing an obligation under one of the contracts, or the downgrading of one of the parties’ credit rating following its merger with another company.

It is worth noting that the event triggering termination is determined, in certain jurisdictions, under the relevant legislation itself. In particular, the insolvency of one of the parties may lead to the termination of all open contracts by operation of the statutory law. Parties may supplement this statutory consequence of the termination event with additional contractual rules providing for other elements needed to achieve the result of close-out netting (cf. supra, paragraph 17). Such arrangements are likewise envisaged by the present definition.
'Reduced to or replaced by a single net obligation'

23. A close-out netting mechanism is commonly understood as resulting in a single payment obligation owed by the party that is ‘out of the money’ to the party that is ‘in the money’. However, a number of different functional steps can be used to achieve this result, and these can potentially be based on a number of differing legal concepts.

24. A netting mechanism generally involves several or all of the following steps: (i) termination of the contracts, (ii) acceleration of obligations, (iii) valuation of the contracts, and, (iv) aggregation to result in an overall net amount. The order of acceleration, aggregation and valuation can vary according to the actual netting provisions. Not all netting provisions need all of these steps to come to the functional result of close-out netting. Which elements are needed and used depends, rather, on the design of the relevant provision and the boundaries under the applicable law. Examples:

- Termination of each contract; valuation of each contract; aggregation of all values to form one net payment obligation.
- Acceleration of each contract, valuation of each contract, aggregation of all values to form one net payment obligation.
- Termination of each contract; valuation of each contract; aggregation of all values to form one net payment obligation; acceleration of the net obligation.
- Termination of each contract; valuation of each contract; creation of a new (immediately due and payable) payment obligation representing the overall value.
- Etc.

25. These functional steps merely describe what happens in practical terms. The relevant close-out netting provision in combination with the applicable law need to provide the necessary legal concepts, since the result (a single net payment obligation) is first and foremost a legal one. The legal concepts and terminology that underlie these steps differ, depending on the design of the netting provision and on the law applicable to it.

26. Termination is a term used to express the functional result of the relevant open contracts being put to an end. National laws achieve this result by legal mechanisms called cancellation, close-out, rescission, termination, etc.

27. Acceleration is a term used to express the concept that an obligation becomes due and payable before the contractually agreed date; there might be other legal concepts and terms to achieve an identical functional result such as the replacement of the original and as yet unmatured obligation with a new obligation that must be performed immediately ('novation'). It should be noted that, while the legal technique of novation is covered by the Principles as one of the methods to replace the original obligations with the single net obligation under the close-out netting provision, the type of transaction commonly referred to as ‘novation netting’ (or settlement netting) is not addressed by the Principles. ‘Transformation’ is another term that might be used in this context.

28. The aggregation element collapses all relevant contracts or the value resulting from them so as to produce one single obligation. This is functionally the same result as the outcome of classical set-off of all valued and payable obligations. Also novation (i.e., the parties’ agreement that after termination of all open contracts a new obligation arises representing the relevant aggregate value) is a suitable concept to achieve the effect of aggregation.

29. The valuation of the terminated contracts or the entire (aggregate) contractual relationship generally seeks to establish a fair and commercially reasonable compensation for the
party that was 'in the money'. This means that the single net obligation is intended to 'represent the value of the combined obligations' that were covered by the close-out netting provision. Whereas the original obligations may be for the payment of money or for any other performance, the resulting single net obligation is an obligation for the payment of money. The valuation is usually (but not necessarily) effected by the non-defaulting party under a mechanism which has been pre-defined in the agreement. The parties are free to define the valuation mechanism and may use concepts such as replacement or market value or any other method that allows for a practicable and commercially reasonable valuation process and a fair and commercially reasonable result.

29. The resulting net obligation must 'represent the value of the combined obligations'. However, the Principles do not intend to lay down any further specific requirements concerning the process of valuation.

'Payable by one party to the other'

30. Where close-out netting occurs in the context of the insolvency of one of the parties, and the net amount is positive for the solvent party, that party is paid from the insolvency estate as an unsecured creditor and may therefore fail to recover some or the entirety of its claim, if unsecured. In the amount of this net sum, the position of the solvent party vis-à-vis the insolvent estate is no better than that of any other party: it needs to be secured in order to be certain of payment and the same requirements apply regarding the necessary proof of the claim. Where the net amount is positive for the insolvent party, as a rule the other solvent party must pay the insolvency estate.

31. However, parties may have agreed on a clause that allows a non-defaulting party which is 'out of the money' to refuse payment to the defaulting party ('walk-away clause'). The background of such clauses is that a defaulting party should not benefit from its own default. However, not all jurisdictions permit such clauses because of their effect on systemic stability. There is a regulatory debate on whether they should be valid in the event of insolvency of the defaulting party. In order to take advantage of close-out netting for purposes of calculating required capital under the regulatory capital adequacy standards of the Basel Committee on Banking Supervision, parties may not rely on a walk-away clause.\(^{10}\) This is a regulatory and policy decision on which the Principles do not reflect a position. As this issue Walk-away clauses are not immediately linked to the enforceability of close-out netting provisions, since they do not affect the steps of termination, acceleration, valuation and aggregation under a close-out netting provision as defined in Principle 2. Rather, they constitute a type of clause which merely affects the payability of the obligations covered by the close-out netting provision or of the single net obligation resulting from its operation. Thus, where parties have concluded a master agreement that contains a close-out netting provision with a walk-away clause, the walk-away clause falls outside the scope of the Principles, while the protection of the operation of the remainder of the close-out netting provision under the Principles is not affected, it falls outside the scope of the Principles.

Automatic or elective operation of the close-out netting mechanism

32. Depending on the specific contractual agreement, close-out netting either occurs automatically, by operation of the contractual agreement ('automatic termination', which is not allowed in a number of jurisdictions), or it may occur at the discretion of the party which is not the

The extent to which the non-defaulting party should be able to suspend or wait for a period of time or for an indefinite period of time to exercise its rights to close-out is currently under discussion among market participants and regulatory authorities, particularly where the defaulting party is in resolution or insolvency. One concern is that a non-defaulting party which is "out of the money" may under the terms of the master agreement be entitled not to make any payments to the defaulting party after the occurrence of the event of default even though the non-defaulting party refrains from terminating and exercising close-out. Thus, the non-defaulting party may through inaction by refraining from the exercise of its rights under the close-out netting provision avoid having to perform under its obligations to the defaulting party, can choose not to terminate and exercise close-out in order to avoid making a payment to the defaulting party. Several different courts with jurisdiction over recent cross-border insolvency proceedings of large financial institutions have come to different conclusions in this respect. The Principles do not take a stand concerning these issues. According to the definition in Principle 2, close-out netting is covered by the Principles only if it takes effect 'upon the occurrence' of a predefined event. This implies that the operation of a close-out netting provision that takes effect only after a period of unreasonable length has passed since the occurrence of the predefined event, is no longer covered by the scope of the Principles, i.e. it is regarded as a policy issue of the implementing State whether or not to impose a time limit for the exercise of the right to termination and close-out. Similarly, any suspension of the payment obligations of the non-defaulting party after the occurrence of a termination event, but before the actual termination itself, does not affect the operation of the close-out netting provision as defined in Principle 2 and is therefore an issue that is not addressed by the Principles on this issue. Close-out netting provisions employing either elective or automatic termination are covered by these Principles. However, these Principles do not address the issue of whether a non-defaulting party may wait for a period of time or for an indefinite period to exercise its rights to terminate and net on a close-out basis.
**Principle 32: Definition of ‘eligible party’**

*a)* *a person other than a natural person;*

*b)* *a partnership or unincorporated association (whether or not its membership includes natural persons) and*

*c)* *any other person or legal entity designated as an eligible party under the law of the relevant State.*

**Key considerations in respect of this definition**

- The definition of eligible parties determines and restricts the scope of these Principles, in conjunction with the definition of eligible obligation. Therefore, the application of these Principles to a legal relationship between two parties depends on whether both are eligible parties, and, cumulatively, whether the relevant legal relationship represents an eligible obligation.

- The definition of eligible parties, as a criterion for determining the personal scope, should be shaped in a broad and comprehensive manner. One of the main issues to be taken into account is consumer protection. Many jurisdictions apply specific measures with a view to protecting consumers. National legislators/regulators *may* determine the extent to which the application of these Principles is compatible with the relevant consumer protection policy.

- Other restrictions regarding the personal and material scope (apart from excluding consumers) frequently exist in national law; these are both highly diverse and difficult to categorise conceptually from an international point of view. The key question appears to be whether a certain kind of business should be able to be included within the ambit of netting. From the point of view of international compatibility, this issue would be best tackled in a precise and consistent manner by restricting the definition of eligible obligations, while leaving the definition of eligible parties as broad as possible.

**Explanation and commentary**

**Sub-paragraph (a) – Person other than a natural person**

*34-38.** *Sub-paragraph (a) covers the greater part of all parties contemplated by these Principles. It follows the key consideration that the personal scope of these Principles should be as broad as possible, given that it is well-nigh impossible properly to classify the different types of actor in the financial market.*

*35-39.** *In particular, professional actors in the financial market, such as banks and securities firms, will usually be organised in a form other than that of a natural person. They are covered by *sub-paragraph (a).*

*36-40.** *Commercial firms such as airlines, energy dealers, producers of chemical industrial goods, etc., are likewise covered. They use derivative contracts for hedging purposes on an ongoing basis. Such contracts typically contain netting clauses.*

*37-41.** *Public law entities are also covered to the extent that they are ‘persons’, i.e., that they have legally recognised personality. This includes States and their divisions, including central banks. Moreover, more or less independent bodies of public law with legal personality are likewise included such as municipalities as well as agencies that are constitutionally independent from the*
state. Furthermore, entities created under public international law, in particular intergovernmental organisations, are also covered.

**Sub-paragraph (b) - Partnership or unincorporated association**

38. The inclusion of the term ‘unincorporated associations’ guarantees that organisations such as universities, religious associations, football clubs, etc. are covered, since they may participate in the financial market to a considerable extent.

39. It should be noted that it is quite easy in many jurisdictions to form such unincorporated associations or partnerships and for them to be given some legal recognition, with few formalities required. This includes associations of natural persons which, if acting as individuals, would fall within the scope of sub-paragraph (c). The fact of being associated and of entering into those contracts enumerated in draft Principle 4 places such groups of individuals within the scope of these Principles.

