7 Resolution and contracts

Francisco J. Garcimartín Alférez and
Sara Sánchez Fernández

7.1 Introduction

In response to the financial crisis of 2008, several jurisdictions have laid down special resolution frameworks giving national authorities extraordinary powers to deal with failing financial institutions. The main purpose of this new framework is to pass on losses to stakeholders, not to taxpayers ('bail in, not bail out'), in accordance with insolvency standards.

In this sense, the resolution framework must satisfy a double test: (i) it must respect, as far as possible, the insolvency statutory order of priorities and the pari passu treatment of creditors of the same class; and (ii) in general terms, it must leave no creditor 'worse off' than if the failed entity would have been wound up under formal insolvency proceedings. The liquidation value is therefore the threshold.

In the European Economic Area (EEA), the Recovery and Resolution Directive (BRRD) creates a new and harmonized framework for the recovery and resolution of credit institutions and investment firms.[1] This instrument reflects that double test in different provisions: e.g. Articles 34 ('General principles governing resolution'), 44 (9) ('Scope of bail-in tool'), 48 ('Sequence of write down and conversion'), or 73 ('Treatment of shareholders and creditors in the case of partial transfers and application of the bail-in tool'). It can be said that this new framework is procedurally administrative law, i.e. resolution authorities are administrative (and not judicial) bodies, but substantially insolvency law, since the principles applied by these authorities are those of insolvency law.

According to the BRRD (art. 37 et seq), the resolution toolkit includes:

(a) selling all or a part of the businesses to a third party;

(b) transferring all or a part of the business to a bridge institution (bridge institution tool);

[1] Directive (EU) 2014/ 59 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/ 891/ EEC, and Directives 2001/ 24/ EC, 2002/ 47/ EC, 2004/ 25/ EC, 2005/ 56/ EC, 2007/ 36/ EC, 2011/ 35/ EU, 2012/ 30/ EU, and 2013/ 36/ EU, and Regulations (EU) No 1093/ 2010 and (EU) No 648/ 2012, [2014] *OJ* L 173/ 190.

(c) transferring assets, rights or liabilities to one or more asset management vehicles (asset separation tool); and

(d) the bail-in tool (re-capitalization measures).

The power to write down and convert capital instruments should be exercised immediately before or together with the application of the resolution tool (art. 37 (2) BRRD) to ensure that losses are first suffered by the holders of these instruments.

Note also that the menu is familiar to any insolvency lawyer: (a) and (b) may be the natural conclusion of liquidation proceedings, whereas (c) and (d) are the natural objective in restructuring proceedings. Furthermore, the BRRD envisages that in the case of a partial sale of assets to a third party or transfer to a bridge bank, the residual entity must be wound up under normal insolvency proceedings (art. 37 (6)).

A similar system has been provided for by the Single Resolution Mechanism Regulation (SRM Regulation):[2] the above mentioned double test is reflected in Article 15 ('General principles governing resolution'), Article 27(12) ('Bail-in tool') and Article 21(10) ('Write-down and conversion of capital instruments'), and the resolution tool kit is regulated in Article 22 et seq.

The purpose of this contribution is to describe the effects of such resolution tools on contracts entered into by the failing institution. Special attention should be paid to cross-border bank resolution scenarios since credit institutions usually have contractual rights and/or liabilities governed by foreign laws in their balance-sheets. In addition, we will focus on the specific case of close-out netting provisions and financial collateral arrangements, since one of the main consequences of the recent financial crisis has been the review of the privileged status that these instruments used to have. We describe, in general terms, these changes in the regulation of close-out netting provisions and financial collateral and analyse the policy underlying them, in particular in relation to

[2] Regulation (EU) No 86/2014 of the European Parliament and the Council of July 2014, establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 [2014] *OJ* L 225/1. The SRM Regulation is applicable to the resolution of credit entities, parent undertakings subject to consolidated supervision by the European Central Bank (ECB) and investment firms and financial institutions covered by the consolidated supervision of the parent undertaking carried out by the ECB, where they are established in a Member State whose currency is the euro or whose currency is not the euro where close cooperation has been established between the ECB and the competent authority of that State(art. 2 SRM Regulation and art. 2 Regulation (EU) No 1024/2013). The uniform rules and the uniform procedure are applied by the Single Resolution Board (SRB) together with the Council, the Commission and the national resolution authorities within the framework of the SRM. In brief, according to Article 7 of the SRM Regulation, the SRB shall be responsible for adopting all decisions relating to resolution for the entities mentioned above -which are considered to be significant in accordance with art. 6(4) Regulation (EU) No 1024/2013 and for other cross-border groups.

the conflict-of-laws dimension. The EU legislation will be used as an example of this relative change of paradigm, which has so far taken place only in relation to resolution scenarios but not for insolvency proceedings. Given that these changes have been inspired by supranational institutions,[3] the analysis may also be applicable *mutatis mutandis* to jurisdictions outside the EU.

The paper is organized as follows. Section 7.2 describes the general regime for contracts differentiating between the substantive law level and the conflict-of-laws level. Section 7.3 focuses on the case of close-out netting provisions and financial collateral. Paragraph 7.3.1 makes a brief introduction to the concept of derivatives and financial arrangements, whereas paragraph 7.3.2 summarizes the situation before the financial crisis and Paragraph 7.3.3 analyses the situation after the crisis, following in both cases the same distinction between the substantive-law and the conflict-of-laws level. Section 7.4 contains some concluding remarks.

7.2 Contracts: general regime

7.2.1 Substantive law level

According to general insolvency principles in many legal systems, outstanding contracts with mutual obligations are protected *vis à vis* cancellation rights and enforcement proceedings linked to the mere entry into insolvency: ipso facto clauses, i.e. contractual provisions that allow one party to terminate the contract upon the occurrence of an insolvency event, are not enforceable.[4]

The same principle is applicable to the entry into resolution or the adoption of any resolution measures. If we take the example of the BRRD, Article 68 establishes that the mere opening of a resolution process or the adoption of resolution tools, including the occurrence of any event directly linked to the application of such measures (e.g. a

[3] See e.g. Financial Stability Board (FSB), *Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 2011), at 10-12 (an updated version was published in October 2014), accessible at <http:// www.financialstabilityboard.org/ 2011/ 11/ r_ 111104cc/ >; Commission (EC), 'Communication on An EU Framework for Crisis Management in the Financial Sector', COM (2010) 579 final, 10; Commission (EC), 'Working document on Technical Details of a Possible EU Framework for Bank Recovery and Resolution', (January 2011), at 64-66, both documents accessible at <www.ec.europe.eu/ internal_ market/ consultations/ 2011/ crisis_ management_ en.htm>.

[4] See e.g. Recommendation 70 of the UNCITRAL Legislative Guide on Insolvency Law, accessible at <http:// www.uncitral.org/ >: 'The insolvency law should specify that any contract clause that automatically terminates or accelerates a contract upon the occurrence of any of the following events is unenforceable as against the insolvency representative and the debtor: (a) An application for commencement, or commencement, of insolvency proceedings; (b) The appointment of an insolvency representative.'

change of control), cannot of itself be characterized by the parties as a termination event. Hence, the counterparty may not exercise an early termination right solely upon the entry into resolution or the exercise alone of the resolution power, provided that the substantive obligations under the contract, including payment and delivery obligations, and provisions of collateral, continue to be performed.

Thus, the condition for the application of this provision is that the failing entity continues performing its contractual obligations. As a consequence, the exercise of termination rights (or the enforcement of collateral) is not prohibited when it is linked to other events, e.g. the breach of those substantive obligations or the opening of normal insolvency proceedings (art. 68 (3) BRRD). The same framework applies, under certain conditions, to cross-default rights (see art. 68 (1) II or 68 (3) (a) BRRD).

The prohibition of ipso facto clauses encompasses all contractual provisions that have the effect of terminating the contract merely by the resolution of the counterparty. For instance, the rule should be also applicable to provisions in contracts that establish that upon entry into resolution, the counterparty can exercise a put option. The rationale underlying the prohibition of ipso facto clauses is to ensure the continuation of the entity's activity in resolution and therefore should include any clause that may lead to hampering this policy.

