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Validity of Contractual Netting under German law.

1 Decision on Netting under German insolvency law: Background

On 9 June 2016, the German Federal Court of Justice (*Bundesgerichtshof*, "**BGH**") handed down a decision on the validity of contractual close-out netting under German insolvency law (the "**Decision**"). The Decision by the IXth BGH senate (IX ZR 314/14) is a milestone for the legal assessment of close-out netting under German law. In view of the significant volumes of cleared and un-cleared derivatives, repo- and securities lending transactions entered into with German counterparties or based on German law agreements, the industry awaited the Decision with suspense.

In very simplified terms, close-out netting consists of the combination of transactions under a master agreement or another set of rules and their termination, valuation and aggregation (of positive and negative values) following an event of default, including, in particular, insolvency. This mechanism is one of the key risk management features in the finance sector as a whole. Its significance extends, however, also to the real economy with companies entering, for example, into derivatives transactions to hedge interest rate or currency risks or using agreements with netting concepts to trade, for example, power, gas, emission certificates or coal.

Following the broader use of master agreements in the early 1990's, the German legislator acknowledged the importance of netting and included statutory guidance for netting agreements into the German Insolvency Code ("**InsO**"). Section 104(2) and (3) InsO deals with the termination and valuation of certain "financial services" and is also referred to as the "statutory netting provisions". These provisions were soon extended by a statement that transactions combined in a master agreement which can only be terminated as a whole in the case of a reason for insolvency shall be respected as a single agreement.

Over the last 25 years, contractual netting has been perceived as a functioning mechanism under German law. Legal opinions typically argued – in line with the majority view in the German legal literature –

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that a contractual termination and close-out netting prior to the opening of insolvency proceedings (for example, linked to the filing of a petition for the opening of insolvency proceedings (*Insolvenzantrag*) (the "**Filing**")) is permitted by Section 104(2) sentence 3 InsO.

The Decision now considers whether and to which extent contractual netting arrangements are void due to deviations from the mandatory statutory netting provisions set out in Section 104 InsO.

2 Facts and Reasoning

2.1 Facts

A company with its seat in England ("**Company**") executed two identical German law governed Master Agreements for Financial Derivatives Transactions (*Rahmenvertrag für Finanztermingeschäfte*, "**DRV**") with two German limited liability companies ("**GmbH**"). The identical sole transactions under each of the DRVs were physically settled covered call options on shares. The Company was the buyer of the call option and the GmbH was the seller of the call option.

At the time of the filing for/the opening of the administration proceedings over the Company's assets in 2008 (which happened on the same day), the Company was in-the-money, *i.e.* the option transaction(s) had a positive market value from the Company's perspective. The GmbH was out-of-the-money by the same amount. The Company demanded payment of the relevant close-out amount from the GmbH.

The Company based its claim on the standard close-out provisions under the DRV (Clauses 7, 8 and 9 DRV). The GmbH refused payment.

2.2 Reasoning

The BGH decided that the Company had a claim for payment of the close-out amount. Such claim was, however, not based on the close-out netting provisions under the DRV but on the statutory close-out netting provisions set out in Section 104 InsO. The BGH's reasoning can be summarised as follows:

> German law is the applicable contract law (cf. Clause 11(2) DRV).

> The EU Insolvency Regulation ("**EIR**") is not applicable since the Company is an investment firm within the meaning of Article 1(2) EIR.

> Based on the German conflict of international insolvency law principles which are applicable instead (here: Section 340(2) InsO; implementing Art. 25 of EU Directive 2001/24/EU), the law governing the contract applies when assessing the effects of insolvency proceedings on "netting agreements" (*lex contractus principle*). Consequently, in the respective case German law

(including German insolvency law) as the law governing the DRV applies.

> German insolvency law (Section 119 InsO) stipulates that agreements deviating from (*inter alia*) Section 104 InsO are void and the statutory close-out netting provisions set out in Section 104 InsO apply directly.

> Whether the insolvency-related termination, which is linked to the filing of the petition for the opening of insolvency proceedings (*Insolvenzantrag*), as such is valid was explicitly left open by the BGH. According to the BGH, the provisions of the DRV are invalid to the extent the valuation methods therein deviate from the statutory valuation method set forth in Section 104(3) InsO.

> Based on the statutory valuation method set forth in Section 104(2) sentence 1 and Section 104(3) sentence 1 and 2 InsO, the Company has a claim for payment of the close-out amount based on the market value (*Marktwert*) of the option transaction(s).

