Survey

European Financial Markets Lawyers Group

EFMLG

THE REGULATION OF CLOSE-OUT NETTING IN THE COUNTRIES ACCEDING TO THE EUROPEAN UNION ON 1 MAY 2004

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INITIAL SURVEY ON THE REGULATION OF CLOSE-OUT NETTING IN THE COUNTRIES ACCEDING TO THE EUROPEAN UNION

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INTRODUCTION

Attached is a brief overview of close-out netting legislation in the ten countries acceding to the European Union (EU) in 2004, namely Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia. Upon accession, the financial markets of these countries will be integrated into the single European financial market and thus an overview of the relevant legislation in these jurisdictions is useful for anyone intending to do business there. Although such legislation is prone to rapid change, it is intended that this report be regularly updated.

What is close-out netting?

There is some confusion regarding the terminology related to netting, set-off, close-out netting, settlement netting – terms that are often used interchangeably although in fact they have different meanings. For the financial and derivatives markets the concept ‘close-out netting’ is of fundamental importance, and this term is the focus of this report. The key question is the enforceability of close-out netting agreements that allow a party:

- to terminate agreements and close-out all (also not yet due) obligations if a certain defined event occurs, and
- to net the termination values into a single net amount.

What makes the issue legally problematic is that such close-out netting arrangements are likely to conflict with traditional bankruptcy rules, which were drafted before the emergence of the derivatives markets. Such rules generally provide for the liquidators’ discretionary powers (‘cherry picking’), the homogeneous treatment of creditors and the invalidity of certain actions following bankruptcy. Given the seemingly conflicting objectives it is often challenging for legislators to address the issues properly.

The importance of close-out netting

The topic is an important one as the satisfactory regulation of close-out netting is one of the pre-conditions for effective financial markets. Close-out netting has several advantages: it reduces credit risk (according to some estimates netting almost halves a bank’s overall exposure), hence the credit exposures that institutions are able to take on can expand. In conjunction with this, the amount of capital legally required for credit institutions to cover their credit exposures could also be reduced. Close-out netting also reduces settlement risk, liquidity risk and as a consequence systemic risk. It benefits financial market participants (financial institutions and other participants) and is important for national central banks as it also increases the efficiency of their monetary policy instruments

Benchmarks for effective close-out netting legislation

It is important to have clear rules on close-out netting. In the light of the uncertainty arising from the existing divergent insolvency regimes, which in many cases were adopted before the derivatives market existed, and in the absence of court decisions in this area, derivatives market participants will greatly benefit from clear statutory recognition and regulation of close-out netting. Such regulations should clearly state that close-out netting will be enforceable and will supersede conflicting provisions of insolvency laws where necessary. The main considerations concerning the applicability and scope of close-out netting legislation are the following:

- **Specificity and contractual freedom.** Legislation should relate specifically to close-out netting and clearly indicate what happens under such agreements in a bankruptcy situation, paying special regard to the provisions of insolvency legislation. In this respect contractual freedom and respect for the intention of the contracting parties is crucial, especially where they reflect standard practice for the derivatives market. Netting legislation should ensure the enforceability of close-out netting, in accordance with the parties’ agreement, following any contractually agreed termination event or default event under a netting agreement, both pre- and post-insolvency. If insolvency law prohibits set-off then netting legislation should provide that close-out netting is not a prohibited form of set-off.

- **Preference over bankruptcy rules.** The rules should make close-out netting enforceable upon bankruptcy, giving them precedence over general bankruptcy rules (such as rules on cherry-picking, other powers of insolvency officers and suspect periods). Regarding cherry-picking: where Member State insolvency law provides that the liquidator may assume or repudiate contracts, netting legislation should limit such assumption or repudiation to the net amount due under the netting agreement. Regarding suspect periods: where Member State insolvency law provides for a suspect period, netting legislation should provide that payments under eligible transactions are not to be treated as preferences where such payments were not intended to hinder, delay or defraud other creditors. In addition, 'insolvency proceedings' should be broadly defined to include both proceedings that exist now or could arise in the future.
- **Enforceability outside bankruptcy situations.** Legislation should be enforceable upon default, even when there is no bankruptcy involved. It should, if necessary, state that it supersedes gaming or similar laws that could invalidate netting agreements on the basis that they are gaming or otherwise unlawful contracts.
- **Flexibility and inclusion of all relevant transactions.** If eligible transactions are defined, this should be in a manner that is broad and flexible enough to include a wide range of fast changing financial products. They should certainly include all commonly used derivatives transactions and possibly also title transfer collateral arrangements to ensure that, where a netting agreement includes such arrangements, obligations to return collateral of equivalent value are netted with obligations under the derivatives transactions. The possibility of giving a public body/regulatory authority the power to designate additional transactions with the development of new financial products could also be considered.
- **Covering more-complex situations - single contract.** Legislation should also enable cross-product, multi-branch and multi-currency netting. In this context it is particularly important to stress that netting legislation should specify that a netting agreement and all eligible transactions under the netting agreement constitute a single contract. Netting legislation should provide that the inclusion of non-eligible transactions under the netting agreement would not destroy close-out netting for the remaining eligible transactions under the netting agreement. In addition, where collateral arrangements cover some transactions which are eligible transactions, and some which are not, the collateral arrangements should remain protected with respect to the eligible transactions.
- **Trades terminate - agreements survive**. Netting legislation should not require the termination of the agreement regulating the relationship between the parties. Only trades or transactions forming part of the single contract should terminate but the single contract itself should survive so that the netting provisions in it are enforceable.
- **Wide range of potential beneficiaries.** Legislation should not be overly restrictive regarding the potential beneficiaries of such regimes, as an increasing circle of market participants, also outside the financial sector, might need to rely on such agreements. Hence, netting legislation should not exclude corporations, insurance companies, special purpose vehicles, wealthy individuals or others that could potentially benefit from close-out netting of over-the-counter derivatives transactions entered into on a bilateral basis.
- **No form requirements regarding the type of agreements.** Close-out netting should not be confined to pre-approved types of netting agreements. Also, close-out netting should be equally permissible in the context of single, master and multiple master agreements.
- **Protection of collateral arrangements.** It is a precondition that netting legislation should not undermine the enforceability of collateral arrangements. Collateral arrangements in support of netting agreements should be exempt from any conflicting Member State collateral law requirements that the collateral taker obtain consent from, or provide notice to, other parties or liquidators prior to the realisation of collateral. In addition, collateral and title transfer arrangements should be included in any definition of protected eligible transactions so that they are also exempt from the usual insolvency rule protections such as stays or avoidance by liquidators.
- **Simplicity.** Unnecessary complexity and overly bureaucratic requirements should be avoided. This is essential in order to provide a user-friendly and flexible legal framework for an important and fast changing market area.

