NETTING IN FINANCIAL MARKETS

PART 2

NETTING BETWEEN SOLVENT PARTIES

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In the first part of this series of article on netting in financial markets we defined the term netting and described some types of netting used in financial markets. We also said that it was necessary to distinguish between netting in the legal and economic senses of the word. In the economic sense, netting, as determining net positions, need not necessarily, and often does not, mean the lapsing of the original claims. The economic meaning of netting also covers the determining of net positions for the purpose of monitoring the business of a given company in financial markets. Therefore in this part, describing netting between solvent parties, we will again distinguish between netting in its legal meaning and the calculation of the net position in the economic meaning for supervisory purposes.

Netting

In the Slovak legal environment the most usual classification of netting is that into unilateral netting and contractual netting. Unilateral netting occurs through a legal act of one of the parties of a binding relationship, leading to netting on the basis of law, i.e. without the need for any agreement between the parties on the netting. Contractual netting requires an agreement between the parties whose mutual claims are to be set off.

Unilateral netting

Unilateral legal act. Unilateral netting is realised via an act leading to netting. This act may, for example, be in the form of a fax, letter, oral notice, and in author's opinion also an implied legal act such as the payment of a net amount. As this concerns a unilateral legal act, for its effect it is essential that it is delivered to the other party. In unilateral netting the Commercial Code, and by subsidiarity also the Civil Code, imposes several conditions as regards claims. We shall now look at each of these, in particular from the financial market aspect.

Mutuality. The first requirement is that the claim must be mutual. This means that netting by a unilateral legal act may not be executed in the case of a debtor's claim against a third party and the creditor's claim towards the debtor, but must be a claim between the same persons.[1] An indirect exception from this rule is allowed in the Commercial Code only for the multiple assignment of a claim, where the debtor has the right to set off its claim that it had at the moment of the transfer to the first creditor.[2] This provision at the same time deviates from the civil-legal regulation, where it is possible to net claims towards any assignor.[3] Nevertheless, the possibility of setting off claims towards assignors is not a full exception from the mutuality rule, as it is essential that at the moment of assigning the claim between the assignor and the debtor the claims are mutual.

Mutuality does not exist in "cyclical" claims. For instance, company A owes to company B, company B to company C and company C to company A. Although all of these claims would be otherwise off-settable, they cannot be netted, since they are not mutual. This situation can though be resolved in several ways.

Firstly, company A can assign its claim towards company C to the company B, where here a new obligation arises to the company B to settle remuneration for the claim assigned by the company A. Thus two mutual claims exist between the companies A and B and the companies B and C, which will be netted.

Secondly, all three companies can terminate the effect of the "cyclical" claims in an agreement pursuant to Article 570 et seq., and replace their effect by a new one. Although we can only hardly speak of this as netting pursuant to Article 358 et seq. of the Commercial Code or Article 580 of the Civil Code, it seems correct to use analogously also for this lapsing of claims, the provisions on netting claims by agreement.

Type. The second requirement for netting claims by a unilateral legal act is, under subsidiary civil-legal regulation[4] that these mutual claims be of the same type. In the case of financial claims it is as a rule presumed that they are of the same type. However, in the globalised

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[1] Ovečková, O. a kol.: Commercial Code – commentary. Edition, Bratislava 1995,. pg. 887.

[2] Article 363 of Act No 513/1991 Coll. Commercial Code as later amended (in the text of the whole series simply "the Commercial Code").

[3] Article 529 (2) of Act No 40/1964 Coll. Civil Code as later amended (in the text of the whole series simply "the Civil Code").

[4] Article 580 of the Civil Code.

financial market it can happen than some claims are denominated in currencies that are not freely convertible. Where accordingly such claims intended for netting are denominated in a freely convertible currency and in a freely non-convertible currency, they are not, without contractual authorisation, mutually off-settable.[5]

Coverage. The third requirement of the Civil Code is that claims must mutually cover one another. This legal formulation determines the scope in which the netted claims lapse, i.e. the scope of their mutual coverage.

Exigibility. The fourth requirement, comprising several provisions of the Civil and Commercial Codes is that of exigibility. In other words, claims must be recoverable at court, be due and not statute-barred.

In the field of recovery via the courts attention must to be paid in particular to the reformulation risk of certain investment gaming and betting instruments, claims not yet due and statute-barred claims, which are not recoverable via the courts in the case of objections raised on the basis of the claims' being statute-barred.

