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Philipp Paech

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Close-out Netting, Insolvency Law and Conflict-of-Laws

Philipp Paech *

Abstract: Close-out netting is a risk mitigation tool used by financial institutions. It is comparable to set-off and in insolvency situations any solvent counter-party that is able to use it obtains a very strong position as compared to other creditors. Therefore, it might conflict with the *pari passu* principle. Many jurisdictions have solved that conflict and adapted their laws so that close-out netting is enforceable even in the event of insolvency. However, as the financial market is global, the parties, their branches and assets might be located in different jurisdictions. Still, countries failed to agree on a harmonised conflict-of laws rule, despite the obvious need, when they decided not to include a conflict-of-laws principle in the 2013 *Unidroit Principles on the Operation of Close-out Netting Provisions*. The relevant EU law, though patchy, already addresses this concern. This Article identifies the underlying conceptual difficulties and proposes a solution for an improved framework for both the EU and other financial marketplaces.

* Assistant Professor of Law, London School of Economics and Political Science. The author was member of the UK delegation to UNIDROIT and *rapporteur* to both the Study Group and to the Intergovernmental Committee of UNIDROIT Member States for the adoption of the UNIDROIT Principles on Close-out Netting. The author is grateful to Francisco Garcimartín, Jan Kleinheisterkamp, Jacco Bomhoff, Niamh Moloney and Michael Bridge for their comments on an earlier draft of this article, as well as to Holger Hartenfels and Hendrik Haag, fellow panellists at a conference on this subject organised by the Institute for Law and Finance (Frankfurt). Any errors are the author's own.

A. THE SUDDEN DEATH OF A CONFLICTS NORM

The idea for this article sparked from an episode that took place at an intergovernmental conference in Spring 2013—the final session of the ‘UNIDROIT’ Committee of Governmental Experts for the adoption of international legal principles on close-out netting¹—where one of the most important parts of the negotiated text miraculously disappeared during the morning coffee break. In a matter of minutes, the relevant Principle 9 setting out a conflict-of-laws rule for close-out netting was deleted. This important change was recorded in the official report in one brief sentence.² The proposal for deletion was submitted by France and supported by the UK, the US and the EU Commission. Other delegations did not object. As a consequence, the only internationally agreed instrument in this area was adopted without a conflict-of-laws rule.

Remarkably, delegations had previously underlined the importance of clarifying the conflict-of-laws framework.³ At the very beginning of the negotiations, France had even pushed hard—though unsuccessfully⁴—to have Principle 9 negotiated *before* any of the eight substantive provisions, highlighting the fact that settling on the substantive law would not make much sense and might be counterproductive if there was no clarity on the conflict-of-laws regime.

What was behind this sudden change of heart? On the surface, it was the usual argument referring to complexity and available time—but complexity could not possibly have come as a surprise to any of the negotiating States because, as we will see in Section C below, the enforceability of close-out netting is primarily a matter of insolvency law, the co-ordination of which is known to be one of the most painful exercises in any legal harmonisation project, particularly when it comes to cross-jurisdictional issues and conflict-of-laws.⁵ We may safely assume

¹ International Institute for the Unification of Private Law (UNIDROIT), *Principles on the Operation of Close-out Netting Provisions* (2013), available online at <http://www.unidroit.org/english/governments/councildocuments/2013session/cd92-06a-e.pdf>, last accessed on 27 December 2013. The adopted text of the Principles is in the following referred to as ‘UNIDROIT Netting Principles’.

² ‘It was agreed that this provision should be deleted.’, UNIDROIT, *Report on the Second Session of the Committee of Governmental Experts on the Enforceability of Close-out Netting Provisions* (C.G.E./Netting/2/report), March 2013, Paragraph 153, available online at <http://www.unidroit.org/english/documents/2013/study78c/cge-02/cge-2-report-e.pdf>, last accessed on 27 December 2013.

³ See UNIDROIT, *Report on the First Session of the Committee of Governmental Experts on the Enforceability of Close-out Netting Provisions* (C.G.E./Netting/1/Report), paragraphs 98-112, available online at <http://www.unidroit.org/english/documents/2012/study78c/cge-01/cge-1-report-e.pdf>, last accessed on 27 December 2013; Report on the Second Session of the Committee, *ibid*, paragraphs 88-95.

⁴ See Report on the First Session of the Committee, *ibid*, paragraph 3.

⁵ See a parallel argument in relation to cross-jurisdictional securities holding, transfer and collateralisation, the enforceability of good-faith acquisition and conflict-of laws, P Paech, ‘Market Needs as Paradigm – Breaking up the Thinking on EU Securities Law’, in PH Conac, L Thévenoz and U Segna (eds), *Intermediated Securities*, (Cambridge University Press, 2013), 22-64.

that, as a matter of course, those delegations that had previously stressed the indispensability of agreeing a conflict-of-laws rule were not struck by total amnesia overnight, and that they were fully aware of the fact that legal certainty would suffer from the absence of such a rule. Rather, the motive for this *volte face* may have been that the negotiating States—some consciously, others innocently — ultimately preferred to maintain a certain level of ambiguity, that ambiguity that is inherent in the private international law framework of close-out netting—as will be shown in Section D—, even at the expense of maintaining a significant degree of legal uncertainty. They seem to have been confident that if the law is tested in—domestic!—court proceedings, judges will guarantee that the national law will resolve any cross-jurisdictional issues appropriately. This pattern may be observed in related areas as well⁶ and may therefore represent a common phenomenon in the area of financial law.

Most jurisdictions accept party autonomy. As a consequence, parties can determine not only the substance of the relevant rights and obligations but also the jurisdiction the law of which is to govern the contract. In respect of the financial market, most countries have accepted that English or New York law applies widely where party autonomy reigns. However, once a party becomes insolvent, mandatory insolvency law kicks in from which it is not easy for parties to derogate. Thus, in case of insolvency the law remains firmly within the purview of the *forum* State. That is why efforts to harmonise conflict-of-laws rules are looked at with distrust where it is suspected that they may erode this mandatory character, *i.e.*, as soon as they are perceived as bringing aspects of insolvency law from the scope of domestic law into the scope of a foreign law.

The principal aim of this article is to show that it is a fallacy to believe that maintaining ambiguity in the conflict-of-laws regime governing close-out netting is necessary for the sake of preventing the erosion of national mandatory law. States must acknowledge that globalised financial markets cannot work properly and safely against a backdrop of heterogeneous and thus potentially conflicting national frameworks. They should relax their insistence on the primacy of their own insolvency law in cross-jurisdictional situations, at least to some small extent, in exchange for a comprehensive and consistent international framework better able to serve the aims of certainty while at the same time implementing States' insolvency policies more efficiently, as shown in Section E. Such framework should ideally be provided by a global standard.

Some clarifications are in order. If one were trying to describe in two words the nature of close-out netting, 'extended set-off' would probably be an adequate term. The mechanism is based on a contractual agreement between the parties allowing the non-defaulting party to terminate all open contracts with the defaulter

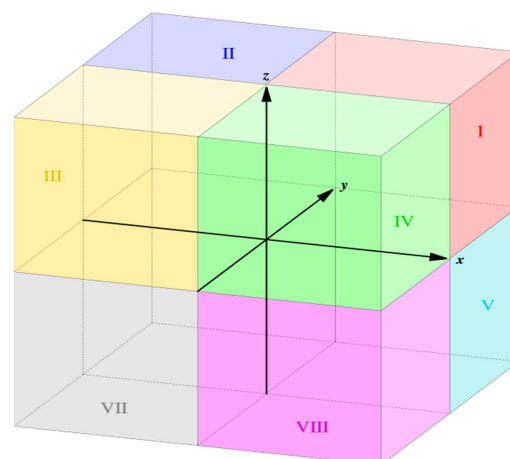
⁶ The issue raised in note 5 is probably the most notorious example in the area of financial law. National laws obviously do not provide consistent solutions for conflict-of-laws situations. They are fragmented, as is EU legislation in this field. However, an international convention capable of removing that legal uncertainty, the Hague Securities Convention, first adopted in 2002, is now unlikely to be implemented by the Contracting States, mainly due to resistance from a handful of them, see Paech, *ibid.*, 51-53.

and determine the market value of all of these, which are then to be set-off against each other so that only a single amount is owing (either to the defaulter or to the non-defaulter, depending on who is 'in the money'). In essence, a close-out netting agreement aims at arranging a privileged position for a creditor in its counterparty's insolvency, remotely comparable to the privilege that a secured creditor obtains. As we will see, this commercial law concept is the spearhead of risk mitigation in the financial market, together with security and collateral.

The following model should assist in delineating the scope of the analysis, as the relevant playing field could be described as confusing, at best. To begin with, there are eight different scenarios to consider and the legal analysis of close-out netting could be seen as hovering in a three-dimensional model, the three axes of which represent three dichotomies.

On the x-axis, 'solvent' is positive and 'insolvent' negative, *i.e.*, it mirrors the question of whether insolvency proceedings have been opened over one of the parties to a close-out netting agreement. Regimes obviously change depending on that question, with party autonomy reigning among solvent parties, whereas mandatory insolvency law to a great extent controls the insolvent ones as well as their counterparties. The y-axis refers to the distinction between the commercial non-financial world (positive) and the financial world (negative).

In relation to close-out netting, the law may change dramatically depending on whether or not financial institutions are involved. The z-axis relates to the internationality of the relevant scenario, *i.e.*, the question of whether all facts of a given case are to be analysed on the basis of one law, or whether or not international and conflict-of-laws considerations are relevant ('domestic' is positive and 'cross-jurisdictional' is negative).



Source: LH Rohwedder, [http://de.wikipedia.org/wiki/Oktant_\(Geometrie\)](http://de.wikipedia.org/wiki/Oktant_(Geometrie))
Licence: http://commons.wikimedia.org/wiki/File:Octant_numbers.svg

All eight theoretically possible combinations of the aforementioned factors do arise in practice, *i.e.*, all octants of our model are occupied in commercial reality.

The cosiest octant, from a legal viewpoint, is the first (all positive) which corresponds to the solvent, non-financial, purely domestic scenario (example: two local energy producers enter into a close-out netting agreement and make use of it without either of them becoming bankrupt). However, this article exclusively addresses scenarios belonging to the admittedly somewhat extreme—from the legal viewpoint—seventh octant (all negative), notably cross-jurisdictional situations involving financial market players, one of which has become or is about to become insolvent (example: an English hedge fund and a French insurance company enter into repurchase transactions covered by a close-out netting agreement before the insurance company goes bankrupt and the hedge fund attempts to enforce their close-out netting agreement in French insolvency proceedings). Though ‘extreme’, scenarios belonging to this octant are ubiquitous in practice, involving staggering amounts of money, and they are pivotal in terms of financial market stability. The reason why this octant is so tricky is because it involves the interaction of insolvency regimes, contractual arrangements and the question of the applicable laws; moreover, the relevant rules are spread out in an array of national and EU pieces of legislation, with all the typical incongruities that classically derive from sectoral multi-layer rules which are not made all of a piece.

