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Preliminary Draft Principles regarding the Enforceability of Close-out Netting Provisions

(Prepared by Mr Philipp Paech, member of the Study Group, on behalf of the UNIDROIT Secretariat) [1]

Introduction

1. Financial institutions and other financial market participants in their daily operations basically apply two types of mechanism designed to reduce their risk exposure. First, they provide to each other security or collateral. In addition, they may agree that close-out netting shall apply to the financial 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. Taken together, security/collateral and close-out netting form the spearhead of modern 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. However, close-out netting encompasses many additional elements and is functionally and conceptually different from traditional set-off.

3. Close-out netting arrangements 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 arrangements. Close-out netting is typically applied to transactions such as derivatives, repurchase and securities lending agreements, and other kinds of financial transaction that tend to carry a high counterparty and/or market risk.

4. Regulatory authorities (most recently, the *Cross-border Bank Resolution Group* of the Basel Committee on Banking Supervision) strongly encourage the use of such netting arrangements (alongside collateral) because of their beneficial effects on the stability of the financial system.

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[1] This draft is partly based on Document 2, Document 3 and Document 6 of the UNIDROIT Study Group and on the deliberations of all its members during their two meetings in 2011. The author and the UNIDROIT Secretariat would like to thank Ms Joyce Hansen and Mr Hideki Kanda, members of the Study Group, for their useful comments on an earlier draft of this document.

5. However, these beneficial effects are particularly palpable in the event of the insolvency of a counterparty. 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. Globally, however, the current *status quo* is that while many jurisdictions recognise netting in insolvency, the extent to which they do so and the scope and legal effects differ. Other jurisdictions do not clearly recognise netting, and the legal practice in such jurisdictions often resorts to the principles governing set-off, failing to recognise 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.[2]

6. An additional aspect of the enforceability of netting agreements 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 moratorium on the netting mechanism in pre-insolvency or insolvency situations affecting a financial institution, so as to allow the regulator the time needed to decide if and how to save an ailing entity for reasons of systemic stability. The Financial Stability Board has recently provided guidance as to how the regulatory interest should be reconciled with financial firms' and its regulators' need 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. [3] 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 regulatory measures such as moratoria on termination or portfolio transfers to the essential insolvency and commercial law framework might fail in certain cases. Notably, regulatory measures aimed at restricting close-out netting in bank resolution procedures might be less effective. Further, the global patchwork leads to situations where portfolios of financial contracts covered by close-out netting agreements are difficult to transfer to a cross-border acquirer. This situation calls for a more harmonised and streamlined framework regarding close-out netting on which market participants and regulatory can rely across all financial markets. [4]

8. First steps have meanwhile been taken towards an international consensus on the principles underlying the legal cornerstones regarding enforceability of close-out netting agreements. The Geneva Securities Convention sets out an optional framework for the protection of collateral transactions. This protection extends to netting agreements provided they are concluded as part of a collateral transaction. The Convention therefore contains a definition of close-out netting and a key rule on enforceability. [5]

9. Furthermore, netting has also been recognised in the work of UNCITRAL on cross-border insolvency. Notably, the *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 of financial contracts should be allowed under the applicable insolvency procedure.[6]

10. The aim of the 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-

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[2] *Cf.* for a detailed analysis Document 2, 1st Part, in particular pp. 32 *et seq.*

[3] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011, section 4, in particular section 4.3.

[4] *Cf.* for a detailed analysis Document 2, 2nd Part, in particular pp. 68 *et seq.*

[5] 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).

[6] UNCITRAL, Legislative Guide on Insolvency, 2005, Recommendations 7g) and 101-107.

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.

Principle 1: Definition of 'Close-out netting provision'

Alternative (c)[7]

1. "Close-out Netting Provision" means a contractual agreement relating to Eligible Financial Contracts between Eligible Parties under which, on the occurrence of a predefined event in relation to one of the parties, the respective obligations of the parties under such Eligible Financial Contract are reduced, so as to result in a single net obligation representing the aggregate value of all combined obligations, which is then payable by the relevant party. 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 the party which is not the party to which the predefined event relates.

Key considerations in respect of this definition

- The definition of close-out netting provision shall be broad so as to encompass different types of provision which achieve a functionally identical result.
- It shall 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 shall exclusively relate to contractual close-out netting. Statutory provisions that achieve an identical or similar result are not addressed in this definition.

