NETTING IN FINANCIAL MARKETS

PART 3

NETTING IN INSOLVENCY PROCEEDINGS

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The second part of this series of articles on netting in financial markets focused on the conditions for the mutual offsetting of claims between solvent parties. This part deals with netting of claims towards a person in bankruptcy according to the Act on Bankruptcy and Settlement or according to the new Act on Bankruptcy and Restructuring[1]. In the following fourth part we shall look in detail at several particularities of netting between parties in financial difficulties, though from the aspect of proceedings other than bankruptcy.

On 1 January 2006 insolvency proceedings are to undergo substantial changes; on this date the Act on Bankruptcy and Restructuring shall enter into force. During 2005 though the original legal regulation of the Act on Bankruptcy and Settlement shall continue to apply, and therefore in this article we shall focus concurrently on both the presently applicable and new legal regulation.

Slovak law

Current state. Under Article 14(i) of the Act on Bankruptcy and Settlement the netting of a bankrupt's claims with those of the bankrupt's creditor is prohibited, even if this claim would otherwise be nettable. This prohibition causes substantial difficulties in the case of trades on the financial markets, mainly in the field of derivatives and structured finance. These deals are characterised by the fact that the contracting parties endeavour to achieve, by means of a combination of several financial instruments, a resultant financial position that for them represents an optimal relation between an investment's risk and its yield.

The resultant financial position is the difference between long and short positions, i.e. simply between the obligations of a given entity and its claims. If however netting in bankruptcy and settlement is prohibited, it is not practically possible to create this position. There thus exists the risk that the solvent party will have to fulfil its obligations, while the insolvent party does not fulfil its obligations, or fulfils them only partially, something which is a substantial weakening of the synallagma, present throughout the whole of commercial law.

To find the reasons for this prohibition we must look back to the explanatory memorandum to the draft amendment of the Act on Bankruptcy and Settlement prohibiting netting in insolvency proceedings[2]. The memorandum justified this proposal by the fact that the institute of netting had often been abused in insolvency proceedings by administrators of a bankrupt estate. The question however arises as to whether the abuse of netting should not rather be solved via stricter penalties, than an across-the-board prohibition afflicting also honest subjects.

From the context of the ban on netting in the Act on Bankruptcy and Settlement it results that it relates to netting in the meaning stated in the respective provisions of the Civil and Commercial Codes. Clearly however it relates also to any set of legal acts having an equivalent legal effect. This concerns mainly the novation of an obligation, in the case of which on the basis of an agreement between the parties the original obligations would lapse regardless of their maturity and a new obligation corresponding to the net position according to the original obligations would arise (this is also termed *replacement netting*[3]). This differentiation is necessary, because from the wording of Article 580 of the Civil Code it ensues that through netting according to this provision the larger of the claims lapses only in the extent in which it covers the smaller mutual claim; and the situation is not that both claims lapse and are replaced by a new one. Netting according to the Act on Bankruptcy and Settlement is however

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[1] Act No 328/1991 Coll. on Bankruptcy and Settlement as later amended (in the text of the whole series of articles referred to as "the Act on Bankruptcy and Settlement") and Act No 7/2005 on Bankruptcy and Restructuring and on the amendment of certain acts (in the text of the whole series of articles referred to as "the Act on Bankruptcy and Restructuring").

[2] See amendment No 238/2000 Coll., Government Resolution No 561/2000 on the draft amendment to the Act on Bankruptcy and Settlement and the explanatory memorandum to this draft.

[3] For this term see for more detail the first part of this series of articles (Biatec 1/2005, pgs 25 and 26).

being interpreted more broadly and, in the author's opinion, covers also replacement netting. In this case netting needs to be seen in the wider economic sense, i.e. that it is not possible to realise even close-out netting, which, for example, is governed by the ISDA Master Agreement[4].

In connection with the institute of close-out netting it is necessary to examine not only whether it is possible, in the case of a declaration of bankruptcy, to net claims, but also whether it is possible and in what way to terminate the transactions. In the case of terminating the transactions in the framework of close-out netting we cannot speak of withdrawal, since although the mutual claims from transactions lapse, the contracting parties are not obliged to return what they have already fulfilled. Rather, one may incline to the interpretation that the contracting parties in the master agreement have by agreement changed their mutual rights and obligations, and thus this represents a novation agreed in advance and tied to a precedent condition[5].