In addition, the resolution authorities may go further and impose a temporary suspension of the payment or delivery obligations deriving from a contract until midnight the next business day, i.e. a 'temporary stay' (art. 69 BRRD). This may give resolution authorities some time to, for example, carry out a transfer of assets and liabilities of the failing institution to a creditworthy new entity (a bridge bank) or to a private sector purchaser. Other than the time limit, which cannot be extended, these powers of the resolution authorities are accompanied by certain safeguards. Two, in particular: (a) a sort of *non adiempleti contractus* rule: during that period, the obligations of the relevant counterparties are also suspended (art. 69 (3) BRRD); and (b) the Directive expressly states that the obligations of the failing institution will become due immediately upon expiry of the suspension period (art. 69 (2) BRRD). In order to ensure the effectiveness of these measures, the Directive gives resolution authorities an equivalent power of suspension that may be invoked *vis à vis* the enforcement of security interests (art. 70 BRRD) and the exercise of termination rights (art. 71 BRRD). This latter provision envisages the suspension of termination rights for events different from those established in Article 68 BRRD, i.e. the exercise of resolution powers, and

includes cross-default rights. In any event, the obligations to Central Banks, Central Counterparties and EU clearing and settlement systems are excluded from this temporary stay (arts 69 (4) (b), 70 (2), 71 (3) BRRD). Eligible deposits are also excluded from the power to suspend payments or delivery obligations (art. 69 (4) (a) BRRD).

If the suspension period has expired, the regime for termination rights depends on whether there has been a transfer or not. If the contract has been transferred to a third party, the counterparty may only exercise his termination rights on the occurrence of a subsequent default by the recipient (art. 71 (5) (a) BRRD). If neither a new termination event nor a new event of default occurs, the contract must remain outstanding. Conversely, if the contract has not been transferred, and the resolution authority has not applied the bail-in tool, which entails that the counterparty is left with an insolvent residual entity, it may exercise its termination rights (art. 71 (5) (b) BRRD). As explained above, these rules on temporary suspensions mainly complement the other two resolution tools, the sale of a business and the transfer to a bridge institution, since they give some time to the resolution authorities to carry out the transfers.

The SRM Regulation, in turn, does not establish rules with regard to the effects of resolution tools on contracts. However, decisions relating to resolution made by the SRB are implemented by the national resolution authorities designated under the BRRD and, in doing so, the national resolution authorities will apply national rules, including those transposing the BRRD in relation to outstanding contracts described above.[5]

7.2.2 Conflict-of-laws level

In the EEA, the Directive on the reorganization and winding up of credit institutions (CIWUD)[6] establishes that the effects of the application of the resolution tools on current contracts to which the (failing) entity is a party are governed by the *lex fori concursus*, i.e. the law of the home Member State of that entity.[7] Outside an insolvency scenario, the law governing the contract is the law chosen by the parties

[5] See arts 5, 7, 18, 21, 22, 23, among others, of the SRM Regulation.
[6] Directive (EC) 2001/ 24 on the reorganization and winding up of credit institutions, [2001] *OJ* L 125/ 15.
[7] See arts 3.2 and 10.2 (d) CIWUD.

ex Article 3.1 Rome I Regulation, or the law determined by its Article 4 in the absence of choice (*lex contractus*).[8]

Further to the general rule, the CIWUD also contains some special rules for (i) employment contracts, which are governed by the law of the Member State applicable to the employment contract (*lex contractus*); (ii) contracts conferring the right to make use of or acquire immovable property, which governed solely by the law of the Member State within the territory of which the immovable property is situated (*lex rei sitae*); and (iii) transactions carried out in the context of a regulated market, which are governed solely by the law of the contract which governs such transactions (*lex mercatus,* as the law applicable to such transactions is the law of the Member State on which the financial instrument is traded). [9]

In turn, the BRRD, which unlike the CIWUD only applies in resolution scenarios, qualifies its Article 68 prohibiting ipso facto clauses as an overriding mandatory rule within the meaning of Rome I Regulation (art. 68 (6) BRRD). That provision, therefore, shall apply even if the contract is governed by a foreign law, i.e. the law of another Member State or the law of a third country. And it must be applied by the authorities of any Member State, i.e. the resolution authorities or the authorities of another Member State, since it is an EU overriding mandatory provision. Third countries are not bound by it.

> **Example:** A Spanish bank (A) enters into a loan agreement with a Dutch bank (B) which includes a choice of law clause in accordance to which the contract is subject to New York law. Let us imagine that A becomes financially distressed and a resolution procedure is opened. New York law would determine whether the contract is valid and enforceable in the pre-insolvency scenario (*lex contractus*) and Spanish law, as the law of the home Member State, would determine the effects of the insolvency on the loan agreement (*lex concursus*). An early termination clause in the loan agreement that can be triggered by the adoption of a resolution measure would be unenforceable regardless of the law applicable to the contract (New York law) *ex* art. 68 BRRD.

7.3 Close-out netting provisions and financial collateral

[8] Regulation (EC) 593/ 2008 on the law applicable to contractual obligations (Rome I) [2008] OJ L 177/ 6.

[9] See, respectively, arts 20 (a) and (b) and art. 24. With regard to art. 26 (repurchase agreements) and, specially, art. 25 (netting agreement) vid. *infra* 7.3.3.2 (b).

7.3.1 Introduction

In colloquial terms, derivatives (such as swaps, futures, options, or warrants) are contractual arrangements whose value depends on the value of an underlying or benchmark asset, such as a commodity, currency, or security. They are used for different purposes, including insuring against price movements (hedging) or increasing exposure to price movements for speculation or getting access to otherwise hard-to-trade assets. Nowadays, the volume of money at stake in derivatives markets reaches astronomic figures.[10]

Derivatives rest upon two mechanisms to reduce the exposure to counterparty and market risks: close-out netting provisions and collateral arrangements. The former reduces the counterparty risks from a gross exposure to a net exposure.[11] According to that provision, on the occurrence of a predefined event: (i) all outstanding obligations between the parties are accelerated or terminated, (ii) the negative or positive value of each transaction is assessed on the basis of an agreed valuation mechanism (normally equivalent to its mark-to-market replacement costs), and (iii) all these amounts are offset so that only the balance is due. By the same token, it serves to regulatory capital requirements of credit institutions.[12]

> **Example**. A and B have entered into several derivative transactions, multiple interest rate swaps for example. Numerous mutual payment obligations result from these transactions. If B defaults on one of them, a close-out netting arrangement allows A, i.e. the party *in bonis*, (i) to terminate all transactions early, (ii) to assess the value of each transaction (some of which may have a positive and others a negative replacement value), and (iii) to offset these amounts. Let us imagine that the parties have entered into three transactions: 1, 2, and 3. Transactions 1 and 2 had a positive value for B of 8 (i.e. B was in the money) and transaction 3 had a positive value for A of 10 (i.e. with regard to 3, A was in the

[10] See <www.bis.org/ statistics/ about_ derivatives_ stats.htm?m=6%7C32>, where the Bank for International Settlements (BIS) publishes information about the size of both exchange-traded derivatives and over-the-counter (OTC) derivatives markets.
[11] UNIDROIT, *Principles on the Operation of Close-Out Netting Provisions. Explanation and Commentary*, (2013), para 1, accessible at <www.unidroit.org/ instruments/ capital-markets/ netting>. See also Directive (EC) 2002/ 47 on financial collateral arrangements [2002] OJ L 168/ 43, Recital 14; ISDA, *Research Notes* (November 2010), para 1, accessible at <www.isda.org/ researchnotes/ pdf/ Netting-ISDAResearchNotes-1-2010.pdf>: 'Close-out netting has reduced over-the-counter derivatives credit exposure by over 85 percent; without the benefits of netting, Banks worldwide might face a capital shortfall of over $500 billion.'
[12] See, in Europe, Articles 295 and 296 of Regulation (EU) No 575/ 2013 on prudential requirements for credit institutions and investment firms (CRR), [2013] OJ L 176/ 1.

money). In this example, the reciprocal payment obligations are computed so as to result in a single net payment obligation of B to A: A only has to receive 2 from B, instead of paying 8 and requesting 10 from B. If B were insolvent, A would qualify as an unsecured creditor, but only for the net amount, i.e. 2.

