Derivatives in a cross-border context: a conflict-of-laws analysis

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Abstract

Derivatives are financial instruments, typically under standardized documentation, in which close-out netting provisions, i.e. clauses providing for the termination of outstanding obligations and their set-off, play a key role. Additionally, reciprocal payment obligations generated by derivatives are often secured by financial collateral. The purpose of this article is to analyse some of the conflict-of-laws issues that arise within the realm of derivative contracts in the EU. It distinguishes between pre-insolvency and insolvency scenarios. In a pre-insolvency scenario, derivatives and financial collateral arrangements raise both proprietary and contractual conflict-of-law problems. Financial collateral arrangements are basically addressed by the Financial Collateral Directive, while derivatives, as contractual obligations, are addressed by the Rome I Regulation. In an insolvency context, these contracts and collateral arrangements have enjoyed special treatment. For example, unlike any other types of contract obligations, ipso facto clauses are enforceable. This privileged status is replicated on the conflict-of-laws level in accordance with the Credit Institutions Winding-Up Directive. However, the privileged treatment does not fit well within the resolution framework established by the Bank Recovery and Resolution Directive. Hence, these financial contracts have been partially re-routed to general insolvency principles on both the substantive and conflict-of-laws levels.

1. Introduction

The purpose of this article is to analyse some of the conflict-of-laws issues that arise within the realm of derivative contracts in the EU. Where appropriate, we will use Spanish law as an example to illustrate some of the issues. The article is organized as follows. Section 2 makes a basic introduction to this kind of contracts and their most relevant clauses. Section 3 describes the general conflict of laws regime of derivative contracts and financial collateral arrangements. Section 4 refers to insolvency issues, i.e. what is the law applicable to the effects of the opening of insolvency proceedings on derivative contracts and financial collateral? Finally, Section 5 analyses the situation where the insolvent party is a credit institution and resolution tools are applied.

2. Derivative contracts: general issues

This introduction briefly describes the three main elements of our analysis: derivative contracts, close-out netting provisions and financial collateral arrangements.

2.1 Derivative contracts

A derivative is a contractual arrangement under which the obligations of the parties (or at least of one of them) are determined by the value of an underlying or benchmark asset or index, such as an interest rate, a loan, shares, the price of a commodity, or even meteorological data. Examples of derivatives are swaps, financial futures and options. Although its value is linked to that of the underlying asset (since it is determined by the variations in its price) it can be dealt

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with and negotiated as an independent contract. From an economic perspective, players with different preferences as regards the risk associated with the asset or index converge in derivatives. The exchange of the said risks allows for a more efficient allocation of such preferences. Since they are voluntary agreements, risks can be allocated to the least cost bearer.

> **Example 1**: Interest rate swap
> Company A has a variable interest rate loan. If A is interested, because of its financial situation, in getting a fixed interest rate, it has two alternatives: (i) modifying the loan's terms and conditions or (ii) entering into an interest rate swap. Company A will choose the cheapest option In option (ii), it would enter into a contract with Bank B in accordance with which A would periodically pay B a fixed interest rate (e.g. 7%) and B would pay A a variable interest rate (e.g., Euribor + 0.5%) during a prescribed period and by reference to a specific face value (e.g. EUR 10 million). As a consequence, on each payment date, B would pay A Euribor + 0.5% of EUR 10 million and A would pay B 7% of the same amount. Of course, both obligations are set off and A would pay B/B would pay A a net amount, depending on whether the fixed interest rate is above or below the variable interest rate. Thus, A hedges against interest rate fluctuations.

> **Example 2**: Options
> A enters into a contract with B under which, in a prescribed period and in exchange for a premium, A has the option to purchase from B 10,000 shares of Company X at EUR 2 per share. At the due date, if there has been a share value increase, e.g. the shares are listed at EUR 3, A would exercise the option to buy the shares and B shall be obliged to deliver 10,000 shares of X at EUR 20,000 (if they agreed on physical settlement) or to pay EUR 10,000 (if they agreed on cash settlement). In such a way, A can hedge against X's value fluctuations or use the option as a synthetic investment on such corporation. Where the shares value is more than the price fixed in the option, A would obtain a benefit, and vice versa.

Different professional associations have drafted standardized contracts for derivatives. An example in international markets is the International Swaps and Derivatives Association (ISDA). In the Spanish market, the Contrato Marco de Operaciones Financieras (CMOF) is an example of the same. The use of standardized documents significantly reduces transaction costs. *Ex ante* it allows the parties to focus on the economic aspects of the transaction when negotiating the contract. *Ex post* it reduces litigiousness, as it offers a harmonized and objective framework for contract interpretation and thus enhances legal certainty.

