

Learning Curve

China—The New Netting Jurisdiction

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Market practitioners have long looked forward to the enforceability of close-out netting for over-the-counter derivative transactions under the International Swaps and Derivatives Association master agreement in China.

This key milestone has finally been reached following a judicial interpretation issued by the **Supreme People's Court** in September last year. It is now clear that post-insolvency close-out can take place (albeit before acceptance of a bankruptcy petition by the People's Court) and post-insolvency netting can be achieved by the assertion of the creditor's right to set off.

Background

Where neither party is insolvent, the enforceability of the close-out netting provisions in the ISDA master agreement is not generally controversial. This is because the choice of governing law (typically English or New York law) is recognised under the conflicts of laws rules in most jurisdictions, including China, and close-out netting will be enforceable as a matter of contract law.

However, where a party has become insolvent, the enforceability of close-out netting against such counterparty become subject to mandatory insolvency requirements, and it becomes necessary to determine whether the rights to close-out and net are affected. In China, the Enterprise Bankruptcy Law is the primary law governing insolvency proceedings.

Close-out netting provisions comprise, firstly, the right to close-out (or terminate) transactions and, secondly, the right to net the values of all terminated transactions to come up with a single net amount which will be payable by one party to the other. Each of these steps is to be considered separately under China's bankruptcy law.

The Right To Net

As there is no separate legal concept of netting in China, any proposed post-insolvency netting would need to be recognised under the concept of set off. Previously, under the old China bankruptcy law (trial implementation - 1986), a creditor was required to "apply" to the liquidation committee in order to set off mutual obligations between the bankrupt debtor and the creditor. While the new bankruptcy law removed the requirement to "apply" and instead allowed a creditor to "assert" its right to set off, uncertainty still remained as to whether any such assertion operated as a self-help remedy, or was still subject to the approval of, or acceptance by, the bankruptcy administrator.

This lingering uncertainty has been removed by the SPC interpretation. The SPC interpretation clarifies that the right of set off is effective upon receipt of a set off notice from the creditor by the administrator. The administrator is not required to take any

positive actions for the right of set off to be effective. While the administrator is able to challenge such right of set off, any such challenge may only be made during a limited period and based on limited grounds. Accordingly, it is now clear that a creditor only needs to assert the right of set off and such creditor's right of set off operates as a self-help remedy.

The Right To Close-Out: Time Window For Exercising The Right To Close-Out.

Under the bankruptcy law, after the commencement of bankruptcy proceedings, the administrator is entitled to choose whether to terminate or continue performing a contract within 60 days (or 30 days, if requested by the relevant creditor). As a statutory right under the bankruptcy law, the moratorium right of the administrator prevails over the non-defaulting party's contractual right to close-out under an ISDA master agreement.

However, unlike certain jurisdictions, the moratorium right of the administrator commences from the acceptance (and not the filing) of a bankruptcy petition with a court. This means that there is a "time window" during which the right to close-out may be exercised (i.e. the period prior to the acceptance of a petition), and the key issue is to ensure that the right to close-out is exercised during such time window.

Designation Of Early Termination Date

This raises the question as to whether the non-defaulting party will have sufficient time to designate an early termination date under the ISDA master agreement falling prior to the acceptance of the petition by the court.

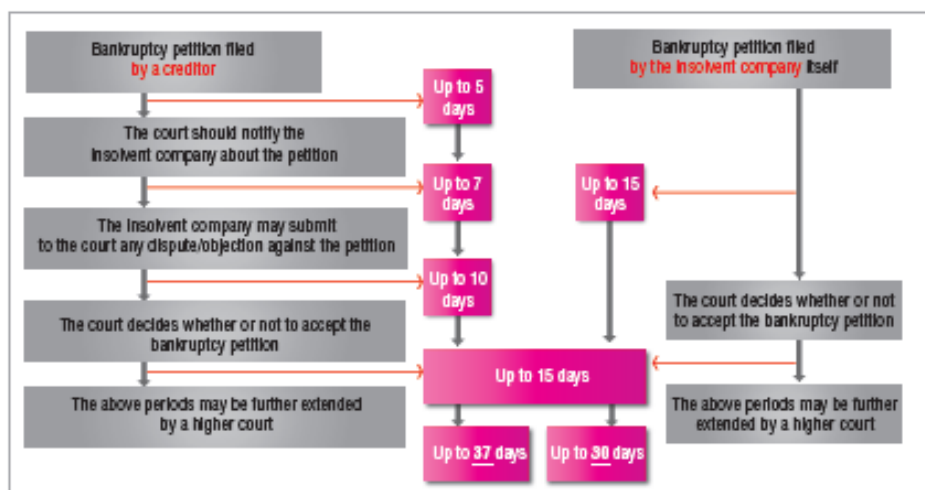
Generally speaking, there should be sufficient time, although this will depend on the facts. For example, even where a petition has already been filed, pursuant to the bankruptcy law, there are up to 37 calendar days (in the case of creditor-initiated petition) or 30 calendar days (in the case of debtor-initiated petition) between the filing and the acceptance of the petition.