Since netting in bankruptcy is at present not possible, sometimes in Slovakia it is recommended to agree automatic early termination of transactions concluded under the Master Agreement, this coming into effect on the date preceding the declaration of bankruptcy. Although this in the author's opinion is a legitimate effort of the contracting parties to apply netting in the financial market shortly prior to the commencement of bankruptcy, there does exist the risk of its illegality and the risk that courts would not recognise such a provision as valid, reasoning that through its retroactive nature it evades the spirit of the act[6].

A problem also lies in the fact that on a given day it is never clear whether on the following day the precedent condition for novation will be satisfied, and therefore it is never possible on a given day to say with absolute certainty whether or not the automatic early termination of the contract has already happened.

New law on netting in bankruptcy. The Act on Bankruptcy and Restructuring introduces substantial changes at the very beginning in its general rules on netting. Generally it applies that claims towards a debtor upon whom bankruptcy has been declared may be netted[7]. In certain cases, however, it is following the declaration of bankruptcy prohibited to net claims towards a debtor even under the Act on Bankruptcy and Restructuring.

It is not possible to net: (1) a claim arisen towards a debtor prior to the declaration of bankruptcy with a claim of this debtor arisen following the declaration of bankruptcy; (2) a claim undeclared in insolvency proceedings; (3) a claim acquired by the creditor by means of transfer or conveyance following the declaration of bankruptcy, even if this claim was declared in the insolvency proceedings; and (4) a claim acquired on the basis of a contestable legal act. The third exception should clearly prevent claims towards a debtor in bankruptcy being transferred to persons who are net debtors of the bankrupt.

Close-out netting. One exception however lies in the form of the introduction of a special regime for close-out netting arrangements. These arrangements, or contracts, on close-out netting are not affected by the declaration of bankruptcy[8].

In order for close-out netting to occur between contracting parties in the financial markets, several conditions must be satisfied.

The first condition is that there must exist a valid close-out netting contract between the parties.

The second condition is that at least one of the parties to the contract must be a financial institution as defined in Article 151me of the Civil Code, and where the other party may be a different juristic person. No exceptions to close-out netting under the Act on Bankruptcy and Restructuring shall apply to a similar close-out netting arrangement between a financial institution pursuant to Article 151me of the Civil Code and a natural person.

The third condition is that close-out netting may be performed only in relation to one or more derivative trades, repo trades, loans of securities, foreign exchange deals or other trades concluded outside an organised public market. The meaning of the individual terms can be found in the Act on Securities and in practice in the financial markets. In the light of the newly-adopted Directive on markets in financial instruments, the expression “other trades” may clearly include credit derivatives and climate derivatives, which cannot be included in the present definition of the term “derivatives” in the Act on Securities[9]. Likewise, commodity trades, which this directive assigns to a specific regime, could also fall within this term. In each case

[4] The close-out netting mechanism was described in more detail in the first part of this series of articles (Biatec 1/2005, pgs 25 and 26).
[5] Article 516 of Act No 40/1964 Coll., the Civil Code as later amended (in the text of the whole series of articles simply referred to as the “Civil Code”).
[6] Automatic early termination is often bound also to other precedent conditions such as the submission of a proposal for the declaration of bankruptcy, or the appointment of an preliminary administrator, where the risk of invalidity is lower, despite the fact that this agreement can be still criticised for its retroactive nature.
[7] Article 54(3) of the Act on Bankruptcy and Restructuring.
[8] Article 180(3) of the Act on Bankruptcy and Restructuring.
[9] See Annex 1, Part C of Directive 2004/39/EC of the European Parliament and of the Council on markets in financial instruments amending Council Directives 85/611/EC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

however the expression "other trades concluded outside an organised public market" indicates that this must concern trades concluded outside a stock exchange, or commodities exchange (e.g. trading in gold).