> The aim of Section 119 InsO is to protect the assets of an insolvent company (*Masseschutz*). The cap set forth in Clause 8(2) sentence 1 DRV pursuant to which the solvent party's obligation to pay the benefit (*Vorteil*) to the insolvent party is limited to the amount of the insolvent party's damage (*Schaden*) conflicts with the protection level guaranteed by Section 104(3) InsO. The same is arguably true for deviating methods of calculating the compensation payment.

> For the calculation of the market value, the possibility of replacement transactions (*Möglichkeit der Ersatzeindeckung*) and not the tradability of the option transactions (*Handelbarkeit der Optionen*) is decisive. If a replacement transaction was not possible, no compensation claim is payable.

> Given that Section 104(3) InsO does not provide for interest payment claims following the due date of the compensation claim, the DRV clause dealing with interest on due claims (Clause 3(4) DRV) is void.

3 Impact on Master Agreements and Mitigants

In principle, all types of (master) agreements containing close-out netting clauses may be affected by the Decision if Section 104 InsO is applicable either (i) directly due to the centre of main interest of an insolvent party being in Germany (*lex fori principle*) or, (ii) if German law agreements are used (as in the case at hand), indirectly in accordance with the applicable German conflict of insolvency law principles (*lex contractus principle*).

The Decision impacts, for example, the DRV and the corresponding German Master Agreement for Repurchase Transactions (*Rahmenvertrag für Wertpapierpensionsgeschäfte (Repos)* and the German Master Agreement for Securities Lending Transactions (*Rahmenvertrag für Wertpapierdarlehen*). At the same time, the ISDA Master Agreement, the Global Master Agreement for Repurchase Transactions (GMRA) or the Global Master Agreement for Securities Lending Transactions (GMSLA) with certain types of German counterparties remain unaffected unless the EIR is applicable in the relevant case (*i.e.* the *lex contractus* principle does not apply – see below).

Whilst the resulting impact looks very broad at first sight, a number of restrictions to the scope of application of the Decision and general legal mitigants are available, depending on the facts of a specific case:

> In constellations where non-German law governed agreements are entered into with German counterparties which are within the scope of Article 1(2) EIR (*i.e.* credit institutions, investment firms, insurance undertakings or collective investment undertakings), the above mentioned *lex contractus* principle applies, pointing to the non-German law governing the agreement when considering the validity of the netting arrangement (*example*: an English law governed ISDA Master Agreement with an insolvent German bank; Section 104 InsO and the Decision would not be relevant, since English insolvency law applies).

> The BGH did not further limit the admissibility of non-insolvency related termination clauses (*insolvenzunabhängige Lösungsklauseln*). In line with previous case law by the same senate of the BGH, there are good arguments that for example a termination and contractual close-out netting following a failure to pay or non-delivery of collateral is permitted, subject to general insolvency avoidance rules. This may help to reduce the risk of having an overly long period between the Filing and the actual opening of insolvency proceedings.

> Transactions not terminated prior to the opening of insolvency proceedings will be terminated by law under Section 104 InsO if such transactions qualify as financial services (*Finanzleistungen*) within the meaning of Section 104 InsO.

> If Section 104 InsO applies to client clearing agreements or clearing rules for central counterparties, specific privileges for close-out netting following a clearing members' insolvency must be considered (Article 102b of the Introductory Act to the Insolvency Code in connection with Article 48 EMIR).

> The Decision assumes a partial invalidity of the DRV (with a focus on Clause 8 DRV) and also treats the underlying transaction as a valid transaction which is subject to the legal consequences set forth in Section 104(2) and (3) InsO.

4 Impact on CRR Issues

It will have to be further assessed how the Decision impacts the regulatory capital treatment of netting arrangements contained in the relevant master agreements. The basis for such considerations in Germany is the Capital Requirements Regulation (EU) No 575/2013 ("**CRR**").

The requirement for recognition of contractual netting agreements are set out in Articles 206 and 295 *et seqq*. CRR and include *inter alia* that an "*institution has concluded a contractual netting agreement with its counterparty which creates a single legal obligation, covering all individual transactions, such that, in the event of default by the counterparty it would be entitled to receive or obliged to pay only the net sum of the positive and negative mark-to market values of included individual transactions*".

Although the contractual netting provisions are partially impacted by the Decision, the statutory netting regime is available to the extent contractual netting provisions are considered to be void.