Under the Civil Code winnings from bets and games may not be recovered, as neither can claims from loans be recovered where these have been knowingly provided for a bet or game, unless this concerns a gaming business run by the state or which is officially licensed.[6] Even despite the risk of the reformulation of investment instruments as gaming and betting instruments being low, mention of this is sometimes made in the case of credit and climatic derivatives,[7] theoretically the situation should be that the court would not recognise the netting of claims, since the entities in financial markets are not, as a rule, license holders for operating gaming and betting. Such a classification could have an adverse effect on some transactions in financial markets.

Neither can fulfilments from a non-payable claim be recovered via the courts, as claim ensuing from it has not yet arisen. Such a claim may be set off via a unilateral act only where this concerns a claim towards a debtor unable to fulfil its financial obligations, or if the creditor, at the debtor's request, has postponed the maturity of its obligation without any change to its content.[8]

The Commercial Code lays down, expresis verbis, that unilateral netting is not prevented by the fact that a claim is statute-barred, provided it became statute-barred only after the term when the mutual claims could lapse through set-off.[9] Such a claim may be set off, even if it is statute-barred, representing a deviation from the civil-legal regulation.[10]

Origin. The fifth requirement ensuing from the legislation is, in certain cases, the requirement of the claim's origin. With reference to the subject of this series of articles, we will ignore the specific provisions concerning compensation for damage caused to health or provisions ensuing from the Act on the Family and will focus instead on deposits.

As for unilateral netting, it is specifically prohibited to set off between the deposits and claims of a person receiving the deposits.[11] This notwithstanding, the Commercial Code, in contrast to the Civil Code, provides for an exception and allows the setting off of potential funds on current accounts or deposit accounts against mutual claims arisen on the basis of the same contract on a current account.[12]

Contractual nettin

Agreement. According to the Commercial Code it is possible, on the basis of agreement, to set off any mutual claims, i.e. also those claims which could otherwise not be set off according to the mentioned Commercial or Civil Codes through a unilateral legal act.

This broad formulation of the possibility to set off on the basis of an agreement highlights two facts.

Unilateral legal act. Firstly, despite the fact that the legal formulation presumes the existence of an agreement on netting for this type of netting, it is doubtful whether it is correct to understand it in the meaning of the condition that the effects of netting must be directly based on this agreement. In other words it means that agreement-based netting may be bound to the precedent condition of the performance of a certain unilateral act by one of the parties. Looking at the ratio legis, by which the protection of both parties against the set-off of lower "quality" claims against more creditable ones against their will, the author is of the opinion that it is enough for the agreement on netting defines those claims from the trade-legal relations that can be set off, and the legal act by which the set-off is to be carried out. This act, based on the agreement on netting, can then "activate" the effects of the set-off of the defined claims, even if it were to be unilateral. In drawing up such an agreement on netting it is necessary to be cautious so that it cannot be interpreted as the abandonment of a future right.

Mutuality. Secondly, in the framework of trade-legal relations it is possible to set off by agreement various mutual claims, i.e. also claims not recoverable via the courts or claims of various types. From the nature of the matter it is not possible though to set off claims that are not mutual, or in a scope in which they do not overlap. This need not mean that such claims cannot be settled

[5] Article 362 of the Commercial Code.
[6] Article 845 of the Civil Code.
[7] Vauplane, H. a Bornet, J. P.: Droit des marchés financiers. Paris 2001, pgs. 636 and 642.
[8] Articles 359 and 360 of the Commercial Code.
[9] Article 362 of the Commercial Code.
[10] Article 581 (2) of the Civil Code.
[11] Article 581 (2) of the Civil Code.
[12] Article 361 of the Commercial Code.

so that the results will be analogous to that of netting in the case of mutually overlapping claims. Instead, it means that this type of act is not "netting" in the true legal meaning, but a combination of other legal institutes, possibly also together with netting.

Let us return to the mentioned example, where person A owes to person B, person B owes to person C and person C owes to person A. The result where the persons A, B and C owe each other only amounts reduced by the lowest of the mentioned claims may be achieved with the aid of a trilateral agreement. In this case, however, it is not correct to use the term netting, since the claims were not mutual, and therefore the set-off could not even occur. In this case it is an innominate contract or settlement, if it concerns disputable or doubtful claims.

Coverage. Another example concerns coverage of claims. If, on the basis of a legal act between two parties, two mutual claims arise, though in an unequal amount, this would not be the institute of netting as such. It could be a combination of netting claims in the amount in which they overlap, and the abandonment of the right possibly of the deal or agreement on the lapsing of the rights.