Furthermore, close-out netting provisions also reduce market risks. These provisions allow the party *in bonis* to terminate and assess the value of its transactions at a predefined moment. Otherwise, that party would be exposed to changes in the value of its transactions during the period of time that insolvency proceedings may be pending, which may be particularly difficult to manage when the market is very volatile. At a macroeconomic level, close-out netting is justified on the basis that it both preserves liquidity in securities markets and minimizes systemic risk.

Financial collateral arrangements, whether in the form of title transfer or security interest (e.g. a pledge), fulfil a similar function.[13] The exposure to the counterparty risk is mitigated by the value of a financial asset. This asset, the collateral, is posted for the benefit of the party owed. If the collateral arrangement is legally enforceable then the exposure is reduced to the difference between the secured obligation and the value of the posted collateral.

Example. In the former example, we have concluded that in a scenario where B is insolvent, A would qualify as an unsecured creditor, but only for the net amount, i.e. 2. However, if B had granted a pledge in favour of A, the close-out netting amount would be reduced by the value of the collateral. Thus, for instance, if the current value of the collateral is 2, and both the close-out netting provision and the collateral arrangement are legally enforceable, the final result is that A would not be exposed to the insolvency risk of B.

7.3.2 Pre-crisis scenario: privileged status of derivatives and financial collateral

Close-out netting provisions included in derivative instruments and financial collateral arrangements have benefited from a privileged status, both at the substantive law level (7.3.2.1) and at a conflict-of-laws level (7.3.2.2). This privileged status has been particularly relevant in insolvency scenarios since, in practice, it has effectively placed

[13] UNIDROIT Principles (n 11) para.1: 'Both mechanisms, security/ collateral on the one hand and close-out netting on the other hand, serve the same purpose, that is, to ensure that one party's exposure to the other parties' solvency and to changes in the value of the relevant assets is kept at manageable levels. Both mechanisms are capable of independently mitigating counterparty risk as well as market risk.'

those transactions outside the normal bankruptcy process that we have discusses above (7.2).[14]

7.3.2.1 Substantive-law level ('safe harbours')

(a) General considerations

In principle, close-out netting clauses included in derivative instruments and financial collateral arrangements are governed by civil and commercial law. In many jurisdictions they are governed by special provisions that depart from the general regime applicable to other contracts and secured transactions and, for example, rule out the application of certain formal requirements for perfection or effectiveness of these arrangements or facilitate their enforcement. This user-friendly approach has been promoted by different supranational initiatives, such as the UNIDROIT Principles on close-out netting.[15]

The privileged status of close-out netting provisions contained in derivative instruments and financial collateral arrangements is particularly relevant in an insolvency scenario. In broad terms, policymakers have also supported the enforceability of close-out netting provisions in cases of insolvency of one of the parties (the so-called 'safe harbour'[16]). The protection granted to these financial transactions typically departs from general insolvency law in two respects. First, the party *in bonis* may close out all outstanding transactions merely due to the insolvency of the counterparty. Second, the insolvency practitioner is not entitled to cherry pick between transactions governed by the same master agreement. These provisions therefore are enforceable even if, according to the general insolvency principles, outstanding contracts cannot be terminated due to such a circumstance, i.e. termination of executory contracts is stayed pending the decision by the insolvency practitioner (or debtor in possession) to assume or reject those contracts.

---

[14] See e.g. Robert B Bliss and George G Kaufman, 'Derivatives and Systemic Risk: Netting, Collateral and Closeout' (2006) JFS 56, 56.

[15] UNIDROIT Principles (n 11), see in particular Principle 5: the operation of the close-out netting provisions should not depend on the performance on any formal act other than a requirement that it be evidenced in writing. Or Principle 6: a close-out netting provision is enforceable in accordance with its own terms and in particular States should not impose enforcement requirements beyond those specified in the close-out netting provision itself.

[16] See summarizing the status and providing a comparative law analysis, with further references, Ole Böger, 'Close-out Netting Provisions in Private International Law and International Insolvency Law (Part II)' (2013) UnifLR 532, 532– 57; Philipp Paech, 'The Value of Insolvency Safe Harbours', *passim*, accessible at < https:// papers.ssrn.com/ sol3/ papers.cfm?abstract_ id=2578521>.

In many legal systems, the same holds for financial collateral arrangements: they can usually be enforced in cases of the counterparty's insolvency, 'even if according to the general insolvency principles other security interests are subject to an automatic stay'.[17] Finally, close-out netting provisions and financial collateral arrangements may also enjoy special protection from insolvency avoidance actions, in particular with regard to payments or delivery of collateral at a pre-insolvency stage. They are, therefore, to a certain extent immunized *vis à vis* general principles of insolvency law, in particular automatic stays and avoidance actions.[18]

(b) European law

In Europe, all Member States of the EEA have largely recognized that privileged status. In particular, close-out netting provisions and financial collateral arrangements are regulated by the Financial Collateral Directive (FCD).[19] Furthermore, most Member States at national level also protect them, although there are no European rules on the validity and enforceability of mere close-out netting provisions, i.e. those provisions that do not form part of a financial collateral arrangement (which is certainly very unusual).

The FCD provides special protection for financial collateral arrangements, including close-out netting provisions. It not only reduces the legal formalities for the perfection of close-out netting agreements (art. 3) and facilitates their enforcement (art. 4), but also

[17] UNCITRAL (n 4) Recommendation 46.
[18] The UNCITRAL Legislative Guide has endorsed the special treatment of financial contracts in this threefold dimension (no cherry picking, enforceability of 'ipso facto clauses' and protection vis à vis avoidance actions): see Recommendations 71, 92, and 10– 107; also e.g. World Bank, Principle C10.4 of the *Creditor Rights and Insolvency Standard*, accessible at <http:// www.worldbank.org/ >. However, an important group of academics is sceptical on privileging close-out netting; see, for example, Bliss and Kaufman (n 14); Franklin Edwards and Edward Morrison, 'Derivatives and the Bankruptcy Code: Why the Special Treatment?' (2005) YJR 91; Vincent R Johnson, 'International Financial Law: The Case against Close-Out Netting' (2015) BIILJ 101, 115– 25; Mark J Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator' (2011) StandLR 539; David Skeel and Thomas H Jackson, 'Transaction Consistency and the New Finance in Bankruptcy' (2012) ColumbLR 152. Steven L Schwarcz and Ori Sharon, 'The Bankruptcy-Law Safe Harbour for Derivatives; A Path-Dependance Analysis' (2014) Wash and LeeLR 1715. Summarizing the *status quaestionis*, Francisco Garcimartín and Maria Isabel Saez, 'Set-off, Netting and Close-Out Netting' in Matthias Haentjens and Bob Wessels (eds), *Research Handbook on Crisis Management in the Banking Sector* (Edward Elgar 2015) 331, 334-343; Gerry G Kounadis, 'Striking the Correct Balance Between Imposing a Suspension of Close-Out Netting Rights while Preserving Legal Certainty and Market Integrity in View of the Bank Recovery and Resolution Directive 2014/ 59/ EU: Part A' (2015) JIBLR 228, 229– 35; David L Mengle, 'Close-Out Netting and Risk Management in Over-the-Counter Derivatives' accessible at <http:// ssrn.com/ abstract=1619480>; P Paech (n 8), *passim* (drawing a favourable conclusion to maintaining insolvency safe harbours for financial transactions).
[19] FCD (n 11).

enhances such special protection in an insolvency scenario (arts 7 and 8). The FCD ensures that certain provisions of insolvency law do not apply to such arrangements, in particular those insolvency rules that may hamper the effective realization of the collateral (e.g. an automatic stay) or the effectiveness of other sound market practices to manage risk exposure, such as close-out netting, top-up collateral or substitution of the assets provided as collateral (see Recital 5 FCD). Due to the nature of this instrument, i.e. a Directive, and the alternatives that it allows Member States, national laws may differ and therefore the determination of the applicable law may become a key issue in practice (see 7.3.2.2).

