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Client Alert: Close-out Netting Provisions partially held invalid by German Federal Court of Justice

General Administrative Act (*Allgemeinverfügung*) issued by German Federal Supervisory Authority to avoid Legal Uncertainty and Distortions in Financial Markets

EXECUTIVE SUMMARY

The German Federal Court of Justice (*Bundesgerichtshof*, "BGH") ruled on 9 June 2016 that contractual close-out netting provisions which deviate from section 104 of the German Insolvency Code (*Insolvenzordnung*) are invalid and section 104 of the German Insolvency Code applies in lieu of the invalid contractual provisions (the "BGH Ruling"). According to the BGH Ruling, certain provisions of the German Master Agreement for Financial Derivatives Transactions (*Deutscher Rahmenvertrag für Finanztermingeschäfte*, the "German Master Agreement") concerning the calculation of the compensation claim resulting from close-out netting are therefore void.

Close-out netting provisions are a standard element in master agreements for financial derivatives and hence widely-used. Such provisions determine the compensation claim of the respective counterparty in the event of an early termination of the master agreement (in particular, as a result of insolvency) by netting the outstanding claims resulting from all financial derivatives transactions made under such master agreement.

The scope of the BGH Ruling is therefore not limited to derivatives transactions governed by the German Master Agreement but extends to close-out netting provisions in other types of master agreements governed by German law (e.g. the Master Agreement for Repurchase Transactions (*Rahmenvertrag für Wertpapierpensionsgeschäfte (Repos)*). Furthermore, where master agreements are not governed by German law (but e.g. English law, as for instance ISDA Master Agreements), it should be noted that the BGH Ruling may nevertheless apply in case of an insolvent German counterparty which does not qualify as an insurance undertaking, credit institution or investment undertaking.

The BGH Ruling could, *inter alia*, have a material impact on regulatory capital requirements of credit institutions as contractual close-out netting provisions may no longer be recognisable for regulatory capital purposes. In order to avoid this and other severe consequences of the BGH Ruling, the German Federal Supervisory

Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin") took preliminary action and issued a general administrative act (*Allgemeinverfügung*) pursuant to its powers under the German Securities Trading Act (*Wertpapierhandelsgesetz*). Such general administrative act ("GAA") provides that contractual netting agreements shall, for the time being, continue to be settled as contractually agreed. The GAA applies until 31 December 2016, 24.00 hrs. Generally speaking, BaFin has therefore to a large extent neutralised the immediate impact of the BGH Ruling.

THE JUDGMENT OF THE GERMAN FEDERAL COURT OF JUSTICE

On 9 June 2016 the German Federal Court of Justice rendered a judgment (docket: IX ZR 314/14) on the validity of close-out netting provisions for stock option transactions. The BGH held that provisions in stock option transaction agreements governed by German law which provide for the netting of claims in the event of an insolvency (close-out netting provisions) are invalid to the extent such provisions deviate from section 104 of the German Insolvency Code.

In the BGH Ruling, the parties, two German limited liability companies ("GmbH") and Lehman Brothers International (Europe), a company organised under the laws of England and Wales ("LBIE"), entered into German Master Agreements under which call options on shares of SAP Aktiengesellschaft were traded. On the date of the filing for the institution of insolvency proceedings over LBIE, such call options had a positive market value for LBIE and a corresponding negative market value for GmbH. LBIE demanded payment from GmbH pursuant to the close-out netting provisions of the German Master Agreement.

The relevant provisions in the German Master Agreement provide for the immediate termination of the agreement without notice in the event of an insolvency and the substitution of any outstanding obligations thereunder which would have become due on the day of such termination or later by compensation claims. Such compensation claims are then consolidated, together with any other outstanding amounts or obligations, into a single compensation claim ("netting"). The party entitled to receive payment from its counterparty pursuant to such single compensation claim is commonly referred to as the party being "in the money".

The BGH held that due to section 119 of the German Insolvency Code – which stipulates that agreements purporting to exclude or limit the application of sections 103 to 118 of the German Insolvency Code are void – section 104 of the German Insolvency Code overrides the corresponding contractual arrangements. For all practical purposes, this means that contractual close-out netting provisions which deviate from section 104 of the German Insolvency Code are invalid to such extent and section 104 of the German Insolvency Code applies in lieu of such contractual provisions. In the BGH Ruling, the BGH asserted the following discrepancies:

- The German Master Agreement limits any claim of the insolvent party against the solvent party for compensation of an overall financial benefit derived by the solvent party from the termination of the transactions (if any) to the amount of

losses incurred by the insolvent party (see No. 8 para. 2 of the German Master Agreement). According to the BGH Ruling, such limitation is void as section 104 of the German Insolvency Code does not provide for such limitation.