2.2 Close-out netting provisions

Clauses in a standardized contract are detailed and complex and they are organized in different documentation layers (master agreement, annexes, confirmations, etc.). Within them, early termination clauses perform a key role; in particular, the so-called close-out netting provision, which governs the various transactions (individual derivatives) entered into by the parties.

A netting agreement is a contractual arrangement whereby two parties with one or more reciprocal rights and obligations agree, on the occurrence of a predefined event, to set-off and consequently reduce those rights and obligations to a net value, in accordance with the provisions established in the contract. Together with the set-off of these rights and obligations, the agreement provides for the early termination and the resulting cancellation of the outstanding obligations, i.e. contracts or transactions still outstanding on the occurrence of the event triggering the application of such a clause. The close-out netting clause is often applicable to several categories of transactions (derivatives, repos, securities lending, etc.) and it usually entails: (i) termination of such transactions; (ii) early termination or acceleration of the outstanding obligations; (iii) assessment of the value on the basis of an agreed valuation system; and, finally, (iv) set-off and calculation of a net amount. This net amount is the single net payment that one of the parties (the party out of the money) will have to pay the other (the party in the money). This is why these clauses are called 'close-out netting'.

Example

Let us suppose that in Example 1 corporations A and B have entered into several interest rate swaps. Under a close-out netting framework agreement, if A becomes insolvent the contracts are terminated, the outstanding obligations terminated or accelerated, set off and reduced to a net amount. The fundamental issue is that B's exposure to counterparty risk is reduced from gross exposure to net exposure. Indeed, if A becomes insolvent, B would not have to pay A the amount due in accordance with each contract and lodge its claims in the proceedings as an unsecured creditor. On the contrary, all transactions are set off so that only the balance is due (without entering into technical nuances). Let us imagine that they have entered into three transactions: 1, 2 and 3. Transactions 1 and 2 had a positive value for A of 5 and 15, respectively (total amount being 20). Transaction 3 had a positive value for B of 10. In this scenario, B (the party out of the money in the aggregate amount) will only have to pay 10 to the bankruptcy estate (the party in the money) instead of paying 20 and lodge its claims as unsecured creditor for 10. The value of each transaction – i.e. 5, 15 and 10 – is assessed on the basis of an agreed valuation mechanism and normally equivalent to its mark-to-market replacement costs. This is the amount each party would have to pay (if it is out of the money) or would receive (if it is in the money) in the market to enter into a derivative with equivalent terms and conditions to those of the one which has been cancelled.

As shown in the examples above, close-out netting arrangements mitigate counterparty risk by reducing it from gross exposure to net exposure. The set-off works as a guarantee. In addition, close-out netting provisions reduce market risk. The provisions allow the party *in bonis* to terminate the transaction, thus protecting it from volatility of the assets and from the possibility that some but not all of the contracts are terminated in the interest of the insolvency proceedings (*infra* section 4). At a macroeconomic level, and due to the high interconnection of players in this market, its role of prevention of systemic risk is enhanced. The possibility to cancel the transactions and reduce them to a net amount, isolates the party *in bonis* from counterparty breach and prevents the ripple effects which it may cause.[1]

2.3 Financial collateral

Derivatives generate reciprocal payment obligations. On top of the set-off of the obligations themselves, such obligations – in particular amounts resulting from the set-off – are coupled with financial collateral, which often is cash deposited in bank accounts or liquid securities (e.g. sovereign debt or shares of listed companies). Close-out netting provisions, together with financial collateral, are essential tools for counterparty risk management in financial markets.

There are two kinds of financial collateral, security financial collateral arrangements (e.g. a pledge) or title transfers (see Article 2(1)(a) of Directive 2002/47/EC on financial collateral arrangements, 'FCD').[2] The former are financial collateral where the guarantor retains title (or ownership) over the asset, which is encumbered by a security interest, e.g. a pledge. The latter are financial collateral where the guarantor (collateral giver) transfers ownership to the beneficiary (collateral taker) and only retains a right to claim the *tantundem*, i.e. an equal amount of the same or equivalent asset. In most legal systems, it is commonly

