Client Update
Germany's Highest Court Invalidates Standard Close-Out Netting Clause for Financial Derivatives—BaFin Order Neutralizes the Effects of the Decision

FRANKFURT
Dr. Thomas Schürrle
tschuerrle@debevoise.com

Klaudius Heda
kheda@debevoise.com

Dr. Friedrich Popp
fpopp@debevoise.com

NEW YORK
Lee Schneider
lschneider@debevoise.com

INTRODUCTION

Parties to financial derivative transactions routinely agree on clauses that provide for a close-out netting of the positions in case of a default of the counterparty. The aim is to reduce the risk of an insolvent counterparty by setting off all respective positions to create a single, small net position. Close-out netting is a key provision in significant standardized master agreements, such as the Master Agreement for Financial Derivatives Transactions (the "German Master Agreement"),[1] as recommended by the Association of German Banks, the Master Agreements of the International Swaps and Derivatives Association,[2] the International Securities Lending Association[3] and the Securities Industry and Financial Markets Association.[4]

The enforceability of standard close-out netting provisions supports the stability of capital markets trade systems and has a significant regulatory impact. Various European instruments, including the Capital Requirements Regulation (the "CRR"),[5] refer to and rely on the enforceability of such risk-reducing measures.

---

[1]   See Sections 7 et seq. of the 2001 German Master Agreement.

[2]   See Articles 5 and 6 of the 2002 ISDA Master Agreement.

[3]   See Section 11 of the 2010 Global Master Securities Lending Agreement.

[4]   See Section 10 of the 2011 Global Master Repurchase Agreement.

[5]   Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

Several Basel III rules, such as the liquidity coverage ratio and net stable funding ratio, also use netting to give certain benefits to financial institutions subject to their requirements.

The German Federal Court of Justice (*Bundesgerichtshof*, the "BGH") invalidated a close-out netting clause in its 9 June 2016 decision (the "Decision")[6] to the extent it contradicts the calculation method for claims resulting from counterparty insolvency outlined by the German Insolvency Ordinance (the "InsO").

To counter the adverse effects of the Decision, the German Federal Ministry of Finance and the Federal Ministry of Justice and Consumer Protection announced on the very same day that, if the grounds of the Decision (by that time not yet available) so required, legislative measures would be undertaken to ensure that the market and the supervisory authorities would continue to accept the currently used master agreements.[7] Also on the same day, the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin") issued a General Administrative Order (*Allgemeinverfügung*, the "Order"), ruling that close-out netting agreements between certain institutions and counterparties have to continue to be complied with as agreed.[8]

This update describes the Decision and BaFin's Order, and discusses the legal consequences of the further use of close-out netting clauses.

DECISION

Facts and Ruling

German plaintiffs granted the defendant, a UK bank, call options for a certain number of SAP shares, to be exercised on the expiration date. In addition, the plaintiffs granted the defendant a security interest in SAP shares to secure its claims against the plaintiffs arising under the transactions. Insolvency proceedings for the defendant bank were opened in London before the expiration date and the plaintiffs claimed for the return of the security. The insolvency administrator not only refused to return the security but also counterclaimed for compensation calculated in accordance with the netting clause of the German

---

[6]   Case number IX ZR 314/14. See http://tinyurl.com/hs5y6qw.

[7]   See http://tinyurl.com/gph27qm.

[8]   See http://tinyurl.com/gqzz63s.

law governed master agreement that was modeled after the German Master Agreement.

Choice of Law and Applicable Insolvency Law

As a preliminary issue, the BGH addressed the question of whether English insolvency law, the law of the state of the opening of the proceedings or German insolvency law applied to the disputed claim. The Decision gave effect to the parties' contractual choice of German law and held that, under the InsO, the choice of German law did not only relate to the substantive contractual stipulations, but also to the insolvency law that applies to them, settling another question of German law.[9]

Invalid Contractual Deviation from German Insolvency Law

The parties' master agreement provided for termination without notice in the event of insolvency and defined insolvency to include certain events leading up to the opening of insolvency proceedings.[10] The master agreement netting clause provided that, in case of termination, the positions of both parties would be offset / netted to result in a single compensation claim. The damage claim of the solvent party would be calculated individually on the basis of concrete replacement transactions. While the general civil law concept of damages calculation would require the solvent party to share benefits from replacement transactions with the insolvent party that exceed its loss, the master agreement limited any such claim by the insolvency estate.