At this point, it is important to note that the ideas expounded in this article apply only, in one way or another, to jurisdictions that recognise close-out netting in insolvency. Such jurisdictions are commonly called ‘netting-friendly’. The uncertainties described in relation to these jurisdictions grow exponentially as soon as netting-*unfriendly* jurisdictions are involved. Furthermore, it should be noted that the ambit of this article is not confined to EU law and to the law of EU Member States. However, the European context is much in evidence as it offers the only internationally binding standards on close-out netting, the UNIDROIT Netting Principles being non-binding and still fairly new. Therefore, EU law serves as an excellent example for both positive steps taken and negative consequences flowing from unclear laws in view of the enforceability of close-out netting. The conclusions drawn in relation to EU law apply *mutatis mutandis* to any other netting-friendly jurisdiction.

This article will seek to conduct the analysis without referring extensively to the details of national or European legislation simply because that landscape is itself so complicated and fragmented that it is only too easy to lose sight of the underlying principles. As will be shown later on, there are four EU regimes in this area, two of which address close-out netting directly but in a different manner—although there is substantial overlap. The other two address the neighbouring area of set-off but *not* close-out netting, and their effect in this respect is questionable. One of the EU instruments is a regulation and thus directly applicable. The other three instruments are directives and are thus implemented in all EU jurisdictions, albeit in different ways and with a number of material differences, which is hardly surprising. On top of that, as there are situations involving close-out netting which are not addressed by either of the EU instruments, there is still room for autonomous domestic law to apply to close-out netting. Also, non-EU

jurisdictions often have more than one set of rules that address close-out netting. This article is not aimed at cutting through this thicket. Rather, it will only consider the relevant principles and main legislative messages in relation to the seventh octant (cross-jurisdictional—insolvent—financial institutions) and leave any wrangling over details not germane to the present purpose for some other occasion.

The analysis proceeds as follows. Having discussed some of the key features of close-out netting and its interdependencies with insolvency (section B), it goes on to illustrate the consequences if the scenario located in the ‘seventh octant’, *i.e.*, when the situation not only involves the insolvency of a financial institution but is in addition international. It is here that the conflict between the *lex contractus* and the *lex fori concursus creditorem* arises (section C.). This section is divided into, first, an analysis of the interplay between the *lex contractus* and the *lex fori concursus* in general terms (C-1.), and second, an analysis of the EU framework in this regard (C-2.), together with an analysis of the two areas that countries prefer to reserve for the *lex fori concursus*, notably the implementation of the *pari passu* principle (C-3.) and the definition of the scope of the netting privilege (C-4.). In the following section (D.), the various pieces will be pulled together and it is submitted that while the erosion of mandatory insolvency law is inevitable, there is no coherent framework providing for certainty and stability to make up for the loss of consistency. The final section (E.) returns to the discomfort States feel in relation to such a new framework and seeks to formulate a concept capable of dissolving that discomfort by intertwining conflict-of-laws and substantive law rules.

B. CLOSE-OUT NETTING AS INSOLVENCY PRIVILEGE FOR FINANCIAL INSTITUTIONS

Any bank or other participant in the financial markets takes risks and therefore exposes itself to the other party’s insolvency. That exposure materialises with the opening of insolvency proceedings over the other party’s estate. Any two major financial players, for instance two globally active banks, will have hundreds or thousands of open contracts between them at any given point in time, for example derivative transactions or repurchase agreements. Each contract creates exposure to the relevant counterparty’s solvency, the ‘counterparty credit risk’. Close-out netting is a process intended to reduce that exposure should one party become insolvent or should a like event occur. To this end, parties enter into close-out netting agreements, usually (but not necessarily) in the form of a master agreement, as, for instance, the ISDA master agreement⁷ for derivatives. Such a

⁷ See, *e.g.*, Sections 5 and 6 Master Agreement for derivatives transactions (2002 version) promoted by International Swaps and Derivatives Association (‘ISDA’), not publicly available; Section 10 *Global Master*

close-out netting agreement covers the entire bundle of open contracts between the parties.

1. FUNCTIONALITY

In the event of default or insolvency, the close-out netting agreement typically provides that the solvent or non-defaulting party can terminate all outstanding contracts between the parties, calculate the losses and gains on each contract and then set them off so that only a balance is owing.⁸ That balance is often called the ‘net amount’. If the net amount is positive for the insolvent estate, the solvent party must pay. If, by contrast, the solvent party is ‘in the money’, the insolvent party will not pay but the solvent party becomes general creditor in the amount of the calculated balance, if not covered by security or collateral.

Close-out netting is different from solvent (‘common’) set-off. The latter traditionally applies only to obligations of the same kind which are already due, whereas the former is designed to aggregate the values of a multitude of contracts that are still open with variable content.⁹ In that respect, close-out netting is very similar to a process known as insolvency set-off. A classic example for insolvency set-off is Rule 4.90 of Insolvency Rules 1986 in the UK. This rule provides that, before a company goes into liquidation, an account must be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party must be set off against the sums due from the other, even if the sums are not yet due, contingent or need to be ascertained. Close-out netting achieves the same or a very similar result but is based on contract and therefore benefits from party autonomy, whereas the insolvency set-off rule is mandatory law. Under a contractual agreement, issues of connexity, acceleration of maturity, set-off of non-congeneric claims can be altered unlike in insolvency set-off,¹⁰ as can the speed at which the mechanism comes into effect (this may even happen automatically) and the methods deployed to value the terminated positions.

Repurchase Agreement (2011 version) promoted by the International Capital Markets Association (‘ICMA’), available online at http://www.icmagroup.org/assets/documents/Legal/GMRA-2011/GMRA-2011/GMRA%202011_2011.04.20_formular.pdf, last accessed on 12 April 2014, and Section 11 *Global Master Securities Lending Agreement* (2010 version) promoted by the International Securities Lending Association (ISLA), available online at <http://www.isla.co.uk/index.php/master-agreements/gms-la>, last accessed on 12 April 2014); Sections 6 and 7 *European Master Agreement* (2004 version), which is a multi-product standard contract promoted by the European Banking Federation (EBF), available online at <http://www.ebf-fbe.eu/european-master-agreement-ema/>, last accessed on 12 April 2014). There are many other regional and national master agreements. Even though close-out netting agreements are included in such standardised contracts, they could be self-standing and separately entered into, see P Paech, *The Need for an International Instrument on the Enforceability of Close-out Netting in General and in the Context of Bank Resolution*, (2011) UNIDROIT Study S78c, Doc. 2, 11.

⁸ See *Commissioners for Her Majesty’s Revenue & Customs v Enron Europe Ltd*, [2006] EWHC 824 (Ch), [2006] B.C.C. 953, at [20], per Lightman J.

⁹ See on the delimitation of set-off, settlement netting, net settlement and close-out netting P Paech, ‘The Enforceability of Close-out Netting’ (2013) 1 *Journal of International Banking and Financial Law*, 13, 14.

¹⁰ See Dalhuisen, *Transnational Comparative, Commercial, Financial and Trade Law*, Vol. 3 (Oxford and Portland, Hart, 4th edn, 2010), 344.

As is often the case, commercial law in its development trails behind market practice. As a result, close-out netting is still a relatively new addition to the legal terminology.¹¹ Furthermore, until recently there was no common understanding of exactly which functions close-out netting encompasses and how these functions might be appropriately translated into legal concepts indigenous to the various jurisdictions. Legal definitions of close-out netting are always based on a specific domestic view. The definition presented at the beginning of this section, for instance, is based on an English court decision (see note 8) and is therefore a definition from an English perspective, comprising the elements of termination, valuation, and set-off. In other jurisdictions, that definition might not work, for instance because the term ‘set-off’ might be inappropriate in that context, as set-off might require the mutual claims to stem from the same or connected legal relationships. The UNIDROIT Netting Principles, adopted in May 2013, now provide a functional definition that is universally valid in order to guarantee that all clauses that achieve functionally the same result are covered by the Principles.¹²

2. MARKETS AND REGULATORS

From an international perspective, then, the legal framework is still patchy, despite the fact that close-out netting is well-nigh universally used in financial and certain other markets. Most importantly, close-out netting has been legally sanctioned for some 20 years now by the relevant banking regulation, notably the ‘Basel Accords’ on capital requirements for banks.¹³

¹¹ In 1989, within the Bank for International Settlements, the Group of Experts of the Central Banks of the Group of Ten Countries (the predecessor of the Basel Committee on Banking Regulation) issued the *Report on Netting Schemes*, available online at bis.org/publ/cpss02.pdf, last accessed on 12 April 2014. This report was probably the starting point for the prevalence of the concept and terminology of netting. Its findings are still valid. Simultaneously, ‘netting’ started to appear as a concept in legislative acts, albeit very few. Later on, ‘close-out netting’ became widely used under the master agreements provided by market associations, see *supra*, n 7.

¹² UNIDROIT Netting Principles (*supra*, n 1), Principle 2: “‘close-out netting provision’ means a contractual provision on the basis of which, upon the occurrence of an event predefined in the provision in relation to a party to the contract, the obligations owed by the parties to each other that are covered by the provision, whether or not they are at that time due and payable, are automatically or at the election of one of the parties reduced to or replaced by a single net obligation, whether by way of novation, termination or otherwise, representing the aggregate value of the combined obligations, which is thereupon due and payable by one party to the other.”

¹³ See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards – A Revised Framework, Comprehensive Version*, June 2006, paragraphs 117, 118, 139, and 188. The introduction of ‘net risk’ in the Basel II Accord marks the point at which close-out netting was firmly introduced in international finance. Its importance has remained unchanged, as is confirmed in recent international regulatory texts, in particular those of the Financial Stability Board, *Key attributes for effective resolution regimes for financial institutions*, available online at http://www.financialstabilityboard.org/publications/r_111104cc.pdf, last accessed on 14 April 2014. More detailed is the predecessor document, Basel Committee on Banking Supervision, *Report and Recommendations of the Cross-border Bank Resolution Group*, March 2010, available online at <http://www.bis.org/publ/bcbst169.pdf>, last accessed on 14 April 2014, Recommendation 8, 36-38.

Close-out netting provisions are a main building block of standard documentation for, in particular, derivatives transactions, foreign exchange contracts, repurchase agreements and securities lending agreements.¹⁴ Moreover, central counterparties (CCPs), *i.e.*, infrastructures for central clearing of derivatives and other financial instruments, proceed on the basis that their exposures towards their participants are limited by the application of close-out netting and are covered by financial collateral.¹⁵ Also, central banks use close-out netting in the context of their financing operations when providing cash to commercial banks against delivery of collateral. It is probably fair to say that close-out netting is *the* commercial law mechanism underlying the major part of modern wholesale financial transactions, together with collateralisation.¹⁶

Regulatory statistics show that the mutual exposures between parties to the aforementioned types of transaction are reduced by 85% as a consequence of having them covered by a close-out netting agreement.¹⁷ In other words, where a bank would have risked losing '100' in its counterparty's insolvency under traditional rules, it will now only lose '15'. The financial industry and regulatory community agree that close-out netting has a hugely beneficial fall-out for systemic stability¹⁸ as the feared domino effect of bank insolvencies is much less likely to occur.¹⁹ Whereas supervisors are naturally concerned above all with that systemic

¹⁴ See *supra*, n 7.