**Sub-paragraph (c) - Any other person or legal entity designated as an eligible party**

40. This paragraph reflects the policy considerations raised by the possible participation of individuals in financial market transactions. States may decide

- not to apply these Principles to individuals at all,
- to apply these Principles only to restricted classes of individual such as professionals and other sophisticated or high-net-worth individuals,
- to apply these Principles to restricted classes of individual and in respect of certain types of contract into which these individuals may enter,
- to apply these Principles to individuals only to the extent that they contract with a counterparty falling within the ambit of sub-paragraphs (a) or (b).

- Such a decision will generally be made within the overall framework of the relevant state’s rules and policy on the protection of individuals in general and of consumers in particular.

41. This paragraph aims to cover persons commonly referred to as ‘natural persons’ (cf. also the negative use of that definition under sub-paragraph (a)). However, the Principles intentionally do not use this term in sub-paragraph (c) in order to avoid confusion with the category described under sub-paragraph (b). Natural persons organised in a partnership or an association and acting as such fall within sub-paragraph (b), although many jurisdictions would still regard them as natural persons in legal terms. As a consequence, sub-paragraph (c) covers natural persons acting individually, or ‘individuals’. It should be noted that sub-paragraph (c) also covers legal entities in general, i.e. implementing States may extend the scope of application of the Principles towards entities that are not legal persons even beyond the scope of sub-paragraph (b).

42. Unincorporated entrepreneurs (merchants) are covered by sub-paragraph (c) even where they engage in business usually conducted by incorporated companies. As a consequence, they fall within the scope of the netting principles only if and to the extent that they are designated as eligible parties under the law of the relevant state.
Principle 43: Definition of ‘eligible obligation’

43. ‘Eligible obligation’ means an obligation arising under one of the following contracts:

a) derivative instruments, meaning "derivative instrument" means an option, forward, future, swap, contract for differences or other transaction in respect of a reference value that is \[\text{, or in the future becomes,}\] the subject of recurrent contracts in the derivatives markets;

b) repurchase agreements, lending agreements and margin loans relating to the sale or purchase of securities, money market instruments and units in collective investment schemes;

c) title transfer collateral arrangements securing another eligible obligation;

d) contracts for the sale, purchase or delivery of
   (i) securities;
   (ii) money market instruments;
   (iii) units in a collective investment scheme;
   (iv) currency of any country, territory or monetary union;
   (v) gold, silver, platinum, palladium, or any other precious metal; or
   (vi) any other fungible commodity, meaning a commodity that is \[\text{, or in the future becomes,}\] the subject of recurrent contracts in the spot, forward or derivatives markets;

e) any other type of contract designated to that effect under the relevant law; and

f) agreements under which a party assumes a liability undertaken (whether by way of surety or as principal debtor) for the performance of obligations assumed by another person under any agreement referred to in sub-paragraphs (a) to (e).

Key considerations in respect of this definition

- From the perspective of the purely legal mechanisms involved, netting is possible in respect of all mutual contractual relationships the value of which can be expressed in an amount of currency. However, in the event of default of one of the parties, netting offers special treatment of the non-defaulting party in relation to the insolvent's general creditors. Therefore, there need to be elements justifying a contractual relationship being covered by a netting provision. There are three such elements.

- Single relationship: contracts entered into on the understanding that each as a practical matter affects the others should be covered. (i) A first such case is the quasi ‘natural’ category of transactions in which the single relationship is directly implied. For example, swaps or repurchase transactions are entered into on the understanding that the mutual rights and obligations (which are legally distinct from each other) within a single transaction cannot be separated by the parties and should not be looked at separately in the event of one of the parties becoming insolvent (i.e., no cherry picking should apply in relation to only one leg of these transactions). (ii) In a second category of cases, this single relationship is wider and created contractually by the parties. However, given that close-out netting leads to special treatment in the event of insolvency, this contractual single relationship can only be established where there are good objective reasons to deal with a
multitude of contracts on a collective basis. The main reasoning here is that it is more efficient for parties to monitor and manage their mutual risk exposure on the basis of an overall assessment of all contracts outstanding between them.

- **Rapid changes of value**: A second justification for applying close-out netting to certain of the parties' mutual rights and obligations stems from the fact that the volatility of the value of certain financial transactions would expose parties to considerable market and credit risk which they would have difficulty managing if they were not allowed to terminate such transactions upon the occurrence of one of the pre-defined termination events, in order to determine gains and losses and to re-hedge their portfolio. Any stay on termination imposed by (in particular) insolvency law would lead to the contractual close-out rights being delayed. Rapid and significant changes in the contract value during this time might expose the non-defaulting party to a multiple of the anticipated counterparty and market risk which cannot be hedged any more in an appropriate way.

- **Systemic risk**: A third justification is the avoidance of systemic risk. This element flows partly from the second justification. In deteriorating market conditions, the ability to terminate contracts and thus to limit exposures is important in guarding against the situation where the failure by one of the parties to perform its obligations causes its counterparty likewise to become unable to perform its obligations vis-à-vis third parties.

**Explanation and Commentary**

**General**

43-47. The term ‘contracts’ is understood in a broad sense and also includes contracts that might be categorised as ‘commercial’ contracts. It is impossible to make a neat distinction between financial contracts, on the one hand, and commercial contracts, on the other hand. For instance, futures and forwards are both used by industrial and commercial companies to hedge price swings in relation to raw materials, etc. Application of these rules to contracts entered into by energy traders, airlines and similar businesses would be beneficial as these face similar exposures to rapid price swings as face financial firms.

**PSub-paragraph (a) – Derivative instruments**

44-48. The term ‘derivative instrument’ describes a contract the value of which depends on a reference value. The reference value can consist of rates or indices, or of any other measure of economic value, or of factual events. In today’s markets, the reference value usually consists of a rate, yield, price or index relating to interest rates, currencies, transferable securities, money market instruments, commodities, precious metals, credit risk, energy, emissions, economic or monetary statistics, actuarial or other insurance-related data, meteorological data, freight forward rates, bandwidth or property. However, other reference values are also conceivable.

45-49. Derivative instruments will typically fulfil all three criteria (cf. key considerations, supra) for inclusion into the list of contracts. First, two typical financial market participants like banks, merchant banks, funds, insurance companies, etc. will always ordinarily regard the multitude of their open derivative instruments with each other as one single relationship. The risk monitoring and assessment will ordinarily be done by the parties on an aggregate basis.

46-50. Derivative instruments also pass the test of the second criterion, i.e. exposure to considerable market and credit risk. They are often highly volatile transactions with rapid and significant price movements. Rapid price movements combined with large outstanding counterparty credit exposures and transaction volumes could also pose the threat of systemic risk (third criterion).
Financial markets subdivide derivatives contracts into a number of categories, notably options, forwards, futures, swaps, contracts for differences, and their respective subcategories. The boundaries between these categories are not always clear-cut. Moreover, the list of derivatives categories can never be exclusive, in view of the need to cater for future market developments and differences in categorisation. Therefore, the underlying consideration is that these Principles apply to all derivatives covered by the definition in the preceding paragraph, regardless of which category market practice may attribute to them.

Depending on the provisions of the relevant contracts, derivatives can be either physically settled or cash settled. Both are included within the scope of these Principles.

For the purpose of these Principles, it is immaterial whether the relevant contracts are entered on-exchange or off-exchange, or whether they are settled 'over-the-counter' or through a clearing mechanism or central counterparty (n.b. that in the latter cases, a bilateral close-out netting provision between the central entity and the system participant emerges, cf. supra paragraph 22).

**Sub-paragraph (b) – Securities repurchase agreements, securities lending and margin loans**

A repurchase agreement is a combination of two processes simultaneously agreed upon between the same parties: first, the sale and outright transfer of an asset (e.g. a bond), and second, the subsequent repurchase and re-transfer of that same asset at a slightly higher price. This type of agreement is usually driven by cash needs, i.e., in functional terms, it has the same effect as a secured cash loan. The cost of financing (reflected, under a loan agreement, by the payment of interest) is here expressed in the price difference between the sale and repurchase legs of the transaction.

Securities lending entails that the securities are made available to the counterparty with a simultaneous agreement to retransfer or return them, or equivalent securities, at a predetermined point in time. The borrower must provide collateral (e.g. in the form of cash) to the lender for the duration of the arrangement. Securities lending is mostly driven by the borrower’s need for a certain type of securities.

In functional terms, the mutual flows of assets are identical for both types of transaction. Both types consist of a pair of reciprocal transactions. Although in both cases, each separate transaction could be regarded as legally independent, neither a repurchase agreement nor a securities lending agreement should be at risk of unbundling in an insolvency procedure. Therefore, a repurchase or a securities lending agreement per se fulfils the first element of justification mentioned above (single relationship, first case).

In much the same way, under a margin loan money is advanced by a bank to its customer to purchase financial instruments on condition that the bank can subsequently regard these as collateral securing the loan. Again, the two prongs of such arrangements are (i) a flow of cash in one direction, and, (ii) the provision of rights over securities (collateral) in the other direction. The collateral can be provided under a title transfer arrangement or a non-title transfer arrangement (cf. sub-paragraph (c), infra), i.e., depending on the arrangement, ownership of the securities is transferred to the bank.

Where two parties have a multitude of repurchase, securities lending and margin lending agreements, these are usually closely interconnected as the cash and collateral flows are managed on an aggregate basis rather than separately. As a consequence, there is an objective reason for the parties to cover their mutual exposures flowing from these types of transaction by a close-out netting provision (single relationship, second case).
There are title-transfer collateral arrangements and non-title transfer collateral arrangements. They differ as to their nature and the analysis as to whether and to which extent they are suitable to be included in a netting provision differs accordingly.

Under a title transfer collateral arrangement, full legal title is passed to the collateral taker and the collateral provider receives a claim for transfer of the identical sum or asset at a later stage (cf. also sub-paragraph (b)). No property interest is retained on the provider’s side. As a consequence, the valuation and inclusion in the net amount of both legal positions are possible because there are claims for retransfer on both sides (a claim for repayment/retransfer of the value of the transaction, and a claim for retransfer of the collateral).