Although it is outside the ambit of this review, it should be mentioned that netting regimes in the context of payment systems are expected to comply with the so-called Lamfalussy standards.

The scope of the review

As far as the scope of the review is concerned, it does not aim to review all types of netting agreements (set-off, novation netting, payment netting, etc.) in the given jurisdictions. It focuses only on the enforceability of close-out netting agreements that, as mentioned above, allow a party to terminate agreements and close-out all (also not yet due) obligations if a certain defined event occurs, and to net the termination values into a single net amount.

As a consequence, the focus is the compatibility of such agreements with bankruptcy legislation, leaving aside other aspects of bankruptcy legislation. If there are no specific provisions on close-out netting, then the general rules on set-off and bankruptcy will also be examined. Other national legislation will also be mentioned in so far as relevant to the application of close-out netting agreements. Please note that the English translations of the legal texts reviewed are unofficial.

Key initial findings

It is only possible to take a snapshot of the situation as in most of the examined countries netting legislation is only envisaged or in the process of being introduced. Prior to 1 May 2004 significant legislative changes are expected in the Czech Republic, Cyprus, Latvia, Lithuania, Slovenia and Slovakia. In Latvia and Lithuania such changes are probably limited to financial collateral arrangements, as Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements[1] (the 'Financial Collateral Directive') still needs to be implemented. Legislative change has been triggered both by the need to prepare for EU accession and by the general overhaul of the bankruptcy systems. In addition, the legislative proposals of the International Swaps and Derivatives Association (ISDA) should also be mentioned.

Only three countries (Hungary, Malta and Poland) have opted for comprehensive legislation on close-out netting. The Czech Republic is half way there (with the amendment of bankruptcy rules being on hold), whilst the other jurisdictions have no comprehensive and specific close-out netting laws. Two of the three countries that opted for comprehensive rules (Hungary and Poland) decided to confine them to the financial sector, whilst Malta opted for a very liberal, all-encompassing approach to the subject.

Of the countries that have not yet adopted close-out netting legislation, Cyprus and Slovenia have a favourable environment where such agreements are recognised under certain restrictions, although the legal soundness of the present regime is questionable. In the other jurisdictions (the Baltic countries and Slovakia) close-out netting is either not recognised at all, or only in a very limited manner and usually in the context of payment systems.

Although close-out netting is currently only recognised in three countries, set-off in an insolvency context (without close-out) is allowed in most other jurisdictions. Such set-off is possible under certain conditions in Estonia, Lithuania and Slovenia. In Latvia, netting in an insolvency situation is very much an exception to the rule. Slovakia and the Czech Republic currently have a total prohibition, even as regards set-off in a bankruptcy situation.

Although derivatives markets and their regulatory regime have quite a short history in the countries examined, there can already be some comments made on the problems market participants have to face in practice from a legal point of view. Generally the greatest problem is insufficient or non-existent regulation of close-out netting. However, it is also possible to identify legislative obstacles in countries with appropriate netting regulation. Such obstacles mainly hinder cross-border business and it is still premature to expect appropriate court practice to have developed in this area.

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1 OJ L 168, 27.6.2002, p. 43.

Suggested way forward

The fact that various aspects of the legislation on close-out netting are currently being changed undoubtedly complicates such a review. However, it also provides an opportunity to influence the legislative outcome, hence this comes review just at the right time. One possible outcome of this exercise could be the submission of proposals to legislators in the acceding countries that are in the process of changing their laws in this area. Another possibility is to consider an EU wide approach possibly culminating in a directive specifically addressing close-out netting related issues. The EFMLG intends to consider ways forward following the publication of this report. Such initiative could help create a business-friendly environment in the field of close-out netting, able to accommodate even cutting-edge financial products.

REPUBLIC OF CYPRUS

1. RULES APPLICABLE TO CLOSE-OUT NETTING

Although Cypriot law does not expressly provide for close-out netting, it is recognised, with certain limitations, in the context of contractual agreements between parties. It is up to the parties to define the conditions of close-out netting. Such close-out netting agreements can allow the unilateral exercise of set-off, which the other party can only challenge in court if the right was improperly exercised. Parties can provide for such agreements to require the mutual consent of both contracting parties for set-off. In this case the insolvency officer might be able to object to the agreement under the conditions set out below.

Close-out netting is valid and cannot be set aside by an administrator as long as:
- it did not occur less than six months prior to the commencement of the proceedings, or
- it does not constitute a fraudulent preference of a creditor.

Therefore, the time at which the close-out netting agreement was entered into is a very important factor with regard to its validity.

The most important pieces of legislation on this issue are the following:
- Article 301 of the Companies Law (Cap.113) provides that any conveyance made by a company less than six months prior to the commencement of its winding-up procedure would be deemed a fraudulent preference against its creditors and be invalid,
- Article 2 of the Fraudulent Transfers Avoidance Law (Cap. 62) states that any transfer made by someone who intends to thereby hinder or delay his/her creditors in recovering their debts from him/her will be deemed to be fraudulent and will be invalid against such creditors, irrespective of when it was entered into.

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

The present legal situation is clearly not sufficient to create an appropriate business environment for financial transactions. The Financial Collateral Directive is in the process of being implemented in Cyprus. In this respect, Article 7 on the recognition of close-out netting provisions is expected to be transposed in the national legal order. However, no draft of the implementing law is currently available.

CZECH REPUBLIC

1. RULES APPLICABLE TO CLOSE-OUT NETTING

‘Close out netting’ is recognised under Act No. 591/1992 Coll., as amended (the ‘Securities Act’). However, as the reform of the insolvency regime is still being debated at Government and Parliament level, close-out netting has not yet been incorporated into bankruptcy legislation, hence its enforceability in a bankruptcy situation is highly questionable.