¹⁵ See J Braithwaite, 'The Inherent Limits of 'Legal Devices': Lessons for the Public Sector's Central Counterparty Prescription for the OTC Derivatives Market' (2011) 12 *European Business Organization Law Review*, 87, 104-114

¹⁶ See M Bridge and J Braithwaite, 'Private Law and Financial Crisis', (2013) 13 *Journal of Corporate Law Studies* 361, 364, underlining that given the absence of collection and enforcement cost, it is even more effective than collateral.

¹⁷ The Bank for International Settlements provides data illustrating the effect of close-out netting in relation to the example of the derivatives market (the effects are comparable in relation to the repo and securities lending market): the notional amount (face value) of all types of OTC contracts stood at approximately USD 693 trillion at the end of June 2013. The gross market value of these contracts, *i.e.*, the cost of replacing all of them by equivalent contracts at the market price, was approximately USD 20 trillion. This amount corresponds to the gross market risk inherent in these contracts, *i.e.*, market participants were, on an aggregate basis, exposed to each other by that sum. At the same time, market participants' aggregate actual credit exposures, *ie*, the remaining credit risk taking into account legally enforceable netting agreements, amounted to USD 3.9 trillion, which represents a risk reduction of about 80 %. See Bank for International Settlements, *OTC Derivatives Statistics at End-June 2013* (November 2013), 2, available online at http://www.bis.org/publ/otc_hy1311.pdf, last accessed on 4 January 2014.

¹⁸ Systemic stability is at risk where market participants are exposed to each other's failure in such a way that the inability of one financial market participant to meet its obligations when due will cause other participants to fail to meet their obligations when due, Bank for international Settlements, *Report on Netting Schemes*, *supra*, n 11, 10.

¹⁹ However, academia sees this issue as more critical, stressing in particular that it is due to close-out netting that banks are able to inflate their balance sheets to an extent they could never achieve without being allowed to calculate exposures on a net basis: D Duffie and D Skeel, 'A Dialog on the Costs and Benefits of Automatic Stays', Rock Centre for Corporate Governance at Stanford University Research Paper No. 108, (March 2012), 7-8, available online at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1982095, last accessed on 4 January 2014; M Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator' (2011) 63 *Stanford Law Review*, 539, 555-559; E Perotti, 'Systemic Liquidity Risk and Bankruptcy Exceptions', Duisenberg School of Finance Policy Papers Series, No 8 (October 2010), 1-2, available online at <http://dare.uva.nl/document/461912>, last accessed on 4 January 2014. See for a brief overview of arguments European Parliament, Committee for Economic and Monetary Affairs, *Shadow Banking: Legal*

aspect, banks are even more interested in the positive effect on their liquidity and capital structure. As risk management under the Basel Accord allows Banks to calculate exposures, on a continuous basis, using only net amounts,²⁰ only the net risk, which we will assume here to be around 15%, needs to be collateralised and covered by sufficient capital buffers. As a result, banks can finance themselves considerably more cheaply and use freed liquidity for additional transactions. Lower cost and improved liquidity, in turn, appeal to governments as they render financial market places more attractive. As a consequence, there is broad support for this mechanism from both the private and the public sector.

3. THE KEY ISSUE: TO PROTECT ENFORCEABILITY IN INSOLVENCY

However, the parties, their supervisors and the market as a whole can build on these beneficial effects only to the extent that there is the highest possible degree of *ex ante* certainty that the close-out netting provision agreed between the parties will actually be enforceable once it is needed, that is to say, as soon as one party defaults or becomes insolvent and the counterparty terminates the entire bundle of contracts as a consequence.²¹

A netting agreement is a contract and therefore subject to party autonomy, and there are no particular obstacles to its enforceability as long as both parties are *solvent* and netting occurs as a consequence of a simple default situation. However, the legal environment changes dramatically where close-out netting occurs as a consequence of the *insolvency* of one of the parties. The background to this scenario is that in places where insolvency set-off has always been an alien concept, *i.e.*, in most civil law countries of the ‘Napoleonic’²² type, and the US, close-out-netting is seen as contrary to fundamental principles of insolvency law, notably *pari passu* and its emanations,²³ and hence, the terms of the contract would be overridden by the insolvency law and its mandatory rules.²⁴ As a consequence, enforceability in insolvency is doubtful.

Issues of Collateral Assets and Insolvency law (June 2013), 10-11, available online at [http://www.europarl.europa.eu/RegData/etudes/note/join/2013/507460/IPOL-ECON_NT\(2013\)507460_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/note/join/2013/507460/IPOL-ECON_NT(2013)507460_EN.pdf), last accessed on 4 January 2014.

²⁰ See *supra*, n 13 and accompanying text.

²¹ The *ex ante* assessment of enforceability is therefore a requirement following paragraph 188(a) of the Basel II Accord, *supra*, n 13.

²² See PR Wood, *Principles of International Insolvency*, (London, Sweet & Maxwell, 2nd edn, 2007), paragraph 6-006, as opposed to the ‘Germanic type’.

²³ For ease of reference, this article adopts a broad understanding of *pari passu* as the principle of equal treatment of general creditors which informs three questions, notably which assets are available for distribution, who participates in the distribution and how the assets should be shared amongst the general creditors (notably *pro rata*). However, in detail these three issues differ conceptually, see, for example, Bridge and Braithwaite, *supra*, n 16, 367-370.

²⁴ P Paech, *supra*, n 7, 33-34, available online at <http://www.unidroit.org/english/documents/2011/study78c/s-78c-02-e.pdf>, last accessed on 4 January 2014; O Böger, ‘Close-out Netting Provisions in Private International Law and International Insolvency Law’ (Part I, 2013) 18-2 *Uniform Law Review*, 232, 250.

Most developed economies have come to realise the potential of this issue as a crucial factor in determining the attractiveness of their financial market places, largely because their own banks were suffering from the continuing legal uncertainty.²⁵ Furthermore, legislators expect to support market liquidity by enabling their market participants to calculate their exposures and therefore their capital requirements on a 'net' basis.²⁶ More and more countries have accordingly amended their laws to become netting-friendly,²⁷ and the mechanisms designed to enforce the *pari passu* principle, notably avoidance and cherry-picking powers, have been disapplied to the extent to which the legislator has decided to protect the enforceability of close-out netting. Therefore, in netting-friendly jurisdictions, these mechanisms are generally not available to the insolvency administrator in respect of close-out netting. Parties to a close-out netting agreement can therefore rely on its enforceability in insolvency.

Principle 7(1) of the UNIDROIT Netting Principles, the core rule on enforceability, illustrates how national rules should be shaped should the legislator decide to protect the enforceability of close-out netting:

[...] the law of the implementing state should ensure that upon the commencement of an insolvency proceeding [...] in relation to a party to a closeout netting provision:

- (a) the operation of the close-out netting provision is not stayed;
- (b) the insolvency administrator, court or resolution authority should not be allowed to demand from the other party performance of any of the obligations covered by the close-out netting provision while rejecting the performance of any obligation owed to the other party that is covered by the close-out netting provision;
- (c) the mere entering into and operation of the close-out netting provision as such should not constitute grounds for the avoidance of the closeout netting provision on the basis that it is deemed inconsistent with the principle of equal treatment of creditors;
- (d) the operation of the close-out netting provision, and the inclusion of any obligation in the calculation of the single net obligation under the close-out netting provision, should not be restricted merely because the close-out netting provision was entered into, an obligation covered by the provision arose or the single net obligation under the close-out netting provision became due and payable during a prescribed period before, or on the day of but before, the commencement of the proceeding. [...]

²⁵ I Annetts and E Murray, 'Set-off, Netting, and Alternatives to Security' in D Prentice and A Reisenberg (eds.), *Corporate Finance Law in the UK and EU* (Oxford University Press, 2011), 269, 281.

²⁶ See Paech, *supra*, n 24, 17-19.

²⁷ At the moment, ISDA refers to 44 jurisdictions as having close-out netting-friendly legislation in place, see online at http://www.isda.org/docproj/stat_of_net_leg.html#f1, last accessed on 4 January 2014.

As a functional rule, Article 7(1) focuses on describing the results to be achieved by domestic legislation, without suggesting the relevant legislative means and techniques. This is because jurisdictions use different methods to achieve the same result and it would be too cumbersome and indeed unnecessary to try to achieve a truly uniform conceptual solution.

Generally, the methods employed to ensure the enforceability of close-out netting appear to fall into three categories: (i) the carve-out, (ii) the blunt reference to the parties' agreement and (iii) the assimilation of close-out netting with insolvency set-off. The relevant Belgian law is a good example of the carve-out type of legislation. In short, it provides that a number of requirements—the *pari passu* principle, the maturity requirement and the requirement that the obligations need to be of the same kind or in the same currency—do not apply to close-out netting agreements.²⁸ It disapplies these requirements in relation to close-out netting but stops short of a broader statement to the effect that such agreements are generally enforceable. English financial collateral legislation on the other hand is an example of the 'blunt statement' approach, in that it simply declares that close-out netting agreements are enforceable despite the opening of insolvency proceedings.²⁹ Lastly, German law provides an example of the third approach. Netting agreements are valid before insolvency (as a matter of freedom of contract) and their effects must be accepted by the insolvency administrator.³⁰ Upon insolvency, insolvency set-off kicks in by operation of law which is deemed to have the same effect as netting agreements, as protected under the Financial Collateral Directive.³¹ The UK also follows this approach in its framework where

²⁸ The rule is not, however, an easy read: 'Netting agreements as well as termination clauses, conditions subsequent or acceleration clauses stipulated in order to allow novation or set-off, may, without any prior notice or default of judicial decision, notwithstanding any transfer of rights thereunder, in the case of an insolvency proceeding, attachment or any situation where the *pari passu* principle applies, be enforced upon creditors provided the claims and debt be novated or set-off existed at the time of opening of the insolvency proceeding, the attachment or situation where the *pari passu* principle applies, irrespective of their maturity date, subject-matter or the currency in which they are denominated.' Article 3 paragraph 4 and Article 14 Financial Collateral Act 15 December 2004 (Belgium), English translation adopted from PR Wood, *Set-off and Netting, Derivatives, Clearing Systems*, (Sweet&Maxwell, London, 2nd edn, 2007), 146.

²⁹ 'A close-out netting provision shall [...] take effect in accordance with its terms notwithstanding that the collateral-provider or collateral-taker under the arrangement is subject to winding-up proceedings or reorganisation measures.' Rule 12.1 of the Financial Collateral Arrangements (No 2) Regulation 2003 (UK).

³⁰ U Ehrlicke (2006), 'Zum anwendbaren Recht auf ein in einem Clearing-System vereinbartes Glattstellungsverfahren im Fall der Insolvenz ausländischer Clearing-Teilnehmer', (2006) 45 *WM Zeitschrift für Wirtschafts- und Bankrecht*, 2109, 2109.