A non-title transfer collateral arrangement involves traditional security agreements such as pledge or charge. These are characterised by the fact that they are proprietary in nature and both the collateral provider and the collateral taker have proprietary interests in the encumbered asset. In particular, the collateral provider will usually retain legal title to the asset. This type of arrangement is not generally susceptible to close-out netting as commonly understood, since a proprietary interest cannot be combined with a claim of a monetary character. However, where both close-out netting and a traditional security interest apply under the parties’ agreement, close-out netting operates under exclusion of the security interest. Rather, the security interest, in a second logical step, secures the net amount.

Under a title transfer collateral arrangement, full legal title is passed to the collateral taker and the collateral provider receives a claim for transfer of the identical sum or asset at a later stage (cf. also paragraph (b)). No property interest is retained on the provider’s side. As a consequence, the valuation and inclusion in the net amount of both legal positions are possible because there are claims for retransfer on both sides (a claim for repayment/retransfer of the value of the transaction, and a claim for retransfer of the collateral).

An important sub-hybrid category is the non-title transfer collateral arrangement which includes a right of use. In these cases, the relevant law permits parties to agree, generally or in effect, that the proprietary right may, under a non-title transfer collateral arrangement, be replaced, at the election of the collateral taker, by a right to the return of identical or equivalent assets. This is the case, in particular, where the agreement, sanctioned by the relevant law, permits the collateral taker to use the encumbered asset for its own purposes, in particular to ‘rehypothecate’ it, and subsequently to return not the same asset but an equivalent one. In this instance, the residual property interest originally vested in the collateral provider may cease to exist in this instance and is replaced by a contractual claim for re-transfer or the equivalent thereof. In other words, the use of the encumbered asset by the collateral taker for its own purposes transforms the legal characteristics of a non-title transfer collateral interest into an interest equivalent to that of a title transfer collateral arrangement. As a consequence, again, there are claims of an obligatory nature on both sides (cf. preceding paragraph). Therefore, such an arrangement is capable of being included in a netting provision.

As is the case with repurchase agreements and securities lending agreements, the separate obligations which constitute a title transfer collateral agreement (and a non-title transfer collateral agreement including a right of use) should not be at risk of being unbundled by the insolvency law (single relationship, first case). Likewise, collateral is managed on an aggregate basis. For this reason, a multitude of collateral arrangements between two parties should also be capable of being included in the scope of close-out netting.

It is important to note that repurchase, securities-lending as well as title transfer-collateral agreements may be are collectively managed and monitored from the perspective of counterparty risk. Because of the functional convergence of these types of transaction, there is
good reason to do so. Therefore, it makes sense to cover all transactions falling into one of these three categories by a netting provision between two parties.

**PSub-paragraph (d) – Contracts for the sale and delivery of certain assets**

62-66. **PSub-paragraph (d)** relates to contracts for the sale and delivery of certain assets against payment in so far as they are not covered by the definition of derivative instruments, in particular futures and forwards. For example, on the spot market, prices are agreed and paid immediately whereas delivery occurs within a time frame of less than one month. A typical example is the spot market for crude oil. **This provision would also cover transactions concerning emission allowances.**

63-67. The relevant contracts are regularly entered into on the basis of a single relationship, and are subject to the same type of credit risk and change in value as other types of eligible obligation. In addition, they may be subject to settlement risk.

**PSub-paragraph (e) – Other types of contract**

64-68. A State may decide to include other types of contract in the list, which means that the obligations flowing from such a contract would be eligible for inclusion in a close-out netting provision. The question of whether loans and deposits should be included is particularly relevant. However, there might be other types of contract which States may decide to include, such as contracts for the clearing of obligations covered by sub-paragraphs (a) to (d).

65-69. The inclusion of loans and deposits in the list of contracts is controversial because a number of reasons speak for their inclusion whereas other aspects advise against. From the outset, the discussion has not been about ‘consumer’ deposits and loans, as individuals are generally excluded from the scope of these Principles (they can be included only at the election of the national legislator, cf. Principle 32).

66-70. Loans and deposits are closely related to one another from a functional perspective. Both are technically an advance of money (the principal) by one party to another, entailing a promise to return the principal at some point. Both generally, but not necessarily, carry the obligation to pay interest. A more superficial difference concerns the parties’ motivation. It is assumed that a borrower accepts the principal from the lender in order to satisfy its own funding needs, whereas the depositary rather takes the role of safe-keeper of the money in the depositor’s interest. However, in practice, banks’ traditional sources of financing have been their clients’ deposits, a fact which rather blurs that distinction. From a functional and legal point of view, therefore, loans and deposits are akin to one another. From a regulatory point of view, on the other hand, deposits enjoy specific protection, most particularly the circumstance that deposits receive special support under national legislation and traditionally, only licensed credit institutions (‘banks’) are able to take deposits.

67-71. It might be argued that neither loans nor deposits pose a particular risk or a threat to systemic stability that can be best prevented by the application of close-out netting. They are not necessarily subject to rapid changes in value and the volatility of markets. They are not used for hedging but rather for funding and they are not traded in large volumes. However, a number of factors suggest that the inclusion of loans and deposits might be worth considering in certain circumstances.

- Loans mainly consist of a transfer and retransfer of cash. This functionality is identical to the cash leg of a number of transactions used by banks and central banks, notably repurchase agreements, securities-lending agreements and cash-title transfer collateral agreements. The latter are all undoubtedly within the scope of close-out netting. Carving out loans generally would mean that a clear distinction would have to be made between
Banks regularly post deposits with and give loans to one another. Such deposits might be very short term and thus as a funding source be quite volatile as volumes might change from day to day according to the relevant needs and because they are often provided in different currencies. Such arrangements expose the parties to credit risk and market (currency) risk. Banks might wish to calculate their mutual risk exposure flowing from these operations on a net, rather than a gross basis.

Central banks take deposits from banks (in fulfilment of their minimum reserves policy) and extend loans to banks (in the framework of their monetary operations). A central bank will have an interest in being able to manage the risk exposure to each of the relevant banks on a net basis, i.e., in being able to apply close-out netting. Therefore, many central banks apply close-out netting to such loans and deposits.

Furthermore, the phenomenon of ‘cash-pooling’ benefits from close-out netting. Cash pooling occurs where member companies of the same group manage their cash reserves collectively. Typically, the positive credit balance of one member of the group is made available to any others members that are in need of cash, through a common master cash account held by the parent company. A deposit (alternatively: loan) arrangement comparable to a revolving account facility exists between each member of the cash pool and the parent company, under which mutual repayment obligations are expressed as a net credit balance. Legally, mutual payment obligations are not settled until the member in question exits the cash pool arrangement (despite the fact that the current exposure is expressed as a net balance). However, the parties would not enter into such agreement if their exposure were not limited to the net exposure in the event of the counterparty’s insolvency. If the insolvency administrator were able to cherry-pick those deposits/loans that were favourable to the insolvent estate, and if it could at the same time set aside those that were unfavourable, the risk to the solvent party would be considerably increased.

On the other hand, there are arguments against making loans and deposits eligible for close-out netting. In addition to the reasons articulated above:

- including loans and deposits would mean that that part of a bank’s balance sheet that was subject to close-out netting would be considerably increased.
- excluding deposits and loans from the scope of application of close-out netting would not necessarily mean that set-off was equally excluded. Many of the aforementioned arguments put forward in favour of the eligibility of loans and deposits for close-out netting could probably be addressed by set-off.

Sub-paragraph (f) – Surety agreements

This paragraph ensures that not only the obligations of the (direct) parties to one of the contracts enumerated in draft Principle 34 fall within the scope of these Principles but also the obligations of third parties that assume a liability (whether by way of surety or as guarantor or as principal debtor) for the performance of promise to perform on the obligation of another one of the parties to that contract. The most prominent of such arrangements are guarantee and indemnity arrangements or letters of credit, or other types of personal surety that may exist in different jurisdictions and regardless of the wording employed.
Principle 5: Formal and Reporting Requirements

5. (1) The law should not make the operation, creation, validity, enforceability, effectiveness against third parties or admissibility in evidence of a close-out netting provision dependent on
   a) the performance of any formal act other than a requirement that a close-out netting provision be evidenced in writing or any legally equivalent form; and
   b) the use of standardised terms of specific trade associations.

(2) The law should not make the creation, validity, enforceability, effectiveness against third parties or admissibility in evidence of a close-out netting provision and the obligations covered by the provision dependent on the compliance with any requirement to report data relating to those obligations to a trade repository or similar organisation for regulatory purposes.

[(3) This Principle does not affect the application of any laws or regulations of the implementing State that provide for administrative, regulatory or penal sanctions for the non-compliance with formal requirements.]

Principles 4–6 on formal requirements for close-out netting provisions

4. The law should not make the creation, validity, enforceability, effectiveness against third parties or admissibility in evidence of a close-out netting provision dependent on the performance of any formal act, but the law may require that a close-out netting provision shall be evidenced in writing or any legally equivalent form.

5. The law should not make the creation, validity, enforceability, effectiveness against third parties or admissibility in evidence of a close-out netting provision dependent on the use of standardised terms of specific trade associations.

6. To the extent that the law requires data relating to contracts covered by a close-out netting provision to be reported to a trade repository or similar organisation for regulatory purposes, a failure to comply with that requirement should not affect the creation, validity, enforceability, effectiveness against third parties or admissibility in evidence of the contracts and the close-out netting provision.

Key considerations in respect of these Principles:

- Formal requirements that impinge on the legal enforceability of close-out netting provisions have considerable potential to create legal uncertainty in a cross-jurisdictional context. Accordingly, the enforceability operation of close-out netting provisions should not depend on requirements such as prior registration with a public register or notarisation.

- The enforceability operation of close-out netting provisions should not depend on the use of standard documentation so as to allow for tailor-made close-out netting provisions and framework agreements, for individual changes to existing standard documentation or for market-led changes of standard documentation itself. The regulatory framework may impose restrictions in this regard; however, these must not hamper enforceability in commercial and insolvency law terms.