Explanation and commentary

'Close-out netting'

11. 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 financial contracts between the parties is contractually covered by a netting agreement. Upon the occurrence of a predefined event, all non-performed contracts covered by the netting provision cease to be treated individually. Their aggregate value 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 to be settled and is generally due shortly after being determined.*

'Provision' and 'contractual agreement'

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

[7] Alternatives (a) and (b) of Principle 1 in Document 6 are retained. The explanations given here in relation to Alternative (c) could be applied accordingly.

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. In practice, an agreement 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 "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.

15. 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.

'In relation to eligible {financial} contracts'

16. *Cf.* relevant definition.

'Between eligible parties'

17. *Cf.* relevant definition. Financial contracts 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. Bilateral settlement between the parties is the standard case and covered by these principles.

19. These principles also cover 'central clearing' 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 works by interposing a central entity between the parties to every financial 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 replace by bilateral obligations between each participant and the central clearing entity (there are very few truly multilateral clearing mechanisms). Consequently, 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.

20. 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, capped by a system of mutual cross-assignments. It is used as a tool to circumscribe the exposure of one market participant *vis-à-vis* a multitude of other, independent market participants, typically a bank managing its risk exposure

under one single netting agreement 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 agreement 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.

'Predefined event'

21. The event that usually triggers the application of the netting provision (the 'predefined event') is commonly referred to in the relevant documentation as the 'termination event', 'enforcement 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 agreement 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. Netting agreements additionally include external circumstances as termination events, such as the objective impossibility of performing an obligation under one of the financial contracts, or the downgrading of one of the parties' credit rating following its merger with another company.

22. It is worth noting that the event triggering termination may be 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 13). Such arrangements are likewise envisaged by the present definition.

'Reduced so as to result ...'

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, are 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 financial contracts, (ii) acceleration of obligations, (iii) valuation of the contracts' value, and, (iv) aggregation to result in an overall net amount. The order of acceleration, aggregation and valuation can vary according to the actual netting agreements. Not all netting clauses 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. Concepts such as termination, cancellation, close-out, rescission, *etc.* achieve the same functional result of putting an end to the relevant open contracts.

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').

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'. 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 valuation process and a fair and commercially reasonable result.

'Payable by the relevant party'

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 lose some or the entirety of its claim. 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, the solvent party must pay the insolvency estate.

Automatic or elective operation of the close-out netting mechanism

31. 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 party to which the predefined event relates. The extent to which the non-defaulting party should retain the freedom to close-out after the predefined event has occurred is currently under discussion. Close-out netting provisions employing either elective or automatic termination are covered by these principles.

Principle 2: Definition of 'eligible party'

2. 'Eligible party' means

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 designated as an eligible party under the law of the relevant State.

Key considerations in respect of this definition

- The definition of 'eligible party' determines and restricts the scope of these principles, in conjunction with the definition of 'eligible financial contract'. 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 contract.
- The definition of eligible parties, as a criterion for determining the personal scope, should be shaped in a broad and comprehensive manner. The main issue to be taken into account is consumer protection. Many jurisdictions apply specific measures with a view to protecting consumers. National legislators/regulators shall 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 contracts, while leaving the definition of eligible parties as broad as possible.

Explanation and commentary

Paragraph (a)

32. 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 on the financial market.

33. 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 paragraph (a).

34. 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.

35. 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.

Paragraph (b)

36. 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.

37. It should be noted that it is quite easy in many jurisdictions to form such unincorporated associations 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 remit of paragraph (c). The fact of being associated and of engaging in eligible financial contracts places such groups of individuals within the scope of these principles.

Paragraph (c)

38. 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 eligible financial 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 *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.

39. This paragraph aims to cover persons commonly referred to as 'natural persons' (*cf.* also the negative use of that definition under *paragraph (a)*). However, the principles intentionally do not use this term in *paragraph (c)* in order to avoid confusion with the category described under *paragraph (b)*. Natural persons organised in a partnership or an association and acting as such fall within *paragraph (b)*, although many jurisdictions would still regard them as natural persons in legal terms. As a consequence, *paragraph (c)* covers natural persons acting individually, or 'individuals'.

40. Unincorporated entrepreneurs (merchants) are covered by *paragraph (c)* even where they conduct themselves as 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.