While due to the dynamism of development in the financial markets a broad definition is necessary, there does nonetheless exist the risk that the broad term "other trades concluded outside an organised public market" will come to subsume also trades to which the exceptional close-out netting regime does not justifiably relate. The question of where to draw the line must be left to the judiciary.

The fourth condition is adherence to the content of the close-out netting contract. This must necessarily govern the calculation of the single net obligation in relation to the actual or estimated loss, or actual or estimated profit, arisen in connection with the termination or annulment of one or more trades concluded in connection with or under such a contract.

The Act on Bankruptcy and Restructuring defines the meaning of close-out netting as the calculation of the single net obligation in accordance with the conditions of the close-out netting contract in relation to actual or estimated losses, or actual or estimated profits, arisen in connection with the termination or annulment of one or more trades concluded in connection with or under a close-out netting contract. The method of calculating this single net obligation is agreed by the contracting parties in the close-out netting contract, where the calculation is made with regard to the actual or estimated losses, or actual or estimated profits, of the contracting parties concerning any payments or performances that would have been made, had there not occurred the event causing the termination or annulment of one or more such trades, including any costs or revenues arisen in connection with such a termination or annulment; the calculation may be based on interest-rate, exchange-rate quotes, or prices gained from other participants in the respective financial markets in connection with the trades terminated or annulled[10].

Benefit of the new law. The benefit brought by the Act on Bankruptcy and Restructuring, in its permitting the institute of close-out netting, is clear. At present financial trades in which at least one Slovak party features face the risk that in the case of bankruptcy netting cannot occur and thereby increases the credit risk to the whole system. It is clear that the failure of one large financial player can in such a situation be transmitted via a knock-on effect much more strongly than would otherwise occur in the case of permitting close-out netting.

The second benefit connected with the reduction of risk in the Slovak markets will be a reduction in prices, since if an investor is to bear high risk, he will also require an additional yield as compensation for this. This reduction in risk will thus strengthen the competitiveness of Slovak entities in the financial markets.

European law

One of the main pressures for allowing the netting of claims in bankruptcy and settlement came from Slovakia's obligation to harmonise its law with EC legislation, which is now directly or indirectly introducing this institute into national legal codes in the framework of insolvency proceedings.

General. The most general European law for insolvency proceedings is the directly applicable Council Regulation on insolvency proceedings[11]. Its general principle is that through the opening of insolvency proceedings the right of creditors to request the netting of claims towards the bankrupt is not affected, provided that this netting is permitted by the legal code under which the claim towards the creditor is governed. This regulation is directly applicable in Slovakia, though does not relate to those banks, insurance companies, stock brokers or fund managers that, pursuant to European law, are subject are to specific regulation. It does however relate to the netting of such companies' claims towards bankrupts the insolvency proceedings of which are the subject of this regulation.

In interpreting the legal regulation of netting according to the regulation on insolvency proceedings the key question is then the meaning of the term "law applicable to the insolvent debtor's claim". Even if in foreign literature there are, pursuant to this regulation, several issues connected with the matter of determining the governing legal code[12], some lawyers incline to the opinion that the law relating to this claim should probably be that under which the bankrupt's claim arose[13]. This interpretation does not exclude the fact that it would be possible to net a claim against a Slovak party in bankruptcy, despite the fact the Slovak legal code does not allow for this (whether under the present Act on Bankruptcy and Settlement, or the new Act on Bankruptcy

[10] Article 180(1) and (2) of the Act on Bankruptcy and Restructuring.

[11] Council Regulation 1346/2000 of 29 May 2000 on insolvency proceedings.

[12] See for example team of authors: The EU Regulation On Insolvency Proceedings. Freshfields, London 2004. http://www.freshfields.com/practice/finance/publications/pdfs/8732.pdf., pg. 14 or team of authors: European Regulation on Insolvency Proceedings. V: Bulletin. Allen&Overy, London 2002. http://www.allenovery.com/asp/pdf/European%20Regulation%20on%20Insolvency%20Proceedings%20-20June%202002.pdf. pg. 5.