³¹ 'If financial performance with a market or stock exchange price was agreed to take place at a fixed date or within a fixed period, and if that date or expiry of the period occurs after the insolvency proceedings were opened, performance may not be claimed, but only claims for non-performance. [...] If transactions on financial performances are combined in a framework contract in which agreement has been reached that in the event of violations of the contract it may only be terminated uniformly, the totality of these transactions shall be regarded as a mutual contract [...]', §104(2) Insolvency Act (Germany), unofficial translation cited after <http://www.iuscomp.org/gla/statutes/statutes.htm>, last accessed on 13 October 2013. The details are the subject of intense discussion in the literature, see for a full account Fried, "§19 – Vereinbarkeit von Netting-Vereinbarungen mit §119 InsO und §§103ff InsO", in JC Zerey (ed), *Finanzderivate* (Nomos, Baden-Baden, 2013), 393-405.

the insolvent is not a bank and no collateral is involved, and there is agreement that contractual netting is acceptable only as long as it does not produce rights better than those granted under statutory insolvency set-off, notably Rule 490 of the Insolvency Rules 1986.³²

C. THE CONFLICT BETWEEN *LEX CONTRACTUS* AND *LEX FORI CONCURSUS*

At present, 44 jurisdictions³³ have enacted legislation using one of these three approaches with a view to becoming netting-friendly. In principle, this means that close-out netting provisions should be enforceable where the *forum* of the insolvency proceedings is one of these jurisdictions and the facts of the case are actually covered by the netting-friendly legislation. However, as soon as cross-jurisdictional elements are present, *i.e.*, when the situation falls within the ambit of the ‘seventh octant’, foreign law might become relevant and distort this clear-cut result.

Doubts arise, in particular, where the close-out netting agreement is governed by a law other than the law of the *forum*. The first reason for such a mismatch is that in most jurisdictions, the law applicable to the contract can be chosen by the parties.³⁴ For instance, parties often choose English law for repurchase, securities lending or derivatives contracts, as the relevant master agreements are geared³⁵ towards that law even if none of the parties is located in England. Furthermore, there is a multiplicity of potential *fora*, in particular referring to criteria such as (i) the centre of main interest of a financial institution; (ii) its headquarters; (iii) its place of incorporation; (iv) its branches;³⁶ (v) or its assets, related to the close-out netting agreement, which are located in foreign jurisdictions. As a consequence, a potential mismatch between the law of the *forum* and the law governing the close-out netting agreement is inherent in any situation involving any of these cross-jurisdictional constellations.

The following sections will concentrate on such cross-jurisdictional situations and the role of the applicable foreign law in the insolvency of one of the parties.

³² See J Dalhuisen, *supra*, n 10, 341 in note [408]; A McKnight, *The Law of International Finance*, (Oxford University Press, 2008) section 14.11.2.3.2; LC Ho, ‘The Financial Collateral Directive’s Practice in England’ (2011), *Journal of International Banking Law and Regulation*, 167-168; Bridge and Braithwaite, *supra*, n 16, 364.

³³ See *supra*, n 27.

³⁴ On exceptions to party autonomy see Böger, *supra*, n 24, 241-244.

³⁵ See Schedule to the ISDA 2002 Master Agreement, Part 4(h)—English or New York law; Global Master Repurchase Agreement (2011 version) §17—English law; Global Master Securities Lending Agreement (2010 version) §23(1)—English law, for references see *supra*, n 7.

³⁶ Annets and Murray, *supra*, n 25, 280.

1. FOOT IN THE DOOR: THE FOREIGN LAW IN INSOLVENCY PROCEEDINGS

The relationship between, on the one hand, the foreign law applicable to a close-out netting agreement, and, on the other hand, the law of the *forum* is characterised by some basic conflict-of-laws considerations. The law applicable to the contract might take a route to protecting close-out netting in insolvency quite different from the approach underlying the relevant rules of the *forum*. Even if both are netting-friendly, there are fundamentally different approaches, as has just been shown (carve-out, blunt statement and assimilation with insolvency set-off, see *supra*). Therefore, what an insolvency court finds ‘inside’ a foreign-law-governed close-out netting provision may vary considerably from domestic ideas in the matter.

Apart from different approaches, material differences between two regimes occur notably as regards questions such as (i) who is allowed to use close-out netting, (ii) which types of contract are eligible, (iii) to what extent close-out netting is compatible with the *pari passu* principle, and, closely related to this issue, (iv) what is considered an unjustified preference to the detriment of general creditors. These differences typically create uncertainties where the chosen law is more accommodating of the parties’ situation, whereas the *forum* law is stricter on the relevant issues, as will be shown below.

The question we face, therefore, is to what extent the *forum* law should be ready to ‘import’ the approach of a foreign-law-governed netting provision into domestic insolvency proceedings. To do so might result in narrower provisions of the *forum* law being trumped by wider rules of the chosen law. Such a result might be perceived as problematic, since the policy considerations which led to a jurisdiction becoming netting-friendly generally comprise clear ideas on the limits of close-out netting.³⁷ The involvement of a foreign-law-governed close-out netting agreement therefore risks overriding those very policy considerations.

Close-out netting agreements and the transactions covered by them are in principle no different from other types of commercial contract, *i.e.*, the applicable law needs to be identified in respect of various matters, such as the legal capacity of corporations, interpretation, agency, nullity, performance on contractual obligations and their extinction, and damages.³⁸ Furthermore, there may be questions such as whether the parties are actually allowed to choose the law

³⁷ See O Böger, ‘Close-out Netting Provisions in Private International Law and International Insolvency Law’ (Part II, 2013) 18-3 *Uniform Law Review*, 1, 27.

³⁸ In the EU, for instance, following Articles 10 to 12 of the Rome I Regulation (Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations, OJ L 177/6 of 4.7.2008), the *lex contractus* governs (i) the existence and material validity of a contract, (ii) its formal validity, (iii) its interpretation, (iv) the performance of the obligations arising under it, (v) the consequences of breach of obligations arising under the contract and the assessment of damages, (vi) the various ways of extinguishing obligations and prescription and limitations of actions, and, (vii) the consequences of nullity of the contract.

applicable to their close-out netting agreement³⁹ or whether, in the absence of such choice, the law applicable to the agreement can be determined on the basis of workable default rules.⁴⁰

From the outset, these issues are governed in their entirety by the *lex contractus*. As soon as insolvency proceedings are opened, the *lex fori concursus* comes into play. In other words, the law applicable to the close-out netting agreement as a commercial contract is split from this point in time onwards. Some of the aspects listed above remain within the purview of the *lex contractus* also in insolvency scenarios, whereas those aspects touching upon core considerations of insolvency, notably the relationship between the insolvent estate and its creditors and the priorities and preferences amongst the creditors, are governed by the *lex fori concursus*.⁴¹

However, in respect of the enforceability of close-out netting, there seems to be no coherent answer to the question of whether enforceability is determined by the law of the *forum* or by the foreign law governing the close-out netting agreement, or by a combination of both. National and EU legislation are ambiguous in that respect, even amongst netting-friendly jurisdictions.

2. THE EU FRAMEWORK

The conflict caused by the dichotomy of *lex contractus* and *lex concursus* may arise wherever a given situation belongs to the ‘seventh octant’, *i.e.*, wherever cross-jurisdictional elements are present in the insolvency of a financial institution. In that respect, the problem is a global one that occurs as a logical consequence of the fact that the relevant laws are not supranational or harmonised but remain national. Obviously, the EU is in a privileged position here, if it makes appropriate use of its legislative powers in this field—and it would seem that it increasingly does.

The EU legislator has tried to shape national laws so as to avoid inconsistency, notably in respect of the wholesale financial sector. There are four different EU regimes that either directly address close-out netting or are somehow relevant in that context. However, the scopes of the Financial Collateral Directive,⁴² the Banks Winding-Up Directive,⁴³ the relevant parts of the Solvency II-recast⁴⁴ and the Insolvency Regulation⁴⁵ combine to produce what is still a confusing overall picture.

³⁹ See n 34 and accompanying text.

⁴⁰ G Minne, ‘Les Règles de Conflit de Loi en Matière de Compensation dans le Secteur Financier’ (2011) 47 *Bulletin Droit et Banque*, 7, 14-23.

⁴¹ See Böger, *supra*, n 37, 27-28.

⁴² Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L168/43 of 27.6.2002, in this article referred to as ‘Financial Collateral Directive’.

⁴³ Directive 2001/24/EC of 4 April 2001 on the reorganisation and winding up of credit institutions, OJ L125/15 of 5.5.2001, in this article referred to as ‘Banks Winding-up Directive’.

⁴⁴ Council Directive (EC) 2009/138 on the taking-up and pursuit of the business of Insurance and Reinsurance, OJ 335/1 of 17.12.2009, in this article referred to as ‘Solvency II-recast’.

(a) *The Current Patchwork ...*

The Financial Collateral Directive protects transactions basically between all types of financial institution, public authorities, central banks and, where it has not been excluded by the implementing State, other types of market participant transacting with a counterparty belonging to one of the aforementioned three categories.⁴⁶ Most, but not all, financial transactions are covered, as the condition for coming within the scope of the Directive consists of collateral or security being provided between the parties—a very common characteristic in wholesale transactions. The effect of entering the scope of application is that collateral transactions are shielded against a number of typical threats to enforceability that can arise in insolvency proceedings, notably recharacterisation by the court, avoidance by the insolvency administrator, *etc.*⁴⁷ Close-out netting agreements, which are as a rule part of collateral arrangements, are especially protected, as Article 7 provides that a close-out netting agreement takes effect in accordance with its terms even if insolvency proceedings are opened. Article 7 is a substantive law provision, ordering Member States to protect the enforceability of close-out netting agreements within their insolvency law,⁴⁸ and therefore differs from the rules contained in the other EU instruments described below, which are conflict-of-laws rules. Other authors read this rule as ‘affecting’⁴⁹ the rules of private international law, but its wording and its position in the text⁵⁰ of the Financial Collateral Directive do not suggest its being a conflict-of-laws rule.

The Banks Winding-up Directive applies to insolvent banks⁵¹ and—in the near future⁵²—to EU-regulated investment firms but to no other type of financial institution. It prescribes a universalist approach to insolvencies in that only the home Member State’s⁵³ courts are empowered to open insolvency proceedings, including over the bank’s and investment firm’s foreign branches; the *lex fori*

⁴⁵ Council Regulation (EC) 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L 160/1 of 30.6.2000, in this article referred to as ‘Insolvency Regulation’.

⁴⁶ Article 1(1)-(3) Financial Collateral Directive.

⁴⁷ Articles 3-8 Financial Collateral Directive.

⁴⁸ R Goode, *Principles of Corporate Insolvency Law*, (London, Sweet&Maxwell, 4th edn, 2011), para 1-71.

⁴⁹ Cf Böger, *supra*, n 24, 253.

⁵⁰ The Directive contains Article 9 (entitled ‘Conflict of laws’) as a separate provision. If a conflict-of-laws rule in respect of close-out netting was meant to figure in the Directive one would expect it to be included in that Article or to be stated in a separate, similarly clear and apparent provision.

⁵¹ The Directive uses the term ‘credit institutions’. For the sake of readability, this article uses the word ‘bank’.

