

[Name]
Commission of the European Communities
Brussels
Belgium

[date] 2003

Contact persons: Niall Lenihan,
Ext.: +49 69 1344 7964
Klaus Löber,
Ext.: +49 69 1344 7225
E-mail: secretariat@efmlg.org

Dear [...],

**RE: EFMLG VIEWS REGARDING ENFORCEABILITY OF INSOLVENCY CLOSE-OUT
NETTING ARRANGEMENTS UNDER COLLATERAL & WINDING-UP DIRECTIVES**

The European Financial Market Lawyers Group (EFMLG)¹ has recently considered the implications for the enforceability of insolvency close-out netting provisions contained in bilateral master agreements for swap, derivative, foreign exchange, repurchase and securities lending transactions of certain provisions of

- Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements² (the “Collateral Directive”); and
- Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions³ (the “Winding-up Directive”, together with the Collateral Directive, the “Directives”).

¹ The European Financial Markets Lawyers Group (EFMLG) was established in 1999 with the support of the European Central Bank in order to discuss possible initiatives that would lead to increased harmonisation in the legal aspects and contractual practices of the EU financial markets following the introduction of the euro. The group is composed of in-house lawyers of those EU based credit institutions that are most active in the European financial markets. The members of the group, who are listed in the Annex to this letter, are selected exclusively on the basis of their personal experience and do not represent their institutions.

² OJ L 168, 27.06.2002, p. 43.

³ OJ L 125, 5.5.2001, p. 15.

Formatted: German
(Germany)

Formatted: German
(Germany)

Formatted: German
(Germany)

Formatted: German
(Germany)

The EFMLG has also conferred with the London Financial Markets Law Committee and the New York Foreign Exchange Committee's Financial Market Lawyers Group[, as well as the Banking Federation of the European Union and the International Swaps and Derivatives Association,] regarding this letter as the implications of these Directives are of interest to market participants in both the EU and the broader global financial markets.

The EFMLG has reached a number of conclusions regarding the proper interpretation of these provisions of the Directives, and considers that it might be useful to share these conclusions with you in connection with the Commission's verification of the implementation of the Directives by EU Member States, including the 10 Accession States acceding to the EU.

As you know, the Collateral Directive must be transposed into national laws by 27 December 2003 and the Winding-up Directive by 5 May 2004.⁴

1. Collateral Directive

Regarding the recognition of close-out netting provisions accorded by Article 7 of the Collateral Directive, the EFMLG takes particular note of the definition of 'close-out netting provision' contained in Article 2(1)(n) of the Collateral Directive, according to which

*'close-out netting provision' means a provision of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise: (i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; and/or (ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.'*⁵

The EFMLG takes particular note of the rationale behind the close-out netting provisions of the Collateral Directive, including the above underlined language, which is clarified in the fourteenth recital of the Collateral Directive:

The enforceability of bilateral close-out netting should be protected, not only as an enforcement mechanism for title transfer financial collateral arrangements including repurchase agreements

⁴ The EFMLG is aware that the issues discussed in this letter touch also on questions posed in the Green Paper on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernisation (COM (2002) 654(01)), where set-off is dealt with under the names 'offsetting' and 'legal compensation'. The EFMLG makes no comment on the substance of that paper here, but would emphasise out the highly technical and market-sensitive nature of the subject, and stands ready to assist as appropriate if the issues discussed in this letter are taken further in the context of the Rome Convention.

⁵ See Collateral Directive, Article 2(1)(n) (emphasis added).

but more widely, where close-out netting forms part of a financial collateral arrangement. Sound risk management practices commonly used in the financial markets should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of the collateral.

The EMFLG considers that these provisions of the Collateral Directive require Member States to ensure the enforceability of close-out netting provisions contained in any master agreement under which exposures are capable of being collateralised by way of title transfer or pledge arrangements, including master repurchase and securities lending agreements, as well as master swap agreements of which a financial collateral arrangement forms part (e.g., an ISDA Master Agreement of which an ISDA Credit Support Annex or Deed forms part or the Margin Maintenance Annex to the FBE Master Agreement for Financial Transactions). In particular, this implies that the close-out netting recognition provisions in the Collateral Directive apply to any master agreement of which a financial collateral arrangement forms part, even if the parties in a particular relationship or transaction have not actually provided any collateral.

2. Winding-up Directive

The EFMLG has considered the interpretation of Article 25 of the Winding-up Directive, which provides as follows:

Netting agreements shall be governed solely by the law of the contract which governs such agreements.