[13] Team of authors: European Regulation on Insolvency Proceedings. V: Bulletin. Allen&Overy, London 2002, pg. 5.

and Restructuring in the framework of its exceptions from permitting netting), if this netting were possible under the law chosen by the contracting parties for the given contractual relationship.

Transfers. In the financial markets there is a risk known as the "Herstatt risk", named after a bank which in 1974 became insolvent due to the time shift between individual exchanges. This bank was to have supplied one currency in an operation, but the time shift did not allow it acquire the currency from the other market[14]. It is clear equally that the certainty that a transaction input into the clearing and payments system will actually lead to the supply or payment is essential for financial planning and avoiding similar bankruptcies caused by failing supplies and payments. In the interest of reducing the risk caused by bringing transfers in the system of payments into question the EU in 1998 adopted the Directive on settlement finality[15]. According to the official Slovak translation of Article 3 of this directive transfer orders and netting shall be legally enforceable and, in the case of insolvency proceedings against a participant in the system of payments, they shall be effective for third parties under the condition that the transfer orders entered the system before the moment insolvency proceedings were begun. This exception applies even in the case that the transfer orders entered the system following the commencement of the insolvency proceedings and are performed on the date of these proceedings commencing, provided that the clearing agent, central counterparty or clearing institution can, following the moment of clearing, prove that they were not or could not have been informed of the commencement of these proceedings.

The official Slovak translation in this field uses the expression "vysporiadanie" – a term akin to "settling up", while the English version speaks of "netting", and the French "compensation", where both cover the concept of setting off.

This directive was implemented in Slovakia via the Act on Bankruptcy and Settlement[16] and the Act on the System of Payments[17]. However, neither of these acts speaks of netting in this regard. They speak mainly of "the use of funds for the purpose of concluding clearing" and "processing and clearing orders". It can however, on the basis of the general meaning of the economic terms "processing" or "clearing", be assumed that they cover legal terms such as novation or netting.

Banks. Specific provisions relating to the netting of claims towards banks in bankruptcy are contained also in the Directive on the reorganisation and winding up of credit institutions[18]. The term "winding up" is defined in this directive more broadly than in the Slovak commercial code and includes also bankruptcy[19]. Under this directive the right of creditors to request netting of their claims against those of a credit institution is not affected by the adoption of reorganisation measures or the commencement of winding up, provided that this netting is allowed by the legal regulations applicable to the credit institution's claims. The Directive also states that agreements on netting and novation, i.e. agreements on close-out netting, shall be governed exclusively by the law of the contract governing these agreements.

In the case of the Directive on the reorganisation and winding up of credit institutions professionals are generally inclined to adopt an interpretation similar to that of the conflicting provision mentioned above, as was stated in the Regulation on insolvency proceedings: Through their choice of law, contracting parties can cardinally influence the nettability of their claims[20]. If at present netting in bankruptcy is prohibited in Slovakia, through submitting a contractual relationship to English law, which in the case of a declaration of bankruptcy upon a debtor allows, indeed requires, netting, in implementing this directive the Slovak Republic is under the obligation to allow the netting of a creditor's claims towards the mutual claims of a Slovak bankrupt that is a bank, if the claims of this bank are governed by English law this law allows such netting.

Insurance companies. In European law the bankruptcy of insurance companies is governed by the Directive on the reorganisation and winding up of insurance undertakings[21]. This directive explicitly lays down that the conditions under which claims in the case of bankruptcy may be netted shall be governed by the

[14] Vauplane, H. a Bornet, J. P.: Droit des marchés financiers. Litec, Paris 2001, pg 625..
[15] ZDirective 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.
[16] Article 14(6) and (7) of the Act on Bankruptcy and Settlement.
[17] Article 35 of Act of the National Council of the SR No 510/2002 Coll., on the system of payments and on the amendment of certain acts as later amended (in the whole text of this series of articles simply referred to as "the Act on the System of Payments").
[18] 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 (in the whole text of this series of articles simply referred to as "the Directive on the reorganisation and winding up of credit institutions").
[19] Compare Article 70 et seq. of the Commercial Code and Article 2 of the Directive on the reorganisation and winding up of credit institutions.
[20] See the analogous analysis in Moss, G.: The impact of the EU Regulation on UK insolvency proceedings. International Insolvency Institute. Brussels 2002, pg. 4. http://www.iiiglobal.org/country/european_union/EUReg_Conference.pdf.
[21] Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings (in the whole text of this series of articles simply referred to as "the Directive on the reorganisation and winding up of insurance undertakings").