[1] This conclusion is, however, disputed among legal scholars. Some consider that, under certain circumstances, systemic risk may indeed be exacerbated by this clause. See R.B. Bliss and G.G. Kaufman, 'Derivatives and Systemic Risk: Netting, Collateral and Closeout', *Journal of Financial Stability* (*JFS*) 2006, pp. 55 et seq.; D. Duffie and D. Skeel, 'A dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements', 2012, *passim*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1982095 (accessed 19 February 2018); P. Bolton and M. Oehmke, 'Should derivatives be senior?', Columbia University Working Papers, May 2011, *passim*; D. Skeel and T.H. Jackson, 'Transaction Consistency and the New Finance in Bankruptcy', *Columb Law Rev.* 2012, pp. 152 et seq., *passim*; M.J. Roe, 'The Derivatives Market's Payment Priorities as Financial Crisis Accelerator', *Stand Law Rev.* 2011, pp. 539 et seq., *passim.*

[2] Directive (EC) 2002/47, of 6 June 2002, on financial collateral arrangements [2002] *OJ* L 168.

understood that this right has a personal, i.e. contractual, legal nature *(in personam)*. Consequently, the beneficiary obligations – viz. the return of the *tantundem* – are subsumed in the close-out netting master agreement. The beneficiary obligation to return the *tantundem* is included in the obligations covered by the netting agreement and subject to the set-off, which will result in a net amount. Conversely, in the case of pledged assets, transactions covered by the close-out netting provision are typically first settled and the collateral enforced subsequently. Where the pledged collateral is granted with a right of use (as defined in Article (1)(m) FCD), it can be subsumed in the close-out netting provision. The obligation is then covered by the provision and thus subject to set-off, especially where such a right has been exercised.

Excursus

It may be worth elaborating further on the differences between both figures. When the pledge is granted, and if the pledgee becomes insolvent, the pledgor has a right *in rem* over the asset, which he can recover once the debt is paid. When there is a title transfer, the transferor has a right to obtain the *tantundem* in return. When the beneficiary becomes insolvent, and he or she has made use of the assets (i.e. they have been sold, lent, etc.) the transferor has a personal right. However, in the unlikely event that assets are still in the acquirer's possession, the question is more complex. The 'cause' of the transfer of the assets was to use them as collateral. Therefore, there are arguments in some legal systems to assert that the transferor (the guarantor) still has a right *in rem*, and not merely a contractual one, whose exercise is conditioned to the payment of the debt. If the beneficiary becomes insolvent, the transferor/guarantor then has a right of separation *ex iure dominii* (upon payment of the debt). This may be in its interest if the assets value is higher than the debt value, i.e. if the creditor is 'over-secured'. For instance, the Royal Decree-Law 5/2005 transposing into Spanish Law the FCD is compatible with such understanding. The law only deals with the enforcement of the collateral upon non-payment of the secured obligations by the debtor to the beneficiary, without referring to the beneficiary's insolvency. In case of the beneficiary's insolvency, it can be argued that the debtor maintains a 'proprietary interest' in the collateral (subject, naturally, to the payment of the secured obligation).

Example

Let us imagine that A and B have entered into several derivative contracts. As collateral, A has transferred shares in the listed Company X to B as security for payment. (The collateral, in practice, is adjusted to the value of the obligations secured; therefore, it can go either way, although this is irrelevant for the purposes of our example). Let us suppose that A becomes insolvent, but now the settlement of the derivatives has a positive value for B of 5. The 5, which A owes B, will be set off with those 10 which, in accordance with the collateral, B owes A. The final result is that B will only return to the bankruptcy estate X shares for 5 (or the equivalent in cash).

Let us imagine that it is B that becomes insolvent. On the one hand, the derivatives settlement has a positive value for B (i.e. B's bankruptcy estate) of 5. On the other hand, A has a positive value deriving from the return of the collateral of 10. The issue here is the legal nature of A's right over the difference. If it is a mere contractual right, the claim will be lodged as an unsecured creditor for 5. Conversely, if it qualifies as a right *in rem*, and the shares are still in B's possession, A could request their return upon the payment of the debt, *ex iure domino*.

On the following pages, we will address the main issues that derivatives raise from a conflict-of-laws perspective. Firstly, we will refer to its pre-insolvency regime, namely, the law governing derivative contracts and the law applicable to proprietary aspects of financial collateral. Secondly, we will analyse legal issues arising in insolvency scenarios and—because derivatives are core assets on any credit institution's balance sheet—bank resolution scenarios. As a matter of substantive law, the key question is whether close-out netting provisions can be invoked upon insolvency. These provisions are protected in the majority of legal systems, thus departing from general insolvency law principles. However, there is a wide diversity of nuances

among them. Consequently, the determination of the applicable law becomes essential. Particularly important to determine is whether close-out netting provisions are subject to the *lex contractus* or to the *lex fori concursus*. In the last part of the contribution, we will refer to the special regime applicable to bank resolution measures, its rationale and its conflict-of-laws treatment.