1.1. Close-out netting outside a bankruptcy situation

The Securities Act currently restricts the application of close-out netting outside a bankruptcy situation. Only professional investors, namely licensed securities dealers, are entitled to terminate derivatives agreements early under close-out netting, and even then only pursuant to a netting agreement of the type described in the Act. Licensed banks and branches of foreign banks will usually also be licensed as securities dealers on the basis of a special permission (licence) issued by the Czech Securities Commission.

Article 87(d)(1) of the Securities Act provides for the possibility of close-out netting:

‘A securities dealer (i.e. brokerage house) may effect final settlement of profits and losses (hereinafter "final settlement”), which means calculation of the net amount of the parties' outstanding payables or receivables on termination and settlement of transactions covered by the contract on final settlement or another contract involving the same. This calculation is based on the amount of loss and profit, whether actual or envisaged, determined in respect of any fulfilment or payment to be effected (provided that there is no breach of the parties' obligations under the contract on final settlement or no fact invalidating such contract, and also that no other similar fact occurs), including any costs incurred or proceeds (yields) acquired in connection with the transactions' termination and settlement. The net balance of the parties' payables or receivables after termination and settlement of each individual transaction or a block of transactions covered by the contract on final settlement can be determined, for example, as the net result of quotations (prices, indices, rates) obtained from one or more brokerage houses operating on the relevant markets.’

The term ‘contract of final settlement’ (i.e. a netting agreement) is defined in Article 87(d)(2) of the Securities Act:

‘A contract on final settlement shall mean a contract, including any framework contract, concluded for the purpose of regulating relationships based on one or more transactions in derivatives, repurchase transactions, loans of securities or other financial transactions concluded outside organised public markets, which stipulates that the calculation of the net amount of the parties' outstanding payables or receivables on termination and settlement of one or more transactions concluded under such contract shall be based on profit or loss, actual or envisaged, made by the parties.’

This definition provides for close-out netting regarding a sufficiently wide circle of transactions. It covers derivatives, repurchase transactions, securities lending and also other such financial transactions that are concluded outside an organised securities market under an agreement that includes a netting clause. It is also clear from Article 87(d) that multi-transaction netting is possible under such a netting agreement. Article 87(d)(1) explicitly states: *‘after termination and settlement of each individual transaction or a block of transactions, covered by the contract on final settlement’. Furthermore,* Article 87(d)(2) refers to *‘one or more transactions’.*

Multi-branch netting, i.e. the ability of any branch of the counterpart entity listed in the netting agreement to benefit from netting, is also possible. This is a matter for the parties to decide in the agreement.
Parties may also use multi-currency netting, as the definition of netting in Article 87(d) does not restrict the transactions covered to any one currency.

1.2 Close-out netting in a bankruptcy situation

The above-mentioned provisions of the Securities Act do not however clarify the status of close-out netting under local bankruptcy law if a Czech counterpart went bankrupt. In particular, it does not clarify whether the bankruptcy administrator would be permitted to 'cherry-pick' between transactions.

If close-out netting were considered to be set-off, it might not be enforceable if the counterpart went bankrupt (i.e. an event of early termination) due to the current Act on Bankruptcy and Settlement of Claims No. 328/1991 Coll. ('Act on Bankruptcy') as amended. Article 364 of Act No. 513/1991 Coll, (the Commercial Code) permits business parties to set off mutual claims on the basis of an agreement. 'Mutual' means that the same parties owe the debts to each other and that they arise from the same legal relationship. However, the current Act on Bankruptcy prohibits the realisation of set off upon the debtor's bankruptcy. Article 14(1)(i) of the Act on Bankruptcy provides that:

'*The declaration of bankruptcy shall have the following effects:*

(i) the set-off of claims belonging to the bankrupt estate, [which would otherwise be able to be set off], shall not be possible.'

There is no case-law on the extent to which close-out netting is analogous to set-off as defined in the Act on Bankruptcy. It is also unclear whether an automatic early termination clause, when bankruptcy is declared, would be enforceable. It should be noted that there is a six-month suspect period preceding a bankruptcy declaration, during which certain of the debtor's acts (such as, arguably, entering into a disadvantageous derivatives transaction) are without effect against its creditors. The initial intention behind legal reform was to introduce close-out netting not only in securities legislation, but also in the bankruptcy regime. However, this has not yet happened, and as a consequence it is doubtful whether close-out netting is enforceable in a bankruptcy situation.

As regards netting within payment systems, whilst legislation on, *inter alia*, payment systems, viz. Act No. 124/2002 Coll., is in force, it is silent on the question of the netting-out of claims upon the insolvency of one of the participants. It is thus also unclear whether courts would recognise close-out netting in such circumstances.

1.3 New legislation in preparation

There are two key issues regarding the legislation on close-out netting that are currently being debated in relation to legislative proposals. One issue is the fact that at present it appears that only securities dealers may benefit form the relevant close-out netting provisions of the Securities Act. The other issue is – as mentioned above – the validity of close-out netting in an insolvency situation.

The *draft law on Trading on the Capital Markets,* is currently in the consultation phase at Government level. This draft will, if adopted in the June 2003 form considered for this review, replace and extend the scope of the present Securities Act. The draft aims to harmonise Czech law with the EU *acquis* in the area of capital markets and investment services. The draft essentially contains the same definitions of 'close-out netting' (Article 162) and 'agreement on netting/final settlement' (Article 163) as are contained in the current Articles 87(d)(1) and (2) of the Securities Act. These definitions appear to be in line with the texts proposed by the ISDA. The only difference between Article 162 of the draft and the current Article 87(d)(1) is that Article 162 would apply generally and, unlike Article 87(d)(1), it does not restrict netting to securities dealers alone.

Insolvency legislation is also being overhauled. The Government's legislative committee is presently discussing a draft law on Insolvency. It is not clear at this stage when this bill will be submitted to Parliament, if at all, and nor is it clear whether or not it will contain effective provisions on close-out netting. The draft that was presented to the legislative committee on 10 October 2003 contained provisions expressly permitting netting upon insolvency and stating that it was not set-off. It also provided that the normal six-month period prior to insolvency during which transactions for ‘obviously disadvantageous terms’ are invalid against creditors does not apply to close-out netting. However, this draft was rejected in favour of a single harmonising amendment to the existing Act on Bankruptcy. It is not yet certain whether close-out netting will feature in this amendment.