law of the insurance undertaking's home member state[22]. On the other hand however, similarly as in the case of the Directive of the reorganisation and winding up of credit institutions, it states that through the opening of bankruptcy the right of creditors to request the netting of their claims towards those of the insurance undertaking cannot be affected, provided that the legal regulations relating to the insurance undertaking's claims allow this. Therefore, on the basis of analogy the analysis above concerning banks applies under European law to netting towards insurance undertakings' claims.

Collateral. Two of the most topical problems for efficiency of using collateral in the financial market are, firstly, the question of the law under which these rights are governed and, secondly, the possibility of netting the obligation to return of the collateral to the debtor with the creditor's unpaid claim. There has in part been an effort to harmonise these laws at the European level, through the Directive on financial collateral[23]. The official Slovak translation of the Directive's title uses the word "záruka", or "guarantee", thereby suggesting a meaning substantially broader than the Directive's actual content, since essentially it relates only to the pledge and the securing transfer of a right.

The Slovak Republic was required to have implemented these provisions into its legal code as at the date of its accession to the European Union. For its final implementation however the Slovak market will have to wait until the new Act on Bankruptcy and Restructuring enters into force.

An interesting feature of the Directive is the fact that it defines the concept of the "provision on close-out netting", as an agreement or legal provision on the basis of which in the case of a defined event in the use of netting or otherwise (1) mutual obligations are accelerated and become immediately payable and are expressed as the obligation to pay a sum representing their estimated current value or are terminated and replaced by an obligation to pay such a sum; and / or (2) there is cleared that which the parties mutually owe one another in relation to such obligations, and only the net sum equal to the net value that the party with the higher sum outstanding is to pay the other party shall be owed.

On the basis of the Directive on financial collateral member states are obliged to ensure the force of close-out netting arrangements regardless of the commencement of insolvency proceedings against the secured or securing party. This means that in the case of a securitisation transfer of a right of ownership the party secured should be allowed that, in the case of the non-payment of an obligation by a bankrupt, the creditor shall be not obliged to surrender the collateral (or its equivalent) into the bankrupt estate and shall be able to net its secured claim with the price valuation of the debtor's claim for the return of the collateral. This provision however can be understood even more broadly, since it does not relate solely to the obligation to surrender collateral and the fulfilment of a debtor's obligation. The main aim of this provision results from techniques used in financial markets where often the creditor requires collateral covering only its net position in relation to the debtor. The aim of this provision is for it to be possible to net in bankruptcy all such mutual claims and satisfy the net position separately from the collateral's realisation.

In connection to this the question arises as to whether it is correct to restrict the application of the special close-out netting regime under the new Act on Bankruptcy and Restructuring only to trades "concluded outside an organised public market" and whether a general allowing of netting, with exceptions, would bring about a state in full accordance with the Directive on financial collateral.

Conclusion

Even if European insolvency rules in Slovakia will in principle be implemented in the field of netting after the Act on Bankruptcy and Restructuring takes effect, it will be interesting to see whether netting with some exceptions and the recognition of close-out netting contracts under the Act on Bankruptcy and Restructuring does indeed fully cover all the exceptions that the Slovak Republic has been obliged to provide to residents of other member states. Slovak law will have to stand this test both in Slovak legal practice as well as in the judiciary of the Court of Justice of the European Communities.

In either case it can already today be presumed that the new Act on Bankruptcy and Restructuring will be of significant benefit to the Slovak financial market, primarily for the non-organised financial market, since as a result of the recognition of the special regime for close-out netting contracts, the competitiveness of Slovak players in these markets will have been increased.

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[22] Article 9(2)(c) of the Directive on the reorganisation and winding up of insurance undertakings.

[23] Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (in the whole text of this series of articles simply referred to as "the Directive on financial collateral arrangements").