3. General regime (pre-insolvency)

The conflict-of-laws regime takes as a starting point the distinction between contractual aspects (derivative contract, *infra* section 3.1) and rights *in rem* aspects (collateral, *infra* section 3.2). In turn, within the first category, we will describe contracts between professionals and contracts with consumers separately.

3.1 Contractual aspects

Derivatives are contractual obligations. Consequently, their conflict-of-laws regime is regulated by the Rome I Regulation.[3] Among professionals and unless it is a purely domestic contract, the parties can freely choose the law applicable to the contract (Article 3(3) and Article 3(1) Rome I, respectively).[4] Such a choice can be expressly made or 'clearly demonstrated by the terms of the contract or the circumstances of the case'. For instance, if the parties enter into the agreement in a CMOF, the contract may be interpreted to be governed by Spanish law even if no choice of law clause is included.

> **Example**
> A Spanish bank enters into an interest rate swap with a French bank. According to the Rome I Regulation, the parties can document the contract under an ISDA format and subject it to English law or to New York law. If it were two Spanish banks and assuming that the contract had no relevant connection with any other country, such election would be valid but would not prejudice the application of the (internal) Spanish mandatory rules (see Article 3(3) Rome I).

It is customary to include a choice of law clause in derivative transactions. Therefore, under the umbrella of the Rome I Regulation, the problems of identifying the applicable law are usually not relevant in practice. However, where this is not the case – or where there are contradictory clauses and the contradiction cannot be resolved through document hierarchy – recourse must be made to the other connecting factors established in Article 4 of the Regulation.[5] In such a scenario, given that swaps are usually the example for contracts without a 'characteristic performance', since both parties assume reciprocal rights and obligations. the law applicable is the law of the country with which the contract is most closely connected. When specifying this clause, elements such as the home State of the parties, their establishments, the place where the contract was executed or the contract currency must be taken into account. The connection with other contracts or financial collateral arrangements, for instance, can also be relevant.

> **Example**
> In the example above, for the unlikely case that the parties have not chosen – expressly or implicitly – the applicable law, if the contract was executed in Spain through an establishment

[3] Regulation (EC) 593/2008 of 17 June 2008 on the law applicable to contractual obligations [2008] *OJ* L 177/6 ('Rome I').
[4] See on Art. 3(3) Rome I *Dexia Crediop s.p.a.* v. *Comuni di Prato* [2017] EWCA Civ 428 and *Banco Santander Totta SA* v. *Companhia Carris de Ferro de Lisboa SA & Ors* [2016] EWCA Civ 1267.
[5] As is well known, and in very broad terms, this provision provides for a cascade of connecting factors. First of all, the contract shall be governed by the law of the country where the party required to affect the characteristic performance of the contract has his habitual residence. Failing this, i.e. where there is no 'characteristic performance', the law of the country with which it is most closely connected applies.

in Spain of the French bank and payments are also to be made in Spain, there are arguments to assert that the contract is most closely connected with Spain and, consequently, must be governed by Spanish law.

With regard to transactions entered into on an organized market, derivative contracts are typically concluded with the central counterparty of the market (CCP). The applicable law will be the law governing the market, either by a choice of law, or by application of Article 4(1)(h) Rome I.

Without prejudice to the insolvency specificities that we will analyse below, the applicable law as determined by the above criteria, governs the validity of the contract, its interpretation and its execution. This is similarly the case with regard to specificities that may be imposed by the overriding mandatory rules under Article 9 Rome I (most regulatory rules can qualify as overriding mandatory rules and will therefore prevail over the chosen law). Where the close-out netting provision covers more than one transaction, it is possible, although not usual, that the law applicable to each of them is different from the law applicable to the master agreement where this provision is included.[6]

Capacity issues remain outside the scope of application of Rome I. Capacity and the effects on the contract of lack of capacity (absolute or relative nullity, for instance) are governed by the personal law of each party (see, however, Article 13 Rome I).[7]

In principle, the special provision for consumer contracts is not applicable to derivatives, according to the exception in Article 6(4)(d) and recital 30 of the Regulation. The former excludes from the consumer provision's scope of application the rights and obligations that constitute a 'financial instrument'. The latter refers for the definition of financial instrument in Directive 2004/39/EC ('MiFID Directive'), where derivatives are included in the definition.[8] This means that the derivative itself, i.e. the rights and obligations as a financial instrument, is governed by the general regime of Articles 3 and 4 of the Regulation discussed above.