⁵² The scope of the Banks Winding-up Directive will be extended to the near totality of investment firms by the Article 117(1) of Directive 2014/59 of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms [*etc.*] of 15 May 2014, available online at http://eurlex.europa.eu/legalcontent/EN/TXT/PDF/?uri=OJ:JOL_2014_173_R_0008&from=EN, last accessed on 14 June 2014.

⁵³ Article 9 Banks Winding-up Directive; the ‘Home Member State’ is the State in which a bank has been authorised, see Article 2 Banks Winding-up Directive with Article 1 point (6) Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 on the taking up and pursuit of the business of credit institution, OJ 126/1.

concursum is the law of that State.⁵⁴ In relation to a number of contracts and rights (e.g., employment contracts, rights *in rem*, etc.), it provides for differentiated conflict-of-laws rules⁵⁵ to supplement or replace the general *lex fori* rule, amongst them one special rule on set-off and one on netting. In respect of set-off, the *forum* law governs the conditions under which it may be invoked.⁵⁶ The creditor of the insolvent bank or investment firm can still demand set-off if the law applicable to the insurance company's claim allows it. However, the rule clarifies that voidability and unenforceability will still be governed by the *lex fori concursus*.⁵⁷ Thus, depending on the situation, the law governing set-off in insolvency may be split between the *lex fori concursus* and the *lex contractus*. This is different when it comes to close-out netting. Article 25 provides that 'netting agreements shall be governed solely by the law of the contract which governs such agreement'. The use of the word 'solely' and the comparison with the rules on set-off—in particular the lack of clarification regarding voidability and unenforceability—indicate that this reference is to the exclusion of the insolvency law of the *forum*.⁵⁸

The relevant parts of the Solvency II-recast were originally contained in a separate instrument, the Insurance Winding-up Directive.⁵⁹ They apply in the insolvency of insurance undertakings. The reasoning, the approach and the rules on the *forum* and the applicable law in general and in relation to certain rights and contracts⁶⁰ are very similar to those contained in the Banks Winding-up Directive. The rules on set-off⁶¹ are almost identical to those described above. However, a rule on close-out netting corresponding to Article 25 of the Banks Winding-up Directive is missing.

The Insolvency Regulation applies to insolvency proceedings over debtors other than insurance undertakings, banks, investment firms or collective investment funds.⁶² Much like the bank and insurance insolvency legislation described above, it provides rules on how to identify the *forum*—the country where the debtor has its centre of main interest—and the law applicable to the insolvency proceedings, which is that country's law.⁶³ Likewise, there are

⁵⁴ Articles 9, 10 Banks Winding-up Directive.

⁵⁵ Articles 20-30 Banks Winding-up Directive.

⁵⁶ Article 10(2)(c) Banks Winding-up Directive.

⁵⁷ Article 23 Banks Winding-up Directive.

⁵⁸ See the detailed analysis in European Financial Markets Lawyers Group, *Protection of bilateral insolvency set-off and netting agreements under EC law*, (2004), 37-42, available online at <http://www.efmlg.org/documents.htm>, last accessed on 4 January 2014.

⁵⁹ Council Directive 2001/17 of 19 March 2001 on the reorganisation and winding-up of insurance undertakings, OJ L 110/28 of 20.4.2001.

⁶⁰ Articles 273, 274, 285-292 Solvency II-recast.

⁶¹ Articles 288(1) and 274(2)(f) Solvency II-recast.

⁶² Article 1 Insolvency Regulation. The provision is likely to be amended to match the inclusion of EU-regulated investment firms in the Banks Winding-up Directive, see Point (21) in Council of the European Union, 'Proposal for a Regulation of the European Parliament and of the Council amending Council Regulation (EC) 1346/2000 on insolvency proceedings', of 25 February 2004, available online at <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%205983%202014%20REV%201>, last accessed on 14 April 2014.

⁶³ Articles 3 and 4 Insolvency Regulation.

differentiated rules on the law applicable to certain types of rights and contracts,⁶⁴ including rules on set-off⁶⁵ which are identical to the ones described above. However, as in the Solvency II-recast in respect of insurance undertakings' insolvency, there is no specific rule on close-out netting.⁶⁶

There was some discussion⁶⁷ in relation to the Insolvency Regulation, which applies *mutatis mutandis* to the rules on insurance companies' insolvency now contained in the Solvency II-recast, on whether the provisions relating to set-off could be applied to close-out netting. However, interpretation prohibits this analogy, mostly because there is no unintended lacuna—the Banks Winding-up Directive, the predecessor rules to the Solvency II framework and the Insolvency Regulation all date from 2000/2001 and it seems highly unlikely that the absence of rules on close-out netting was an oversight, all the more so as the 'oversight' could have been remedied on the occasion of the Solvency II-recast in 2009 or in the context of the revision of the Insolvency Regulation.⁶⁸ On that basis, the legislator's intention may be assumed to have been not to provide for such a rule. Consequently, in relation to both the scope of the Solvency II rules and the Insolvency Regulation, the general rules apply, referring the question of enforceability of close-out netting to the *forum* law.

As regards the domestic law of EU Member States, each jurisdiction has its conflict-of laws and substantive rules, except where the matter comes within the scope of application of the—directly applicable—Insolvency Regulation. The domestic rules implementing the three directives may or may not differ within each jurisdiction. The rules contained in the directives themselves differ from one another but jurisdictions do not necessarily exactly mirror these divergences and may have created consolidated rules instead that are regarded as implementing all three directives. In addition, there is still room for autonomous national law, covering transactions that do not fall within the ambit of the aforementioned EU instruments.

(b) ... and the Resulting Open Issues

For the purpose of this article, the following three main messages flow from the above. (I) First, in the insolvency of a bank or investment firm, the enforceability of a netting agreement is governed solely by the *lex contractus*. (II) Second, in the event of insolvency of an insurance company or a market participant covered by

⁶⁴ Articles 5-15 Insolvency Regulation.

⁶⁵ Articles 4(2)d and 6 of the Insolvency Regulation.

⁶⁶ The recent proposal (see n 62) contains draft Article 2(1)a and draft Article 6a concerning close-out netting provisions entered into by an entity covered by the Insolvency Regulation and a bank or investment firm: in this case, the rules of the Banks Winding-up Directive should apply. However, at the time of writing the proposal, which was originally submitted by the EU Commission, was reported not to have found support with the Member States.

⁶⁷ See the extensive textual, comparative, contextual and teleological interpretation undertaken by the European Financial Markets Lawyers Group, *supra*, n 58, 11-33.

⁶⁸ See *supra*, n 66.

the Insolvency Regulation, the enforceability of close-out netting agreements is determined by the law of the *forum*. (III) Third, in relation to those entities covered by neither EU instrument, notably investment firms not covered by the Banks Winding-up Directive and collective investment undertakings, each Member State's autonomous private international law rules determine which law governs the question of enforceability of close-out netting in insolvency. (IV) Fourth, the domestic substantive law of each Member State ensures that a collateral-related close-out netting agreement is enforceable in accordance with its terms, notwithstanding the insolvency of one of the parties, provided that at least one (or, at the election of the implementing Member State: both) of the parties is a financial institution, public authority or central bank.

Consequently, there is only one scenario in which the law governing the enforceability of close-out netting provisions is clear: where both parties are banks or investment firms and the relevant transactions are collateralised. Here, two Directives apply cumulatively in any of the potential scenarios. The Banks Winding-up directive determines that the law governing the contract will also govern questions of enforceability in insolvency proceedings. If the parties have chosen a EU law, they can be sure that it is netting-friendly, as the Financial Collateral directive has been implemented in all EU jurisdictions.

For the important remainder of situations, EU law remains incomplete. The consequences of this incompleteness will be described below, starting from three questions, with an analysis of two examples in the succeeding sections.

The first question relates to the importance of the missing reference to the law governing the contract. As we have just seen, in respect of large parts of the market, the *forum* law will be applicable to the close-out netting agreement in insolvency. This includes scenarios in which a bank contracts with a non-bank entity, for example an insurance company or a hedge fund. In such cases, the non-bank will bring in the law of the *forum* in addition to the law applicable to the contract. The good news in relation to insurance companies is that, if they become insolvent, there is only one possible *forum*, and that is its home Member State. If any other type of entity is involved, there may even be multiple *fora*. Taking the example of a hedge fund, the close-out netting agreement might be scrutinised under the forum law of the place of incorporation, the head office, the location of assets or any branch through which the firm is transacting.

This leads us to the second question, *i.e.*, how much room will be given to the law applicable to a close-out netting agreement in case the law of the *forum* comes in, and, more specifically, whether or not that law will determine or partly determine the enforceability of the close-out netting agreement. As we have seen, the law governing the contract is not entirely replaced but only trumped by the *forum* law in respect of certain mandatory aspects. This principle is mirrored in the Rome I Regulation on the law applicable to contractual obligations, according to which a commercial contract is governed by the law chosen by the parties unless

there are overriding mandatory provisions of the *forum*.⁶⁹ Hence, this tension between the *forum* law and the law applicable to the close-out netting agreement still needs to be resolved.

The third question pertains to the importance, if any, of the diverging implementation of the Financial Collateral Directive and to differences in the substantive law in general. The extent to which these differences impinge on legal certainty still needs to be defined. This is, of course, most relevant where the conflict-of-laws framework is complicated, as the *forum* law and the law applicable to the contract compete. However, this issue might equally play a role where the conflict-of-laws framework focuses on the law governing the contract, as is the case in bank insolvencies. The relevant substantive rules are sometimes fundamentally diverse.⁷⁰ For instance, the Belgian, English and German rules cited above⁷¹ are construed in a very different way but are all considered national implementations of Article 7 of the Financial Collateral Directive.⁷² Furthermore, in a number of jurisdictions, the Financial Collateral Directive does not apply to non-financial institutions, *i.e.*, the protection it affords is not effective for either party if one of them belongs to that category of counterparty.

These three questions all reflect the fact that domestic law attempts to retain control over the enforceability of close-out netting by upholding the *forum* law as the relevant law and through domestic idiosyncrasies in respect of its substantive law. As a consequence of international harmonisation, jurisdictions might lose some control over these levers which traditionally transmit national policies with regard to the relationship of the insolvent estate with its creditors. Nevertheless, the concerns of national policy makers are recognised in Recital 15 of the Financial Collateral Directive which seems to allow States to maintain restrictions to netting.⁷³ This would appear to be a ‘soft’ safeguard the precise effect of which is unclear, apart from the apparent message that EU Member States agree to reserve certain questions regarding the enforceability of close-out netting for the *forum* law.

The relevant policy concerns crystallise around the two main aspects that fundamentally inform the issue of how a State’s insolvency policy is translated into practice. First, States are interested in retaining control over the scope of the close-

⁶⁹ Articles 3(1) and 9(1) Rome I Regulation.

⁷⁰ The diverging implementation in EU Member States is evidenced by the States’ replies to the European Commission’s *Questionnaire on The Implementation Of Directive 2002/47/EC On Financial Collateral Arrangements*, available online at http://ec.europa.eu/internal_market/financial-markets/collateral/consultation_results_en.htm, last accessed on 4 January 2014.

⁷¹ See notes 28, 29, and 31 and accompanying text.