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

As indicated above, it remains to be seen how close-out netting will be regulated in the case of insolvency. There are no precedents as to how Czech bankruptcy judges will deal with a netting clause in a recognised industry standard, such as the 1992 ISDA master agreement, nor do the draft laws provide much guidance.

It should also be mentioned that under the Foreign Exchange Act 528/1995 Coll. as amended, persons and entities resident in the Czech Republic that are not duly licensed foreign exchange dealers (i.e., banks or financial institutions licensed to make monetary transactions abroad), may only conclude financial derivatives transactions with entities that are not foreign exchange dealers, on the basis of a foreign exchange licence issued by the Czech national bank. They may, however, freely contract with a licensed bank whose banking licence authorises it to enter into such transactions.

ESTONIA

1. RULES APPLICABLE TO CLOSE-OUT NETTING

1.1 Close-out netting

Under the provisions of the Credit Institutions Act close-out netting is allowed only in very limited situations and under specific conditions. The Act states that only credit institutions can apply close-out netting in the case of bankruptcy with respect to payments already placed in the payment system. Article 87 of the Credit Institutions Act deals with the conditions of close-out netting and it states out the following:

'1) A credit institution shall open an account in the Bank of Estonia.
2) Payments of credit institutions shall be settled through a payment system pursuant to the procedure established by the Bank of Estonia.
3) A payment system is deemed to be a body of rules and procedures for the settlement of payments, established on the basis of an agreement entered into by three or more parties.
4) Upon making settlements through a payment system, credit institutions may offset liabilities pursuant to the procedure established by the Bank of Estonia.
5) A payment order given to the administrator of a payment system by a credit institution pursuant to the rules of the payment system is irrevocable. Declaration of a moratorium or commencement of bankruptcy proceedings shall not suspend the execution of payment orders given pursuant to the rules of the payment system. Payment orders given before the declaration of a moratorium or commencement of bankruptcy proceedings shall be executed out of the collateral instruments of the payment system, the procedure for formation and use of which shall be established by the Bank of Estonia.'

According to these rules credit institutions have to open an account with Eesti Pank and close-out netting is only possible among credit institutions within the payment system of the central bank. The internal rules and procedures of Eesti Pank set out the ways in which close-out netting can operate.

As far as the scope of such close-out netting is concerned, it is worth mentioning that nothing in the legislation prevents multi-transaction, multi-branch or multi-currency netting in the context of payment systems. Article 3(2) of the Real-time Gross Settlement General Conditions and Article 2(2) of the Designated Net Settlement System General Conditions provide that payments have to be settled in Estonian currency, and the use of other currencies is dependant upon the decision of the system manager.

With regard to the Bankruptcy Act it should be mentioned that the Credit Institutions Act is a special law, which, under the Estonian legal system, means that whenever there is a conflict between the two legal acts, the Credit Institutions Act will prevail. Therefore, general bankruptcy rules will be applied only when there are no special rules available. Article 87(5) prevents insolvency officers from using any cherry-picking powers.

1.2 Set-off

Set-off can be effected even upon bankruptcy as long as the claim could have been set off before the bankruptcy declaration (i.e. no close-out). It can be exercised up until the confirmation of the distribution plan by the court, by notifying the insolvency officer. However, various restrictions exist such as the assignment of claims arising less than three months prior to bankruptcy, suspending conditions, claims of different nature, etc.

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

Admittedly, the present rules on close-out netting are quite restrictive, allowing it only in the context of payment systems and linking it to strict conditions.

REPUBLIC OF HUNGARY

1. RULES APPLICABLE TO CLOSE-OUT NETTING

Hungary adopted insolvency close-out netting legislation with the adoption of Act CXX of 2001 on Capital Markets (the 'CMA'). Article 5(87) of the CMA provides a broad definition of netting that is sufficient to include most of the relevant financial products:

'*Close-out netting: transformation of liabilities arising from spot foreign exchange and securities transactions, derivative transactions, agreements involving repo or reverse repo, or securities loans, or other similar financial transactions into one single net debt or receivable, in the form of a settlement accepted at the given financial market, as a result of which the debt or receivable is limited only to the thus established net amount.* '

The CMA also amended Act XLIX of 1991 on Bankruptcy, Liquidation and Voluntary Winding-up Proceedings (the 'Bankruptcy Act'). The amended provisions of the Bankruptcy Act provide for the enforceability of contractual close-out netting regarding the types of transactions mentioned above and prevent the insolvency officer from 'cherry picking'. Article 28(3) of the Bankruptcy Act provides that:

'*If an agreement for netting to close positions was concluded between the creditor and the debtor prior to the starting date of liquidation, the creditor shall report the net receivable to the receiver as the creditor's claim*'

The reference to a time 'prior to the starting date of liquidation' makes it clear that there is no question of a suspect period applying. In order to clarify any possible conflicts with the general principles of bankruptcy legislation Article 40(2) of the Bankruptcy Act states that

'Netting on the basis of a netting agreement to close positions shall not be deemed to be a legal transaction aimed at misleading creditors and reducing the debtor's assets. '

It should be noted that under the Bankruptcy Act once debtors have filed for bankruptcy, and under certain conditions, they may apply for a moratorium on their payment obligations. During this moratorium - in accordance with Article 12(2) of the Bankruptcy Act – no legal consequences of non-payment can occur. It could be argued that this prevents creditors from terminating transactions early or applying close-out netting provisions. In practice, however, such a moratorium is unlikely to cause any problems as creditors have considerable time between the filing for bankruptcy and the declaration of a moratorium to exercise early termination rights and close-out netting.