3.2 Financial collateral

Financial collateral may be granted by way of cash deposited in a bank account (cash collateral) or securities (securities collateral). Problems may arise with regard to securities collateral, in particular if they are represented in book-entry form. Where the derivative contract comes together with a pledge over book-entry securities, the law applicable to the *rights in rem* aspects is the law of the country where the relevant account is maintained (see Article 9(1) FCD). That is, the account where the entries are made by which the book-entry securities collateral is provided to the collateral taker.[9] It is advisable that the law coincides with the law applicable to the derivative contract.

Example

Let us continue with the example above. If the parties have chosen English law as the law governing the derivative contract, it is reasonable that, in case there is collateral, it is granted under English law by pledging book-entry securities, which are registered in an account located in England. In this case, the rights *in rem* are governed by English law since the relevant account

[6] For a detailed analysis of this issue, see UNIDROIT, Draft Principles regarding the enforceability of close-out netting provisions, C.G.E./Netting/2/W.P. 2, December 2012, pp. 33-34, available at https://www.unidroit.org/english/documents/2012/study78c/cge-02/cge-2-wp02-e.pdf (accessed 9 February 2018).

[7] See *Dexia Crediop s.p.a.* v. *Comuni di Prato* and *Banco Santander Totta SA* v. *Companhia Carris de Ferro de Lisboa SA & Ors* (*supra* n. 4).

[8] From January 2018, Directive 2014/65/EU (MIFID II) will be applicable and MIFID I Directive will be repealed.

[9] With regard to the issues arising from this concept, see F.J. Garcimartín and P. Lluesma, 'Prenda sobre valores cotizados españoles pero depositados en el extranjero', *Revista de Derecho del Mercado de valores* 2010, pp. 263 et seq., *passim.*

is located in England. Indeed, the standardized documents for this transaction foresee models for the granting of collateral. An example of this is found under the ISDA, the Credit Support Deed.

If the relevant account is located in a country other than that whose law is applicable to the derivatives contract, a qualification problem may arise. The determination of which aspects qualify as contractual and which qualify as *in rem* have legal ramifications.[10] The derivatives contract and, consequently, the calculation of the secured obligation are governed by the law applicable to such contract. Conversely, the property aspects are subject to the law of the country where the relevant account is located. Such law would determine, among other issues, if and under which circumstances enforcement by way of direct sale or appropriation is possible, in order to subsequently proceed to set-off with the amount arising from the derivative settlement.

Example
The parties may have chosen English law as the law applicable to the derivatives contract, but granted the pledge over a securities account located in Spain. In this case, Spanish law will likely regulate rights *in rem* effects of the pledge, including the possibility and conditions of enforcement by way of direct sale and appropriation. If this is possible, the asset enforcement value will be offset with the amount arising from the derivative settlement.

When it comes to title transfers, the issue is a bit more complex. This category of collateral is directly subsumed in the close-out netting master agreement (in ISDA documents, the Credit Support Annex, which implements this kind of guarantee, is part of the master agreement, see also *supra* section 2.3). As already discussed, this means that once granted, there is full property transfer and the guarantor only maintains a personal right to obtain the *tantundem* in return, which can be added to the other payment obligations of the derivative contract(s). All obligations, including the amounts resulting from each derivative settlement and the return of the resulting *tantundem*, fall under the close-out netting provision umbrella. Nevertheless, this conclusion raises a 'preliminary issue' of the validity and enforceability of this kind of collateral, i.e. whether a title transfer is acceptable as a guarantee mechanism so that it will not be re-qualified as, for instance, a mere pledge. If the assets are still in the beneficiary's possession (the transferee's), this 'preliminary issue' is governed by the law of the country where the registration account is located.

Example
The parties may have chosen English law as applicable to the master agreement, under which all derivative transactions are subsumed. They may also have documented the collateral as a title transfer under a Credit Support Annex. If the securities have been transferred to a beneficiary's account in London—which will be the usual situation to make sure that the applicable law coincides with the law governing the agreement—this does not pose problems. However, let us suppose that the securities in question have been registered in the beneficiary's name in an account in another State, Y. The question then is which law governs the rights *over* such assets. In particular, the question is whether the beneficiary has acquired full title over them and whether the guarantor has lost any right *in rem* over such assets and only retains a contractual right to obtain the *tantundem* in return. In principle, this depends on the law of Y, since the securities are credited to an account located in this State.