5 Steps by Political Stakeholders, BaFin and ECB

The German Ministry of Finance and the Ministry of Justice have issued a joint statement in relation to the judgement. In case the judgement will have a broader impact on the acceptance of commonly used master agreements in the market and by the supervisory authorities, the German government will immediately initiate a change of the relevant insolvency law provisions in order to ensure that master agreements remain accepted in the market and by the supervisory authorities.

In order to ensure legal certainty until the change of the German Insolvency Code as envisaged by the German Ministry of Finance and the Ministry of Justice will take effect, the German Federal Financial Supervisory Authority (*BaFin*) has – based on Section 4a of the German Securities Trading Act (*Wertpapierhandelsgesetz*) – issued a general decree (*Allgemeinverfügung*) (the "**Decree**") stating that contractual netting agreements, as described in Article 295 of the CRR, for which it is agreed that – in the event of default of one of the parties – the institution or its counterparty would be entitled to receive or obliged to pay only the net sum of the positive and negative mark-to-market values of included individual transactions, shall be settled in accordance with the respective contractual arrangements. This does not apply to such agreements which are subject to on-going court or insolvency proceedings.

BaFin has also issued an FAQ-list, answering key questions in relation to the Decree. This includes the statement that the Decree is set to create legal certainty until the announced change in law is effective. According to BaFin Risk-Weighted-Assets (RWAs) will not need to be

weighed differently. BaFin also notes that the Decree is a binding sovereign order (*bindende hoheitliche Anordnung*) with direct legal effects. The addressees are set out in the Decree.

6 Summary

The public announcements issued by the German Ministry of Finance and the Ministry of Justice and by BaFin are strong signs and will help to reduce the Decision's impact. Whilst the Decision is clearly respected in relation to the specific case, the announcements confirm at the same time the clear intention that contractual netting in general will remain possible under German law.

Given that netting is the legal foundation for functioning risk management in financial and commercial markets globally, legal certainty in this area is indispensable. The Decision can therefore be seen as a chance to promote necessary legal and regulatory changes for future cases.

7 Relevant documents

The Court's decision (only available in German):

http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=en&Datum=2016&nr=74978&pos=0&anz=1174

The Court's press release:

English convenience translation:

http://www.linklaters.com/pdfs/mkt/frankfurt/PM_BGH_EN_trans.pdf

German original:

http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=pm&Datum=2016&Sort=3&nr=74933&pos=0&anz=102

BaFin general decree:

English version:

http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Aufsichtsrecht/Verfuegung/vf_160609_allgvfg_nettingvereinbarungen_en.html

German version:

http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Aufsichtsrecht/Verfuegung/vf_160609_allgvfg_nettingvereinbarungen.html

FAQ (only available in German):

http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/FAQ/faq_netting.html

Joint statement by German Ministry of Finance and Ministry of Justice:

English convenience translation:

http://www.linklaters.com/pdfs/mkt/frankfurt/PM_BMJ_and_BMF_english.pdf

German original:

http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/Themen/Internationales_Finanzmarkt/2016-06-09-gemeinsame-erklaerung.html

Annex

Excerpt Section 104(2) and (3) InsO / Statutory Netting Provisions

(English Working Translation)

Section 104 Fixed Date Transactions, Financial Services (translation)

(2) If, for financial services with a market or stock exchange price, a fixed date or a fixed period was agreed, and if such date or expiry of the period occurs only after the insolvency proceedings were opened, performance may not be claimed, but only claims for non-performance. In particular the following shall be regarded as financial services:

1. the delivery of precious metals,

2. the delivery of securities or comparable rights if it is not intended to obtain a participation in a company in order to establish a permanent relationship with such company,

3. payments which have to be effected in foreign currency or in a mathematical unit,

4. payments the amount of which is indirectly or directly determined by the exchange rate of a foreign currency or mathematical unit, by the interest rate prevailing for claims or by the price of other goods or services,

5. options and other rights to deliveries or to payments within the meaning of nos. 1 to 4,

6. financial collateral within the meaning of Section 1(17) of the German Banking Act.

If transactions on financial services are combined in a master agreement for which it has been agreed that, upon the occurrence of reasons for the commencement of insolvency proceedings, it may only be terminated uniformly, the entirety of these transactions shall be regarded as a mutual contract within the meaning of Sections 103 and 104 InsO.