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

It is not clear from the rules whether foreign banks may deal in derivatives in Hungary. This would qualify as an investment service under the CMA and as such can only be provided by licensed local banks or licensed local branches or subsidiaries of foreign banks. As a consequence, a Hungarian branch of a non-Hungarian bank must be a party to a derivatives related master agreement itself and each transaction under it for close-out netting to be enforceable against that non-Hungarian bank in question. However, it could also be argued that the relevant rules could be interpreted as meaning that foreign banks are not prevented from directly entering into cross-border derivative deals with Hungarian counterparts. In such a case the key question is whether the investment service takes place in Hungary. In the absence of a definition of the place of investment service in the CMA, the general provisions of the Hungarian Civil Code apply. They provide that the contracting parties are free to determine the place of performance in their contract. If the place of performance is defined as being outside Hungary, then it could be argued that no investment service is provided inside Hungary. In any case, the issue will disappear for investment service providers with a registered seat in the EU, as the CMA explicitly provides that they will be authorised to provide cross-border investment services as soon as Hungary joins the EU.

REPUBLIC OF LATVIA

1. RULES APPLICABLE TO CLOSE-OUT NETTING

Close-out netting is not possible under Latvian law. Set-off outside the context of bankruptcy is possible pursuant to the general rules in the Civil Code (Articles 1846 – 1851). Although the origin of the claim is irrelevant, the terms of the claims must have expired and the subject matter of each claim must be of the same class. However, in the context of bankruptcy, close-out netting agreements are currently not recognised either for credit institutions or for any other companies.

1.1 Credit institutions

Once the court decides to declare the credit institution insolvent, the institution's business activities will be suspended. The credit institution is prohibited from discharging any debts or claims against it. Any payments due from the credit institution, which have been incurred as a result of its default under any agreement and any interest payments, are suspended. The administrator of an insolvent credit institution may also bring an action before the court in order to declare contracts void that have been entered into by the credit institution up to five years prior to the declaration of insolvency. Article 173 of the Credit Institution Law lists the conditions of such a declaration:

'(1) Pursuant to the request of an administrator, transactions of a credit institution may be declared void regardless of the type of such transactions, if:
a) they have been concluded after the day when the insolvency came into effect, and the credit institution has occasioned losses to creditors thereby;
b) they have been concluded within five years before the day when the insolvency came into effect, the credit institution has knowingly occasioned losses to creditors thereby, and the person with whom, or on behalf of whom, the transaction was concluded, has known about the occasioning of such losses; or
c) they have been concluded within five years before the day when insolvency came into effect and a court has determined that the credit institution was brought to insolvency by a criminal offence and the person with whom, or on behalf of whom, the transaction was concluded, knew about such offence.

(2) If the transactions, through which losses have occurred to creditors, have been concluded by the credit institution with persons with interest regarding the credit institution, or on behalf of such persons, it shall be assumed that such persons knew of the occurring of losses or the criminal offence, if they do not prove the contrary.

(3) A secured creditor may submit an action to a court to have a transaction concluded by the administrator declared to be void, if the transaction relates to property pledged to secure a claim, and the rights of the secured creditor have been violated.'

The Credit Institution Law also explicitly prohibits set-off in the event of insolvency, although some exceptions are foreseen in Article 158:

'From the day of the initiation of the insolvency proceedings neither full nor partial redemption of claims or debts shall be allowed, except the situations where it has been envisaged in the rehabilitation plan approved by the Financial and Capital Market Commission and a meeting of creditors.'

1.2 Other companies

The Law on the Insolvency of Undertakings and Companies contains rules similar to the Credit Institutions Law regarding the validity of contracts and set-off. Set-off is explicitly prohibited in the event of insolvency, however, no exceptions are foreseen.

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

At the moment close-out netting is not possible at all and this seriously hinders the development of financial markets in the country. However, there is now an inter-institutional working group drafting a new insolvency law. Specific rules are also being proposed in relation to settlement finality and the realisation of assets in payment and securities settlement systems. The draft law on 'Settlement Finality in Payment and Securities Settlement Systems' is now being prepared for its third reading in Parliament. This legislation is intended to implement Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems[2] (the 'Settlement Finality Directive').

[2] OJ L 166, 11.6.1998, p. 45.

REPUBLIC OF LITHUANIA

1. RULES APPLICABLE TO CLOSE-OUT NETTING

There is no specific law in Lithuania dealing with close-out netting. The issue is governed by general legal rules, which makes the enforceability of close-out netting agreements highly questionable. However, specific and more favourable rules apply in relation to settlement finality and the realisation of assets in payment and securities settlement systems.

1.1 Freedom to set-off outside of insolvency situation

If no bankruptcy proceeding has been initiated against a legal person, the set-off of reciprocal obligations of the same kind is available under the general rules of the Civil Code (Articles 6.130 – 6.140). The courts have also established that even obligations of the same type arising under different transactions may be set off. If the parties so agree, there should be no obstacle to set-off obligations of a different type (e.g. an obligation to deliver securities against an obligation to pay). As a general rule one of the parties must make a declaration of set-off. It could be argued that automatic set-off is also possible (under certain conditions), although there are no court rulings on this issue.

1.2 Limited set-off in case of insolvency

Set-off may even be carried out against an insolvent debtor:

Article 6.140 of the Civil Code provides:

'If the debtor becomes insolvent, the creditors may set-off their claims, even when the claims have not yet matured, if not otherwise provided by laws.'

This rule has important exceptions. Neither the Enterprise Bankruptcy Law (No 31-1010 of 2001) nor the Law on Restructuring of Enterprises (No 31-1012 of 2001) nor the Law on Commercial Banks (No 2-33 of 1995) allows mutual obligations to be freely set off once bankruptcy or restructuring proceedings have commenced. Set-off must be approved by the court. The Supreme Court has upheld the position of lower courts in this matter on several occasions. Interestingly, set-off may be permitted when a credit institution's operations are suspended by Lietuvos bankas and formal bankruptcy proceedings have not yet been commenced.