4. Insolvency regime

[10] For examples of such situations, see P. Paech, 'Preliminary draft report on the need for an international instrument on the enforceability of close-out netting in general and in the context of bank resolution', S78C – Doc. 2, March 2011, pp. 50-52, available at https://www.unidroit.org/english/documents/2011/study78c/s-78c-02-e.pdf (accessed 19 February 2018).

The main function of close-out netting provisions is, as discussed above, to mitigate the counterparty risk from a gross exposure to a net exposure. The stress test for this mechanism is determined by insolvency. In an insolvency scenario, can this provision be invoked? Is it possible, only as a consequence of the opening of insolvency proceedings, to terminate the contracts, early terminate the outstanding obligations, calculate the value on the basis of the agreed mechanism, aggregate the balances and obtain a net amount? Legal systems provide different answers to these questions.[11]

In broad terms, the departure point under insolvency law is that the mere opening of insolvency proceedings must not interrupt professional or business debtor activity. Consequently, it must not affect the outstanding contracts. Without this caveat, the role of insolvency as a means for business reorganization would be illusory.[12] The same holds true if the alternative would be the sale of a business as a going concern. Agreements which, directly or indirectly, empower the party *in bonis* to terminate the relationship, must not be included. Thus, according to most insolvency regimes, parties cannot include in their contract that the mere opening of insolvency proceedings is a triggering event for the termination or modification of its terms and conditions.

However, there are exceptions to this principle. Derivative contracts and financial collateral have benefited from a privileged status.[13] To justify this status, several arguments are usually invoked, e.g.:

(i) There is a need to reduce systemic risk, i.e. the breach by one party may cause the counterparty to breach its contracts with third parties, and so forth ('ripple' or 'domino effect');

(ii) Derivatives are not, in general terms, essential assets in order to continue the debtor's activity; and

(iii) Derivatives are linked to very volatile assets or indexes, whose value may significantly change in a short period of time and for reasons out of the parties' control and, as a consequence, the risk would be very difficult to manage if the parties could not cancel them when insolvency proceedings are opened.

Furthermore, it has been argued that the volatility inherent in the asset would allow opportunistic delays by the insolvency practitioner when deciding whether to maintain or terminate the contract.[14] The exposure to insolvency proceedings may therefore be harmful for the party *in bonis*. In order to prevent this risk, transactions must be settled fast and in net amounts.[15]

Even in legal systems which protect close-out netting provisions in insolvency scenarios (which are the majority) there are significant differences with regard to eligible parties (who can do it) and 'eligible transactions' (which transaction can be subsumed in the agreement and

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[11] See UNIDROIT 2012, p. 2 (*supra* n. 6).

[12] UNCITRAL Legislative Guide on Insolvency Law, pp. 143-148, available at https://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (accessed 19 February 2018).

[13] For an analysis of the advantages and disadvantages of this privileged status, see, *inter alia.*, R. Bliss, 'Bankruptcy law and large complex financial organizations: a primer', *Economic perspectives* 2003, pp. 52-54; F. Edwards and E. Morrison, 'Derivatives and the Bankruptcy Code: Why the Special Treatment?', *Yale Journal on Regulation* (*YJR*) 2005, pp. 91 et seq., *passim*; Skeel and Jackson 2012, *passim* (*supra* n. 1); UNIDROIT 2012, pp. 12-13 (*supra* n. 6).

[14] D.G. Baird and E.R. Morrison, 'Dodd-Frank for Bankruptcy Lawyers', 2011, p. 27, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1895692 (accessed 19 February 2018).

[15] The argument of 'cherry-picking' is often used to justify the privileged status of close-out netting provisions: the goal of preventing 'cherry-picking' is to avoid a situation in which the insolvency practitioner only maintains the derivatives in which he is interested and terminates the others. As a matter of fact, such argument is not persuasive, since it would not be applicable where there is only one transaction. Or it would only militate for the exclusion of 'cherry-picking', that is, to limit the insolvency practitioner's power to terminate 'all or nothing'. Such privilege goes beyond that, since it is the party *in bonis* who has the power to terminate. Therefore, policy goal arguments that justify it should be derived from the prevention of systemic risk or from the asset price's volatility. Furthermore, the fact that in resolution scenarios the privileged status has been partially reconsidered (see *infra* section 5), relativize the value of the above arguments, since it implies that there are reasons to establish a different solution in a similar context.

under which circumstances). When the law applicable to the insolvency proceedings (*lex fori concursus*) does not coincide with the law applicable to such agreement (*lex contractus*), the characterization question plays an essential role: are close-out netting provisions subject to the *lex fori concursus* or to the *lex contractus*?

