INTERNATIONAL INSTITUTE FOR THE UNIFICATION OF PRIVATE LAW
INSTITUT INTERNATIONAL POUR L'UNIFICATION DU DROIT PRIVE

UNIDROIT Study Group on principles and rules on the netting of financial instruments

UNIDROIT 2012
Study LXXVIII C – Doc. 14
Original: English
May 2012

Preliminary Draft Principles regarding the Enforceability of Close-out Netting Provisions

Principle 9: Governing law of close-out netting provisions

9. (1) The conditions for the validity and effectiveness of the close-out netting provision, including formal steps to be taken to render the provision valid and effective, are determined by the law governing the close-out netting provision.

(2) The law governing the close-out netting provision further determines which contracts are eligible for being covered by the close-out netting provisions.

(3) Except as otherwise provided by the parties, the choice of law made in a close-out netting provision should prevail over any previous, different choice-of-law clause contained in a contract covered by the close-out netting provision in respect of the matters specified in paragraph (1) above.

(4) Notwithstanding the above, if insolvency proceedings have been commenced in respect of a party to the close-out netting provision [or a branch of that party], the laws that govern those proceedings should also govern:

a) the avoidance of a close-out netting provision as a preference or a contract in fraud of other creditors of the insolvent party; and

b) the termination or temporary stay of a close-out netting provision as a consequence of the commencement of the insolvency proceeding.

Key considerations in respect of this Principle

- The effectiveness of a close-out netting provision that meets the formal and substantive validity requirements of its own governing law, as well as the eligibility of contracts for close-out netting according to that law, must be preserved in a cross-border context.

- The law governing the insolvency proceedings in respect of a party to the close-out netting provision determines the extent to which a stay may be imposed on the close-out mechanism or whether the close-out netting provision may be avoided on grounds of fraud or preferential treatment, but should not otherwise affect the validity or enforceability of a close-out netting provision that was validly entered into in accordance with its own governing law.

Explanation and commentary[1]

119. The majority of financial market transactions, for example derivatives, foreign exchange, securities lending and repurchase contracts, are concluded using standard documentation ('master agreements'). A number of master agreements are available for the various types of financial contract and for various jurisdictions. While master agreements are not necessarily tied to any one particular applicable law, the laws of some jurisdictions are often chosen for cross-border agreements.

120. Most legal systems recognise the principle of party autonomy in contractual relations, leaving the parties free to choose the content of their mutual obligations. In many legal systems, this principle also entails the freedom to choose the law governing the contract.

121. Market participants choose the governing law of a close-out netting provision on the basis of their assessment of the suitability of the chosen law to adequately govern their obligations under the close-out netting provision. Most jurisdictions with developed financial markets recognize the freedom of parties to financial contracts to choose the law governing their transactions, including a close-out netting provision.

122. However, several jurisdictions do not yet generally recognise choice of law in contractual matters, or else they impose a number of limitations to its admissibility, in particular by requiring some additional connection with the jurisdiction the law of which has been chosen. In view of the objective of achieving legal certainty and predictability in cross-border transactions, it appears that it is not in the first place the question of whether the parties' choice is fully respected or different conflict of laws rules of the forum are applied instead that matters. Rather, what must primarily be ensured is that a close-out netting provision that is validly entered into in accordance with its own governing law is not later undone. As regards matters of conflict of law, this would at least appear to entail that in jurisdictions that require an additional connection between the parties or the contract and the law chosen by the parties, the choice of a particular law to govern a close-out netting provision should not be disregarded solely on the basis that it is not the law in force in the jurisdiction where enforcement of the netting provision is sought.

Paragraphs (1) and (2)

123. The validity and enforceability of a close-out netting provision, and the eligibility of contracts for inclusion in a close-out netting set that meets the applicable requirements of its own governing law should not be affected by the fact that the enforcement of the close-out netting provision is sought in a jurisdiction different from the jurisdiction the laws of which govern the close-out netting provision. This general rule should apply even if the enforcement of a close-out netting provision is sought in the context of insolvency proceedings commenced in that jurisdiction (*cf. infra paragraphs 130-131*).

124. As indicated, the parties usually choose the law of a particular jurisdiction to govern their close-out netting provision. Where the close-out netting provision relates to the parties' obligations to a payment or settlement system or to a financial market, the law governing a close-out netting provision relating to those obligations is usually the law of the State which is applicable to the relevant system or market.