- The reporting of data in relation to certain financial transactions to trade repositories and similar organisations is an important feature of the supervisory framework. However, non-compliance with the duty to report such data should not entail the non-enforceability of the relevant contracts and the close-out netting provision which covers them.
The principle that the operation of close-out netting provisions should not be made subject to formal and reporting requirements does not restrict the implementing State’s power to provide for administrative, regulatory or penal sanctions for the non-compliance with formal requirements. Moreover, only the operation of the close-out netting mechanism is not to be made subject to requirements of form. Where and to the extent that the parties agree on the provision of security in the same contractual (master) agreement, form requirements of secured transactions law may apply, which can result in the ineffectiveness of purported security interests.

Explanation and commentary

70-74. The effect of non-compliance with formal requirements (in the broadest sense) needs to be considered carefully. Where such non-compliance entails invalidity or unenforceability of a contract, the legislator should always have regard to the fact that both parties to a contract are affected by this consequence. The effect of a considerable number of contracts and/or a close-out netting provision being unenforceable can pose a significant risk to one or both of the parties. In particular in cross-jurisdictional situations, at least one of the parties might be taken by surprise by that consequence. Thus, where the rules on formalities aim at promoting safe and sound market conditions, unenforceability will undermine rather than promote these objectives, and it might be better to settle for other enforcement measures, such as fines, personal liability of staff, withdrawal of license, etc., which can be imposed without creating additional legal uncertainty for the counterparty.

Paragraph (1)(a) - Formal requirements

Principle

4

71-75. For the above reasons, in a cross-border context, any formal requirements other than writing (or equivalent forms) appear to create additional risk. There are two strands of such potential risk.

72-76. First, there is the general risk that, in a cross-border context, formal requirements other than writing are liable to be misunderstood or mishandled from an operational point of view. Such requirements might be overlooked, in particular as it cannot be excluded that different laws may be applicable within a single bundle of contracts covered by a netting provision. The necessary steps might not be carried out simply because of practical difficulties such as language requirements.

73-77. Second, even if formal requirements are initially complied with under the first law, any possibility of transferring a close-out netting provision (including the contracts covered) to a new, foreign entity would be in jeopardy since it is unlikely that the law of the acquirer would require compliance with exactly the same formal steps.11

This aspect is particularly relevant where a holding company re-integrates with a hitherto legally independent foreign subsidiary, in which case all contractual agreements entered into by the subsidiary would from that point on be subject to a different insolvency law, i.e., the law applicable to the parent company. It is unclear whether a contract transferred in this manner would be upheld in the event of the parent company’s insolvency if the formal requirements regarding the close-out netting provision differed.

11 Cf. UNIDROIT 2012 - S78C - Doc. 2, p. 37 (Example 7), p. 71 (Example 17).
that law imposes formalities on close-out netting provisions, it is very unlikely that the formalities (if any) under which the close-out provision was originally entered into would suffice.

74-78. The registration of close-out netting provisions (and in some cases, the obligations covered by them) is required in certain jurisdictions as a condition for the creation, validity, enforceability, effectiveness against third parties, or admissibility of the close-out netting provision. In some cases, this requirement has a deterrent function against fraud, e.g., to exclude fraudulent backdating of close-out netting provisions prior, but close to insolvency. However, this means that all domestic and foreign parties, including those acting in good faith and in the absence of any fraudulent behaviour, as well as in the absence of insolvency of one of the parties, would be hit by the unenforceability of the netting provision as a consequence of non-compliance with the registration requirement, e.g., due to a simple operational mistake. This situation might potentially create great legal uncertainty, and this is why registration should not be linked to the unenforceability of the netting provision. However, there is nothing in these Principles to prevent courts from sanctioning fraudulent behaviour occurring prior, but close to insolvency: Principles 6(2) and 7(2) leaves open the possibility for the applicable insolvency law to treat netting provisions as unenforceable as a consequence of fraudulent behaviour (cf. Principle 7(c)(iv)).

Paragraph (1)(b) - Use of standardised terms of trade associations

75-79. Another issue is the tension between netting provisions contained in a standard master agreement and agreements between parties that wish to customise the close-out netting provision. If jurisdictions were to protect the enforceability of netting provisions only where the latter are included in standard documentation, individual amendments would imperil enforceability.

76-80. However, the relationship between two financial institutions can be quite an elaborate one and call for the master agreement to be customised to some degree. It is impossible to harmonise the extent to which such changes should be admissible, simply because there are too many different, individual situations. Hence, the concept of only protecting the enforceability of netting provisions that are part of standard documentation is not appropriate, especially not in a cross-jurisdictional context.

Paragraph (2) - Reporting requirements

81. In attempting to render the derivatives market more transparent, many jurisdictions have recently introduced or are about to introduce a duty to report data (parties, volume, type of transaction, date) relating to certain types of standardised derivatives to a trade repository. This measure serves prudential/supervisory purposes. It should not be made a condition for a contract’s capability of being included in a close-out netting provision, since the underlying motivation is not the same. Additionally, the legal consequences are different: failure to report as such, in the supervisory context, does not produce risk but will merely entail fines or similar sanctions. Should reporting be a prerequisite for the enforceability of the netting provision, any non-compliance would actually create risk, since it would endanger enforceability in situations which the parties (and possibly also their regulator) might not have anticipated since the failure will in most cases be a consequence of unintentional operational failure. This result would be clearly disproportionate and dangerous.

77-82. This reasoning supports also the extension of Principle 5(2) to the obligations covered by the close-out netting provision. The regulatory reporting requirements typically have the objective of ensuring transparency and of monitoring the market in order to control risks that may be building up. If a failure to report an underlying obligation would result in the ineffectiveness of this obligation, this sanction would be creating additional risks, if both parties have relied upon this transaction in their risk-management. In order to avoid such unforeseen risks it appears preferable
to let the parties rely on the effectiveness of the transaction and on its valid inclusion in the close-out netting provision. Of course, this does not rule out any other consequences of the failure to comply with the reporting requirement concerning the obligations covered by the close-out netting provision.

Paragraph (3) - Administrative, regulatory or penal sanctions

The reasoning in the preceding paragraphs argues against the restriction of the operation of a close-out netting provision (and of the obligations covered by that provision in the situation of paragraph (2)) as a consequence of the failure to comply with formal and reporting requirements. Other sanctions, especially administrative, regulatory or penal consequences of such a non-compliance are not affected by Principle 5, as is expressly spelt out in paragraph (3). It should be noted that the Principle regulates the consequences of a failure to comply with formal requirements in relation to the close-out netting mechanism only. Where the parties agree on a close-out netting provision and on the provision of security in the same contractual (master) agreement, the validity of the security agreement may be subject to form requirements of secured transactions law notwithstanding Principle 5. This may result, for instance, in the ineffectiveness of the provision of collateral as security for the obligations of the parties under the close-out netting provision.

6.(1) The law should ensure that a close-out netting provision is enforceable in accordance with its terms. In particular, the law

a) should not impose enforcement requirements beyond those specified in the close-out netting provision itself; and

b) should ensure that, where one or more of the obligations covered by the close-out netting provision are, and remain, invalid, unenforceable or ineligible, the operation of the close-out netting provision is not affected in relation to the other covered obligations [, which are valid, enforceable and eligible].

[(2) Nothing in these Principles affects the application of any laws and regulations restricting the operation of close-out netting provisions in whole or in part on the basis that the close-out netting provision conflicts with laws and regulations concerning fraud or the conditions for validity of contracts.]


7.(1) The law should ensure that upon the commencement of insolvency proceedings in relation to a party to the close-out netting provision

a) the operation of the close-out netting provision is not stayed;

b) the [relevant] insolvency administrator or [relevant] court should not be allowed to demand from the other party performance of any of the obligations covered by the close-out netting provision, even if these obligations are otherwise enforceable, while rejecting the performance of any obligation owed to the other party that is covered by the close-out netting provision and otherwise enforceable;

c) the mere entering into and operation of a close-out netting provision as such should not constitute grounds for the avoidance of a close-out netting provision on the basis that it is deemed inconsistent with the principle of equal treatment of creditors; and

d) the operation of a close-out netting provision should not be restricted merely because the close-out netting provision or one or more of the obligations covered by this provision were entered into during a prescribed period before, or on the day of but before, the commencement of the proceedings.

[(2) These Principles do not affect a partial or total restriction of the operation of close-out netting provisions under the relevant insolvency law as a fraudulent transaction or as a preference that is detrimental to other creditors, where factors other than or additional to those covered by paragraph (1) of this Principle are present].

Principle 7: Enforceability of close-out netting

7. The law should ensure that a close-out netting provision is enforceable in accordance with its terms, before and after the commencement of an insolvency proceeding in relation to one of the parties. Without limiting the generality of the foregoing—
a) The law should not impose enforcement requirements beyond those specified in the close-out netting provision itself.

b) A close-out netting provision should remain enforceable even if one or more of the obligations covered are, and remain, unenforceable or ineligible.

c) If an insolvency proceeding in relation to one of the parties has been commenced,
   i. the insolvency administrator or court should not be allowed to demand from the other party performance on only some of the obligations covered by the close-out netting provision, while repudiating the remaining obligations;
   ii. the operation of the close-out netting provision should not be stayed;
   iii. the operation of the close-out netting provision should not be impaired on grounds that such operation or the mere fact of entering into such provision violated the principles relating to the equal treatment of creditors;
   iv. a close-out netting provision and any of the obligations covered by it should not become unenforceable solely on the ground that it was entered into during a prescribed period before, or on the day of but before, the commencement of the proceeding.

Key considerations in respect of Principles 6 and 7

- The enforceability of close-out netting provisions often conflicts with a number of insolvency law rules. Principles 6 and 7 aim at protecting close-out netting provisions from the effect of the application of these rules domestic laws and regulations that may hinder the operation of close-out netting provisions whenever the application of such rules would be in conflict with the objectives of the Principles.

- Close-out netting provisions should be enforceable between the parties and against third parties. In the event of insolvency of one of the parties, this includes the insolvency administrator and the general insolvency creditors, if applicable, of the defaulting party.

- The operation of close-out netting provisions should be governed by the terms agreed by the parties, both before and after the commencement of insolvency proceedings. As a general rule, implementing States are advised not to impair the operation of close-out netting provisions by imposing restrictions under national laws and regulations, neither in the form of general rules nor through specific rules directed against close-out netting.