> **Example**
> In our example, the parties, a Spanish bank and a French bank, have chosen English law as the law applicable to the contract (=*lex contractus*). However, the Spanish entity's insolvency is subject to Spanish law (=*lex fori concursus*). The essential question is whether the French entity's power of invoking the close-out netting provision in case of the counterparty's insolvency is subject to English law (*lex contractus*) or Spanish law (*lex fori concursus*).

The answer to this question is found in Directive 2001/24/EC on the reorganisation and winding up of credit institutions ('CIWUD')[16] – transposed into Spanish law in Law 6/2005, of November 22, on reorganization and winding-up – (*infra* (i)) and the Insolvency Regulation recast ('EIR 2015') (*infra* (ii)).[17]

(i) The conflict-of-law regime in the CIWUD is based on a rule-exception structure. In principle, the effects of the opening of reorganization or winding-up proceedings upon outstanding contracts are subject to the *lex fori concursus* (Article (10(2)(d) CIWUD). However, there are several exceptions, including one for netting agreements. The law applicable to their insolvency treatment is the law governing the agreements, i.e. the *lex contractus*. According to Article 25 CIWUD, 'without prejudice to Articles 68 and 71 of Directive 2014/59/EU,[18] netting agreements shall be governed solely by the law of the contract which governs such agreements'. This exception applies to the possibility to terminate the contract, accelerate the outstanding obligations and aggregate them (the 'close-out'), including the insolvency rules of the law applicable to the contract. Moreover, the CIWUD establishes a special rule for repos (Article 26 CIWUD), and collateral whose object are book-entry securities: the effects on them of the insolvency proceedings are subject to the law of the State where the relevant account is located (Article 24 CIWUD). Although the wording is not crystal clear, the idea underlying this solution is to protect the parties' expectations so that the insolvency risk is governed by the same law as the validity and enforceability of their rights, contractual or *in rem*, according to the rules applicable to its granting. The law that governs the right, i.e. the *lex contractus* for contractual rights or the law of the relevant account for rights *in rem*, coincides with the law that governs their insolvency treatment.

> **Example**
> If the Spanish entity is a credit institution, the effects of a reorganization or winding-up measure on netting agreements are governed by English law as the law applicable to the close-out netting provisions. The reference to English law includes English insolvency rules. The counterparty could invoke the provision under the same circumstances as if the insolvency proceedings where opened in England. The idea is that the counterparty credit risk, including the insolvency risk, is governed by the law chosen by the parties for the agreement. The same applies, *mutatis mutandis*, for repos (Article 26 CIWUD, again 'without prejudice to Articles 68 and 71 of Directive 2014/59/EU'). The effects on collateral, whose object are book-entry securities, are governed by the law of the place where the principal account is located. If the Spanish entity has pledged book-entry securities registered in an account in London, and the beneficiary is the

[16] Directive (EC) 2001/24, of 4 April 2011, on the reorganization and winding up of credit institutions [2001] *OJ* L 125/15.
[17] Regulation (EU) 2015/848 on insolvency proceedings (recast) [2015] *OJ* L 141/19, applicable as of 26 June 2017.
[18] That is, 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 in resolution scenarios. See *infra* section 5.

French entity, then the effects of the insolvency over the pledge would be governed by English law, including English insolvency rules. As discussed below, the CIWUD regime partially follows the one established by Article 8 EIR 2015 recast.[19]

(ii) Where the insolvent debtor is not a financial institution, the law applicable is determined by the EIR 2015. The Regulation only lays down a special rule for set-offs (see Article 9 EIR 2015). We have argued elsewhere that the EIR 2015 should be broadly construed as taking into account the CIWUD and, therefore, close-out netting should be included within the scope of Article 9 EIR 2015.[20] Otherwise the result would be paradoxical. In a contractual relationship between a credit institution and a non-financial entity, the close-out netting arrangement would only be protected, at the conflict-of-laws level, when the credit institution becomes bankrupt (since the CIWUD would apply), but not when the non-financial entity goes bankrupt. This result is inconsistent with the rationale of these provisions, i.e. protecting credit institutions from the insolvency of their counterparties.