<u>Principle 3: Definition of 'eligible [financial] contract</u>

3. 'Eligible [financial] contract' means

a) derivative instruments,
'derivative instrument' means an option, forward, future, swap, contract for differences or other transaction in respect of a reference value that is, or may in the future become, the subject of recurrent contracts in the derivatives markets.

b) repurchase agreements, lending agreements and margin loans relating to securities, money market instruments and units in collective investment schemes,

c) title transfer collateral arrangements,

d) [deposits,] [to the extent designated by the law of the relevant State,]

e) [loans,] [to the extent designated by the law of the relevant State,]

f) contracts for the sale, purchase or delivery of

1.- securities

2.- money market instruments

3.- units in a collective investment scheme

4.- currency of any country, territory or monetary union

5.- gold, silver, platinum, palladium, iridium, or any other precious metal

6.- any other fungible commodity,
'Fungible commodity' means a commodity that is or may in the future become the subject of recurrent contracts in the spot, forward or derivatives markets.

g) agreements under which a party undertakes (whether by way of surety or as principal debtor) to perform obligations assumed by another person under any agreement referred to in paragraphs [a] to [f].

h) claims based on the principle of unjustified enrichment and occurring in connection with one of the above types of transaction, whether or not the parties agreed to that transaction in a legally effective manner.

<u>Key considerations in respect of this definition</u>

- 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 arrangement. There are three such elements.

- *Single relationship*: contracts entered into on the understanding that they are connected to each other 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 financial 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

General

41. The term 'financial 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.

Paragraph (a) – Derivative instruments

42. The term 'derivative instrument' describes a financial 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.

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

44. Derivative instruments also pass the test of the second criterion, *i.e.* exposure to considerable market and credit risk. They are the paradigmatic high volatility transactions with

rapid and significant price movements. Rapid price movements combined with huge outstanding notional amounts and transaction volumes also pose the threat of systemic risk (third criterion).

45. 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.

46. Certain types of derivative can be either physically settled or cash settled. Both are included within the scope of these principles.

47. 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 agreement between the central entity and the system participant emerges, *cf. supra* paragraph 19).

<u>Paragraph (b) – Securities repurchase agreement, securities lending and margin loans</u>

48. Paragraph (b) covers three methods of securities financing: sale and repurchase agreements, securities lending agreements, and margin loans.

49. 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 driven by cash needs, *i.e.*, in functional terms, it has the same effect as a 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.

50. Securities lending entails that the securities are made available to the counterparty under a pledge and a simultaneous agreement to retransfer them 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.

51. In functional terms, the mutual flows of assets are identical for both types of transaction. Both types consist of a pair of reverse 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).

52. 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 financial instruments 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. paragraph (c), infra*), *i.e.*, depending on the arrangement, ownership of the securities is transferred to the bank.

53. 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 in a close-out netting agreement (single relationship, second case).

Paragraph (c) - Title transfer collateral arrangements

54. There are title-transfer collateral arrangements and non-title transfer collateral arrangements. They differ as to their nature and the analysis as to whether they are suitable to be included in a netting agreement differs accordingly.

55. The first type of 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 it is impossible to aggregate a net sum that encompasses these proprietary positions. This is because the characteristics of split property cannot be expressed in purely monetary terms.

56. 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)*). There is no split property. As a consequence, the valuation and inclusion in the net amount of both legal positions (full title on the one hand – claim on the other hand) are possible.

57. An important hybrid category is the non-title transfer collateral arrangement which includes a right of use. In some 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 *identical* or *equivalent* one. In this instance, the residual property interest originally vested in the collateral provider ceases to exist in this instance and is replaced by a contractual claim for re-transfer. 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 those of a title transfer collateral arrangement. As both positions (full title on the one hand – claim on the other hand) can be given a clear market value, such an arrangement is capable of being included in a netting arrangement.

58. 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.

59. It is important to note that repurchase, securities-lending as well as title transfer-collateral agreements 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 agreement between two parties.

Paragraph (d) – Deposits

60. In considering whether and to what extent deposits should be included within the ambit of legislation aimed at and affirming the enforceability of close-out netting, domestic legislators and policymakers will need to give careful consideration to various policy objectives.

61. Loans and deposits are closely related 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 traditionally, only licensed credit institutions ('banks') are able to take deposits.

62. The first question is whether there is a practical case for including deposits within the scope of these principles. (*e.g.*, deposits of one bank with another bank; of an industrial company with its bank; of a hedge fund with its prime broker). This question is to be considered from the viewpoint of professional market participants and of consumers.