Article 10, Part 7 of the Enterprise Bankruptcy Law provides that:

'After the court order to institute bankruptcy proceedings becomes effective:
[…]
3) discharge of financial obligations not met prior to the institution of bankruptcy proceedings, including payment of interest, default interest, taxes and other mandatory payments, also recovery of debts from the enterprise through court or without suit shall be prohibited. Computation of default interest and interest on all obligations of the enterprise, including on default in payments related to employment relationship, shall be suspended […] The prohibitions to perform financial obligations and to recover debts shall not apply in cases set out in the Law on Settlement Finality in Payment and Securities Settlement Systems;
[…]'

Article 14 of the Enterprise Bankruptcy Law provides:

'1. From the day the order to initiate of bankruptcy proceedings becomes effective:
1) the right to manage, use and dispose of the assets/funds of the enterprise in bankruptcy shall be granted only to the administrator. No creditor of the enterprise shall have the right to take over the property and funds owned by the enterprise otherwise than prescribed by this Law, except for cases set out in the Law on Settlement Finality in Payment and Securities Settlement Systems;
[…]

2. All contracts entered into in breach of provisions of paragraph 1 of this Article shall be invalid as of their conclusion.'

Although the Enterprise Bankruptcy Law does not explicitly prohibit set-off, legal commentators have concluded that such a prohibition derives from the spirit of the law. In addition, the law prohibits the performance of financial obligations. The courts were not reluctant to share this opinion.

Article 9, Part 1 of the Law on Restructuring of Enterprises provides:

'1. From the day when a decision to initiate restructuring proceedings becomes effective the following shall apply:
1) it shall be prohibited to discharge liabilities which were not discharged before the day when the court order to initiate the enterprise restructuring proceedings became effective, including payment of interest, default interest and compulsory payments, to recover debts from the enterprise in a judicial or extra-judicial manner, to apply judgement mortgage, servitude, usufruct, to offset claims, to pledge, with the exception of cases under subparagraph 5 of this paragraph, sell or transfer in any other way the assets of the enterprise necessary for the continuation of its activities;
[…]'

Article 46, Part 5 of the Law on Commercial Banks states that:

'If the court institutes bank bankruptcy proceedings:
[…]
2) the performance of all financial obligations, including interest and taxes as well as their recovery by suing for claims or without suit shall be prohibited; also prohibited shall be the distribution or any other allocation of bank assets without a special court order except the expenses necessary for the administrator's activities during the court proceedings. These prohibitions shall not apply in cases foreseen in the Law on Settlement Finality in Payment and Securities Settlement Systems;
[…]'

According to the Enterprise Bankruptcy Law and the Law on Restructuring of Enterprises, a contract which is either detrimental to the creditors of the company and could lead to them having financial difficulties or concluded in breach of a company's objectives may be held to be void if concluded in the three-year period preceding the commencement of bankruptcy proceedings (or one year before the commencement of restructuring proceedings). Arguably, even a set-off effected before the commencement of bankruptcy or restructuring proceedings could be challenged if these conditions were fulfilled.

1.3 Limited recognition of close-out netting in respect of collateral arrangements

Very limited recognition of close-out netting was introduced by the implementation of the Settlement Finality Directive. The Law on Settlement Finality in Payment and Securities Settlement Systems (Law 61-2754 of 2003) protects certain close-out netting agreements in the event of the insolvency of a participant in a payment or securities settlement system. Relevant amendments were also introduced in the laws governing bankruptcy of companies and credit institutions enabling the Law on Settlement Finality in Payment and Securities Settlement Systems to have precedence over these laws.

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

The Enterprise Bankruptcy Law, the Law on Restructuring of Enterprises and the Law on Commercial Banks represent obstacles to close-out netting. This problem will be partially cured by the implementation of the Financial Collateral Directive. The first draft of the law implementing this directive has been prepared by a working group comprising representatives from the Ministry of Finance, Lietuvos bankas, the Lithuanian Securities Commission, the Central Depository and the Ministry of Justice. A draft is not yet available and thus the exact scope and the approach adopted by the draft law are not yet clear.

Finally, it is interesting to note that according to Article 9 of the Law on State Language (Law 15-344 of 1995), all contracts and unilateral declarations of intent concluded by Lithuanian natural or legal persons must be in Lithuanian. Contracts and unilateral declarations of intent between Lithuanians and foreigners must be concluded in Lithuanian and any other language agreed between the parties. It is unclear what the consequences of the breach of this rule might be. However, judging from the courts' past practice it is highly unlikely that a contract in a foreign language would be declared unenforceable.

REPUBLIC OF MALTA

1. RULES APPLICABLE TO CLOSE-OUT NETTING

The Set-off and Netting on Insolvency Act – Act IV of 2003 ('Netting Act') provides a flexible regime in support of netting. Its scope is very wide, covering basically any contracts, not only agreements with respect to derivative deals. As Article 3(1) provides:

'…any close-out netting provision or any other provision in any contract providing for or relating to the set-off or netting of sums due from each party to the other in respect of mutual credits, mutual debts or other mutual dealings shall be enforceable in accordance with its terms, whether before or after bankruptcy or insolvency, in respect of mutual debts, mutual credits or mutual dealings which have arisen or occurred before the bankruptcy or insolvency of one of the parties.'

The only limitation to the application of the above-mentioned provision is that netting can be rendered unenforceable on grounds of fraud or similar reason. As different types of claims – also non-financial – can be netted under the legislation, the Netting Act also explicitly provides for the enforceability of contractual clauses that set out the mechanism for converting non-financial obligations into monetary obligations.

It is also clear from the Netting Act, that liquidators and insolvency officers do not have 'cherry picking powers' when a netting agreement is in place. Article 3(1)(c) specifically provides for the enforceability of netting agreements against liquidators, whilst Article 4(c) enables parties to agree that:

'any transactions or other dealings carried out pursuant to any contract…shall be treated as a single transaction or dealing for the purpose of set-off or netting provisions in the contract.'

This agreement has to be respected by liquidators as well.

There is also an explicit provision in Article 3(2) of the Netting Act providing for multi-currency netting:

'When a close-out netting provision is enforced, obligations expressed in different currencies are converted into a single currency and such obligations shall be discharged by the payment of an aggregate net sum equal to the balance of account by the party from whom the larger amount is due.'

With respect to such multi-currency netting, according to Article 4(4)(b), it is up to the parties:

'to agree on the rate of exchange or the method to be used to establish the rate of exchange to be applied in effecting any set-off or netting when the sums to be set off or netted are in different currencies, and to establish the currency in which payment of the net sum is to be effected.'

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

There is no information available on the Maltese netting practice but the approach adopted in the Netting Act in support of netting seems to indicate a relatively smooth practice.