The EFMLG interprets Article 25 of the Winding-up Directive as meaning that the selection of a governing law from a netting-friendly jurisdiction should ensure the enforceability of netting against an EU-incorporated credit institution (and/or its liquidator or other insolvency official) even if the credit institution is incorporated in a less netting-friendly jurisdiction. This interpretation may be supported by the text of Article 25, and is fully consistent with applicable principles of interpretation of Community law.

The EFMLG notes that the use of the word ‘solely’ in the text of Article 25 of the Winding-up Directive implies that the law of the contract applies to the exclusion of any other potentially applicable legal system. In view of the traditional relevance of insolvency law in assessing the enforceability of insolvency close-out netting arrangements, the EFMLG considers that the provision deliberately departs from the general principle established by the Winding-up Directive that a credit institution shall be wound-up, and reorganisation measures shall be applied, in accordance with the laws, regulations and procedures applicable in its home Member State.⁶

⁶ See Winding-up Directive, Articles 3(2) and 10(1).

The EFMLG notes that the interpretation that Article 25 of the Winding-up Directive applies to the exclusion of any other potentially applicable legal system is also supported by a teleological interpretation of the provision, having regard to the purpose or object of the provision.⁷ Article 25 of the Winding-up Directive was absent from earlier versions of the draft Directive proposed by the Commission and considered by the European Parliament. The first draft of Article 25 was introduced when the Council established a common position on the Directive on 17 July 2000. In the Statement of the Council's reasons for the introduction of this provision, the Council clarified as follows:

This Article derogates from the basic principle of the application of the law of the Home Member States.... The overall objective of this Article [is] to ensure legal certainty in particular cases where it is thought that the importance or the special nature of the contract justifies the derogation from the principle of universality. Paragraphs 1c) and d) concern contractual netting agreements (agreements to set off positive and negative balances) between a credit institution and its counterparty and repurchase agreements (an agreement between a seller and a buyer of securities where the seller agrees to repurchase the securities at an agreed price) respectively. In both cases the law of the Member State applicable to the agreement applies⁸. Such agreements are commonly used on the financial markets and the Council considers that the especial function of such contracts requires a derogation from the principle of universal application of home Member State law in order to protect the functioning of the financial markets and to ensure legal certainty for the contracting parties.⁹

The EFMLG notes that the interpretation that Article 25 of the Winding-up Directive applies to the exclusion of any other potentially applicable legal system is a necessary interpretation in the sense that any other interpretation would imply that the provision expresses a mere truism, repeating the tautology that netting agreements are governed by the law of the contract that governs such agreements. The EFMLG does not consider that such an interpretation is feasible since such an interpretation would render Article 25 of the Winding-up Directive meaningless, contrary to the principle of Community law applied by the Court of Justice that a legal provision must be interpreted in such a manner that its implementation is effective and useful (l'effet utile).¹⁰

⁷ See, e.g., Case 294/83, *Parti Ecologiste "Les Verts" v. European Parliament*: [1986] ECR 1339; Case 302/87, *European Parliament v. Council*: [1988] ECR 5615.

⁸ As discussed below, it is noted that the law of non-EU jurisdiction (e.g., New York law) might be chosen as the governing law of the agreement.

⁹ See Common position EC No 43/2000 adopted by the Council on 17 July 2000 with a view to adopting Directive 2000/.../EC of the European Parliament and of the Council of... on the reorganisation and winding-up of credit institutions, OJ C 300, 20.10.2000, p. 13.

¹⁰ See, e.g., Case 8/55, *Fédération Charbonnière de Belgique v High Authority*: [1954-56] ECR 245 and 292; Case 25/59, *The Netherlands v High Authority*: [1960] ECR 355; Case 34/62, *Germany v Commission*: [1963] ECR 131.