- However, close-out netting is not shielded against every rule of commercial or insolvency law. The demarcation between those legal rules that should not apply to close-out netting and other legal provisions that should continue to apply requires careful consideration, both in relation to laws and regulations of a general nature and in relation to insolvency-specific restrictions. As a general rule, provided that the general requirements for the valid creation of contracts are fulfilled, the sole fact of entering into a close-out netting provision should not be subjected to additional conditions under contract or commercial law and should also not cause the application of insolvency avoidance rules. However, if a situation involves qualifying elements (for example, fraud vis-à-vis other creditors), the relevant contract law and insolvency law tools (remedies for fraud, avoidance, actio pauliana) should continue to apply.

- For purposes of international compatibility, a common standard in this regard is of utmost importance.
Explanation and commentary to Principles 6 and 7

Systematic structure of Principles 6 and 7

84. The common objective of Principles 6 and 7 is the comprehensive protection of the operation of close-out netting provisions, covering all aspects from the creation and formal validity (see also the specific rule in Principle 5), to the effectiveness against third parties, admissibility in evidence and enforceability in insolvency.

85. Principle 6 sets out the general rules on the protection of the operation of close-out netting provisions. This general standard of protection applies both in and outside of situations of insolvency.

86. Rules that are specific to situations of insolvency are contained in Principle 7. The protective rules of Principle 6 remain applicable even after the commencement of insolvency proceedings and are complemented under Principle 7 by additional rules that are directed against a number of typical specific restrictions of the operation of close-out netting provisions in situations of insolvency.

87. Principles 6(2) and 7(2) both allow exceptions to the general rules on the protection of the operation of close-out netting provisions, allowing restrictions under the laws and regulations of the implementing State that do not limit the operation of close-out netting provisions as such, but are triggered by the presence of other factors, especially fraud.

88. Principles 6 and 7 are not intended to impinge upon the particular rules applicable in the context of bank resolution which under certain conditions may supersede close-out netting provisions. The relationship of the Principles to those rules is addressed in Principle 8.

Principle 6(1) sent. 1 - Enforceability of a close-out netting provision according to its terms

Chapeau

79. The chapeau of this Principle aims at clarifying two aspects.

80-89. Principle 6(1) sent. 1 Second, it is a ‘catch-all’ provision addressing all statutory rules that could potentially conflict with close-out netting provisions but should not (reservations apply, cf. infra).

84-90. The wording ‘enforceable in accordance with its terms’ is the core idea of these Principles. It relates to the challenge posed to close-out netting provisions by some quasi-universally recognised legal rules. The best example is probably the insolvency administrator’s right to ‘cherry pick’ (cf. infra), but there are others. However, the diversity of legal systems and of the rules within them makes it very difficult to find a general, international formula that precisely describes which insolvency or commercial law rules and principles cause problems. Such a description is possible only in relation to the most obvious rules, which are here captured under paragraphs (a)-(e)Principle 6(1)(a) and (b) and Principle 7(1)(a) to (d). However, as close-out netting provisions are embedded in commercial and insolvency law in much the same way as any other contract, many other legal obstacles are capable of rendering a close-out netting provision unenforceable. These are potentially numerous, but difficult to describe.

12 Please note that the order of the paragraphs in this section has been changed and that insolvency-related paragraphs have been moved into the subsequent section.
An important reason for this is that close-out netting is a new concept as yet not properly addressed in many jurisdictions, thereby forcing the courts to seek analogies to deal with this new matter. A telling example of a conflict that might hamper the enforceability of close-out netting would be its assimilation to statutory set-off rights under commercial law and the resulting application of the requirements for set-off to close-out netting. Despite the fact that statutory set-off is more limited than close-out netting, in the absence of any clarifying legal rule courts and insolvency administrators might apply its requirements in analogy to close-out netting provisions, thus potentially distorting the enforceability of close-out netting. In particular, (i) set-off traditionally applies only to obligations that are due; (ii) in many jurisdictions, set-off traditionally applies only to obligations flowing from the same agreement, or that are very closely connected to each other; (iii) set-off applies only to payment obligations or obligations of the same kind (for the delimitation between set-off and close-out netting see also supra paragraph 2). As these requirements will rarely be complied with by a close-out netting provision, there is a real risk that it will be stayed or declared invalid.

Similar impediments to the enforceability of close-out netting provisions might stem from their perceived similarity to such known concepts as, for example, novation, and the subsequent application of the enforceability requirements of a novation agreement to a close-out netting provision. However, as analogies like these are probably very diverse, there is a need for a 'catch-all' rule. This is why Principle 6(1) sent. 1 the chapeau prescribes that close-out netting, as defined in functional terms in Principle 2 Principle 1, should be generally enforceable.

It is obvious, though, 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. In certain cases, the distinction may be quite difficult to make (cf. in particular paragraphs (c)(iii) and (iv), infra). This is why Principle 6(1)(a) and (b) and Principle 7(1)(a) to (d) in paragraphs (a)-(c) this Principle sets out the most typical challenges to close-out netting provisions stemming from general insolvency and commercial law rules that should be disapply in order to guarantee the enforceability of close-out netting, while exceptions to this general rule apply under Principles 6(2) and 7(2).

Enforceability of a close-out netting provision in and outside of insolvency situations

The systematic structure of Principles 6 and 7 as set out above First, it makes sure that the scope of the protection principle on the enforceability of a close-out netting provision according to its terms that is laid down in Principle 6(1) sent. 1 covers non-insolvency situations as well as the insolvency of one of the parties to the netting provision.

The background of the formula 'before and after the commencement of an insolvency proceeding' in the chapeau this is as follows. A close-out netting provision is a bilateral contractual relationship. Outside insolvency, such a netting provision rarely clashes with policy considerations. Therefore, the law has scant reason to prohibit or limit its use. As a consequence, a netting provision will generally be effective and enforceable as between two solvent parties.

The role of close-out netting in reducing counterparty and systemic risk becomes dominant in particular in the event of the counterparty’s insolvency. However, rules of insolvency law intended to preserve the insolvency estate for distribution to creditors and to ensure equal treatment of the latter are potentially incompatible with essential features of close-out netting. One of the primary purposes of insolvency law is to determine the question of which creditors’ claims should be prioritised over other creditors’ claims. Insolvency law traditionally provides for tools
such as ‘cherry picking’ and avoidance of contracts to put its insolvency policies into practice (cf. infra), and the application of such rules may render close-out netting provisions meaningless. However, the enforceability of close-out netting is crucial both inside and outside insolvency. Accordingly, the purpose of Principles 6 and 7, the chapeau, is to make clear that the law should protect the enforceability of a close-out netting provision throughout its lifetime and in both situations.

98. For the purpose of these Principles, the understanding of which ‘insolvency’ procedures should accommodate close-out netting should be very broad, i.e. the law governing a great variety of different procedures is targeted by these Principles. Reference is made to Article 1(h) of the Geneva Securities Convention: “Insolvency proceeding means a collective judicial or administrative proceeding, including an interim proceeding, in which the assets and affairs of the debtor are subject to control or supervision by a court or other competent authority for the purpose of reorganisation or liquidation. Both judicial and administrative proceedings are covered, aiming at either liquidation or reorganisation.

99. Consequently, the definition also covers the newly developed ‘resolution regimes for financial institutions’, as described in the relevant document of the FSB. Under such procedures, a national authority (typically the central bank or the financial services authority, or both) takes appropriate measures in respect of a financial institution that is no longer viable, such as, in particular, transferring the failed firm’s assets and liabilities to a bridge institution, overriding shareholders’ rights, conducting a ‘bail-in’, etc. It follows from FSB Key Attributes, para. 4.1 that, first, the legal framework for close-out netting during a crisis should be clear and that netting should be enforceable. Accordingly, these Principles should, in general, also apply to administrative procedures aiming at the resolution of financial institutions. Second, however, close-out netting should not hamper the effective implementation of resolution measures: in particular, the early termination of large volumes of assets under close-out netting provisions has the potential of undermining the effectiveness of the authority’s measures since such termination might occur before the appropriate measures can be taken. That is why the FSB document requires, inter alia, in its section 4.3, that the regulator be given the right temporarily to stay early termination and acceleration rights (Key Attributes, para. 4.3). This exception to Principle 7(c(ii) issue is addressed separately in Principle 8.

Principle 6(1)(a) Paragraph (a) – Additional enforcement requirements

92-100. Whereas Principle 5 deals with the formalities required to contractually conclude a valid and enforceable which should not be required for the operation of a close-out netting provision, the present Principle 6(1)(a) relates to additional conditions for the enforcement of a close-out netting provision. The practical value and effect of close-out netting would be significantly diminished or even rendered void if the law were to impose formal, procedural or other specific additional requirements as conditions for the enforcement of close-out netting provisions that went beyond those that the parties might have contractually agreed. In particular, the requirements traditionally imposed on the realisation of security interests such as pledges, charges and mortgages should not be made to apply to close-out netting. Such specific requirements may include, for example,

− prior notice to the defaulting party that the close-out netting provision may be put into operation;

approval of the terms of the realisation or operation of the close-out netting provision by a court or other public authority; or that

- the realisation be conducted by public auction or in any other prescribed manner; or that

- the close-out netting provision be operated in a legally prescribed manner; or that

- the close-out netting provision be subject to the requirements that may apply in the context of enforcing set-off.

93. It should be noted, however, that since the parties’ contract is based on contractual freedom, they are free to include any of the above or similar requirements in the close-out netting provision, if they so wish.

101. On the basis of the general structure of Principles 6 and 7, the rule under Principle 6(1)(a) applies both outside and in situations of insolvency.

Principle 6(1)(b) Paragraph (b) – Invalid/Non-unenforceable/Ineligible obligation included

94. Another group of potential obstacles to the enforceability of netting provisions relates to the obligations covered. One or several of the obligations covered might flow from a particular type of contract which is invalid or unenforceable or ineligible. Since the close-out netting provision and all the obligations to which it applies are often regarded as one contract, general principles of commercial law could hamper the enforceability of the bundle as a whole. This might endanger the enforceability of the netting provision as a whole, i.e., with respect to all remaining obligations. A better solution would be to ensure that the netting mechanism is not affected in relation to the other obligations that are excluded from the netting mechanism only specific valid, enforceable and eligible or non-enforceable or non-enforceable contracts once they have been identified.