Outside the scope of the FCD,[20] EU legislators have not harmonized the substantive rules governing close-out netting arrangements. Thus, for example, a close-out netting provision included in a transaction which does not form part of a financial collateral arrangement— or of an arrangement of which the financial collateral arrangement forms part[21]— is not governed by (harmonised) EU law.[22] Nevertheless, most EEA jurisdictions grant special protection to those provisions under their internal laws, in particular recognizing their enforceability in an insolvency scenario.[23] Naturally, the scope of protection applicable to close-out provisions may vary among jurisdictions as regards, for example, the parties that may benefit from it or the eligible obligations.[24] Determining the applicable law also matters in this context.

7.3.2.2 Conflict-of-laws level

In the EU, the law applicable to the contractual obligations stemming from derivative transactions, including their close-out netting provisions, is the law chosen by the parties in accordance with Article 3.1 of the Rome I Regulation.[25] When the parties

[20] See also Article 3 of Directive (EC) 98/ 26 on settlement finality in payment and securities settlement systems (Finality Directive), [1998] OJ L 166/ 45.
[21] See Article 2(1) FCD.
[22] See European Commission, 'Non-paper on Close-out Netting' (2 September 2013) Doc Number 13233/ 13, at 9– 10, accessible at <www.consilium.europa.eu/ en/ documents-publications/ public-register/ >.
[23] See e.g. Joanna Benjamin, *Financial Law* (OUP 2007), 270; Ole Böger, 'Close-Out Netting Provisions in Private International Law and International Insolvency Law (Part I)' (2013) UnifLR 2013,232, 237; Johnson (n 18) 111; ISDA, Netting Legislation-Status, accessible at <www.isda.org>; Philipp Paech, 'Close-out Netting, Conflict of Laws and Insolvency', 13, accessible at <https:// www.lse.ac.uk/ collections/ law/ wps/ WPS2014-14_ Paech.pdf>; Philipp Wood, Set-off and Netting, Derivatives, Clearing Systems (2nd edn, Sweet & Maxwell 2007) para 7-010.
[24] Philipp Paech, 'Enforceability of Close-out Netting: Draft UNIDROIT Principles to Set New International Benchmark' (2013) BJIBFL 13, 17; Philipp Paech (n 16) 10-13.
[25] Note, however, that the law applicable to capacity (and the consequences of lack of capacity on the validity of the contract) is excluded from the scope of this instrument (art. 1 (2) (a) and (f)). See Böger (n

have not chosen any law, the applicable law will be determined by Article 4 of this instrument. In turn, the law applicable to the proprietary effects of a financial collateral arrangement is the law of the State where the relevant account is located in accordance with Article 9 (1) FCD.[26] The relevant account, in relation to book-entry securities, is defined as the register or account in which the entries are made by which that book-entry securities collateral is provided to the collateral taker. The solution is based on the so-called 'PRIMA-rule'.[27]

> **Example.** A is a Spanish entity and B is a Dutch bank. Both parties enter into an ISDA Master Agreement governed by English law, which contains a close-out netting provision. According to the general conflict-of-laws rules, the validity and enforceability of the close-out netting agreement is governed by English law, as the law chosen by the parties in accordance with Article 3 of the Rome I Regulation (=*lex contractus*). If the close-out netting amount is secured by a pledge over a securities account located in Luxembourg, the proprietary effects of this pledge, including the steps required for its realization, are governed by Luxembourg law in accordance with Article 9 (1) FCD (=*lex conto sitae*).[28]

Furthermore, in an insolvency scenario, the applicable law determined by those conflict-of-laws rules prevails over the application of the *lex fori concursus*.

(a) Close-out netting

In cross-border insolvencies, the problem of conflict of laws arises when the *lex fori concursus* does not coincide with the law applicable to the netting agreement (*lex*

16) 238-239; Francisco Garcimartín 'Contratos de derivados y conflictos de leyes', in Carmen Alonso Ledesma and Alberto Alonso Ureba (eds) *Estudios Jurídicos sobre Derivados Financieros* (Thomson Reuter 2013), 319, 325-328.

[26] See also Article 9 (2) of the Finality Directive.

[27] The PRIMA rule has been thoroughly studied by legal scholars and practitioners; see, with further references, Stefania Bariatti, 'Le garanzie finanziarie nell'insolvenza transnazionale: l'attuazione della directiva 2002/ 47/ CE' (2004) RDIPP 841; Franciso Garcimartin and Florence Guillaume, 'Conflict of Laws Rules' in T Keijser (ed), *Transnational Securities Law* (OUP 2014), 285; Roy Goode, Hideka Kanda, and Karl Kreuzer, Hague Securities Convention. Explanatory Report (Martinus Nijhoff 2005), para Int.41– Int.46; Guy Morton, 'Modernization of EU Financial Law: The Directive on Financial Collateral Arrangements' (2003) Euredia 11; Richard Potok (ed) Cross-border Collateral: Legal Risk and the Conflict of Laws, (Bloomsbury 2002); and the seminal work: The Oxford Colloquium on Collateral and Conflict of Laws. A Special Supplement to Butterworth's Journal of International Banking and Financial Law (September 1998).

[28] On the particular problems deriving from the application of this rule, in particular to title transfer arrangements, Garcimartín (n 25) 327-328.

contractus). In this case, 'the key issue is whether the enforceability of the close-out netting provision in an insolvency scenario is governed by the former or by the latter, i.e. by the lex fori concursus or by the lex contractus'.[29]

> **Example.** A is a Spanish entity which also has its COMI (Centre of Main Interests) in Spain, B is a Dutch bank, and the close-out netting provision is part of an ISDA Master Agreement governed by English law. If A becomes bankrupt, and assuming that the agreement is valid under English law, the question is whether the effects of the insolvency on the close-out netting provision, and in particular whether and under what conditions this provision can be triggered, are (i) subject to Spanish law, as *lex fori concursus*, or (ii) to English law, as *lex contractus*. Since, for instance, the legal framework applicable to the enforceability of that provision may differ under Spanish and English insolvency laws, this may become a key question for the Dutch bank to assess its counterparty risk.

In the EEA, the original text of the CIWUD expressly envisages a special rule on netting agreements. According to Article 25: 'Netting agreements shall be governed *solely* by the law of the contract which governs such agreement'.[30] This rule establishes an exception to the general application of the law of the home Member State (as *lex fori concursus*, see above on the general rule section 7.2.2) and envisages the application of the *lex contractus*, i.e. of the law chosen by the parties to the netting agreement (in the example just given, English law), including its insolvency provisions. This law will govern, in particular, the enforceability of the close-out netting provision in an insolvency scenario and also the claw-back rules, i.e. the actions to set aside legal transactions detrimental to the general body of creditors (note that, unlike other special provisions of the CIWUD, art. 25 does not safeguard the application of the regime on actions to set aside the *lex fori concursus*). The CIWUD also contains a special rule for set-offs (art. 23) and for repo agreements (art. 26). Also this set of rules is based on protecting the autonomy of the parties: in principle, the parties can choose the insolvency framework applicable to the enforceability of the close-out netting provision, and this law applies irrespective of the Member State where the reorganization measures are taken or winding-up proceedings are opened. This solution not only allows the

[29] ibid 329-330; Paech (n 23) 13.
[30] The amendments introduced in this Directive by the new Recovery and Resolution framework will be analysed in the following Section.

parties to choose a netting-friendly jurisdiction but also ensures legal certainty and predictability.