REPUBLIC OF POLAND

1. RULES APPLICABLE TO CLOSE-OUT NETTING

The new Bankruptcy and Restructuring Law of 28 October 2003 (the 'BR') came into effect on 1 October 2003. The new legislation expressly deals with the issue of close-out netting in the case of bankruptcy. It sets up a system that differentiates between different types of transactions and also between different types of insolvency proceedings (liquidation proceedings and moratorium proceedings):

1.1. Liquidation

1.1.1. Special regime applicable to financial transactions

<u>Master agreements</u>. Close-out netting is explicitly provided for with respect to certain types of master agreements. Article 85(1) of the BR provides:

'If a master agreement – one party of which is bankrupt –provides that the individual agreements on future financial transactions or securities repurchase agreements shall be concluded in performance of the master agreement and that the termination of the master agreement shall terminate all individual agreements concluded in performance of it,

- debts, due under the particular individual agreements concluded in performance of master agreement, are not subject to arrangement proceedings;
- the bankruptcy receiver may not terminate the master agreement, referred to in Article 98 hereof.'

The scope of this Article is designed to cover a wide range of derivative transactions, including most transactions that are usually documented under the ISDA Master Agreement. Article 85(2) of the BR lists the following transactions as being covered by the master agreements for which close-out netting is recognised:

'The term 'future financial transactions' referred to in paragraph 1 shall mean the transactions with specified price, quotation, interest rate or index, and in particular the acquisition of funds, securities, gold or other precious metals, commodities or rights, including contracts for differences in prices, options and derivative rights - entered into for settlement on a specified date or for a specified period of time, on the market.'

The BR (articles 85.4 and 85.4) also provides for the possibility that the parties also terminate the framework agreement itself upon the occurrence of a termination event.

"*All parties may rescind the agreement addressed in subsection 1 in compliance with terms agreed upon the agreement as to the means of the calculating the parties close – out amount in the event of the termination of the agreement…Admissible shall be the setting – off a claim resulting from the calculation of the parties close – out amount.*"

As a consequence, parties may need to consider specific language when dealing with Polish counterparts. To ensure "framework agreement" treatment, parties need to confirm that, while the agreement is deemed to terminate, obligations including the obligation to pay a net close-out amount survive.

<u>Stand-alone agreements.</u> The legal situation is somewhat unclear with respect to derivatives transactions concluded without a master agreement. Unlike master agreements, close-out netting is not explicitly provided for in such agreements. However, Article 85(5) of the BR limits the powers of the liquidator with respect to such agreements:

'The provisions of Articles 98 and 99 shall not apply to contracts on financial transactions or securities repurchase agreements, even if they were not entered into in performance of the master agreement referred to in paragraph 1. '

Article 98 of the BR is relevant to financial transactions and enables the liquidator to rescind the agreements of a bankrupt company:

'*If on the day of declaration of bankruptcy the obligations resulted from mutual agreement were not fulfilled as a whole or partly, the bankruptcy receiver may perform the obligations of the bankrupt party and demand in return the performance from the other party or may renounce the agreement.* '

Based on the above, the liquidator cannot request the performance of such stand-alone agreements and cannot repudiate them either. These agreements become automatically due and payable on the date bankruptcy was declared. It seems that the privilege available under Article 85(1) – (4) in relation to these agreements cannot be applied (no close-out). Notwithstanding this these agreements can be used for set-off under the general rules of the BR. In order to avoid any uncertainty it is recommended to conclude such agreements in performance of a master agreement that was at an earlier date. No doubt, the practice of the Polish courts will shed further light on the interpretation of these provisions.

<u>Credit support and security documentation</u>. Article 127(1) of the BR provides that a disposal is void if the bankrupt party disposes of property on a not at arm's length basis in the year preceding bankruptcy. Article 127(3) of the BR lays down a two-month suspect period prior to filing for bankruptcy. Within this period any pre-payment of debt not yet due or provision of security for such debt is considered void. However, there is an exception to these provisions under Article 127(4). According to this provision, if security was provided prior to bankruptcy in connection with financial transactions and repurchase agreements (as defined under Article 85), then these transactions are not rendered void.

1.1.2 General regime applicable to all other liabilities of a bankrupt Polish company

Close-out netting is not recognised outside the cases described under section 1.1.1. As set out in Article 83 of the BR, any stipulation in a contract, providing for early termination or modification of the legal relationship upon a bankruptcy declaration is invalid.

1.2 Moratorium Proceedings

1.2.1 General regime

Under Polish law, a company with financial difficulties can apply to the court for protection from its creditors for a set period of time. During this moratorium the creditors and the company try to reach agreement on settling the outstanding debt. Any repayment and interest accrual with respect to the liabilities of the company is suspended until the end of the moratorium.

1.2.2 Special regime applicable to financial transactions

<u>Master Agreements</u>. Master agreements can be terminated in accordance with their terms even during the moratorium period. After such termination only the close-out amount will become subject of the moratorium proceedings.

<u>Stand-alone agreements</u>. The situation with respect to stand-alone financial agreements during moratorium proceedings is similar to the one described in connection with liquidation proceedings. The difference is that until the end of the moratorium proceedings the parties may not perform such agreements.

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

The Act of 7 October 1999 on the Polish Language (the 'Polish Language Act') has proved to be a significant obstacle for cross-border transactions. It is understood that the Polish Parliament will soon debate an amendment exempting business to business transactions from the requirement of bilingual documentation.

It should also be mentioned that the BR prohibits terminating a contract as a result of the bankruptcy of a contracting party. As a consequence the validity or usefulness of any early termination clause is questionable.

SLOVAK REPUBLIC

1. RULES APPLICABLE TO CLOSE-OUT NETTING

There is currently no valid and enforceable close-out netting legislation upon bankruptcy and insolvency in the Slovak Republic. The Act on Bankruptcy and Settlement of Claims No. 328/1991 (the 'Act on Bankruptcy') is silent on the subject.

However, there is an exception to this situation with regard to close-out netting effected by participants in a payment system, which is specifically made valid and enforceable pursuant to the Act on Payment Systems No. 510/2002. This law aims to ensure the finality of payments by implementing the Settlement Finality Directive. Article 32(6) provides for netting in the context of the payment system, and Article 14(6) makes netting enforceable if the participants or the payment system operator go bankrupt.