⁷² Answers received by Belgium, Germany and the United Kingdom in relation to Question 7.1 of the questionnaire, see n 70.

⁷³ ‘This Directive should be without prejudice to any restrictions or requirements under national law on bringing into account claims, on obligations to set-off, or on netting, for example relating to their reciprocity or the fact that they have been concluded prior to when the collateral taker knew or ought to have known of the commencement (or of any mandatory legal act leading to the commencement) of winding-up proceedings or reorganization measures in respect of the collateral provider.’

out-netting privilege by retaining their grip on the application of the *pari passu* principle, notably by defining details of the scope of avoidance and similar powers of the insolvency administrator or insolvency court (*cf. infra*, 3). Moreover, and for the same reason, States aim at retaining control over the range of eligible parties and eligible contracts (*cf. infra*, 4.).

3. PROTECTION OF GENERAL CREDITORS AND *PARI PASSU*

From a domestic viewpoint, the first means by which national insolvency policy is implemented in respect of close-out netting is the enforcement, or non-enforcement, respectively, of the *pari passu* principle. The essence of this principle is that all unsecured creditors share proportionally in those of the insolvent company's assets that are available for residual distribution.⁷⁴ *Pari passu* has a number of emanations besides the rule of rateable distribution, notably the anti-deprivation⁷⁵ principle and suspect period or 'zero-hour' rules.⁷⁶ Also, the insolvency administrator's cherry-picking powers are ultimately an expression of how jurisdictions read *pari passu*. These limits to party autonomy are generally enforced in practice through avoidance and staying powers⁷⁷ given to the insolvency court or the insolvency administrator.

However, the re-distributional role of insolvency law allows prior private bargains to be taken into account in pursuit of, and to the extent sanctioned by, democratically established national policy interests.⁷⁸ The fact of a jurisdiction being netting-friendly means that it has implemented precisely such a policy decision as it shields close-out netting agreements from these avoidance and staying powers,⁷⁹ despite the fact that such agreements, by their very nature, might be regarded as somehow contrary to the idea of *pari passu* since close-out netting might be equated to a payment on or discharge of the insolvent's debt.⁸⁰ This protection probably constitutes the core characteristic of 'netting-friendliness'. It is not, however, without reservation as jurisdictions draw a demarcation line in

⁷⁴ V Finch, *Corporate Insolvency Law* (Cambridge University Press, 2nd edn, 2009), 599. See also *supra*, n 23.

⁷⁵ Following the anti-deprivation principle, a contract stipulating that in the event of insolvency, the insolvent's property is to be transferred from its estate to someone else is void. See Bridge and Braithwaite, n 74.

⁷⁶ These are rules that declare an insolvent's dispositions void solely because they were entered into either during a prescribed period prior to the opening of the proceedings (*e.g.*, a three- or six-month period) or on the day on which proceedings were opened (*i.e.*, after midnight) but before the actual hour of their commencement, see, *e.g.*, Article 8(1) of the Financial Collateral Directive.

⁷⁷ Staying open contracts is the most immediate consequence of the commencement of insolvency. Except in special cases, any action resulting in a loss or encumbrance of the insolvent's rights (*e.g.*, through performance, enforcement, set-off, *etc.*) is automatically halted, contrary actions are often void *ab initio*.

⁷⁸ Finch, n 74, 601.

⁷⁹ See, for example, the rule in 11 USC §561: '[...][T]he exercise of any contractual right [...] to cause the termination, liquidation, or acceleration of or to offset or net termination values [...] arising under or in connection with one or more [financial contracts], shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by any order of a court or administrative agency in any proceeding under this title.'

⁸⁰ See Wood, *supra*, n 22, paragraph 17-071.

implementing their respective policies beyond which private bargaining cannot trump the application of *pari passu*.

From an international viewpoint, even netting-friendly jurisdictions take slightly differing positions on the co-ordinates of this demarcation line. As a result, only mainstream scenarios of close-out netting agreements conflicting with *pari passu* receive identical treatment, *i.e.*, they are predictably resolved in favour of close-out netting by all netting-friendly jurisdictions. As soon as less mainstream elements are involved, however, that is to say, as soon as the facts edge towards the fringes of the scope of the protection, differences between the forum law and the law applicable to the agreement might become relevant.

Potential cases of diverging laws generally relate to whether or not a transaction prejudices other creditors, such as the length of the applicable ‘suspect period’ before the opening of proceedings over a market participant.^{81, 82} The clearest example for our purposes relates to knowledge by the solvent party of the approaching insolvency of the other party at the time of entering into the close-out netting agreement. The *forum* judge will have to rule whether the *forum* law or the law chosen to govern the contract determines whether or not prior knowledge by one of the parties allows the insolvency administrator to avoid the close-out netting agreement. Both Recital 15 of the Financial Collateral Directive⁸³ and Principle 7(2) of the UNIDROIT Netting Principles⁸⁴ confirm the relevance of such scenarios. Both mention knowledge as a potential hindrance to enforceability of close-out netting, both keeping the list of possible additional exceptions non-exhaustive. Also, knowledge—whatever that may mean exactly—regularly features as a reason for avoidance in domestic insolvency laws. However, neither Recital 15 nor the UNIDROIT Netting Principles provide guidance on what ought to be decided should avoidance powers be triggered under the forum law but not under the law applicable to the contract.

⁸¹ Wood, *ibid*, paragraph 29-047.

⁸² A prominent recent case of diverging laws relates to the ‘wait-and-see clauses’, *i.e.*, the issue of whether clauses are enforceable that allow the non-defaulting party to suspend performance on derivatives contracts even though it does not exercise its contractual right to terminate them because it is out of the money. This type of clause is not part of the close-out netting mechanism itself, and accordingly is not addressed in this article. See *Lomas v JFB Firth Rixson Inc* [2012] EWCA Civ 419, [80]-[99] upholding the effects of the relevant section 2(a)(iii) of the ISDA Master Agreement; see further the analysis offered by Bridge and Braithwaite, n 16, 392-396. The parallel US Bankruptcy case was No. 08-BK-13555 (JMP) (Bankr. S.D.N.Y. September 15, 2009), commonly referred to as *Metavante*, which came to the opposite conclusion, *i.e.*, performance could not be suspended.

⁸³ Recital 15 states that the protection of the Financial Collateral Directive is “without prejudice to any restrictions or requirements under national law on bringing into account claims, on obligations to set-off, or on netting, *for example* relating to their reciprocity or the fact that they have been concluded prior to when the collateral taker knew or ought to have known of the commencement [of insolvency proceedings in relation to the other party]” (emphasis added).

⁸⁴ Principle 7(2) allows implementing States to maintain insolvency law rules restricting the operation of close-out netting provisions ‘on grounds which include factors [...] *such as* knowledge of a pending insolvency proceeding at the time the close out netting provision was entered into or the obligation arose, the ranking of categories of claims, or the avoidance of a transaction as a fraud of creditors’. (emphasis added).

In terms of European law, the conflict is only avoided in respect of bank and investment firm insolvencies, as ‘solely’ the contract law applies to that question, provided the EU Member States’ national laws actually mirror that unambiguity. In case of collateral transactions, however, Recital 15 might open the door to interpretations pointing to restrictions flowing from the forum law, since restrictions or requirements under national law on bringing into account claims on netting continue to apply.⁸⁵ In all other cases, from a EU law perspective, this seems to be a question for Article 9(I) of the Rome I Regulation, *i.e.*, whether the forum rule is an overriding mandatory one, a question which is referred to domestic interpretation.

In all non-EU jurisdictions, the issue is determined by their own private international insolvency law rules, *i.e.*, there is a total absence of harmonisation and predictability.

The answer to the question as to which law governs the issue of avoidance powers, however, is decisive in determining whether or not a close-out netting agreement will ultimately be enforceable should a party become insolvent. For instance, the UK rule⁸⁶ implementing the Financial Collateral Directive protects a contractual netting provision except in cases where, at the time of entering into the agreement, a party was aware or should have been aware of the insolvency proceedings or had notice of one of various facts which typically precede the opening of proceedings. That is, under the UK rule, a close-out netting agreement can be unenforceable if the solvent party should have known about the imminent insolvency when it entered into the agreement. By contrast, following the relevant Belgian rule,⁸⁷ close-out netting agreements concluded prior to the opening of insolvency proceedings cannot be challenged on the grounds of knowledge. Only close-out netting agreements concluded subsequently can be so challenged.

Hence, the laws of two different netting-friendly jurisdictions apparently set partially different criteria for the avoidance of close-out netting agreements. In our example, the ambit reserved for *pari passu* under the UK rule is wider and therefore the protection of close-out netting narrower than under the Belgian rule. Similarly, wider or narrower interpretation of the terms of knowledge or constructive knowledge in different jurisdictions can have considerable impact on the question of whether or not a close-out netting agreement is to be protected.

The above can be summarised in three considerations. First, jurisdictions maintain reservations regarding the enforceability of close-out netting agreements, such as prior knowledge. Second, the relevant criteria (definition of ‘knowledge’, *etc.*) differ depending on the jurisdiction, as there is no harmonised, exhaustive catalogue of relevant criteria. And, third, it is unclear whether the judge of the *forum* may apply the reservations prescribed by the *forum* law even if the law applicable to the relevant close-out netting agreement is foreign and therefore

⁸⁵ See n 73.

⁸⁶ Rule 12.2 of the UK Financial Collateral Arrangements (No 2) Regulation 2003.

⁸⁷ Article 15 Financial Collateral Act 15 December 2004 (Belgium), English translation adopted from Wood, *supra*, n 28, 146.

contains different criteria—with the exception of the case of EU bank insolvencies where the latter alone should set the standard.

4. MANDATORY LAW AND THE PERSONAL AND MATERIAL SCOPE

Furthermore, States control the ambit of *pari passu* and the exceptions thereto by restricting the scope of protected close-out netting agreements. Contractual freedom allows close-out netting as long as both parties are solvent—at least where professional market participants are concerned.⁸⁸ However, even netting-friendly jurisdictions generally restrict the scope of the privilege in order to preserve traditional insolvency distribution for the remaining majority of creditors. Therefore, enforceability is guaranteed in insolvency *only* in respect of certain types of party (‘eligible parties’) and in relation to certain types of contract (‘eligible contracts’).

The scope of eligible parties is mostly restricted to what could be briefly described as ‘financial institutions’, *i.e.*, banks, investment firms, *etc.* Similarly, the list of eligible contracts is generally restricted to ‘financial transactions’, such as derivative, repurchase and securities lending contracts, whereas ‘commercial non-financial’ contracts generally remain outside. In most jurisdictions, the scope is then defined by interweaving the two definitions, *i.e.*, the enforceability of close-out netting agreements is guaranteed only where financial institutions enter into financial transactions with one another. This is also the approach taken by both Article 1 of the Financial Collateral Directive and by in Principles 3 and 4 of the UNIDROIT Netting Principles.