> **Example.** In the former example, if the Spanish entity were a credit institution, English law would govern: (i) the pre-insolvency validity and effectiveness of the close-out netting provision included in the ISDA Master Agreement, in accordance with Article 3.1 of the Rome I Regulation, (ii) and also the question of whether and under what conditions such provision is enforceable in the winding-up proceedings of the Spanish entity, in accordance with Article 25 CIWUD (*rectius* the corresponding national conflict-of-laws rule implementing this instrument).

Article 25 CIWUD only protects the close-out netting provision, including its scope, qualifying parties and eligible obligations. The effectiveness of other provisions that may be included in the Master Agreement (e.g. walk-away clauses, wait-and-see periods or flip clauses) is governed by the *lex fori concursus*. This law also governs the ranking of the close-out netting amount.

Conversely, the EU Insolvency Regulation recast only lays down a special rule for set-offs.[31] According to its Article 9,

> The opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim.

Article 9 complements Article 7, according to which 'the conditions under which set-offs may be invoked' are subject to the *lex fori concursus*. The combination of Articles 7 and 9 ends up permitting set-off in accordance with either of those two laws.

We have argued elsewhere that the Insolvency Regulation should be construed broadly taking into account the Directive and, therefore, close-out netting should be included within the scope of Article 9.[32] Otherwise, the result would be truly paradoxical or absurd. In a contractual relationship between a credit institution and a non-financial company, the close-out netting arrangements would only be protected, at the conflict-of-laws level, when the credit institution becomes bankrupt, as it is in this case, and not when the company goes bankrupt, as the CIWUD applies. This result is

[31] Regulation (EU) 2015/ 848 on insolvency proceedings (recast), [2015] *OJ* L 141/ 19, applicable as of 26 June 2017.
[32] Miguel Virgós and Francisco Garcimartín, *The European Insolvency Regulation. Law and Practice*, (Kluwer Law International, The Hague, 2004), 119-120.

absolutely inconsistent with the rationale of these provisions, i.e. protecting credit institutions against the insolvency of their counterparties.

> **Example**. If the Spanish entity were a non-financial company, it would make little sense to conclude that: (i) if the Spanish company becomes bankrupt, the netting arrangement is not governed by English law but by Spanish law; (ii) but if it is the bank that becomes bankrupt, the enforceability of the agreement is governed by English law and not by Dutch law. We end up granting more protection to non-financial parties than to financial parties. The systematic consistency between EU instrument and the *reductio ad absurdum* argument favours a broad interpretation of Article 9 of the EU Insolvency Regulation recast.

Note, however, that the current legal framework is uncertain and there are a significant number of authors who take the view that Article 9 of the EU Insolvency Regulation recast does not encompass close-out netting arrangements.[33]

(b) Financial collateral

As regards financial collateral, the CIWUD lays down one rule on rights *in rem* (art. 21) and another rule on proprietary rights over book-entry securities (art. 24). These rules are not exactly the same in content. Article 21 CIWUD establishes a sort of immunity rule for rights *in rem* over assets situated in a Member State different from the Member State where the reorganization or the winding-up proceedings are opened (those rights 'shall not be affected' by the proceedings). Conversely, Article 24 CIWUD is a conflict-of-laws rule that basically refers to the law of the Member State where the relevant account is located:

> The enforcement of proprietary rights in instruments or other rights in such instruments the existence or transfer of which presupposes their recording in a register, an account or a centralised deposit system held or located in a Member State shall be governed by

[33] See European Financial Markets Lawyers Group (EFMLG), 'Protection for bilateral insolvency set-off and netting arrangements under EC Law' (October 2004), 11-37, at <www.eflmg.org/ documents.htm>; also, recently and with further references, P Böger (n 23) 259-260; P Paech (n 23) 18. The Commission's Proposal on the EU Insolvency Regulation recast included a rule on netting similar to that contained in the Directive, see COM (2012) 742 final at 23, but it was not maintained in the final text; see Interinstitutional File 2012/ 0360 (COD) No 13233/ 13; all these documents are accessible at <http:// www.consilium.europe.eu/ en/ documents-publications>.

the law of the Member State where the register, account, or centralised deposit system in which those rights are recorded is held or located.

In principle, Article 24 CIWUD is a special rule and therefore should apply when the security interest is created over a financial instrument credited to a securities account. This law will also apply to actions to set aside legal transactions detrimental to the general body of creditors. The solution is equivalent to that applicable to netting arrangements or repos (arts 25 and 26 CIWUD). The law applicable to the rights *in rem* over the financial collateral determines the insolvency risk of the counterparty, irrespective of the Member State where the reorganization measures are taken or winding-up proceedings are opened.

Example. A is a Spanish bank, B is a Dutch bank, and the close-out netting clause is part of an ISDA Master Agreement governed by English law. The close-out netting amount is secured by a pledge over a securities account situated in Luxembourg. If A were to become bankrupt, and assuming that the pledge is valid under Luxembourg law, the effects of the reorganization or winding-up of A upon this pledge, and in particular whether and under what conditions it can be enforced, are governed by Luxembourg law. This law also determines the claw-back actions.

The solution in the EU Insolvency Regulation recast is slightly different. The Regulation only lays down a rule on rights *in rem* based on the 'shall-not-affect principle' (art. 8 Regulation recast): the opening of insolvency proceedings in one Member State shall not affect the rights *in rem* over assets situated in another Member State. The Regulation does not contain a special rule for rights in rem over book-entry securities.[34]

Example. A is a Spanish non-financial company, B is a Dutch bank, and the close-out netting clause is part of an ISDA Master Agreement governed by English law. The close-out netting amount is secured by a pledge over a securities account situated in Luxembourg. If A were to become bankrupt, and assuming that the pledge is valid under Luxembourg law, the opening of insolvency proceedings in Spain shall not affect the

[34] Note that the EU Insolvency Regulation recast has included a rule on location of book-entry securities inspired by the FCD. According to art. 2 (9) (ii) of the Regulation recast, financial instruments, the title to which is evidenced by entries in a register or account maintained by or on behalf of an intermediary (i.e. 'book-entry securities'), are situated in the Member State in which the register or account where the entries are made is maintained. As clarified by the cross-reference in paragraph (i) ('[…] other than those referred to in point (ii) […]'), this rule also applies to book-entry (intermediated) registered shares.

rights of B to enforce such pledge under general Luxembourg law. That is, in contrast with the example above in which the law is determined with the CIWUD, Luxembourg insolvency rules do not apply and, as a consequence, it is more likely that B can exercise his right to enforce the pledge. In cases of financial collateral arrangements, the difference may not have practical consequences; but it may become relevant when the security interest is outside the scope of the FCD. As regards actions to set aside, the Regulation combines the application of the *lex fori concursus* (art. 7 Regulation recast) with the application of the *lex contractus* (art. 16 Regulation recast).

7.3.3 Post-crisis: the review of 'safe harbours'

The financial crisis has led to re-evaluation of the appropriate framework for derivatives and other financial arrangements and, public authorities have partially reconsidered their position and reduced the privileges of those transactions when the failing firm is a financial institution.[35] In this regard, financial transactions are in part 're-routed' to the general principles of insolvency law, both at the substantive law level and at the conflict-of-laws level.[36]

7.3.3.1 Substantive-law level

(a) Close-out netting provisions and collateral arrangements

Safe harbours do not fit well within the new resolution framework described above (section 7.2.1). Financial contracts are core assets for any credit institution and, therefore, early termination of financial contracts under the close-out netting provisions may hamper the effective implementation of resolution measures. If the counterparties of a financial institution under resolution close out all outstanding transactions and enforce the corresponding collateral, this would potentially harm the resolution in an orderly fashion since it limits the possibility for successful reorganizations or going

[35] See e.g. FSB, Key Attributes (n 3) 40-42; Commission (EU), *Bank Recovery and Resolution Working Document* (January 2011), <http:// ec.europa.eu/ internal_ market/ consultations/ 2011/ crisis_ management_ en.htm>; UNIDROIT Principles (n 11) 65-67, in particular Principle 8 enshrines this new policy: 'These Principles are without prejudice to a stay or any other measure which the law of the implement State, subject to appropriate safeguards, may provide for in the context of resolution regimes for financial institutions'.