The EFMLG notes that much netting legislation in the existing 15 EU Member States forms part of national law (including insolvency and bankruptcy codes),¹¹ and in some cases specifies the terms and conditions under which the enforceability of insolvency close-out netting should be recognised. Article 25 of the Winding-up Directive implies, so far as a credit institution is concerned, that the netting legislation of the credit institution's home state is no longer relevant in any way to a determination of the enforceability of the netting agreement where the netting agreement is governed by the law of a jurisdiction other than the credit institution's home state, even where the contractual jurisdiction is that of a country outside the EU.¹²

A residual question which remains is whether the requirement that a netting agreement be governed "solely by the law of the contract which governs such agreements" allows for the application of the insolvency laws of the jurisdiction whose laws have been chosen by the parties to the netting agreement as the governing law of the contract.¹³ As a general matter the EFMLG considers that the reference in Article 25 of the Winding-up Directive to the law of the contract should be interpreted as a reference to the law chosen by the parties as the governing law of the netting agreement. While the law of such jurisdiction would, by definition, include the applicable insolvency and/or netting laws of that jurisdiction, the EFMLG considers that the contractual choice of that jurisdiction's law as the governing law of a netting agreement would not make a party subject to the insolvency and/or netting laws of that jurisdiction if such laws would not, on their terms, apply to such party. Whether the insolvency and/or netting laws of that jurisdiction contain netting rules applicable to a party is a question of interpretation

¹¹ **Austria:** Bankruptcy Code (*Federal Law Gazette 1924/337*) as amended; Banking Act (*Federal Law Gazette 1993/532*) as amended; **Belgium:** Law of 22 March 1993 on the governance and supervision of credit institutions; **Denmark:** Securities Trading Act, Lbleg 2002-07-09, num 587; **Finland:** Act on certain conditions of Securities and Currency Trading as well as Settlement Systems (26.11.99/1084); **France:** Monetary and Financial Code, *Code Monétaire et Financier*; **Germany:** Code of October 5, 1994 Insolvency Code (*Insolvenzordnung*) Entered into force January, 1, 1999 (BGBl. I. S. 2866); **Ireland:** Netting of Financial Contracts Act, 1995, supplemented by the Netting of Financial Contracts Act, 1995 (Designation of Financial Contracts) Regulations, 2000; **Italy:** Decree-Law Num. 58/1998 (*Testo Unico delle disposizioni in materia di intermediazione finanziaria*); **Luxembourg:** Law of 6 of May of 1996 on the set off of claims and debts of the Financial Sector, as amended; **Netherlands:** Bankruptcy Act of 1893, as amended (*Faillissementswet*). Civil Code, Book 6, Chapter 12 (*Burgerlijk wetboek*); **Portugal:** Decree-Law No. 1/97 of 7.01.1997 (Regula a aceitação pelo Estado das cláusulas de compensação, denominadas "netting" e "set-off", no âmbito de acordos sobre produtos financeiros derivados, celebrados nos mercados financeiros) Decree-Law Num 70/97 of 03.04.199; **Spain:** Securities Market Law 37/1998 (*Ley del Mercado de Valores*) as amended by Law 44/2002 of 22 November 2002; and **Sweden:** Financial Instruments Trading Act (SFS 1991:980). Bankruptcy Act (1987:672). In **England & Wales** the enforceability of netting is established at common law, although Rule 4.90 of the Insolvency Rules 1986, SI 1925 also makes provision for mandatory set-off of mutual credits, mutual debts or other dealings between a company that goes into liquidation and its creditors.

¹² For example, according to this interpretation the somewhat elaborate Irish Netting of Financial Contracts Act 1995 would no longer be relevant to a determination of the enforceability against an Irish-incorporated credit institution of a netting agreement governed by English or New York law that is executed by that credit institution. The same analysis would pertain to credit institutions in any EU Member State whose home country laws contain intricate legislation specifying the terms and conditions under which insolvency close-out netting is enforceable.

¹³ See generally Jean-Pierre Degué, Advisor – Belgian Banking and Finance Commission, Directive 2001/24/EC on the reorganisation and winding up of credit institutions finally establishes uniform private international law for banking insolvency proceedings, International Conference on Bankruptcy Reform, Siena, 6-7 December 2000, p. 13-14; Jean-Pierre Degué, Conseiller Adjoint à la Commission Bancaire et Financière (Bruxelles), La Directive 2001/24/EC sur l'assainissement et la liquidation des établissements de crédit: une solution aux défaillances bancaires internationales?, published in Euredia – European Banking & Financial Law Journal, 2001-2002, p. 279, 285-88, 305-7; Christophe Keller, Deutsche Bundesbank, Die Wertpapiersicherheit im Gemeinschaftsrecht, BKR 2002, p. 347, 351

arising under the particular insolvency and/or netting laws of each individual jurisdiction the laws of which may govern a netting agreement.

The practical application of these principles can be more clearly demonstrated by taking the examples of the following four jurisdictions whose laws are commonly chosen as the governing laws of netting agreements to which EU credit institutions are party.