The statutory InsO regime requires[11] the damages to be calculated in a different manner but, according to its plain language, the InsO only applies after opening of the insolvency proceedings. The InsO states that if the parties agreed on financial performance with a market or stock exchange price to occur on a fixed date, and if such date occurs after the insolvency proceedings were opened, only damages for nonperformance can be claimed, notwithstanding the fact that performance is the primary remedy under German law.[12] The statutory claim of

---

[9] A contractual choice was permissible as Council regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, which provides for mandatory conflict rules, does not apply to insolvency proceedings of credit institutions. See Article 1 paragraph 2 of the regulation.

[10] The agreement defined insolvency as occurring either if the insolvent party or a creditor files for insolvency and, in the latter case, the party is insolvent or the opening of insolvency proceedings is otherwise justified under the InsO.

[11] § 119 InsO.

[12] § 104 InsO.

the solvent party that arises after the opening of the insolvency proceedings is calculated on an objective basis and irrespective of concrete replacement transactions: It covers the difference between the market or stock exchange price on the one hand and the price at the time of the insolvency on the other hand.[13]

The BGH opined that the parties are not permitted to circumvent the Code's mandatory calculation scheme for the compensation claim by setting an artificial, but insolvency-related, termination event before the opening of the proceedings. It concluded that the InsO calculation does not apply only to the point in time when the insolvency proceedings already are opened, but also to the point in time when the insolvency proceedings are reasonably expected. Accordingly, the BGH invalidated the netting clause to the extent that it deviated from the InsO.

REGULATORY IMPACT OF THE DECISION AND BAFIN'S ORDER

As an immediate response on the same day, BaFin ordered that the parties must continue to settle close-out netting clauses as set forth in their master agreements, under the definition provided in the CRR,[14] between certain institutions and counterparties.[15] This order had the effect of neutralizing the BGH's decision and reinstating applicability of netting provisions under German law.

BaFin based its decision on a specific authorization in Section 4a Securities Trading Act (*Wertpapierhandelsgesetz*) that grants the supervisory authority, in consultation with the Deutsche Bundesbank, the power to issue orders that are appropriate and necessary to eliminate or prevent undesirable developments that may be detrimental to the stability of, or undermine confidence in, financial markets or impair their proper functioning.

BaFin determined that the scope of the Decision could lead to immediate and serious adverse effects on the market.[16] In addition, the lack of enforceability of

---

[13] If the parties have not agreed on a certain point in time of the insolvency, at the latest the fifth working day after the opening of the insolvency proceedings, the second working day after the opening is the relevant point in time.

[14] The Act is effective as of 10 June 2016 and applicable until 31 December 2016, unless revoked earlier.

[15] The Act defines "institutions" as (i) credit institutions and financial services institutions in the meaning of § 1 paragraph 1b of the German Banking Act (*Kreditwesengesetz*, the "KWG") and (ii) any body established abroad which would be subject to the provisions of the KWG if it were based in Germany or if it conducted banking business or provided financial services. The defined term "counterparty" also includes institutions.

[16] Please note that BaFin left the Order unchanged after studying the grounds of the Decision on 14 June 2016. See http://tinyurl.com/zkmmx5s.

close-out netting agreements was viewed as an impairment of the proper German implementation of certain European Directives[17] and of the interpretation of the collateralization requirements under EMIR.[18] For institutions, the Order recognizes contractual netting as a critical risk-reducing measure[19] and the limitation imposed by the BGH would immediately keep institutions from trading. Consequently, BaFin confirmed in a separate statement that, for the time being, institutions are not required to re-assess their risk weighted assets in light of the Decision.[20]

BaFin's Order seems to be unprecedented in the history of Germany. Two circumstances make the Order unique: Firstly, BaFin "overruled" a decision of the highest judicial authority. Secondly, it appears to be the first time that BaFin used the powers of Section 4a Securities Trading Act to force the financial market to honor invalid contractual arrangements. Section 4a Securities Trading Act was introduced in the course of the financial crisis to limit or prohibit financial transactions if they jeopardize the stability of the financial market.

CONSEQUENCES FOR CLOSE-OUT NETTINGS OF INSTITUTIONS

BaFin's Order is an interim measure requiring certain institutions to comply irrespective of the Decision with the agreed close-out netting mechanisms. The German legislature needs to ensure by changes to the InsO, as announced by the two ministries, that close-out netting clauses as used in standard master agreements for financial derivative transactions continue to operate, and that Germany fulfills its obligations under EU directives.

* * *

Please do not hesitate to contact us with any questions.

---

[17] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements; Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions; and Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

[18] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories.

[19] See Articles 295 et seq. CRR.

[20] See http://tinyurl.com/z8dnd8w.