[36] See, for a further elaboration of the theoretical foundations, Francisco Garcimartín 'Resolución de entidades de crédito, contratos de derivados y garantías financieras: regreso a los principios concursales', (2014) Revista de Derecho Bancario y Bursatil 105; Skeel and Jackson (n 18).

concern sales (see e.g. Recital 94 BRRD).[37] At a certain level, a massive close-out of financial contracts may have systemic impact.

Consequently, legislators have introduced rules limiting the effectiveness of such provisions on two fronts.[38] Firstly, by excluding the entry into resolution or the adoption of a resolution measure as an event that triggers the early termination clause: i.e. a general (or *ope legis*) disapplication of the termination rights linked to the mere entry into resolution (see below (i)). And, secondly, by allowing resolution authorities to suspend all other obligations and termination rights for a limited period of time: i.e. a temporary disapplication of the termination rights linked to other circumstances (below (ii)). Certain limitations on cross-default rights are also introduced. This purportedly gives the resolution authority a window of time to focus on maximizing the effectiveness of the resolution tools.[39] Furthermore, the BRRD gives resolution authorities the statutory powers to trigger application of the close-out netting provision in order to apply the bail-in tool. This latter aspect will be analysed in a separate Section (below (b)).

(i) Firstly, as discussed above (section 7.2.1 and 7.2.2) Article 68 BRRD establishes that the mere opening of a resolution process or the adoption of resolution tools cannot of itself be characterized by the parties as a termination event. Hence derivatives, like other contracts, are also subject to the general framework on 'ipso facto clauses': the counterparty may not exercise an early termination right and close out the derivative contracts solely upon the entry into resolution or the exercise of the resolution power. By the same token, counterparties are prevented from obtaining possession or enforcing any security right over assets of the failing institution by the mere entry into resolution of such an institution or the exercise of resolution powers. Furthermore, these rules are qualified as overriding mandatory provisions within the meaning of the Rome I Regulation and prevail over the provisions of the FCD (art. 68 (1) BRRD and see also art. 118 BRRD amending the FCD).

[37] See also FSB Key Attributes (n 3) (2014), I-Annex 5 'Temporary stay on early termination rights' para 1.1.
[38] Francisco Garcimartin, 'Resolution Tools and Derivatives' in Matthias Haentjens and Bob Wessels (eds) *Bank Recovery and Resolution: A Conference Book* (Eleven International Publishing 2014) 179, 187– 90; Matthias Lehmann, 'La resolution et le droit international privé' (2014) RDBE 88, 93.
[39] See, FSB, 'Principles for Cross-Border Effectiveness of Resolution Actions' (November 2015) accessible at < www.financialstabilityboard.org> 7.

(ii) Secondly, the resolution authorities may impose a temporary stay which allows the resolution authorities to carry out the transfer of assets and liabilities, including derivatives, to a new entity or a private sector purchaser.

When the pool of transferred assets includes derivative contacts, it is essential to assure the new acquirer that those contracts will not be immediately terminated after the transfer. The BRRD ensures this objective in Article 71 (5) (a) (section 7.2.1): the counterparty can only trigger the close-out netting provision on occurrence of any continuing or subsequent enforcing event by the recipient.

Finally, the BRRD ensures additional protection for the rights of counterparties in cases of transfers of assets and liabilities, usually to a third party or to a bridge bank. This protection is consistent with the nature of derivatives transactions. Derivatives allow parties to assess their counterparties' risk on a net basis (see above 7.3.1). For this purpose, it is essential that when a resolution authority carries out a partial transfer of assets and liabilities, it does not separate transactions that are economically and functionally linked (Recital 95 BRRD). All transactions subject to the same master agreement must remain together ('no cherry-picking rule'), and the secured liabilities must remain linked to the relevant collateral. The BRRD guarantees this double protection. On the one hand, in accordance with Article 77, the resolution authorities must prevent split-up and separate transactions subject to the same netting or set-off agreement, i.e. all derivative transactions or title transfer arrangements, for example, under the same netting master agreement shall be transferred together.[40] And, on the other hand, the transfer of secured obligations is legally ineffective unless the related security arrangements, together with the security assets, are also transferred to the new counterparty (art. 78 BRRD).

(b) Bail-in and derivatives

The new resolution framework, and in particular the application of the bail-in tool, may also have a certain impact upon the ordinary functioning of close-out netting provisions and the triggering events.

[40] See also, though in the context of Article 76 BRRD, European Banking Association, *Technical Advice by the European Banking Authority in Classes of Arrangements to Be Protected in a Partial Property Transfer* (14 August 2015).

In principle, the Directive does not exclude derivatives contracts from the scope of bail-in. It is true that there may be certain grounds for such an exclusion, since they are not usually designed as funding transactions, i.e. as a debt instrument, which are those typically subject to bail-in. Furthermore, the valuation of derivatives to determine the amount of liability to be written down and/ or converted entails serious practical difficulties. They are highly volatile instruments with markedly changing values over very short periods of time. The policy underpinning the Directive is, however, to reduce privileges to a minimum (note that any exclusion increases the losses that the rest of the eligible creditors and/ or taxpayers must bear) and, therefore, derivatives are included within the scope of eligible obligations. To the extent that they are not mentioned in the list of exclusions contained in Article 44 (2) BRRD, they may be subject to write-down and conversion, like any other non-excluded liability. National law determines the ranking of (post-netting) derivatives in the sequence of write-down and conversion.

The only loophole would be the general clause established by Article 44 (3) BRRD. This provision gives national authorities discretionary powers to extend the list of excluded liabilities on a case by case basis. The reasons that may justify this extension are, *inter alia*, when it is not possible to bail in that liability within a reasonable time, or when exclusion is strictly necessary to continue the core business of the institution or to prevent a severe disruption of financial markets. Derivatives, unlike other liabilities, are transactions that might typically satisfy those conditions (art. 49 (2) II BRRD mentions this possibility *expressis verbis*). On the one hand, since the application of the bail-in powers to derivatives may require the close-out of a large number of outstanding transactions (*infra*), this may be difficult to do in a reasonable timeframe. Also, the high degree of interconnectedness among institutions and the huge amounts of money at stake may significantly increase the contagion effect and, therefore, systemic risk. Nevertheless, note that the 'test of exclusion' is very demanding: resolution authorities may only exclude derivatives 'in exceptional circumstances' (see also art. 44 (12), foreseeing a certain intervention of the EU Commission).

Secured liabilities are, in any case, exempted from the bail-in powers but, in principle, only up to the value of the collateral. As regards derivatives secured by a security interest, e.g. a pledge, they qualify as secured liabilities and therefore are excluded from the bail-in powers up to the value of the encumbered assets. If the collateral is provided on a title transfer basis, the bail-in only applies to the net close-out amount.

The other issue raised by the application of the bail-in tool in this context is the determination of the liabilities arising from derivatives. Theoretically, the bail-in powers are relatively easy to apply to an obligation. Its nominal value is written down and/ or converted to the corresponding amount and following the hierarchy set out by Article 48 BRRD. Conversely, derivatives are contingent while the transactions are outstanding. An outstanding swap, for example, usually entails an exchange of cash flows with reciprocal obligations to be performed (reduced to a net amount) when the failing institution enters into resolution. Application of the bail-in tool to such liabilities may give rise to severe valuation and operational difficulties. In fact, the application of the bail-in powers to derivatives may only be conceived when the failing institution is 'out of the money' and with regard to (i) the periodic payment amount— i.e. the amount that has become due and payable on a payment date under the relevant, individual derivative transactions, when the bail-in power is exercised, or (ii) the net close-out amount under a master agreement if the transactions are cancelled. Indeed, the application of the bail-in powers to the latter, i.e. to the net close-out amount, is the important element in practice. Determining whether a derivative contract gives rise to a liability and its exact amount requires a closing out of the transaction. That is why Article 49 (2) BRRD establishes that resolution authorities will only exercise the write-down and conversion powers upon or after closing out the derivatives.