- The relevant date for the calculation of the compensation claim is not determined by No. 8 para. 1 of the German Master Agreement, but by para. 3 of section 104 of the German Insolvency Code.
- To the extent the German Master Agreement provides in No. 3 para. 4 for interest claims as of the due date of the compensation claim, such provision of the German Master Agreement deviates from section 104 para. 2 and 3 of the German Insolvency Code and is therefore void.
- Under the German Master Agreement, the "trigger event" for the immediate termination of the agreement without notice (i.e. "automatic" termination) and the application of the close-out netting is, *inter alia*, the filing for the institution of insolvency proceedings, whereas section 104 of the German Insolvency Code refers to the institution of insolvency proceedings. While this distinction was irrelevant for the BGH Ruling,¹ in other insolvency scenarios days, if not weeks, may pass between the filing and the actual institution of insolvency proceedings.

Ultimately, the BGH ruled that LBIE has a compensation claim against GmbH for payment of the close-out amount and that such amount is to be determined based on the valuation method set out in section 104 paras. 2 and 3 of the German Insolvency Code rather than the contractually agreed close-out netting provisions in No. 3 para. 4 and No. 8 paras. 1 and 2 of the German Master Agreement.

PRELIMINARY ASSESSMENT OF THE IMPACT OF THE JUDGMENT OF THE GERMAN FEDERAL COURT OF JUSTICE

Impact not limited to stock option transactions

Although the BGH Ruling expressly addresses a stock option transaction, its scope is not limited to such derivatives. The reasoning of the BGH Ruling also applies to other derivatives that fall within the scope of section 104 para. 2 of the German Insolvency Code, i.e., interest rate swaps, currency swaps, futures and options on securities, commodities, precious metals and foreign currencies etc.

Impact not limited to the German Master Agreement (*Deutscher Rahmenvertrag für Finanztermingeschäfte*)

Furthermore, the reasoning of the BGH Ruling is not limited to derivatives transactions governed by the German Master Agreement but should generally apply to close-out netting provisions, regardless in which form of master agreements they are contained. Hence, the BGH Ruling should also apply to the close-out netting provisions in the German law governed Master Agreement for Repurchase Transactions (*Rahmenvertrag für Wertpapierpensionsgeschäfte (Repos)*) and the Master

¹ The insolvency proceedings over LBIE were opened on the same day of the filing for such proceedings. Hence, the BGH did not decide on this question in the BGH Ruling.

Agreement for Securities Lending Transactions (*Rahmenvertrag für Wertpapierdarlehen*).

Where such master agreements are not governed by German law, but e.g. English law (for instance in the ISDA (International Swaps and Derivatives Association) Master Agreement, the Global Master Agreement for Repurchase Transactions (GMRA) or the Global Master Agreement for Securities Lending Transactions (GMSLA)), it should be noted that the BGH Ruling may nevertheless apply in case of an insolvent counterparty which has its centre of main interests in Germany and does not qualify as an insurance undertaking, credit institution or investment undertaking. In this scenario, Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings ("EUIR") would determine the relevant law resulting in the application of German substantive insolvency law as the law of the territory in which insolvency proceedings were to be opened (*lex fori concursus*). Hence, the BGH Ruling may also apply to close-out netting provisions contained in such English law governed master agreements (e.g. ISDA Master Agreements).

Where master agreements are not governed by German law and the EUIR is not applicable, e.g. as the insolvent counterparty qualifies as an insurance undertaking, credit institution or investment undertaking, special provisions of German international insolvency law would result in the substantive insolvency law of the law governing the respective master agreement being applicable. Therefore, German substantive insolvency law would not be relevant in this case and the BGH Ruling should not apply.

Potential conflict with EU regulations and impact on regulatory capital requirements of credit institutions

The BGH Ruling could conflict with various EU directives and, more importantly, with EU regulations which constitute – in contrast to EU directives – directly applicable law in Germany. As a result, the BGH Ruling could have a material impact on regulatory capital requirements of credit institutions (but for the GAA issued by BaFin, see below):

- Most notably, an invalidity of the close-out netting provisions in German law governed master agreements² could conflict with the provisions of the CRR³: For regulatory capital purposes, close-out netting arrangements are, *inter alia*, only to be recognised by competent authorities if that contractual netting agreement "creates a single legal obligation, covering all included transactions, such that, in the event of default by the counterparty it would be entitled to receive or obliged to pay only the net sum of the positive and negative mark-to-market values of included individual transactions", Article 296 para. 2 of the CRR. Such "event of default" is defined in Article 178 of the CRR which refers not only to the opening of insolvency proceedings, but generally also considers

² And other master agreements not governed by German law to which the BGH Ruling may nevertheless apply, see above.

³ 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 (Capital Requirements Regulation, the "CRR").

non-payment situations and the filing for insolvency proceedings as "events of default". Since section 104 of the German Insolvency Code refers to the institution of insolvency proceedings, the contractual shift to opening of insolvency proceedings may potentially be invalid according to the BGH Ruling. This would have the severe consequence for credit institutions that the contractual close-out netting provisions could not be recognised for regulatory capital purposes pursuant to Article 296 para. 2 of the CRR.