England and Wales. The contractual choice of English law as the governing law of a netting agreement to which an EU credit institution is party would not, by definition, make an EU credit institution subject to the mandatory set-off provisions of Rule 4.90 of the Insolvency Rules 1986 unless the EU credit institution is a company subject to the winding-up jurisdiction of the courts in England and Wales. This is because Rule 4.90 is contained in Part 4 of the Insolvency Rules 1986, which applies only in relation to companies which the courts in England and Wales have jurisdiction to wind up.¹⁴ General principles of English law, however, applicable outside the scope of statutory insolvency law, would normally support the enforceability of a netting agreement.France. The provisions recognising close out netting pursuant to the French Monetary and Financial Code do not form part of French insolvency law, and their application is not confined to parties subject to French insolvency proceedings. These provisions would therefore be applicable to all netting agreements governed by French law to which an EU credit institution is party.¹⁵

Germany. Under the rules of German insolvency law (cf. Art. 94, 95 and 104 of the German Insolvency Code (Insolvenzordnung – InsO) and Art. 105 of the Introductory Law to the German Insolvency Code (Einführungsgesetz zur Insolvenzordnung – EGIInsO), contractual close-out netting provisions governed by German law are valid and enforceable, even in case of insolvency of one of the parties.

However, according to the currently applicable legal framework in Germany (which, however, is going to be changed upon transposition of the Winding-up Directive), the contractual choice of German law as the governing law of a netting agreement to which an EU credit institution is party would not subject the enforceability of a netting agreement against a (non-German) EU credit institution to the provisions of German law that are designed to ensure the enforceability of the close-out, set-off and netting of financial contracts. Art. 102 EGIInsO states that the applicable insolvency law is determined by the place of establishment of the insolvent party (in accordance with the ‘universality principle’).

New York. The contractual choice of New York law as the governing law of a netting agreement to which an EU credit institution is party would not, by definition, render the enforceability of a netting agreement against an EU credit institution subject to the special provisions of U.S. or New York law that are designed to ensure the enforceability of the close-out, set-off and netting of financial contracts against parties that are subject to various U.S. and New York insolvency proceedings to the extent that an EU

¹⁴ See Insolvency Rules 1986, S.I. 1925. r. 03.

¹⁵ See Monetary and Financial Code, *Code Monétaire et Financier*, Article L. 431-7.

credit institution is not itself subject to such proceedings.¹⁶ However, it is noted that the U.S. Federal Deposit Insurance Corporation Improvement Act of 1991 contains certain provisions recognising the enforceability of bilateral netting contracts governed by the laws of a U.S. jurisdiction (e.g., New York law) that are entered into by two ‘financial institutions’, which would include certain EU credit institutions.¹⁷

Finally, the EFMLG notes that Article 25 of the Winding-up Directive does not define the concept of ‘netting’. In the absence of a statutory definition of the term ‘netting’ as used in Article 25 of the Winding-up Directive the EFMLG concluded that the term ‘netting’ should, at least, be understood as referring to the essentially bilateral process of close-out, conversion of obligations into monetary claims and mutual set-off.

The EFMLG would be interested to know if the Commission shares the interpretations set forth in this letter. The EFMLG would also be happy to provide you with any further information or assistance, if required.

Yours sincerely,

Antonio Sáinz de Vicuña
Chairman

Cc: Ms. Joyce Hansen
Chairperson
Financial Markets Lawyers Group
New York Foreign Exchange Committee

Mr. Martin Thomas
Secretary
Financial Markets Law Committee
London

[Mr. Frédéric de Brouwer
Head of Legal Department

¹⁶ See 11 U.S.C. § 109(b)(3); 12 U.S.C. § 1821(e)(8). However, it is noted that the U.S. Comptroller of the Currency is empowered in certain circumstances to appoint a receiver to take possession of all the property and assets of a foreign bank in the United States. See 12 U.S.C. § 3102(j)(1). Also, it is noted that the special provisions of the New York Banking Law that are designed to ensure the enforceability of the close-out, set-off and netting of financial contracts against a New York banking organization that is subject to liquidation proceedings are applicable in the case of the liquidation of a branch or agency of a foreign banking corporation by the New York Superintendent of Banks. See N.Y. Banking Law §§ 618-a(1), 618-a(2) (McKinney 2003).

¹⁷ See 12 U.S.C. §§ 4402(14), 4403(a); 12 C.F.R. §§ 231.2, 231.3.

European Banking Federation]

[Dr. Peter Werner
International Swaps and Derivatives Association
European Office
London]