63. As to professional market participants, the question of whether deposits should be covered by these principles relates mainly to the phenomenon of 'cash-pooling'.

64. 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 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 which 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 incalculable. It would therefore make sense for the common use of cash pooling arrangements to be included within the scope of these principles. In other words, deposits and loans made in the context of such arrangements should be eligible contracts.

65. The second question is, to what extent should deposits be included generally? This is relevant in particular in the context of consumer protection. There are two points to consider.

66. From a policy angle, there might be a need to prevent netting in respect of consumer deposits. Yet, netting is conceivable only where the deposit (*i.e.*, a bank's debt towards its consumer-customer) is paralleled by a customer debt with the bank, in particular a debt arising from a consumer credit, a house mortgage, or a payment obligation arising from the purchase of investment assets. In many jurisdictions, if the customer defaults, the bank would be allowed to set off or otherwise combine these mutual obligations or to realise a pledge taken over the deposit. Logically, the same should apply upon the bank's insolvency. It would be contrary to consumer protection imperatives to allow the insolvency administrator to cherry pick and uphold the consumer's debt to the bank while the bank's debt to the consumer (the deposit) was referred to the insolvency proceeding. While it might be tempting to bar netting or insolvency set-off and to refer the consumer to a deposit compensation scheme (*cf. infra*), this would ultimately result in the deposit compensation scheme supporting the bank's general creditors. Thus, regardless of whether the mechanism is regarded as set-off or netting, it does appear to be a measure that protects consumers both inside and outside the insolvency situation while taking the burden off the consumer compensation scheme (where applicable), as well.

67. A specific concern is that, if close-out netting were to apply between a bank and its customer, the bank would have a convenient means of realising payment claims against the customer stemming from risky investments arranged for the customer by the bank, in particular where the risks incurred had been actually or allegedly misrepresented. Regulators are chiefly concerned about the scenario where consumers are first talked into an unfavourable and ultimately

loss-making investment and the bank then enforces the resulting payment obligation by 'netting away' the consumers' deposit. However, it is questionable whether this – realistic – scenario can actually be resolved in the context of netting. First, the question of which product a bank is allowed to sell to consumers, as well as the framework preventing misrepresentations, are part of the rules on the conduct of business, traditionally a highly regulated area the aims of which cannot be achieved through commercial law considerations. Second, netting might also protect the customer in the event of the bank's insolvency. Third, the bank would be able to achieve the same result via set-off or by taking a pledge over the customer's deposit.

68. An additional issue to consider is that of deposit insurance schemes. The question is whether the possibility of including deposits in netting arrangements might conflict with the protection afforded to deposits under such schemes. In many jurisdictions, certain types of deposit are guaranteed in the event of the bank's insolvency. The legal setup of these schemes varies (insurance, mutual fund of banks, state guarantee, *etc*.). Generally, such protection schemes are limited to deposits made by consumers, although they occasionally extend to deposits made by small businesses. It is very rare for all deposits, including deposits made by any type of business, to be covered. If netting (or insolvency set-off) were to be precluded in the event of the bank's default, the consumer would have to perform on its debt vis-à-vis the bank (since the administrator will cherry pick this claim), whereas the insolvent estate would not perform on its own debt, *i.e.*, the deposit. Netting (or insolvency set-off) would eliminate the customer's exposure in this respect. To compensate the customer in such cases by means of a deposit insurance scheme would certainly protect the customer from loss but might distort the overall picture. If the customer is prevented (on the grounds that its deposit is protected) from invoking its counterclaim against the bank (the deposit), the deposit compensation scheme would ultimately contribute indirectly to increasing the insolvent estate, to the benefit of the general creditors.

Paragraph (e) – Loans

69. As in the case of deposits, the inclusion of loans within the scope of close-out netting needs to be considered carefully. At first sight, loans do not pose a particular risk that can be best prevented by the application of close-out netting. However, a number of factors indicate that the inclusion of loans might be worth considering in certain circumstances.

70. Loans mainly consist of a transfer and retransfer of cash. This functionality is identical to the cash leg of a repurchase agreement, a securities-lending agreement and a cash-title transfer collateral agreement. Carving out loans generally would pose the risk that a clear distinction between (ineligible) loans and the cash leg of the aforementioned (eligible) transactions would need to be made. This might be difficult, particularly in a cross-jurisdictional situation, and thereby create legal uncertainty.