95. An obligation is ineligible if it is not of a type listed above in Principle 34. Ineligible obligations should simply be severed from the bundle of obligations covered by the close-out netting provision and continue their separate lives, whereas the remainder of the obligations can be netted.

96. Even if in principle eligible, an obligation can be unenforceable for various reasons. A prominent case relates to wagering or gaming prohibitions which might apply in relation to certain derivatives transactions in certain jurisdictions. Unenforceable contracts should remain unenforceable and simply be severed from the bundle of obligations covered, whereas That one or more of the obligations that are covered by the close-out netting provision are unenforceable should not have any effect on the netting of the remainder of the bundle of obligations covered by the close-out netting provision can be netted.

97. It is important to stress that this rule does not interfere with the question of whether the single obligation is ineligible or enforceable under the applicable law.

Principle 7(1)(a) Paragraph (e)(ii) – Stay

98. Insolvency rules often impose a stay on all transactions with the insolvent estate as from the moment of the commencement of the proceeding. Such a stay would traditionally also inhibit the operation of set-off. The reasoning is that further outflow of assets must be stopped and the insolvency administrator given the right to repudiate all unfavourable contracts. However, a stay imposed on the close-out netting of eligible obligations leads to a situation in which it becomes impossible effectively to manage the credit and market risk associated with the bundle of

15 Please note that the order of the commentary on stays and cherry-picking has been reversed in order to correspond with the order of Principle 7(1)(a) and 7(1)(b).
obligations covered. During the stay, their value might fluctuate considerably and cause much greater potential damage to the solvent party than would have occurred had termination been possible at the moment of insolvency. Furthermore, from a conceptual angle, a stay appears unnecessary because the insolvency administrator should not have the right to choose among the unperformed contracts (no cherry picking, cf. supra).

Principle 8, infra, addresses an important exception to this rule, accommodating the temporary stays that are of termination and acceleration rights necessary in the context of resolution of financial institutions, cf. also paragraph 99, supra.

Principle 7(1)(b)Paragraph (c)(i) – Cherry picking

In an insolvency proceeding, the insolvency administrator or court may have the right to ‘cherry pick’ from the insolvent party’s non-performed contracts. This means the right to require any counterparty to perform those contracts that are favourable to the insolvent estate while repudiating rejecting those that are unfavourable to it.

If it were possible to cherry pick among a netting set, the bundle of contracts would be disassembled and the solvent party would be required to perform its obligations under all the contracts that were unfavourable from its perspective, whereas the insolvency administrator would not perform the obligations under the favourable contracts – ultimately, the solvent party would be exposed to the full counterparty risk.

Cherry picking is essentially contrary to the characteristics of a single relationship set out supra (cf. key considerations in respect of Principle 4). Furthermore, cherry picking disproportionately increases the counterparty risk for the non-defaulting other party. Therefore, it should not be available to the insolvency administrator.

Those jurisdictions that accommodate close-out netting tend to solve the conflict between cherry picking and enforceability of netting provisions by disallowing the selection of isolated obligations. The insolvency administrator may not demand performance under contracts covered by the close-out netting provision while rejecting any of the obligations owed to the other party. The right of the insolvency administrator, to extent that this right exists under the applicable insolvency law, to reject all contracts covered by the close-out netting provision is not affected. Thus, either all contracts have to be performed, or none (provided, of course, that those contracts are not unenforceable for any other reason). Moreover, no performance can be demanded once the obligations covered by the close-out netting provision are terminated under the close-out mechanism and reduced to or replaced by a single net obligation representing the value of the combined obligations, but giving the insolvency administrator the right to decide whether the parties are required to perform on all obligations covered by the close-out netting provision or whether the entire bundle of obligations covered is to be repudiated – in which case the close-out netting provision applies and all obligations will be terminated.

The same principles apply where close-out netting provisions and their underlying obligations are again bundled by an ‘umbrella’ close-out netting provision (in practice, several master agreements are bundled by a ‘master-master agreement’, see supra paragraph 19). The insolvency administrator should not be allowed to require performance on just one of them.

Principle 7(1)(c)Paragraph (e)(iii) – No conflict with equal treatment of creditors

This paragraph suggests that under the domestic law the mere entering into and operation of a close-out netting provision as such should not constitute grounds for the avoidance of a close-out netting provision on the basis that it is deemed inconsistent with the principle of equal treatment of creditors. Should not impair the operation of a close-out netting provision on the grounds that such operation, or the mere fact of entering into such a provision, violated the...
principles relating to the equal treatment of creditors of the insolvent estate by favouring one creditor to the detriment of the other creditors.

First, this rule is particularly relevant because the effects of a close-out netting provision often occur at the moment of opening the insolvency proceedings, or shortly before. Therefore, conflicts with the so-called ‘anti-deprivation’ principle, the pari passu principle, or the unenforceability of ipso facto clauses might otherwise arise. These principles have sometimes been argued to prohibit any contractual agreements containing a condition precedent to transfer assets from the insolvent estate to another party upon the opening of insolvency proceedings.

Second, this Principle addresses the concern that the mere inclusion of a close-out netting provision in the contractual documentation might be deemed inconsistent with the principle of equal treatment of creditors regarded as fraud to the detriment of other creditors of the insolvent estate. In the absence of any qualifying facts, the conclusion of a close-out netting provision is neutral, as it is not clear which party, if any, will default. Furthermore, at 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 (cf. Principle 7(2)). 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.

National insolvency laws often contain rules avoiding (or allowing the administrator or court to avoid) transfers, payments and provision of collateral which have occurred during a prescribed period prior to insolvency. Such a period is either defined as a fixed period prior to the commencement of insolvency proceedings (e.g., the three months preceding the date of commencement), or it can be defined by the insolvency court, counting, in particular, from the point in time when the over-indebtedness or similar indicator first occurred. The reasoning for such rules is to increase the pool of assets available for distribution amongst general creditors and to avoid unjustified preference of one or more creditors over the remaining creditors by ‘clawing back’ the relevant payments or property.

Neither the close-out netting provision nor, to the extent that they are included into the close-out netting mechanism under this provision, any obligations covered by it should be subject to such avoidance rights.

In some jurisdictions, there might be uncertainty as to whether entering into a close-out netting provision during the suspect period belongs to that category of situations. Therefore, there is a risk that an insolvency administrator or court would attempt to halt, avoid or otherwise render unenforceable a close-out netting provision entered into during the suspect period.

However, parties 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.
In relation to the obligations covered

113. The present principle also covers the obligations covered by the close-out netting provision. As a consequence, to the extent that it is included into the close-out netting mechanism under this provision, no obligation should be subject to avoidance solely on the grounds that it was entered into during the subject period.

114. The reasoning behind the Principle is that the insolvency administrator would typically avoid only those obligations that fall within the suspect period and are favourable to the solvent party. The result would be comparable to that described above (cf. Principle 7(1)(b) Principle 7(c)(i) – 'cherry picking'). As a consequence, the solvent party would be burdened with a considerably increased credit risk which could not be foreseen at the time of entering into the contract. On the other hand, the issue of the enforcement of the obligation concerned as such, where it is not included into the close-out netting mechanism, is outside the scope of the Principles.

Zero-hour rules

115. For the same reason, the enforceability of close-out netting provisions should not be impaired by the application of 'zero-hour rules', i.e., rules that by way of legal fiction bring forward the commencement of insolvency proceedings to 0:00h of the day of the decision to open them.

Safeguard against fraud, misrepresentation, etc.

116. The above applies only to the extent that there are no other qualifying elements present (cf. the wording 'merely because solely on the grounds that'). As a consequence, and in accordance with Principle 7(2), the law remains free to determine the consequences of fraud, misrepresentation and intentional granting of advantages to one creditor to the detriment of the other creditors.

Principles 6(2) and 7(2) – Exceptions

125. Principles 6(2) and 7(2) refer to the laws and regulations concerning fraud or the conditions for validity of contracts and, specifically concerning situations of insolvency, the insolvency law rules on fraudulent transactions or preferences that are detrimental to other creditors. These rules of national law are acknowledged as providing for exceptions to the general principle on the enforceability of a close-out netting provision according to its terms under Principle 6(1) sent. 1 and to its more specific sub-rules contained in Principle 6(1)(a) and (b) and Principle 7(1)(a) to (d).

126. The Principles refrain from specifying the conditions under which domestic legislators and policymakers might wish to restrict the operation of a close-out netting provision (some possible examples have been mentioned supra paragraph 116). Principle 7(2) is specific only insofar as it is expressly spelt out that the elements mentioned in Principle 7(2) cannot justify the restriction of operation of a close-out netting provision, even not on the basis of the rules mentioned in Principle 7(2), unless additional factors are present.

127. It should be noted that Principles 6 and 7 are concerned only with restrictions under national law that impair the operation of the close-out netting mechanism as such. The Principles do not address the enforceability of other clauses that are merely ancillary to a close-out netting provision, such as walk-away clauses and provisions on walk-and-see periods (see supra paragraphs 35 and 37). Similarly, rules of some legal systems which subject the operation of a close-out netting provision to standards of commercial reasonableness are not affected by the Principles to the extent that the definition in Principle 2 covers only such close-out netting
provisions under which the resulting single net obligation is intended to 'represent the value of the combined obligations' (see paragraph 32).\textsuperscript{16}

\textsuperscript{16} Concerning the issue of the consequences of a subordination of obligations covered by the close-out netting provision, the Committee agreed in its first meeting that this issue needed further consideration. It is therefore not yet dealt with in the text of the commentary.
Principle 8: Resolution of Financial Institutions

8. These Principles are without prejudice to a stay of the operation of a close-out netting provision which the law of the implementing State, subject to appropriate safeguards, may provide for in the course of resolution proceedings for financial institutions.

Principle 8: Exception in respect of resolution of financial institutions

8. Principle 7(c)(ii) is without prejudice to any legal rule that provides the competent authorities with the power, in the exercise of their resolution powers in respect of financial institutions, temporarily to stay contractual acceleration or termination rights that might arise under a close-out netting provision.

This exception applies solely to acceleration and termination rights which arise simply because of the entry of the financial institution into resolution or in connection with the exercise of any resolution powers, and to the extent that such stay does not affect the enforceability of acceleration or early termination rights not related to the entry into resolution.