States are extremely keen to retain this lever with a view to their respective policies in respect of *pari passu*. Therefore, despite the fact that the general approach described above is universally followed, the relevant scope of eligible parties and eligible contracts to some extent differs between jurisdictions. Policy being involved, it will come as no surprise that the scope has never yet been co-ordinated internationally, save, to some extent, within the ambit of the EU Financial Collateral Directive. Therefore, outside the ambit of the Directive, there are probably no two jurisdictions worldwide with identical scopes of application of the close-out netting privilege.

This gives rise to a situation where, taking a bird’s-eye view and considering the aggregate of all netting-friendly jurisdictions, a rump of types of party and types of contract that are generally accepted as netting-eligible can be identified. Credit institutions, merchant banks and investment firms are probably universally included in the personal scope,⁸⁹ and there is no doubt in relation to the eligibility

⁸⁸ There might be rules geared to protecting consumers against disparity of bargaining powers and against unexpected clauses in standard contract small print. These rules are not addressed in this article.

⁸⁹ See Principle 3(2) of the UNIDROIT Netting Principles, together with the commentary in paragraphs 48-52.

of derivative contracts, repurchase agreements and securities lending from the perspective of the material scope.⁹⁰

Again, we have to put the question of relevance. As there is consensus among netting-friendly jurisdictions (EU and worldwide) that close-out netting agreements should be protected in insolvency, results should be basically guaranteed as long as the forum is within one of these jurisdictions. The difficulty, however, is that the lack of uniformity creates inconsistencies at the fringes of both the personal and material scope.⁹¹ Thus, in relation to the personal scope, *e.g.*, insurance companies or special purpose vehicles used by banks in the context of securitisation might or might not be netting-eligible, depending on the jurisdiction. A further prominent example is the question of whether partnerships (including, for instance, certain hedge fund structures) are netting-eligible, because they are regarded in some jurisdictions as a group of natural persons without its own legal personality.⁹² As regards the types of eligible transaction, jurisdictions differ, for instance, in their assessment of whether physically settled derivatives should be netting-eligible.⁹³ Furthermore, cash deposited with one another by financial institutions might or might not benefit from the protection of close-out netting, again depending on the jurisdiction.⁹⁴

Consequently, variations in the substantive law can make a considerable difference to the enforceability of close-out netting. The question of whether the *lex fori concursus* or the *lex contractus* defines the scope of the protection of close-out netting therefore has fundamental implications.

D. INEVITABLE EROSION OF MANDATORY *FORUM* LAW?

1. MULTIPLICITY OF ALTERNATIVE *FORUM* LAWS

Returning to the multiplicity of potential *fora* as one of our initial assumptions⁹⁵ as it translates into a multiplicity of alternatively applicable *leges fori concursus*, and with the sole exception of EU banks, investment firms and insurance companies, it is not only the parties' places of incorporation and centres of main interest that may become the *forum* of future insolvency proceedings. Any jurisdiction governing the parties' branches⁹⁶ or any jurisdiction where relevant assets are located may become the *forum*.⁹⁷ Hence, in an international setting there will be a minimum of

⁹⁰ See Principle 4 of the UNIDROIT Netting Principles, together with the commentary in paragraphs 56-81.

⁹¹ See for an overview of coverage of ten types of entities in eleven jurisdictions Paech, *supra*, n 24, 31.

⁹² See Principle 3(1) of the UNIDROIT Netting Principles.

⁹³ See paragraph 63 of the commentary to the UNIDROIT Netting Principles.

⁹⁴ See paragraphs 88-91 of the commentary to the UNIDROIT Netting Principles.

⁹⁵ See *supra*, n 36, and accompanying text.

⁹⁶ Article 3(1) and (2) EU Insolvency Regulation.

⁹⁷ See *supra*, n 36, and accompanying text.

two different *forum* laws that potentially govern the enforceability of close-out netting, but there may be many more. In the insolvency of EU banks, investment firms and insurance companies the number is restricted to two potential *fora*;⁹⁸ however, there may be many more in relation to other types of EU market participant. Which law will ultimately become the *lex fori concursus* depends on where proceedings are opened.

If it were merely a matter of the sheer multiplicity of alternative *fora*, it would suffice to take the necessary care in transacting. The parties' options would be narrowed down since the relevant rules of all potential *fora* would need to be respected cumulatively in order to craft an agreement enforceable in whichever of the potential *fora*. Obviously, no cross-jurisdictional close-out netting agreement can be concluded without a multinational team of specialised legal counsel—but that in itself does not entail legal uncertainty, it is just very cumbersome and costly and there is ample room for mistakes.

However, the role of the law applicable to the close-out netting agreement may change that assessment as the law of each of the potential *fora* takes its own approach to the question of how much room should be given to the law applicable to the close-out netting agreement when issues of enforceability are at stake. In French insolvency proceedings, the effectiveness of rights against the debtor and other creditors, including the question of enforceability of close-out netting agreements, is governed exclusively by French law.⁹⁹ German law refers the issue of enforceability to the law applicable to the close-out netting agreement and German courts would also apply the insolvency law of that foreign jurisdiction to determine enforceability.¹⁰⁰ English courts in principle refer to foreign law regarding the enforceability of a close-out netting agreement but would always regard Rule 490 of the UK Insolvency Rules 1986 as internationally mandatory.¹⁰¹ On the other hand, if a foreign court accepted the reference to English law as the law governing enforceability in insolvency, it would find that Rule 490 was exclusively applicable in proceedings over which English courts have jurisdiction.¹⁰²

It is worth noting that the examples cited above relate to the law of the three most important financial market places in Europe, each with highly developed financial market legislation and generally very elaborate case law. If the potential outcomes are difficult to predict in relation to these markets, it is fair to assume that the law and decisions of the judiciary in younger financial markets are potentially even more uncertain. In all cases, multiple potential *fora* exponentially increase uncertainty in respect of the enforceability of close-out netting agreements.

⁹⁸ See section C.2.a, *supra*.

⁹⁹ Böger, *supra*, n 37, 8-9.

¹⁰⁰ See Böger, *ibid*, 11-12.

¹⁰¹ Böger, *ibid*, 6.

¹⁰² UK Insolvency Rules 1986, Rule 0.3(1).

Again, but only in cases of insolvency of banks and investment firms, EU law should remove that problem as in those cases, the law applicable to the agreement governs enforceability alone.

2. HETEROGENEITY OF SUBSTANTIVE LAWS

Jurisdictions define the extent of the protection afforded to close-out netting in different ways, as discussed above. One way is to fine-tune the demarcation line between protected close-out netting agreements and preferential transactions voidable on the basis of the *pari passu* principle. Another is to define the personal and material scope, *i.e.*, to determine which type of party is protected and in relation to which type of transaction.

In the international context, certainty regarding the enforceability of a close-out netting agreement only exists where the scopes of all potentially applicable laws ‘intersect’, *i.e.*, in respect of close-out netting agreements that would be protected by all relevant laws. This situation can ultimately only materialise as legal uncertainty, for the following reasons.

First, even within the harmonised area of the Financial Collateral Directive, results may diverge considerably. This is a relatively harmless issue where diverging personal and material scopes are concerned, as these are generally set out in the relevant legislation. Thus, the scope of application is not as wide as some might wish (the personal scope in particular does not always cover transactions between a financial and a non-financial institution), but no legal uncertainty flows from this situation.

However, heterogeneity becomes much more dramatic in respect of the equilibrium between enforceability of close-out netting and the *pari passu* principle. Even the law of two major financial market places (London as the European transaction hub, Brussels as the home of a major clearing and settlement organisation) diverges considerably with respect to prior ‘knowledge’, as we have seen.¹⁰³ This issue is very difficult to address *ex ante* as court decisions in this area are difficult to predict, all the more as most jurisdictions do not have statutory rules on this issue as clear as those available in English and Belgian law—if the law addresses the point at all. Outside the ambit of the Financial Collateral Directive, *i.e.*, in relation to non-collateral transactions or transactions beyond the reach of EU law, these concerns are even stronger. As a result, there will always be a residual possibility of a court avoiding a close-out netting agreement on grounds of violation of the *pari passu* principle even where the jurisdiction is netting-friendly in general, or, in the case of EU jurisdictions, where the law is supposed to implement the Financial Collateral Directive. Standard cases will probably not create uncertainties, but any departure from the standard, as for instance in the event of prior knowledge of the counterparty’s imminent insolvency, might well do so.

¹⁰³ See notes 86–87 and accompanying text, *supra*.

A second concern relates to scenarios involving the cross-border transfer of parts of a financial firm's business or portfolio of assets, including the relevant close-out netting agreements contained in the master agreements, for example in the context of a merger of financial institutions or as the result of forced transfer by market authorities exercising reorganisation or resolution powers.¹⁰⁴ Here, the question is whether or not the jurisdiction to which the relevant business or portfolio is transferred already figured on the list of potential *fora*. If it did, the close-out netting agreement will already be geared towards the scenario of insolvency proceedings being opened there. If it was not considered a potential *forum* at the time when the close-out netting agreement was set up, the certainty of enforceability is not guaranteed and parties ought to close these positions quickly, in order not to run too high a risk.

A third concern is more a matter of policy. States form their insolvency law, including the aspect of enforceability of close-out netting, on the basis of national policy, influenced by considerations of creditor- or debtor-friendliness and the importance given to the stability and liquidity arguments and the need to avoid the 'ripple effects weakening the solvency of creditors in ever widening circles'¹⁰⁵ raised in favour of close-out netting. However, this policy can be put into practice fully only in respect of domestic situations. As soon as there is any connecting factor to a potential different *forum*, the policy lines may be trumped. Prudent parties will narrow down the scope of the close-out netting agreement so as to comply with the combination of all potential *fora*. In all likelihood, the scope will be narrower than required under domestic law. Consequently, a mismatch occurs between domestic policy convictions and legal reality that in the end will be detrimental to domestic market participants which find themselves more restricted than the requirements of domestic policy dictate.

3. 'MULTIPLIED HETEROGENEITY'?

In practice, the multiple conflict-of-laws regimes combine with highly heterogeneous substantive law. It is no easy matter to conceptualise the result of combining the findings of the two preceding sections. The enforceability of close-out netting in the seventh octant of our three dimensional model (cross-jurisdictional—insolvent—financial institutions)¹⁰⁶ remains non-transparent globally. Although EU law, notably the Banks Winding-up and Financial Collateral Directives, neutralises the negative effect of the multiplicity of potential *fora*, these two instruments are too sectoral; the Banks Winding-up Directive, for instance, only removes the problem if the close-out netting agreement involves banks or investment firms on both sides. Moreover, the directives are somewhat lacking in

¹⁰⁴ See Paech, *supra*, n 24, 35-37, with further examples.

¹⁰⁵ Wood, *supra*, n 22, paragraph 1-006.

¹⁰⁶ See section A, *supra*.

detail and so do not necessarily guarantee sufficiently co-ordinated implementation into national law. Outside the EU, even amongst netting-friendly jurisdictions, the picture is no clearer. On the contrary, there are no rules comparable to Article 25 of the Banks Winding-up Directive and Article 7 of the Financial Collateral Directive.

Obviously, reform and harmonisation are the answer, but these have thus far met with resistance—see the opening anecdote in this article. However, it is fair to state that States tend to cling to policy decisions that are *de facto* almost untenable in practice.