This, however, raises two additional problems: the exercise of the close-out rights and the calculation of the net close-out amount.

Firstly, the master agreement governing the derivatives may not envisage the exercise of resolution powers as a default or termination event. But even if it did, i.e. assuming that the resolution qualifies as a triggering event, the close-out rights and therefore the calculation of the netted amount would normally be the responsibility of the party *in bonis,* i.e. the counterparty to the institution under resolution. However, since this counterparty would suffer the consequences of the bail-in, it may have no interest in closing out the agreement. In order to overcome these obstacles, the BRRD gives the resolution authorities a specific power to trigger application of that clause. Article 49 (2) expressly recognizes that such authorities '… shall be empowered to terminate and close out any derivative contract' (see also art. 63 (1) (k) BRRD). Note that this power is nothing extraordinary from an insolvency law perspective: in many jurisdictions, the administrators have the right to reject executory contracts under certain

conditions and to assess the value of the damages corresponding to the party *in bonis.*[41] Of course, when derivatives are excluded from the application of the bail-in tools in the terms described above, the resolution authorities shall not exercise that power.

Secondly, the net close-out amount is valued by the resolution authorities, but in accordance with the terms of the agreement (art. 49 (3) BRRD). The reference to the terms of the agreement is mainly to the obligations to be included under the same close-out netting master agreement and determination of the net amount. The master netting agreement, in particular the netting set, must be honoured. This is a corollary of the fact that a netting arrangement limits the reciprocal exposure of the parties to a net amount calculated in accordance with the contractual terms. It prevents the counterparty to the institution under resolution from being required to meet its payment obligations whilst at the same time seeing its claims written down. In this regard, however, art. 49 (4) and (5) BRRD, alongside a reference to the agreement, also includes a reference to certain objective parameters and EBA standards for the valuation of liabilities arising from derivatives.[42]

Finally, the BRRD also adds that, for the purpose of determining the fair and realistic value of the assets and liabilities of an institution (art. 30), the value of all derivatives subject to the same netting agreement shall also be calculated on a net basis.

7.3.3.2 Conflict-of-laws level

(a) Introduction

Most credit institutions operate branches or subsidiaries in foreign jurisdictions, and/ or hold assets, liabilities, and contracts located abroad or governed by a foreign law. The resolution of these institutions requires the cross-border effectiveness of the resolution actions. The bail-in or transfer of assets and liabilities must encompass those located abroad or subject to the law of another jurisdiction. And the same holds for the resolution stay: both (i) the general disapplication of entry into resolution as a termination event, and (ii) the resolution authorities' power to temporally suspend

[41] See e.g. and with further references, F Robert-Tissot, 'The Effects of a Reorganization on Executory Contracts: A Comparative Law and Policy Study', accessible at <www.iiglobal.org>; or Recommendation 73 and 82 of the UNCITRAL Legislative Guide on Insolvency Law (n 4).
[42] See European Banking Association, *Consultation Paper – Draft Regulatory Technical Standards on the Valuation of Derivatives Pursuant to Article 49(4) of the Bank Recovery and Resolution Directive* (13 May 2015), accessible at <https:// www.eba.europa.eu>.

close-out netting provisions and enforcement of collateral rights must apply irrespective of the law governing the agreement or the collateral. Otherwise, by choosing a foreign law and a foreign jurisdiction, or moving the collateral abroad, it would be relatively easy for the parties to avoid the application of these powers and frustrate any resolution process.[43]

(b) Resolution stay

In Europe, the BRRD combines different mechanisms to ensure the cross-border effectiveness of resolution actions. We have already mentioned the first: by characterizing art. 68 BRRD, which excludes the mere exercise of the resolution powers as a termination event, as an overriding mandatory provision for the purpose of the Rome I Regulation. Therefore, this provision is applicable regardless of the law governing the contract.

Additionally, the BRRD modifies the conflict-of-laws rules laid down by the CIWUD. As explained above (7.3.2.2 (b)), in the original version, Articles 25 and 26 of this instrument established that the effect of any reorganization measures on netting or repurchase agreements should be governed solely by the law applicable to such agreements (*lex contractus*). This might lead to the argument that the effects of any resolution measure would not be subject to the law of the home Member State of the failing institution, but to the law chosen by the parties in the agreement; and, therefore, to attempt to exclude the effects of those measures insofar as they would have not been adopted under their *lex contractus*. To prevent this conclusion, the BRRD— together with clarifying that the CIWUD includes resolution tools and the exercise of resolution powers, see the new definition of reorganization measures— amends Articles 25 and 26 CIWUD, to carve out resolution measures from the scope of the *lex contractus*. According to the new wording of these provisions, the effects of entry into resolution, restructuring or winding-up proceedings upon netting and repo agreements shall be governed by the law applicable to those agreements, but 'without prejudice to Articles

[43] See, FSB, *Principles for Cross-Border Effectiveness of Resolution Actions* (November 2015), 5, accessible at <http:// www.financialstabilityboard.org/ 2015/ 11/ principles-for-cross-border-effectiveness-of-resolution-actions/ >; Gerry G Kounadis, 'Striking the Correct Balance between Imposing a Suspension of Close-out Netting Rights While Preserving Legal Certainty and Market Integrity in View of the Bank Recovery and Resolution Directive 2014/ 59: Part B', (2015) JIBLR 5 276, 281-282; Lehmann (n 38) 88; A Wilkinson, A Wood, and P Bagon, 'Can ISDA's Close-out Protocol Stay the Next Lehman Brothers?', (2015) ICR 143, 145-146.

68 and 71' BRRD, i.e. without prejudice to (i) the general exclusion of the entry into resolution as a termination event and (ii) the power to temporally suspend other termination rights exercised by the resolution authorities of the home Member State.

> **Example**. Let us imagine again that the home Member State of the failing institution is Spain. Derivatives were subject to an ISDA Master agreement under English law. In this case, Article 68 BRRD would apply and therefore the resolution measures adopted by the Spanish authorities cannot be invoked to trigger the close-out netting, even though the contract is not governed by Spanish law but by English law, and irrespective of whether the parties have included that exception in the agreement or not. By the same token, if the Spanish authorities exercise the suspension rights set out by Article 71 BRRD, this measure cannot trigger the close-out netting either, even though the contract is subject to English law. The same holds if the contract were governed by e.g. New York law.

Note that Articles 25 and 26 only refer to the recovery and resolution framework. Thus, the law designated by these provisions (i.e. the *lex contractus*) will apply without any carve-out in cases of normal insolvency proceedings of the credit institution.

Conversely, Articles 21 and 24 CIWUD, which establish the application of the *lex rei sitae/ lex conto sitae* as regards rights *in rem*, have not been amended along the same lines, i.e. to safeguard the application of Article 62 BRRD (resolution authorities' power to restrict the enforcement of security interests). EU legislators have probably considered that the references in Articles 25 and 26 CIWUD and the material amendments to the FCD (see art. 118 BRRD, see above 7.3.2.2 (a)) are sufficient to ensure the effectiveness of the resolution measures.

> **Example**. In the former example, let us imagine that the ISDA Master agreement is accompanied by a pledge over a securities account located in Germany. In principle, since the agreement cannot be terminated, there is no possibility of enforcing the pledge; and, in any event, as regards financial collateral governed by the FCD, the resolution measures taken by the Spanish authorities would not qualify under German law as an enforcement event (see new art. 1 (6) FCD). As regards other types of collateral, the issue may be more problematic.