71. The comments in respect of deposits and cash pooling equally apply to loans.

Paragraph (f) – Contracts for the sale and delivery of certain assets

72. *Paragraph (f)* 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. Consideration needs to be given to the extent to which the inclusion of contracts for the sale and delivery of certain assets into the scope of these principles is justified in light of the criteria mentioned in the *key considerations,* above.

73. Transactions involving (near) immediate delivery against payment do not appear to give rise to any particular risk which could only be sensibly addressed by including such transactions within the ambit of close-out netting.

74. A different case might be the spot market, where prices are agreed and paid immediately whereas delivery occurs within a time frame of under one month. A typical example is the spot market for crude oil.

Paragraph (g) – Surety agreements

75. This paragraph ensures that not only the (direct) parties to an eligible contract fall within the scope of these principles but also third parties that promise to perform on the obligation of another of the parties to that eligible 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.

Paragraph (h) – Unjustified enrichment

76. Claims based on the principle of unjustified enrichment arise where assets have been obtained without a valid contractual basis. A simple example is the transfer of assets made despite the fact that the envisaged underlying agreement has not been properly concluded, for example due to an operational failure. Where the parties maintain an ongoing business relationship, such an eventuality is covered by a netting arrangement, and the envisaged, but invalid transaction would be covered by that netting agreement. It would appear natural to include claims based on unjust enrichment in that same netting agreement. These concepts are often covered by references to law merchant or normal business practice under the applicable laws.

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

4. The law should not make the creation, validity, enforceability 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[8].

5. The law should not make the creation, validity, enforceability or admissibility in evidence of a close-out netting provision dependent on the use of standardised terms of specific trade associations[9].

6. The law may require the registration of financial contracts covered by a close-out netting provision [and of the provision itself] with a trade repository or similar organisation for regulatory purposes. A failure to comply with such requirement should not affect the creation, validity, enforceability or admissibility in evidence of [the financial contracts and] the close-out netting provision[10].

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.
- The enforceability of close-out netting should not depend on the use of standard documentation so as to allow for tailor-made close-out netting agreements and framework

[8] *Cf.* former Principles 6 and 7.
[9] *Cf.* former Principle 8.
[10] *Cf.* former Principle 9.

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.

- Registration of financial contracts with trade repositories and similar organisations is an important feature of the supervisory framework. However, non-compliance with the duty to register financial contracts should not entail the non-enforceability of the relevant close-out netting provision [and of the financial contracts].

Explanation and commentary

77. The effect of non-compliance with formal requirements 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, there is a significant risk that at least one of the parties might be taken by surprise by that consequence. Thus, where the rules on form aim at promoting safe and sound market conditions, 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.

Principle 4

78. 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.

79. 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 financial contracts covered by a netting agreement. The necessary steps might not be carried out simply for practical reasons such as language requirements.

80. Second, even if formal requirements are initially complied with under the first law, any possibility of transferring a close-out netting agreement (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 financial 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 [or the underlying contracts] differed.
- It is equally relevant in the context of bank resolution powers, which usually include the possibility of transfer, by regulatory order, of part or all of a bank's business to a second (solvent) bank. If the receiving second bank is subject to a different insolvency law, and if that law imposes formalities on close-out netting provisions, it is very unlikely that the

[11] *Cf.* Doc. 2, p. 37 (Example 7), p. 71 (Example 17).

formalities (if any) under which the close-out provision was originally entered into would suffice.

Principle 5

81. Another issue is the tension between netting agreements 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 agreements only where the latter are included in standard documentation, individual amendments would imperil enforceability.

82. 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 agreements that are part of standard documentation is not suitable in a cross-jurisdictional context.

Principle 6

83. In attempting to render the derivatives market more transparent, many jurisdictions have recently introduced or are about to introduce a duty to register certain types of standardised derivatives with a register or trade repository. This act of registration is required for prudential/supervisory purposes. It should not be made a condition for a financial contract's capability of being included in a netting agreement, since the motivation is not the same. Additionally, the legal consequences are different: non-registration as such, in the supervisory context, does not produce risk but will merely entail fines or similar sanctions. Where registration is a prerequisite for the enforceability of the netting agreement, any non-compliance with that requirement would actually create risk, since it would endanger enforceability in situations which the parties (and possibly also their regulator) might not have anticipated since non-registration in most cases will be a consequence of unintentional operational failure.