Key considerations in respect of these Principles

- The Principles should assist shaping domestic legal rules on close-out netting which also accommodate the special resolution regimes for financial institutions. The current international consensus on standards for such special resolution regimes is laid down in the Key Attributes of Effective Resolution Regimes for Financial Institutions as developed by the Financial Stability Board.17

- The first aspect is that the legal framework governing close-out netting should be clear and transparent and that close-out netting should be enforceable also after a resolution procedure has been started. This aspect is covered by Principles 6 and 7.

- The second aspect is that close-out netting should not hamper the effective implementation of resolution measures. In particular, the competent authority should have, under certain conditions and to a certain extent, the right to delay the operation of a close-out netting provisions by means of stay of the termination or acceleration rights occurring under such provision. As such a right would go contrary to Principle 7(1)(a) and Principle 7(c)(ii) there needs to be an express exception. This is the purpose of Principle 8.

- The reference to ‘appropriate safeguards’ in Principle 8 is to be understood as subjecting the exception in this provision to the international standards on special resolution regimes for financial institutions, as described in Principle 8, shall be strictly oriented and should be interpreted in the light of the FSB Key Attributes part 4.1-4.4.

- Under the applicable national laws and regulations, the competent national resolution authorities may have a variety of other types of resolution powers besides the stay that is mentioned in Principle 8 (see the FSB Key Attributes, part 3). The Principles are without prejudice to any of those other powers which the competent authorities may exercise under the law of the implementing State for the purpose of the resolution of financial institutions and which do not affect the operation of a close-out netting

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17 Cf. Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011.
provision.

Explanation and commentary

117. The Principles ensure the enforceability of close-out netting provisions – including after the commencement of a resolution procedure in relation to a financial institution (cf. Principle 7, supra, paragraph 99, supra). Consequently, stays on close-out netting would, as a rule, not be allowed. However, the Cross-border Bank Resolution Group has shown that the unrestricted exercise of termination rights at the occasion of the entering of a financial institution into resolution proceedings, in particular the simultaneous close-out of high volumes, has the potential of harming the competent authority’s aim of orderly resolving the relevant institution.

Principle 8 provides that stays of the operation of close-out netting provisions should be subject to ‘appropriate safeguards’, which is to be understood as a reference to the international standards concerning special resolution regimes for financial institutions. The FSB, in the Key Attributes part 4.3 and the relevant Annex IV, has set the current international standard for such exceptional stays. This standard set by the FSB guarantees the general reliability of ensuring the parties’ ability to rely on close-out netting despite the possibility to impose a stay, in particular by requiring that –

- ‘subject to adequate safeguards, entry into resolution and the exercise of any resolution powers should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise contractual acceleration or early termination rights provided the substantive obligations under the contract continue to be performed’ (Key Attributes, para. 4.2); the stay may only relate to termination and acceleration rights arising as a consequence of entry into resolution or in connection with the exercise of any resolution powers. Consequently, close-out netting triggered by the default of one of the parties is upheld and not subject to such stay; and

- ‘should contractual acceleration or early termination rights nevertheless be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers. The stay should:

(i) be strictly limited in time (for example, for a period not exceeding 2 business days);

(ii) be subject to adequate safeguards that protect the integrity of financial contracts and provide certainty to counterparties (see Annex IV on Conditions for a temporary stay); and

(iii) not affect the exercise of early termination rights of a counterparty against the firm being resolved in the case of any event of default not related to entry into resolution or the exercise of the relevant resolution power occurring before, during or after the period of the stay (for example, failure to make a payment, deliver or return collateral on a due date)’ (Key Attributes, para. 4.3). The stay shall be limited in time (e.g. 24-48h).

Reference is made to Annex IV to the FSB Key Attributes for further detail.


9.(1) The private international law rules of the implementing State should determine the law that governs the operation of the close-out netting provision, taking into account, to the extent permitted by the laws of the implementing State, any choice of the governing law by the parties.

(2) The governing law in accordance with paragraph (1) further determines which parties and obligations are eligible for being covered by the close-out netting provision.

(3) The law should ensure that a choice of law made in a close-out netting provision prevails [in relation to this provision] over any other choice of law made in or in relation to the obligations covered by the close-out netting provision except as otherwise provided by the parties.

[(4) The law should ensure that the commencement of insolvency proceedings does not affect the determination of the governing law or laws for the operation of the close-out netting provision and the obligations covered by this provision.]

(5) Notwithstanding the above, if insolvency proceedings have been commenced in respect of a party to the close-out netting provision [or a branch of that party] and under a law other than the law determined in accordance with paragraph (1), the implementing State may provide that the law governing the insolvency proceedings governs also

a) the determination of the scope of parties and obligations that are eligible for close-out netting for the purposes of the enforcement of the close-out netting provision in the context of insolvency proceedings before the courts of the relevant implementing State; and

b) the avoidance of a close-out netting provision as a fraudulent transaction or as a preference that is detrimental to other creditors of the insolvent party.

Principle 9: Governing law of close-out netting provisions

9.(1) The conditions for the validity and effectiveness of the close-out netting provision, including formal steps to be taken to render the provision valid and effective, are determined by the law governing the close-out netting provision.

(2) The law governing the close-out netting provision further determines which parties and obligations are eligible for being covered by the close-out netting provisions.

(3) Except as otherwise provided by the parties and to the extent that choice-of-law clauses are admitted by the relevant rules of private international law, the choice of law made in a close-out netting provision should prevail over any previous, different choice-of-law clause contained in a contract covered by the close-out netting provision in respect of the matters specified in paragraph (1) above.

(4) Notwithstanding the above, if insolvency proceedings have been commenced in respect of a party to the close-out netting provision [or a branch of that party], the laws that govern those proceedings should also govern:

a) the avoidance of a close-out netting provision as a preference or a contract in fraud of other creditors of the insolvent party; and

b) the temporary stay of [the exercise of acceleration and termination rights under]

a close-out netting provision as a consequence of the commencement of the insolvency proceeding.
Key considerations in respect of this Principle

- **Principle 9** does not itself prescribe rules for identifying the law governing a close-out netting provision. Rather, the Principle describes the scope of the issues governed by this law, while leaving the determination of this law to the private international law rules of the implementing States.

- While insolvency proceedings (including procedures for the resolution of financial institutions) are governed by the law of the forum, the commencement of such proceedings should not affect the determination of the law governing a close-out netting provision. This aims at ensuring that commencement of such proceedings does not affect the operation of close-out netting provisions which were entered into in accordance with the requirements of their own governing law.

- As an exception to the preceding rule, **Principle 9(5)** allows an implementing State to extend the scope of law governing the insolvency proceedings to the determination of the scope of parties and obligations that are eligible for close-out netting for the purposes of the enforcement of the close-out netting provision in the context of insolvency proceedings and to the avoidance of a close-out netting provision as a fraudulent transaction or as a preference that is detrimental to other creditors of the insolvent party. This opt-out allows implementing States in the interest of their public policy choices to retain more control over the enforceability of close-out netting provisions in insolvency proceedings before their own courts.

- The effectiveness of a close-out netting provision that meets the formal and substantive validity requirements of its own governing law, as well as the eligibility of parties and obligations for close-out netting according to that law, must be preserved in a cross-border context.

- The law governing the insolvency proceedings in respect of a party to the close-out netting provision determines the extent to which a temporary stay may be imposed on the close-out mechanism or whether the close-out netting provision may be avoided on grounds of fraud or preferential treatment, but should not otherwise affect the validity or enforceability of a close-out netting provision that was validly entered into in accordance with its own governing law.

Explanation and commentary

**Paragraph (1) – Determination of the applicable law for close-out netting provisions according to private international law rules of the implementing States**

120. The majority of financial market transactions, for example derivatives, foreign exchange, securities lending and repurchase contracts, are concluded using standard documentation ('master agreements'). A number of master agreements are available for the various types of financial contract and for various jurisdictions. While master agreements are not necessarily tied to any one particular applicable law, the laws of some jurisdictions are often chosen for cross-border agreements.

121. Most legal systems recognise the principle of party autonomy in contractual relations, leaving the parties free to choose the content of their mutual obligations. In many legal systems, this principle also entails the freedom to choose the law governing the contract.

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19 **Cf.** [UNIDROIT 2012 - S78C - Study Group - Doc. 3, Principles 17-19 and Doc. 2, p. 32-35.](#)
Market participants choose the governing law of a close-out netting provision on the basis of their assessment of the suitability of the chosen law to adequately govern their obligations under the close-out netting provision. Most jurisdictions with developed financial markets recognize (as an aspect of the wider principle of party autonomy in contractual relations) the freedom of parties to financial contracts to choose the law governing their transactions, including a close-out netting provision.

However, several jurisdictions do not yet generally recognize choice of law in contractual matters, or else they impose a number of limitations to its admissibility, in particular by requiring some additional connection with the jurisdiction the law of which has been chosen. In view of the objective of achieving legal certainty and predictability in cross-border transactions, it appears that it is not in the first place the question of whether the parties’ choice is fully respected or different conflict of laws rules of the forum are applied instead that matters. Rather, what must primarily be ensured is that a close-out netting provision that is validly entered into in accordance with its own governing law is not later undone. As regards matters of conflict of laws, this would at least appear to entail that in jurisdictions that require an additional connection between the parties or the contract and the law chosen by the parties, the choice of a particular law to govern a close-out netting provision should not be disregarded solely on the basis that it is not the law in force in the jurisdiction where enforcement of the netting provision is sought.

In view of the foregoing, Principle 9(1) abstains from proposing a specific rule on the determination of the law governing the netting provision, be it by an acknowledgement of the parties’ freedom of choice concerning the applicable law or by setting out objective criteria for its determination. An attempt to formulate a default rule in either fashion would exceed the ambit of these Principles and would appear overly ambitious in view of the lack of consensus on the proper law to govern contractual relations. The ambit of this Principle 9 is therefore deliberately restricted to the determination-delimitation of the scope of the law governing the netting provision vis-à-vis the law governing the insolvency proceedings (i.e. the lex fori concursus), while the determination of this governing law is left to the private international law rules of the implementing States. Generally, parties are well-advised to consider the different legal positions under the potential applicable laws and the effectiveness of a choice-of-law clause at the moment of concluding the transaction. It should also be noted that internationally overriding mandatory rules of the forum – as distinct from simple mandatory rules – may limit the enforceability of close-out netting rules in exceptional circumstances (for instance, overriding mandatory rules that render unenforceable agreements made in performing an unauthorised regulated activity or agreements made in consequence of unlawful promotions).