(c) Transfer of assets and liabilities and bail-in

The transfer to a third party or to a bridge bank of assets and liabilities of the institution under resolution may include assets and liabilities governed by a foreign law, including foreign derivative transactions or financial collateral located in another jurisdiction. And the same holds *mutatis mutandis* in relation to the bail-in tool. This power of the resolution authorities, i.e. triggering the close-out of the transactions and applying the bail-in to the net amount, should apply to all derivatives irrespective of the law governing them. If, for example, the resolution authority of Member State A exercises the write-down and/ or conversion power with regard to derivatives, it should in principle include all derivatives irrespective of whether they are governed by the law of Member State A, Member State B, or a third country.

Within the EU this principle of mutual recognition is enshrined by both Article 3 (2) CIWUD, laying down the automatic recognition of the reorganization measures of the home Member State, and Article 66 BRRD, obliging Member States to ensure the mutual recognition of transfer of assets and liabilities and write-down or conversion powers of the resolution authority.[44] The combination of these two provisions implies that the obligation to the host Member State is 'to ensure' the mutual recognition principle.[45] Therefore, in this example, Member State B must recognize the decisions made by the resolution authority of Member State A (see art. 66 (4) BRRD):

> Member State B shall ensure that the principal amount of those liabilities or instrument is reduced, or liabilities or instruments are converted, in accordance with the exercise of the write-down or conversion powers by the resolution authority of Member State A.

> **Example.** Continuing with the same example, if the home Member State is Spain, the decision to write down the close-out netting amount made by the Spanish resolution authority shall in principle apply to any derivatives, irrespective of whether they are governed by Spanish, English, or German law. The authorities of these Member States must recognize the measures adopted by the Spanish resolution authority and the challenge against these measures must be brought before the Spanish courts (art. 66 (6)). In principle, the exclusive jurisdiction clause that may be included in the agreement

[44] See Lehmann (n 38) 89.

[45] As regards transfers of assets and liabilities, the combined application of both provisions should lead to a similar result: The effects of the resolution measures in the home Member State must be recognized and given effects in the host Member State, but certain additional formal requirements required by the law of the host Member State may be fulfilled; see, for further elaboration of the legal regimen (though with a different approach), Lehmann (n 38) 90. A broad approach in Francisco Garcimartín, 'Company Restructuring and Universal Transfer of Assets: Proposal to Deal with the Conflict of Law Problem' (2013) IILR 2 149.

cannot be invoked to exclude this jurisdiction when the merits of the proceedings are the bail-in measures.

With regard to third countries (non-EEA members), the question is more problematic since there is no guarantee of mutual recognition. Parties might then circumvent resolution powers by choosing a third-country law as the law applicable to their contracts and including a third-country jurisdiction, and/ or locating the assets there.[46] Naturally, the home Member State cannot guarantee the world-wide effectiveness of resolution measures.

Theoretically, there are two approaches to address this problem: legally and contractually. Either a change in the third-country law must be made to ensure mutual recognition, unilaterally or by cross-border cooperation agreements with the European authorities, i.e. the resolution measures are imported into the corresponding third country ('statutory recognition'); or an agreement must be made by the bank and its counterparties to expressly recognize such regime and to restrict their contractual rights accordingly ('contractual recognition').[47]

The contractual approach has been envisaged by the BRRD as regards the bail-in tool. When derivatives are governed by the law of a third country, the Directive expressly envisages incorporation of the bail-in possibility in the agreement and the requirements that must be met.[48] According to Article 55 BRRD, Member States shall require financial institutions to include a contractual term by which the creditor or party to the agreement creating the liability recognizes that liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction of the principal or outstanding amount due. The possibility of bail-in becomes an explicit term of the contract.[49] Furthermore, resolution authorities may require legal opinions on the legal enforceability and effectiveness of these contractual terms (see arts 45 (5) and 55 (1) *in fine* BRRD). Conversely, the Directive does not establish any legal requirements

[46] See Financial Market Law Committee, Issue 149 (February 2013), *Recovery and Resolution*, at 8.5–8.7; Garcimartin (n 38) 190-191; Lehmann (n 38) 91.
[47] See FSB, *Principles* (n 39) 5; C Bates and S Gleeson, 'Legal Aspects of Bank Bail-ins' (2011) *LFMR*, 264, 270.
[48] See, on the technical standards envisaged by Article 55 (3), European Banking Authority, *Draft Regulatory Technical Standards on the Contractual Recognition of Write-Down and Conversion Powers under Article 55(3) of Directive 2014/ 59/ EU*, 3 July 2015, accessible at <https:// www.eba.europa.eu>; also FSB, *Principles* (n 39) 15; Garcimartin (n 38) 182-183; Lehmann (n 38) 92.
[49] See e.g. AFME, *Model Clause for the Contractual Recognition of Bail-In under Article 55 BRRD*, September 2015. Note, however, that the failure to include the contractual recognition of bail-in shall not prevent the resolution authority from exercising the write-down and conversion powers in relation to that liability (art. 55 (2) BRRD).

to recognize the effects of resolution stays. At a supra-European level, the FSB has led an initiative to fill this gap, i.e. to require contractual recognition of stays imposed by resolution proceedings.[50] Actually, ISDA has prepared a Resolution Stay Protocol (the 2014 Protocol) that to a large extent incorporates this approach. Its main purpose is to ensure that the parties' rights are only exercised in circumstances that would be permitted under the applicable resolution regime.[51] The Universal Resolution Stay Protocol expands this approach further.[52]

Resolution authorities may also reinforce these measures by requiring the persons exercising control of the institution under resolution to take all necessary steps to ensure the cross-border effectiveness of the transfer of assets and liabilities or write-down or conversion of liabilities. This may be used as an indirect mechanism to ensure the world-wide reach of the resolution actions (art 67 (1) BRRD).[53]

This, nevertheless, does not guarantee that the third-country authorities will recognize the bail-in measures adopted by the resolution authorities.[54] The FSB has promoted a sort of mutual recognition principle at a world-wide level, either by formal recognition, i.e. giving effects to the foreign resolution measures in the host State, and/ or by taking supportive measures.[55] The BRRD, in turn, envisages the possibility of concluding bilateral or multilateral agreements with third countries, but also contains provisions on whether and under what conditions third-country resolution measures will— unilaterally— be recognized in Europe (see arts 93 et seq BRRD).

7.4 Concluding remarks

Under the general principles of insolvency law, outstanding contracts with mutual obligations are protected from termination linked solely to entry into an insolvency situation, i.e. ipso facto clauses are prohibited. The same rule is applicable to

[50] See FSB, *Principles* (n 39) 14-15: 'By providing for parties to a financial contract to opt in to the statutory stay provisions of the resolution regime that applies to the defaulting counterparty, the provision bring the contract within the scope of the relevant statutory regime.' Member States have also followed this approach, see e.g. Draft Section 60a of the German Recovery and Resolution Act; or Bank of England. Prudential Regulation Authority, *Supervisory Statement. Contractual Stays in Financial Contracts Governed by Third-Country Law* (November 2015).
[51] ISDA 2014 Resolution Stay Protocol, see < www.isda.org> ; sceptical, however, on the effectiveness of this approach, A Wilkinson, A Wood, and P Bagon, (n 43) 145.
[52] ibid.
[53] See also FSB Key attributes, (2014), I-Annex 2
[54] See also Article 67 (2) BRRD stating that if the transfer, write down or conversion is not effective, the resolution authorities 'shall not proceed with them'.
[55] FSB, *Principles,* (n 39) 5-6.

resolution scenarios within the new EU resolution framework. Derivatives and financial collateral arrangements, core assets on any credit institution's balance sheet, have traditionally enjoyed privileged status in an insolvency scenario, both at the substantive-law level and at the conflict-of-laws level (the so-called 'safe harbours'). The new resolution framework has to a certain extent reduced that privileged status and 're-routed' those financial agreements to general principles of insolvency law, in particular with regard to the 'ipso facto clause' and other termination rights. The main purpose of this contribution has been to describe the general regime of contracts in resolution scenarios, analysing the change of approach in the specific case of derivatives and explaining its reasons: effective and efficient resolution of a credit institution is not compatible with those privileges.