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,[12] before and after the commencement of an insolvency proceeding in relation to one of the parties.[13] 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 or those required for commercial contracts generally.[14]

b) A close-out netting agreement should remain enforceable even if one or more of the financial contracts covered are unenforceable.[15]

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 financial contracts covered by the close-out netting provision, while repudiating the remaining contracts;[16]

ii. the operation of the close-out netting provision should not be stayed;[17]

iii. the operation of the close-out netting provision should not be impaired by principles relating to the equal or* pari passu *treatment of creditors;[18]

iv. a close-out netting provision should not be unenforceable solely on the basis that it was entered into during a prescribed period before, or on the day of but before, the commencement of the proceeding.[19]

Key considerations

- The enforceability of close-out netting agreements often conflicts with a number of general commercial and insolvency law rules. This principle aims at protecting close-out netting agreements from the effect of the application of these rules.
- Close-out netting agreements shall be enforceable between the parties and against third parties, including the insolvency administrator and the general insolvency creditors, if applicable, of the defaulting party.
- 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 rules that should continue to apply requires careful consideration. Special attention should be paid to the compatibility of enforceable close-out netting agreements with supervisory authorities' bank resolution powers.
- For purposes of international compatibility, a common standard in this regard is of utmost importance.

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[12] *Cf.* Former Principle 10.
[13] *Cf.* Former Principle 11.
[14] *Cf.* former Principle 13.
[15] *Cf.* former Principle 16.
[16] Newly inserted.
[17] Newly inserted.
[18] Newly inserted.
[19] *Cf.* former Principle 15.

Explanation and commentary

Chapeau

84. The *chapeau* of this principle aims at clarifying two aspects.

85. First, it makes sure that the scope of the protection covers non-insolvency situations as well as the insolvency of one of the parties to the netting provision.

86. 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*).

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

88. 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.

89. However, the enforceability of close-out netting is crucial both inside and outside insolvency. Accordingly, the purpose of the *chapeau* is to make clear that the law should protect the enforceability of a close-out netting provision throughout its lifetime and regardless of what type of procedure might be opened over one or both of the parties (regarding the special status of bank resolution procedures, *cf. infra*). To this end, the definition of 'insolvency proceeding' has been kept very wide (*cf.* [special definition]). In this context, it is worth noting that procedures which are technically not insolvency proceedings such as amicable creditor settlements, are also included in the scope of protection (which leaves however unaffected the possibility to change the close-out netting provision by agreement).

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 commercial and insolvency 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)-(c). However, as close-out netting agreements 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 agreement unenforceable. These are potentially numerous, but difficult to describe.

91. 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.

92. 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 netting, in the absence of any clarifying legal rule courts and insolvency administrators might apply its requirements in analogy to close-out netting agreements, thus potentially distorting the enforceability of close-out netting. In particular, (i) set-off traditionally applies only to obligations that are due; (ii) 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. 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.

93. However, as analogies like these are probably very diverse, there is a need for a 'catch-all' rule. This is why the *chapeau* prescribes that close-out netting, as defined in functional terms in *Principle 1*, should be generally enforceable.

94. 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. In certain cases, the distinction may be quite difficult to make (*cf.* in particular *paragraph (c)(iv) infra*). This is why 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 disapplied.

95. Additionally, there are legal rules specifically intended to supersede close-out netting agreements, in particular rules applicable in the context of bank resolution.

Paragraph (a) – Additional enforcement requirements

96. 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 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,

- Notarisation or registration of the agreement with a public authority;
- 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 agreement 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 agreement be operated in a prescribed manner, or that
- the close-out netting agreement be subject to the requirements that may apply in the context of enforcing set-off.

97. 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.

Paragraph (b) – Non-enforceable financial contract included, no contagion

98. Another group of potential obstacles to the enforceability of netting provisions relates to the financial contracts covered. Where the applicable law characterises a particular type of contract as a non-enforceable contract, the enforceability of the netting provision as a whole, *i.e.*, with respect to the remaining financial contracts, might be endangered.

99. A first possible case relates to the inclusion of non-eligible contracts in the close-out netting agreement.

100. A second scenario relates to financial contracts that might not be enforceable *per se* in certain jurisdictions as a result of, for instance, legal rules of general commercial or contract law, *e.g.*, rules on misrepresentation or agency.