In addition, the bankruptcy event of default in the ISDA master agreement (which gives rise to the right to close-out) can be triggered even prior to the time the petition is filed. For example, a bankruptcy event of default may be constituted by an action taken to obtain a shareholder's resolution or the relevant regulator's approval to bankrupt the company. As long as the non-defaulting party is aware of the circumstances triggering the bankruptcy event

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of default, it can designate an early termination date. One concern is that a court is not required to give notice to the insolvent entity's creditors until it accepts the petition. Nonetheless, a petition filed against a major financial institution is typically reported across the newspapers, and the non-defaulting party should have the information it needs in time for it to close out the transactions.

number of other ISDA jurisdictions, including Germany, Switzerland, Japan and South Korea. In particular, the Korean netting opinion suggests using AET to terminate and set off transactions before the commencement of certain corporate reorganization proceeding, after which a counterparty would not have the right to set off against the Korean entity subject to the reorganization proceeding.



Favorable Attitudes From The Courts and Regulators

Particularly comforting is the fact that the courts and the relevant financial regulators in China have been taking a positive and encouraging attitude towards the enforceability of close-out netting.

Recently, the SPC has explicitly required the courts to respect the validity of contracts relating to innovative financial business (which should include arrangements such as close-out netting). In the landmark insolvency of **Guangdong International Trust & Investment Co.**, the application of AET under the 1987 ISDA Agreement was honoured and not challenged by the court.

Automatic Early Termination

To address concerns that a party is not aware of the imminent insolvency or the filing of bankruptcy petition of its counterparty, it would be advisable to provide for automatic early termination in the ISDA master agreement. If, for example, the AET provision were to state that AET shall occur at the time a petition is filed, the close-out would occur upon the filing of the petition prior to the commencement of the moratorium when the petition is accepted by the court.

In certain jurisdictions, AET clauses are drafted to have retrospective effect in that upon the occurrence of an event, say the filing of a bankruptcy petition, the close-out shall be deemed to have occurred immediately prior to such filing. Such retrospective effect might invite scrutiny from the courts on the basis that it is artificial in nature. In China, however, there is no need for the AET clause to have retrospective effect and a close-out can take place upon the making of the petition (so long as it is before the acceptance of the petition by the court).

The question does arise as to whether an AET clause (even without retrospective effect) would be struck down as an attempt to circumvent the moratorium right of the administrator. This should not be the case since the non-defaulting party is always able to exercise its close-out right after the filing of the petition, so long as it is prior to the acceptance of the petition by the court. An AET clause, which is triggered upon filing of the petition, but before the acceptance of the petition by the court, simply dispenses with the requirement for the non-defaulting party to "physically" issue a termination notice.

Readers may wish to note that AET is recommended across a

Moreover, it is a judicial practice and also an express requirement from the SPC that the courts must seek the opinion of the relevant financial regulator when it comes to innovative financial products, and close-out netting has been blessed by most financial regulators. For example, **Liu Mingkang**, the former chairman of the **China Banking Regulatory Commission**, has called for legal clarification to ensure the enforceability of close-out netting. Close-out netting has also been introduced in many of China's own master agreements, such as the National Association of Financial Market Institutional Investors derivative master agreements and the Securities Association of China derivatives master agreement, publication of which have been approved by the **People's Bank of China**, **China Securities Regulatory Commission** and the **State Administration of Foreign Exchanges**.

Conclusion

In light of the above, there is now clear legal and regulatory support for post-insolvency close-out netting in China. Close-out is possible as long as it occurs prior to the acceptance of a bankruptcy petition by the court, and netting is possible as long as the relevant creditor asserts set off against the administrator.

There may yet be further developments in this area. We note, for example, that the **State Council Legislative Affairs Office** together with the CBRC and PBOC are currently drafting bankruptcy regulations for banks and other financial institutions. Market participants should continue to lobby for close-out netting to prevail even after acceptance of bankruptcy petition by the court.