Outside the context of payment systems, however, it is unlikely under the present rules that a close-out netting agreement would be recognised or enforceable in a bankruptcy situation. The Act on Bankruptcy prohibits the realisation of set-off upon the debtor's bankruptcy. Article 14(1)(i) of this Act states the following with regard to a bankruptcy declaration:

' (1) The declaration of bankruptcy shall have the following effects:

…(i) the set off of claims belonging to the bankrupt estate, [which would otherwise be able to be set off], shall not be possible.'

It should also be noted that under the current Act on Bankruptcy, there is a two-month suspect period, prior to any bankruptcy declaration, during which any security rights acquired by creditors against the bankrupt will be void. Transactions concluded in the six–month period prior to bankruptcy and intentionally depleting the debtor's assets would also be void.

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

There is a clear need for close-out netting legislation in Slovakia. Národná banka Slovenska has prepared a legislative white paper on this subject, and calls for a new Act on Bankruptcy. The new law is expected to be adopted and enter into effect by the end of June 2004.

It should be noted that under the current Foreign Exchange Act 202/1995, only either (i) duly licensed 'foreign exchange dealers' (i.e., basically banks or financial institutions licensed to carry out monetary transactions with entities abroad) or (ii) other entities that have obtained a foreign exchange licence, may trade in 'foreign exchange assets' (which the Act defines as including 'financial derivatives'). An entity that is not a foreign exchange dealer must obtain a foreign exchange permit to be able to conclude any financial derivatives transaction, even if the trade is intermediated for that entity by a foreign exchange dealer.

<u>**REPUBLIC OF SLOVENIA**</u>

1. RULES APPLICABLE TO CLOSE-OUT NETTING

1.1 Legal status of contractual close-out netting

The current Slovenian regulatory framework does not provide for specific close-out netting legislation. Close-out netting is allowed based on general principles of law, i.e., as an authorised contractual agreement between contractors.

However, there is no provision concerning the particular status of close-out netting in the event of insolvency. In particular, Slovenian insolvency legislation, the Law on Compulsory Settlement, Bankruptcy and Liquidation of 7 December 1993, as amended (the 'Insolvency Law'), does not provide for an exemption for netting orders, nor does it provide for any other specific provision, which would guarantee the enforceability of close-out netting agreements. Since close-out netting agreements are purely contractual stipulations, they do not enjoy any particular legal status under the insolvency legislation.

The Property Code, which was enacted in 2003, contains provisions on classical pledges as well as title transfer collateral but does not expressly mention or regulate derivatives and repo transactions. Furthermore, the rights to preferential payment are subject to substantial formalities involving a public notary.

Therefore, close-out netting agreements can still be challenged during the period preceding the opening of insolvency procedures and are subject to re-characterisation risk.

Article 125 of the Insolvency Law provides that both creditors and the bankruptcy administrator can challenge every action of a debtor during the year preceding the opening of the insolvency procedure if damages or unjustified advantages result from the action concerned and if the other party knew or should have known of the debtor's bad financial condition. For actions performed during the three months preceding the opening of insolvency procedure, it is presumed that the other party [to the action] knew or must have known of the debtor's bad financial condition. The proceedings in this respect must be initiated within the six months following the publication of the opening of insolvency procedure in the official journal.

In addition to the above-mentioned provision, close-out netting agreements can also be challenged by using the classical civil law instrument of *actio Pauliana*. Even though the conditions for bringing an action under this legal instrument are less favourable to the creditors who have suffered damages, they are not subject to the rather short insolvency law deadlines. In that context, it appears clear that notwithstanding contractual provisions between the parties, close-out netting agreements concluded during the 'critical/suspect' period preceding the opening of the insolvency procedure are open to challenge by other creditors or bankruptcy administrator.

1.2 Legislative set-off in the event of insolvency

As set out above, legislation does not provide for any kind of special treatment for close-out netting agreements in the event of insolvency. The Insolvency Law only provides for the ordinary rules on legal set-off in cases of insolvency. These rules automatically override any type of private/contractual agreement, such as close-out netting agreements.

Article 117 of the Insolvency Law authorises the set-off of claims between a creditor and a debtor in insolvency proceedings:

'A set-off of a claim of a creditor with a counter-claim of a debtor is authorised in bankruptcy procedure.

Claims, which could have been set-off on the day of opening of bankruptcy procedure, are considered as set-off and are not to be reported to bankruptcy estate.

Claims or counter-claims, which were not due on the day of opening of bankruptcy procedure, as well as claims or counter-claims, which were not stipulated in a currency, are also set-off. '

Conditional claims can also be set-off, subject to the authorisation of the court in charge of the bankruptcy procedure. The court in charge of the bankruptcy procedure can subject the set-off of conditional claims to a condition that the creditor provides a guarantee.

Creditors whose claims were set-off must inform the bankruptcy administrator of the set-off. If a creditor did not inform the bankruptcy administrator, he is responsible for damages and costs.

However, this legal set-off is subject to a number of conditions and limitations set out in Articles 118 and 119 of the Insolvency Law:

Article 118

'A set-off is not authorised if the claim has been assigned to the creditor during the last six months before the opening of bankruptcy procedure and the creditor new or must have known that that the debtor has become insolvent or that a proposal for bankruptcy or compulsory settlement procedures has been made. '

Article 119

'A claim of a debtor, which arose before opening of bankruptcy procedure, cannot be set-off with a claim, which arose after the beginning of bankruptcy procedure.'

Thus, the legal set-off rules only achieve the same objective as close-out netting agreements to a limited extent, and do not confer any specific/privileged position on the parties to a netting agreement. Moreover, they are subject to legal requirements and derogations that may be less 'creditor-friendly' than close-out netting agreements.

2. PROBLEM AREAS/SUGGESTIONS FOR FURTHER LEGAL REFORM

The legal situation as set out above is at the moment not sufficient for the development of the derivatives and repo markets in Slovenia. However, with the expected implementation of the Settlement Finality Directive the situation may soon change. The first drafts of the implementing legislation are expected by the end of this year.