(3) Such claim for non-performance shall cover the difference between the agreed price and the market or stock exchange price prevailing (for a contract with the agreed period of performance) at the place of performance at a point in time agreed upon the parties, but no later than on the fifth business day after the insolvency proceedings were commenced. Absent an agreement between the parties, the second business day after the commencement of insolvency proceedings shall be relevant. The other party may bring such claim only as a creditor of the insolvency proceedings.

Excerpt DRV / Contractual Netting Provisions

(English Working Translation)

7. Termination

(1) Where Transactions have been entered into and not yet fully settled, the Agreement can only be terminated by either party for material reason. Material reason includes circumstances where payment or other performance due has not been received, for whatever reason, by the party entitled thereto within five Banking Days after the party liable to pay or to perform has been notified of non-receipt of the payment or other non-performance. Such notification, as well as the notice of termination, must be in writing, either by telex, telegraph, facsimile or in any other similar form. A partial termination, in particular a termination of some, but not all Transactions, is excluded, Clause 12 sub-Clause (5) (B) remains applicable.

(2) The Agreement shall terminate, without notice, in the event of insolvency. Insolvency shall be given, if an application is filed for the commencement of bankruptcy or other insolvency proceedings against the assets of either party and such party either has filed the application itself or is generally unable to pay its debts as they become due or is in any other situation which justifies the commencement of such proceedings.

(3) In the event of termination upon notice by either party or upon insolvency (hereinafter called "Termination"), neither party shall be obliged to make any further payment or perform any other obligation under Clause 3 sub-Clause (1) which would have become due on the same day or later; the relevant obligations shall be replaced by compensation claims in accordance with Clauses 8 and 9.

8. Claims for Damages and Compensation for Benefits Received

(1) In the event of Termination, the party giving notice or the solvent party, as the case may be, (hereinafter called "Party Entitled to Damages") shall be entitled to claim damages. Damages shall be determined on the basis of replacement transactions, to be effected without undue delay, which provide the Party Entitled to Damages with all payments and the performance of all other obligations to which it would have been entitled had the Agreement been properly performed. Such party shall be entitled to enter into contracts which, in its opinion, are suitable for this purpose. If it refrains from entering into such substitute transactions, it may base the calculation of damages on that amount which it would have needed to pay for such replacement transactions on the basis of interest rates, forward rates, exchange rates, market prices, indices and any other calculation basis, as well as costs and expenses, at the time of giving notice or upon becoming aware of the insolvency, as the case may be. Damages shall be calculated by taking into account all Transactions; any financial benefit arising from the Termination of Transactions (including those in respect of which the Party Entitled to Damages has already received

all payments and performance of all other obligations by the other party) shall be taken into account as a reduction of damages otherwise determined.

(2) If the Party Entitled to Damages obtains an overall financial benefit from the Termination of Transactions, it shall owe the other party, subject to Clause 9 sub-Clause (2) and, where agreed, Clause 12 sub-Clause (4), a sum corresponding to the amount of such benefit, but not exceeding the amount of damages incurred by the other party. When calculating such financial benefit, the principles of sub-Clause (1) as to the calculation of damages shall apply mutatis mutandis.

9. Final Payment

(1) Unpaid amounts and any other unperformed obligations, and the damages which are payable, shall be combined by the Party Entitled to Damages into a single compensation claim denominated in Euro, for which purpose a money equivalent in Euro shall be determined, in accordance with the principles set forth in Clause 8 sub-Clause (1) sentences 2 to 4, in respect of claims for performance of such other overdue obligations.

(2) A compensation claim against the Party Entitled to Damages shall become due and payable only to the extent that such party does not, for any legal reason whatsoever, have any claims against the other party ("Counterclaims"). If Counterclaims exist, their value shall be deducted from the total amount of the compensation claim in order to determine the portion of the compensation claim that is due and payable. For the purpose of calculating the value of the Counterclaims, the Party Entitled to Damages shall (i) to the extent that they are not payable in Euro, convert such Counterclaims into Euro at a selling rate to be determined, if possible, on the basis of the official foreign-exchange rate applicable on the day of computation, (ii) to the extent that they are not claims for the payment of money, convert them into a claim for damages expressed in Euro and (iii) to the extent that they are not yet due and payable, take them into account at their present value (also having regard to interest claims). The Party Entitled to Damages may set off the compensation claim of the other party against the Counterclaims calculated in accordance with sentence 3. To the extent that it fails to do so, the compensation claim shall become due and payable as soon as and to the extent that it exceeds the aggregate amount of Counterclaims.

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