125. By the same token, the eligibility of contracts for close-out netting should be established solely in the light of the law governing the close-out netting provision. The integrity of the netting set would be destroyed and the risk-mitigation effect of close-out netting nullified if the contractual

[1] *Cf.* Doc. 3, Principles 17-19 and Doc. 2, p. 32-35.

coverage of a close-out netting provision were to vary according to the jurisdiction in which enforcement of the close-out netting provision is sought.

126. With regard to overriding mandatory rules – as distinct from simple mandatory rules – of the forum, however, it is recognised that these may limit the enforceability of close-out netting rules in exceptional circumstances (for instance, overriding mandatory rules that render unenforceable agreements made in performing an unauthorised regulated activity or agreements made in consequence of unlawful promotions).

Paragraph (3)

127. The master agreement containing the close-out netting provision and the underlying contracts are supposed to form a so-called "single agreement". In fact, the master agreement would be valid but useless without the transactions which it is supposed to cover. If the only choice of law being made is the choice of law included in the master agreement, this will, due to the "single contract" provision, usually extend to the underlying agreements as well. There are, however, situations in which the underlying contracts may also include a choice-of-law clause. This will be unproblematic if the parties have chosen the same law both for the master agreement and the financial transactions. There may, however, be some rare cases in which the law chosen to govern the underlying contracts is different from the law contained in the master agreement.

128. If the close-out netting provision is entered into after the financial transactions have been concluded and some of the latter are governed by a different law, it could be assumed that the choice of law made in the close-out netting provision altered all previous, different choice-of-law clauses contained in the underlying contracts. The subsequent choice of law in the master agreement may be taken as evidence of the parties' intent to override their earlier choice(s) of law. However, if a close-out netting provision that includes a particular choice-of-law clause has been entered into, but the parties subsequently enter into financial contracts (covered by the close-out netting provision) which include a clause expressly choosing a different law, there may be doubts as to whether the law governing the close-out netting provision prevails over the later choice made in the underlying contracts.

129. It is useful, therefore, to clarify that, except as otherwise expressly provided by the parties, the choice of law made in a close-out netting provision should prevail over any previous, different choice-of-law clause contained in a contract covered by the close-out netting provision in respect of the matters specified in *paragraph (1)* above.

Paragraph (4)

130. One area of particular concern relates to the interplay between the governing law of the close-out netting provision and insolvency law. The baseline rule in most jurisdictions is that entitlements pre-dating the insolvency and which are valid and enforceable according to their own governing law, must be respected. In that sense, the close-out netting provisions "survive" the commencement of insolvency proceedings in respect of one of its parties. However, the applicable insolvency law determines to what extent the exercise of those rights is affected by the commencement of insolvency proceedings. Put in general terms, in the context of close-out netting provisions, the *lex contractus* establishes whether an agreement to close out and net the mutual obligations exists and is enforceable, while the *lex fori concursus* addresses restrictions concerning the questions of whether and to what extent the rights arising out of the close-out netting provisions may be exercised against the insolvency estate. The delimitation between the application of these legal regimes to close-out netting provisions is an issue of some delicacy. Its complexity is further exacerbated by the fact that there are particular conflict of laws provisions relating to netting, set-off or payment and settlement systems and financial markets which, to a varying extent, exempt insolvency matters from the application of the *lex fori concursus* ('carve-out provisions').

131. These Principles generally affirm the enforceability of close-out nettings provisions despite the commencement of insolvency proceedings in respect of one of the parties, but acknowledge that the close-out netting provision may be subject to avoidance actions on the basis of fraud or preferential treatment of creditors (see the restricted scope of Principle 7 (c)(iii), *cf.* also the commentary in Doc. 13 *paragraphs 104-107* and *115*). These Principles further acknowledge, within the context of the resolution of financial institutions, the possibility for the resolution authority to impose a short temporary stay on the close-out mechanism (see Principle 8). The law governing the insolvency proceedings determines the extent to which such a stay may be imposed or such avoidance actions may be brought, but it does not otherwise affect the validity or the enforceability of a close-out netting provision that was validly concluded under its own governing law. In particular, as is pointed out in *paragraph (2)* of this Principle, it is the law governing the close-out netting provision, rather than the law governing the insolvency proceedings in respect of any of the parties to the agreement that determines which types of contracts and obligations are eligible for close-out netting.

* * *