Effects of set-off

The lapsing of claims according to the legal regulation does not occur at the moment of performing the legal act leading to the set-off, but at the moment when claims fit for netting meet.[13] It is not completely clear what is understood under the term "meeting" of claims. Some authors speak of "the position of claims against one another", which does not much clear the matters either.[14] However, it seems that the prevailing opinion among authors is that two set-off claims lapse at the moment when both of them, following their arising, fulfil all the conditions for netting.

In connection with this effect ex tunc there can arise the situation where two parties are mutually in arrears in paying the same amount payable on the same day without mutually setting off their claims. Let us imagine that for each of these claims a different interest on arrears has been agreed. In such a case it would be advantageous for the party that is obliged to pay a lower interest on arrears than its counterparty, without taking account of the credit risk, to remain in arrears, in order that it can earn on the difference between the interest rates. The other party however has available the possibility to very efficiently defend itself, as far as the off-settable claims are concerned – it is enough if it simply sets them off. In this way the claims lapse as of the day of their eligibility for netting and it will not be possible to declare that the parties were in arrears, and thus no claim to interest on the arrears arises.

The author thinks that in the case of agreement-based set-off the ex tunc effect can be excluded. In fact, it would not be reasonable that a lawmaker would in such cases restrict the freedom of the contracting parties in trade-legal relations, if it is the will of both the parties that the set-off comes into effect at the moment of performing the legal act. The contracting parties have several ways of avoiding the ex tunc effect. They can for example novate both obligations as of the day of the desired effect.

In practice this problem however does not seem to be that serious, because the tendency of the entities operating in financial markets is to net mutual claims as soon as possible with the aim of eliminating credit risk.

Net positions

Determining the net financial position of an entity is used also for the purposes of supervision over these entities. Nevertheless, determining a net position does not represent set-off in its legal meaning.

Net positions are important in calculating the capital adequacy or asset exposure of banks[15], the capital adequacy of securities brokers[16], and the asset exposure of a pension fund company.[17] The net credit position in this case is, simply said, determined as the difference between the debt position and the short position. The short position, again said simply, is understood to mean the market valuation of the financial instrument which the bank is to deliver to the counterparty, and the long position is the market valuation of the financial instrument which it is to receive from the counterparty or which it owns.

In calculating net positions there is no netting in the legal meaning, as neither claims are discharged and through this non-legal act remain unaffected.

For legal practice however, the calculation of the net position is of substantial importance. Under English law it is, for example, possible to apply net positions for the calculation of certain indicators of the prudent conduct of business by banks only in the case that they are based on an agreement on close-out netting or an agre-

[13] Article 580 of the Civil Code.
[14] Pikna, P.: Započtení pohledávek mezi podnikateli. Právník, no. 4, 1993, pg. 19.

[15] Decree of the National Bank of Slovakia No 6/2002 of 12 December 2002 on adequacy of own financing resources of banks as later amended, Article 11 (3)(c) and Article 16, and Decree of the National Bank of Slovakia No 8/2002 of 12 December 2002 on asset exposure of banks, Article 2 (j).
[16] Article 74 of Act No 566/2001 Coll. on securities and investment services and amending certain acts, as later amended (in the text of the whole series simply "the Securities Act") and Edict of the Ministry of Finance SR No 559/2002 Coll. on adequacy of own resources of securities brokers.
[17] The net position is contained in the expression "value of financial instruments of the money market" in Article 81 (5) of Act No 43/2002 Coll. on old-age pension savings and amending certain acts.

ement on netting by novation. The effect and force of such an agreement must be at the same time verified by independent legal advisors of "an appropriate professional standing". Legal opinions on the enforcement of these netting agreements must be in the case of banks be reviewed annually and issued in relation to the legal code of the contracting counterpart, the legal code of the branch, by means of which the contracting parties act, the legal code by which the agreement on netting is governed, and the legal code by which the transaction itself is governed.[18] In Slovakia similar legal opinions for the purposes of banking supervision are not required.

Conclusion

Under Slovak law, in principle no specific or great problems are found in netting between solvent contracting parties. The basic task is to distinguish the legal institute – classical netting in the meaning of the Civil or Commercial Code, novation, or a combination of various other institutes. According to this, it is necessary to focus on the existence and off-settability of claims and the form and content of the netting act. As we will see in the third part of this series, the situation is more complicated in the case of netting between insolvent parties.

[18] Sourcebook & instruments on prudential regime for banks (IPRU Bank). FSA: London. Ch. NE, para. 5.4 and 6.1.