First, domestic insolvency policy can only be comprehensively implemented in domestic situations, whether or not financial institutions are involved. However, the term ‘domestic’ should be handled with care, as ‘domestic’ here means *purely* domestic. If, for instance, Commerzbank in Frankfurt provides funds under a German-law-governed repurchase master agreement (which includes a close-out netting clause) to a German corporation headquartered in Cologne, this will be a purely German scenario only if and as long as the London branch of Commerzbank is not involved in the transaction, not even behind the scenes. The consequences of the international operations of larger financial institutions are truly remarkable: literally any wholesale transaction is susceptible of being processed through a foreign branch.¹⁰⁷ As a consequence, national insolvency law will be *alone* relevant only where a small or medium-sized financial institution deals with a local counterparty. However, these scenarios are probably not of systemic relevance and as such do not inform the special treatment afforded to financial institutions in insolvency.

In international scenarios, domestic policy cannot have its envisaged impact. This is obvious enough in cases where proceedings are opened in a foreign jurisdiction. Yet even where a domestic court conducts the insolvency proceedings, the enforceability of close-out netting provisions is not entirely subject to domestic rules only. First, within the ambit of the Banks Winding-up Directive, the court may have to apply foreign law. Second, outside the scope of that Directive, the close-out netting agreement will generally be enforceable since the parties will have crafted it carefully so as to ensure compliance with the law of all relevant *fora*. However, that certainty comes at the price of domestic financial institutions being constricted in their dealings as compared to the domestic framework, since they have to comply with multiple insolvency laws at the same time. In other words, multiple heterogeneity also harms national market participants.

And lastly, no jurisdiction is in favour of close-out netting agreements proving unexpectedly unenforceable. However, the risks and inconsistencies described earlier leave a residual risk of unenforceability which might be greater or smaller, depending on the concrete set-up.

¹⁰⁷ Lehman Brothers famously consisted of 2985 legal entities, branches not included.

E. CONCLUSION – THE MISSING PIECES

Countries with an interest in running an efficient yet safe market have over time so shaped their laws as to be netting-friendly. However, the perspective of netting-friendliness is generally a domestic one, neglecting the reality that the vast majority of insolvencies of financial institutions fall within the ambit of the ‘seventh octant’, *i.e.*, that there are cross-jurisdictional elements present. The adoption of the UNIDROIT Netting Principles as well as relevant EU legislation provides evidence that States recognise the need for international harmonisation in this field. The above analysis has shown that the original point made by France, *i.e.*, to address private international and substantive law as a package,¹⁰⁸ evidenced both insight and foresight. But States shied away from drafting a solution for fear of further erosion of their mandatory insolvency laws and of losing their grip on insolvency policy. However, as discussed above, the ambit for implementation of purely autonomous national policy is narrow and of limited import. Rather, shaping an integrated international framework may give States greater influence on the insolvency treatment of close-out netting agreements entered into by their subjects than they could possibly hope to exert single-handedly.

The fundamental guideline for such an integrated framework is that most jurisdictions would not welcome an extension of insolvency privileges through the backdoor of private international law. That means that changes to the fragmented conflict-of-laws framework cannot be justified by the promise of increased legal certainty alone. Safeguards capable of defending implementing States’ own ideas on insolvency policy must accompany them.

A second thought flows from this guideline: from the national perspective, any exercise aimed at improving the status quo is bound to resemble a zero-sum game, with States surrendering some of their grip on the question of the applicable law in return for an assurance that the laws that will ultimately be applicable in practice will be compatible with national policies. In other words, from a national perspective, harmonising conflict-of-laws rules without establishing a common basis of substantive law would lead to unwanted results in an unpredictable number of cases.¹⁰⁹ It is obvious that the EU is in the privileged position of being able to create binding regimes that integrate private international and substantive law aspects, although it has so far used this facility only sparingly where close-out netting is concerned.¹¹⁰

The third fundamental point is that there are two ways of reducing the uncertainty flowing from the current private international law framework for close-out netting. These can be employed alternatively or, ideally, cumulatively. On

¹⁰⁸ See *supra*, section A.

¹⁰⁹ However, the inverse scenario, *i.e.*, harmonising substantive law without at the same time addressing the conflict-of-laws issue, probably does not carry that risk. Here, the French position was probably too pessimistic (see *supra*, n 4 and accompanying text).

¹¹⁰ See for the ‘patchwork’ Section C.2, *supra*.

the one hand, interested States can of course harmonise their rules of private international law. On the other hand, since much of the uncertainty specific to close-out netting flows from the multiplicity of potential *fora*,¹¹¹ considerable relief may be obtained by limiting the number of these *fora* by taking a more universalist approach, restricting it to just two:¹¹² only those States under the law of which the relevant financial institutions are authorised¹¹³ should be empowered to open insolvency proceedings over these institutions. States clinging to a territorial approach to insolvency would have to relinquish the possibility of opening separate proceedings over branches or assets. This is obviously a much broader discussion and should be saved for another time. However, given the actual situation in the EU, where this principle already applies to banks, insurance companies and—in the near future¹¹⁴—investment firms, and given the current trend towards a more universalist approach in the context of bank resolution,¹¹⁵ this proposal need not necessarily come across as utopian.

Whether the number of *fora* is limited or not, the decision as to which law should govern the various aspects of enforceability remains pertinent, to a smaller or greater extent. There are two groups of relevant aspects. First, those aspects where the private international law treatment is largely undisputed (and these fall outside the scope of this article), such as agency, nullity, interpretation, *etc.*¹¹⁶ Traditionally, these continue to be governed in insolvency by the *lex contractus*, and indeed this should not change.

A more nuanced approach is required regarding the more policy-laden aspects, notably those that are at the core of this article, *i.e.*, the relationship of close-out netting to *pari passu*, on the one hand, and the range of netting-eligible types of parties and contracts, on the other hand. The traditional fall-back solution is that the mandatory law of the *forum* overrides any contractual choice of a foreign law in this regard—an approach which carries significant uncertainty, as shown before.¹¹⁷ There are three alternative solutions.

The first alternative is comprehensive reference to the *lex contractus*.¹¹⁸ This approach provides the greatest clarity and is the only way to establish a consistent framework where the number of potential *fora* cannot be restricted. However, this approach entirely deprives the *forum* law of any means of implementing its insolvency policies and instead transfers that power to the law which has been

¹¹¹ See Section D.1, and n 36 and accompanying text, *supra*.

¹¹² This is the route taken by the EU for insolvencies of its banks and insurance companies, see *supra*, n 54 and accompanying text.

¹¹³ The relevant EU regimes applicable to banks and insurance companies refer to the ‘home Member State’, see n 53. Connecting the *forum* of the insolvency of financial institutions to the place of authorisation allows for greater consistency in their relationship to the State, as illustrated by the creation of new ‘bank resolution regimes’, in the context of which a financial institution’s supervisory authority uses a hybrid toolbox of supervisory and private and insolvency law measures.

¹¹⁴ See *supra*, n 52.

¹¹⁵ See FSB, Key Attributes for Effective Cross-border Bank Resolution, *supra*, n 13.

¹¹⁶ See *supra*, n 38 and n 40 and accompanying text.

¹¹⁷ See *supra*, Section D.

¹¹⁸ This solution figures in Article 25 of the Banks Winding-up Directive. See *supra*, n 42 and n 50 and accompanying text. Its general application is proposed by Böger, *supra*, n 37, 28.

chosen.¹¹⁹ As such, it has long been deemed largely unacceptable to States¹²⁰ in the absence of common substantive law rules on enforceability. That has now changed, in that the UNIDROIT Netting Principles now provide such a basis, but these Principles would have to be implemented as a package together with the conflict-of-laws rules, to provide States with the necessary certainty that their fundamental insolvency policies will be respected.

The second alternative is to leave these two aspects to the law of the *forum* and to limit the reach of the chosen law accordingly. This would appear to be more readily acceptable in cases where the number of potential *fora* is reduced to two by way of an international agreement.¹²¹ Otherwise, the law remains caught in ‘multiplied heterogeneity’, as described above.

The third alternative is more complex, involving as it does the sharing of the applicable law between the *lex fori concursus* and the *lex contractus*. The decision as to which aspects should remain within the ambit of the *forum* law and which should be referred to the law chosen by the parties should depend on which distribution would deliver the best compromise in terms of legal certainty and the implementation of insolvency law policies. This article argues¹²² that it is not the multiplicity of *fora* alone that forms the greatest source of legal uncertainty. Rather, it is the combination of that multiplicity with a heterogeneous set of largely substantive avoidance rules that renders the enforceability of close-out netting so unpredictable. By contrast, divergent rules on which types of party or contract are eligible are not nearly as problematic, since prudent contracting parties can accommodate them. At the same time, from a policy perspective, the decision as to which types of entity can use close-out netting seems to be the more important lever as it ‘pro-actively’ shapes each and every transaction entered into by national subjects from the outset. Clearly, more ‘national legislative affection’ seems to be attached to the issue of avoidance powers, even though they become relevant only in a limited number of cases and only as a ‘re-active’ tool. Accordingly, the *forum* law should govern the question of eligibility of the relevant parties and contracts, reserving this important pro-active lever for the implementation of national insolvency policy.¹²³ By contrast, the jurisdiction the law of which has been chosen to govern the contract should provide the relevant insolvency avoidance rules.¹²⁴

¹¹⁹ For purposes of clarity, it should be noted that the understanding of the term *lex contractus* in this scenario would need to be extended to comprise the insolvency law provisions of the jurisdiction the law of which has been chosen to govern the contract. If only the provisions of the contract law of that jurisdiction were envisaged while allowing aspects of enforceability not to be governed by the *lex fori concursus*, the freedom of the parties to circumvent mandatory insolvency law would become boundless.

¹²⁰ It is pure speculation at this point to assume that Article 25 of the Banks Winding-up Directive was only acceptable to EU Member States because they have always retained the implicit reservation that national implementation of directives allows for some legislative freedom—a topic which would deserve a separate comparative study on the national implementation of that Article.

¹²¹ This is the situation for EU insurance companies, see notes 59-61 and accompanying text, *supra*.

¹²² See *supra*, Sections D.2 and D.3.

¹²³ Such a rule would be in line with the ideas underlying the Financial Collateral Directive, which expressly gives EU Member States the power to determine the eligible parties to collateral arrangements

This third solution is preferable, as it provides a maximum of legal certainty while leaving the most relevant policy levers with the *forum* State. It should ideally be combined with a restriction of the number of potential *fora*, as described before. EU law already contains the most important building blocks regarding conflict of laws and the restriction of the number of *fora*, but it would need to be consolidated. Moreover, the substantive law should be harmonised. On a global scale, the standard for the substantive law is now provided by the UNIDROIT Principles, but a common position on conflict of laws still needs to be found.

and the incorporated close-out netting clauses, see Article 1 Financial Collateral Directive. One might even argue that the all-encompassing reference contained in Article 25 of the Banks Winding-up Directive somehow contravenes the spirit of the Financial Collateral Directive.

¹²⁴ See the inverse proposal to refer all issues except the question of avoidance rules to the chosen law, Böger, *supra* n 37, 28-29.