- Another particularly noteworthy issue could arise with respect to EMIR⁴. If netting provisions in German law governed master agreements⁵ were enforceable only in accordance with section 104 of the German Insolvency Code, this may pursuant to EMIR and the related regulatory technical standards (which are currently being drafted) result in increased collateral requirements in respect of such netting provisions due to an extension of the "margin period of risk". Pursuant to Article 17 of such draft regulatory technical standard, the "margin period of risk" is the period of time between the most recent exchange of collateral until the "default" of the counterparty (being the point in time when the respective derivatives transactions are closed out and the resulting market risk is re-hedged). According to the BGH Ruling, such default may potentially no longer comprise the filing for insolvency proceedings, but only the institution of insolvency proceedings pursuant to section 104 of the German Insolvency Code. As weeks may pass between the filing for insolvency proceedings and the institution of insolvency proceedings, the BGH Ruling could extend the margin period of risk and consequently lead to increased collateral requirements.

REACTIONS TO THE BGH RULING – GENERAL ADMINISTRATIVE ACT ISSUED BY GERMAN FEDERAL SUPERVISORY AUTHORITY

On the same day of the BGH Ruling, the German Federal Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, the "BaFin") took preliminary action and issued the GAA under its powers conferred pursuant to section 4a of the German Securities Trading Act. In the GAA, BaFin set out that until new legislation becomes effective, contractual netting agreements shall, for the time being, continue to be settled as contractually agreed. Generally speaking, BaFin has therefore to a large extent neutralised the immediate impact of the BGH Ruling.

Furthermore, the German Federal Ministry of Finance (*Bundesministerium der Finanzen*, the "BMF") and the German Federal Ministry of Justice and Consumer Protection (*Bundesministerium der Justiz und für Verbraucherschutz*, the "BMJV") announced to immediately initiate legislative measures in order to restore legal certainty regarding the validity and enforceability of the close-out netting provisions of the German Master Agreement in light of the new jurisprudence on section 104 of the German Insolvency Code.

⁴ 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 (European Market Infrastructure Regulation – "EMIR").

⁵ And other master agreements not governed by German law to which the BGH Ruling may nevertheless apply, see above.

However, such legislative action may take several months to become effective. In the meantime, market participants have to rely on the GAA of BaFin.

THE GENERAL ADMINISTRATIVE ACT OF BAFIN IN DETAIL

In order to prevent a loss of confidence in the proper functioning of financial markets and to avoid negative effects on financial market stability, in particular as a result of potential impacts on regulatory capital requirements of credit institutions, BaFin issued the following general administrative act on 9 June 2016:⁶

"1. On the basis of section 4a of the German Securities Trading Act (Wertpapierhandelsgesetz – WpHG) [...] the following is ordered:

The contractual netting agreements described in Article 295 of [...] the CRR [...], for which it has been agreed that in the event of default by one of the two parties, the institute or its counterparty would be entitled to receive or obliged to pay only the net sum of the positive and negative mark-to-market values of included individual transaction are to be settled as agreed by the counterparties, including persons, who as parties with particular duties act for and against a counterparty.

This order shall not apply to matters for which a legally enforceable claim or assessment has been achieved or judicial proceedings are pending or insolvency proceedings have been opened.

[...]

3. This General Administrative Act enters into force on 10 June 2016 at 0.00 hrs. and will apply until 31 December 2016, 24.00 hrs.

[...]

*5. This General Administrative Act shall be considered announced on the day after its publication pursuant to section 41 (4) sentence 4 of the VwVfG [German Administrative Procedure Act – *Verwaltungsverfahrensgesetz*]."*

SCOPE OF THE GENERAL ADMINISTRATIVE ACT OF BAFIN

The GAA covers all contractual netting provisions described in Article 295 of the CRR which provide for close-out netting. Hence, any close-out netting arrangements which fall within the scope of Article 295 of the CRR, and should therefore in principle be eligible for regulatory capital risk-reducing purposes pursuant to the CRR, should also fall within the scope of the GAA. This rather broad scope of application intends to procure that contractual close-out netting provisions which would have been recognised for regulatory capital risk-reducing purposes but for the BGH Ruling, may nevertheless be recognised as a result of the GAA.

⁶ The following text is the official translation of the GAA provided by BaFin. Only the German version of the GAA is binding in any respects.

The GAA does not apply to cases where until 10 June 2016 judicial proceedings have been pending, insolvency proceedings have been opened or claims or declarations have been finally judicially determined.

The scope of the GAA is limited to agreements with at least one party being (i) a credit or financial institution within the meaning of section 1 para. 1b of the German Banking Act (*Kreditwesengesetz*) or (ii) an entity having its corporate seat abroad which would be subject to the German Banking Act if its corporate seat was in Germany or if it conducted banking business or provided financial services in Germany. This should result in a broad international scope of the GAA.

Pursuant to section 4a para. 4 of the German Securities Trading Act, a general administrative act is limited to a maximum of twelve months with the permission to extend this period by up to further twelve months. For the GAA, 31 December 2016, 24.00 hrs. is the (initial) expiry date. Hence, 1 January 2017, 0.00 hrs. is the (current) deadline for new legislation to enter into force which shall provide that contractual close-out netting provisions do not conflict with the German Insolvency Code. As described above, BMF and BMJV have already expressed their intention to initiate the legislative procedure for such new legislation. The draft of the new legislation will have to be reviewed carefully once it becomes available.

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