101. A rather prominent case relates to wagering or gaming prohibitions. This falls within the ambit of the previous group. Unenforceability on the grounds of such bans may in some jurisdictions be a cause for real concern, in particular in relation to derivative contracts.

102. Since the close-out netting provision and all the financial contracts 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. A better solution would be to exclude from the netting mechanism only specific non-enforceable contracts once they have been identified.

103. It is important to note that this rule does not interfere with the question of whether the *single* contract, under the applicable law, is enforceable or not.

Paragraph (c)(i) – Cherry picking

104. In an insolvency proceeding, the insolvency administrator often has the right to 'cherry pick' from the insolvent party's non-performed contracts. This means that the insolvency administrator is entitled to require any counterparty to perform those contracts that are favourable to the insolvent estate.

105. Where cherry picking applies to the financial contracts covered by a close-out netting provision, the bundle of financial contracts intended to be covered by the close-out netting mechanism would be disassembled and the solvent party would have to perform all the contracts that were unfavourable from its perspective, whereas the insolvency administrator would not perform the favourable contracts – ultimately, the solvent party would be exposed to the full counterparty risk.

106. Cherry picking is essentially contrary to the characteristics of a single relationship set out *supra* (*cf*. *key considerations* in respect of Principle 3). 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 contracts but giving the insolvency administrator the right to decide whether the net amount is to be paid or not.

Paragraph (c)(ii) – Stay

107. 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 be given the right to repudiate all unfavourable contracts. However, a stay imposed on the termination of financial contracts might lead to contagion from the insolvent party to the solvent party in the sense that the latter becomes unable to perform on its own obligations vis-à-vis third parties ('systemic risk'). Further, from a conceptual angle, a stay appears unnecessary because the insolvency administrator should not have the right to choose among the open contracts (no cherry picking, *cf. supra*).

Paragraph (c)(iv) – Suspect periods, zero-hour rules

108. National insolvency laws often contain rules allowing the insolvency administrator or a court to avoid transfers or payments made prior to the opening of the insolvency proceeding, usually on the ground that not to do so would give an unjustified preference to one or more creditors over the remaining creditors, or give rise to unjustified deprivation of the insolvent estate of the relevant assets. In some jurisdictions, only transfers and payments that were made within a legally defined 'suspect period' can be avoided, whilst in other jurisdictions no time limit exists. In the context of

netting, the risk is that netting will be equated with performance of the obligations flowing from the financial contract.

109. However, the effect of close-out and termination under a netting agreement is not the same as that targeted by the insolvency avoidance rules. Parties cannot know at the time when they enter into a netting agreement which of them might subsequently become insolvent and which party will be 'in the money'. Thus, entering into a close-out netting agreement is neutral from the outset and equally beneficial or disadvantageous to both sides.

110. As netting agreements often define the termination event as something that might occur chronologically before but close to the opening of an insolvency proceeding (for example, the default of one of the parties), the netting mechanism might fall within the scope of the insolvency avoidance rules. Even in cases where the insolvency administrator's attempt to void the transfer or payment is subsequently overruled by a court, the netting agreement would not achieve its purpose of decreasing exposure to the counterparty's risk and avoiding contagion by the insolvency of one party affecting other participants in the financial market, which likewise constitutes a situation capable of creating systemic risk. As a consequence, the law should shield close-out netting provisions against rules on suspect periods and from zero-hour rules.

111. Consideration should be given to the question of whether this rule should also apply to the single financial contract covered by the close-out netting provision, *i.e.* whether a contract entered into during a suspect period cannot be avoided either. At any rate, if there were no such rule, any contagion of the entire bundle of contracts would be avoided under the rule described under *Paragraph (b)*.

Principle 8: Conflict-of-laws Rules for Close out Netting

[tbd.]

Notice

This draft is a work in progress and has been released at this time for discussion purposes only. The draft will undergo future revisions as regards both substance and form on the basis of ongoing discussions in the UNIDROIT Study Group on principles and rules on the netting of financial instruments.

Members of the UNIDROIT Study Group for this project who have participated in the development of this draft have done so on a strictly personal basis. While their collaboration on the project brings extensive experience in the field from around the world, their views as expressed in this draft do not necessarily reflect the views of the institutions they represent.

Comments on substantive issues raised by this draft may be sent by mail to the International Institute for the Unification of Private Law (UNIDROIT), attn. Annick Moiteaux, Via Panisperna 28, 00184 Rome, Italy, or by e-mail to a.moiteaux@unidroit.org.