Paragraphs (1) and (2) - Determination of the eligible parties and obligations

The validity and enforceability of a close-out netting provision, and the eligibility of parties and obligations for inclusion in a close-out netting set that meets the applicable requirements of its own governing law should not be affected by the fact that the enforcement of the close-out netting provision is sought in a jurisdiction different from the jurisdiction the laws of which govern the close-out netting provision. 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.

Paragraph (2) achieves this objective by providing that the governing law in accordance with paragraph (1) should also determine which parties and obligations are eligible for being covered by the close-out netting provision. Generally, this rule should apply even if the enforcement of a close-out netting provision is sought in the context of insolvency proceedings.
commenced in the foreign jurisdiction before the courts of a State other than that whose law governs the close-out netting provision according to paragraph (1) (cf. infra paragraphs 144 et seq. 133-135).

126. As indicated, the parties usually choose the law of a particular jurisdiction to govern their close-out netting provision. Where the close-out netting provision relates to the parties’ obligations to a payment or settlement system or to a financial market, the law governing a close-out netting provision relating to those obligations is usually the law of the State which is applicable to the relevant system or market.

127. By the same token, the eligibility of parties and obligations for close-out netting should be established solely in the light of the law governing the close-out netting provision. 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.

128. The phrase ‘the law governing the close-out netting provision the governing law in accordance with paragraph (1)’ in paragraph (2) refers to the substantive law of the relevant implementing State, rather than to its private international law rules, but is otherwise neutral as to the particular area of the law where provisions on eligibility of parties and obligations for close-out netting are to be found. In some jurisdictions this may be the subject of specific legislation, whereas in other jurisdictions relevant provisions may be found in contract law rules, financial sector regulations or in provisions of insolvency law.

129. It is recognised that overriding mandatory rules of the forum – as distinct from simple mandatory rules – may limit the enforceability of close-out netting rules in exceptional circumstances (for instance, overriding mandatory rules that render unenforceable agreements made in performing an unauthorised regulated activity or agreements made in consequence of unlawful promotions).

130. Furthermore, certain ‘overriding mandatory rules’ of the forum may contribute to determining the law governing the close-out netting provision, thus preventing the parties from circumventing the State’s policy choices concerning, for instance, the parties and obligations eligible for close-out netting.

Paragraph (3) – Choice of law in the close-out netting provision

131. The master agreement containing the close-out netting provision and the underlying transactions contracts are supposed to form a so-called ‘single agreement’. In fact, the master agreement would be valid but useless without the transactions which it is supposed to cover. If the only choice of law being made is the choice of law included in the master agreement, this will, due to the ‘single contract’ provision, usually extend to the underlying agreements transactions as well. There are, however, situations in which the underlying transactions contracts may also include a choice-of-law clause. This will be unproblematic if the parties have chosen the same law both for the master agreement and the underlying financial transactions. There may, however, be some rare cases in which the law chosen to govern the underlying transactions contracts is different from the law contained in the master agreement.

132. If the close-out netting provision is entered into after the underlying financial transactions have been concluded and some of the latter are governed by a different law, it could be assumed that the choice of law made in the close-out netting provision altered all previous, different choice-of-law clauses contained in the underlying transactions contracts. The subsequent
choice of law in the master agreement may be taken as evidence of the parties’ intent to override their earlier choice(s) of law. However, if a close-out netting provision that includes a particular choice-of-law clause has been entered into, but the parties subsequently enter into financial transactions contracts (covered by the close-out netting provision) which include a clause expressly choosing a different law, there may be doubts as to whether the law governing the close-out netting provision prevails over the later choice made in the underlying transactions contracts.

133.140. It is useful, therefore, to clarify that, except as otherwise provided by the parties, the choice of law made in a close-out netting provision should prevail in relation to the determination of the governing law for this provision over any different, whether previous or subsequent, choice-of-law clause contained in a transaction contract covered by the close-out netting provision in respect of the matters specified in paragraph (1) above. The parties may also agree on a variation of the applicable law which might be especially relevant if under the formerly applicable law netting would not have been permitted in relation to some or all of their mutual obligations.

141. As is expressly spelt out in paragraph (1), a choice of the governing law by the parties is to be taken into account to the extent permitted by the laws of the implementing State only. Thus, the reasoning in the preceding paragraphs applies only to the extent that under the private international law rules of the jurisdiction concerned party agreements as to the governing law of contract can be effective.

Paragraphs (4) and (5) – Delimitation of the governing law of the close-out netting provision and the law governing the insolvency proceedings lex fori concursus

134.142. One area of particular concern relates to the interplay between the governing law of the close-out netting provision and insolvency law. The baseline rule in most jurisdictions is that entitlements pre-dating the insolvency and which are valid and enforceable according to their own governing law, must be respected. In that sense, the close-out netting provisions ‘survive’ the commencement of insolvency proceedings in respect of one of their parties. However, the applicable insolvency law determines to what extent the exercise of those rights is affected by the commencement of insolvency proceedings. Put in general terms, in the context of close-out netting provisions, the lex contractus – governing law of the close-out netting provision establishes whether an agreement to close out and net the mutual obligations exists and is enforceable, while the law governing the insolvency proceedings lex fori concursus addresses restrictions concerning the questions of whether and to what extent the rights arising out of the close-out netting provisions may be exercised against the insolvency estate. The delimitation between the application of these legal regimes to close-out netting provisions is an issue of some delicacy. Its complexity is further exacerbated by the fact that there are particular conflict of laws provisions relating to netting, set-off or payment and settlement systems and financial markets which, to a varying extent, exempt insolvency matters from the application of the law governing the insolvency proceedings lex fori concursus (‘carve-out provisions’).

143. These Principles generally affirm the enforceability of close-out nettings provisions despite the commencement of insolvency proceedings in respect of one of the parties (see Principles 6 and 7), but acknowledge that the close-out netting provision may be subject to avoidance actions on the basis of fraud or preferential treatment of creditors (see Principle 7(2) – the restricted scope of Principle 7 (c)(iii), cf. also the commentary in C.G.E./Netting/1/W.P. 2 paragraphs 104-107 and 115). These Principles further acknowledge, within the context of the resolution of financial institutions (which is covered by the broad understanding of the term ‘insolvency proceedings’ within the context of these Principles, see supra paragraph 99 – the commentary in C.G.E./Netting/1/W.P. 2 paragraphs 83-84 and 116), the possibility for the resolution authority to impose a short temporary stay on the close-out mechanism (see Principle 8). These issues are
referred under paragraphs (4) and (5) to the governing law of the close-out netting provision and the law governing the insolvency proceedings, respectively, as follows:

144. First, the close-out netting provision continues to be governed by the law determined in accordance with paragraph (1) regardless of the commencement of insolvency proceedings (see paragraph (4)). As a default rule, this includes also the determination of the eligible parties and obligations and the application of insolvency avoidance provisions on the basis of fraud or preferential treatment of creditors (see the opt-out possibilities under paragraph (5) sub-paragraphs (a) and (b)). This broad scope of application of the law governing the close-out netting provision even in the case of the commencement of insolvency proceedings aims at ensuring that commencement of such proceedings does not affect the operation of close-out netting provisions which were entered into in accordance with the requirements of their own governing law.

145. Second, the insolvency proceeding itself is governed by its own law, typically the law of the forum (lex fori concursus). The phrase ‘if insolvency proceedings have been commenced ... under a law other than the law determined in accordance with paragraph (1)’ in paragraph (5) refers to this application of the law governing the insolvency proceedings, which is a general principle that does not need to be provided for under the Principles. The application of the law governing the insolvency proceedings covers also, as a matter of course, resolution measures under proceedings for the resolution of financial institutions.

146. Third, paragraph (5) sub-paragraphs (a) and (b) allow a partial opt-out from the broad principle laid down supra paragraph 144. Implementing States may wish to avail themselves of this option where it is deemed necessary to preserve the public policy choices made in their own laws as to the issues on the enforceability of close-out netting provisions that are addressed in sub-paragraphs (a) and (b) in insolvency proceedings before their own courts. Specifically, implementing States can provide that the law governing the insolvency proceedings (instead of the law governing the close-out netting provision in accordance with paragraph (1)) governs also the determination of the scope of parties and obligations that are eligible for close-out netting for the purposes of the enforcement of the close-out netting provision in the context of insolvency proceedings (sub-paragraph (a)) and the avoidance of a close-out netting provision as a fraudulent transaction or as a preference that is detrimental to other creditors of the insolvent party (sub-paragraph (b)).

135. The law governing the insolvency proceedings determines, inter alia, the extent to which such a stay may be imposed or such avoidance actions may be brought, but it does not otherwise affect the validity or the enforceability of a close-out netting provision that was validly concluded under its own governing law. In particular, as is pointed out in paragraph (2) of this Principle, it is the law governing the close-out netting provision, rather than the law governing the insolvency proceedings in respect of any of the parties to the agreement that determines which types of parties and obligations are eligible for close-out netting.

136. It should be noted that paragraph (5) sub-paragraphs (a) and (b)—paragraph (4) operates at a different level from Principles 7(2) and 8. Those principles contemplate certain limitations on the enforceability of close-out netting provisions and recommend certain policy options that States may wish to introduce in the context of the application of domestic insolvency rules or resolution powers. Paragraph (45) of Principle 9, in turn, has the sole purpose of affirming that the implementing States may provide that the laws that govern those proceedings, rather than, for instance, the law that governs the close-out netting provision itself, should control the matters specified in sub-paragraphs (a) and (b). The manner in which such laws should address those matters, however, is the object of Principles Principles 7(2) and 8. In line with the underlying philosophy of the Principles, which is to affirm the enforceability of close-out netting provisions, paragraph (54); sub-paragraphs (a) and (b) refer only to those situations in which these Principles
expressly admit some limitation of the enforceability of close-out netting provisions, and do not contemplate other limitations that may be provided by national insolvency laws that are not in conformity with these Principles (such as for instance a possible power of the insolvency representative to ‘cherry pick’ from the insolvent party’s non-performed contracts).

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