With regard to pledges, the EIR 2015 lays down a rule based on the 'shall-not-affect' principle (Article 8 EIR 2015). The opening of the insolvency proceedings in one Member State shall not affect the rights *in rem* over assets situated in another Member State. The EIR 2015 does not contain a special rule for rights *in rem* over book-entry securities.[21]

Example
If the Spanish entity is not a financial institution, the effects of the insolvency proceedings are governed, in accordance with our interpretation of Article 9 EIR 2015, by English law as the law applicable to the close-out netting agreement. Such reference includes English insolvency law. Conversely, with regard to pledges, Article 8 EIR 2015 establishes a rule based on the 'shall-not-affect' principle. The pledges are not affected by the insolvency. Therefore, the counterparty can enforce them under general English law (where the pledged asset is located in England).

Outside the European Union (or in relation to Denmark), national insolvency conflict-of-laws rules are applicable. In Spain, Law 22/2003 of July 9, is equivalent to the EIR 2015 except regarding security rights. With regard to the latter, there is no rule based on the 'shall-not-affect' principle but a reference to the location of the relevant account (see Articles 204-205 Law 22/2003).

Furthermore, the conflict-of-laws regime of claw-back actions does not significantly differ from that of the general regime and therefore it is unnecessary to add much more. Claw-back actions are governed by the *lex fori concursus*, although the party *in bonis* may, under certain circumstances, invoke the application of the law governing the contract to oppose to termination (or the law governing the collateral).[22] The only relevant difference regards financial institutions. For those, claw-back actions are subject to the law applicable to the financial contract or to the financial collateral (note that Articles 24, 25 and 26 CIWUD do not

[19] F.J. Garcimartín, 'The Review of Insolvency Regulation: Some general considerations and two selected issues', in: F.J. Garcimartín and L. Lennarts (eds.), *The review of the EU Insolvency Regulation: Some Proposals for Amendment*, The Netherlands Association for Comparative & International Insolvency Law, 2012, pp. 16 et seq., available at http://www.naciil.org/uploads/files/preadvies-2011.pdf (accessed 19 February 2018).

[20] M. Virgós and F.J .Garcimartín, *The European Insolvency Regulation*, The Hague: Kluwer Law International 2004, pp. 119-120.

[21] Note, however, that the Insolvency Regulation recast includes a rule on location of book-entry securities inspired by the Financial Collateral Directive. According to Art. 2(9)(ii) EIR 2015, financial instruments, the title to which is evidenced by entries in a register or account maintained by or in 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.

[22] See an analysis of the regime in F.J. Garcimartín, 'Acciones de reintegración: competencia judicial y ley aplicable', in: E. Beltrán and E. San Juan (eds.), *La reintegración de la masa*, Madrid: Civitas 2012, pp. 631 et seq.

contain a cross-reference to Article 10(2)(l)). Of course, from a substantive law point of view, special rules exempting financial transactions from claw-back actions are applied where appropriate (for example, where Spanish insolvency law is applicable, financial collateral arrangements can only be challenged by the insolvency practitioner where entered into in fraud of creditors).

5. Resolution

In response to the financial crisis, several jurisdictions have laid down special resolution frameworks giving national authorities extraordinary powers to deal with failing financial institutions. The main purpose of the new frameworks is to pass on losses to stakeholders, not to taxpayers ('bail in, not bail out'), in accordance with insolvency standards. 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.[23] It has been transposed into Spanish law in Law 11/2015. A similar system is provided for by the Single Resolution Mechanism Regulation (SRM Regulation).[24]

In this context, a re-evaluation of the appropriate framework for derivatives and other financial arrangements has taken place and, actually, public authorities have *partially* reconsidered their position and reduced the privileges of those transactions when the failing firm is a financial institution.[25] In this regard, financial transactions are partially 're-routed' to the general principles of insolvency law, both at the substantive-law level and at the conflict-of-laws level.[26]

[23] 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.

[24] 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, if they are established in a Member State whose currency is the euro or has established a close cooperation (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 Art. 7 of the SRM Regulation, the SRB shall be responsible for adopting all decisions relating to resolution for the above mentioned entities – not part of a group – which are considered to be significant in accordance with Art. 6(4) Regulation (EU) No. 1024/2013 and for other cross-border groups.

[25] See e.g. Financial Stability Board (FSB), 'Key Attributes of Effective Resolution Regimes for Financial Institutions', October 2011, at pp. 10-12 (an updated version was published in October 2014), accessible at http://www.financialstabilityboard.org/2011/11/r_111104cc/ (accessed 19 February 2018), pp. 40-42; Commission (EU), 'Bank Recovery and Resolution Working Document', January 2011, http://ec.europa.eu/internal_market/consultations/2011/crisis_management_en.htm (accessed 19 February 2018); UNIDROIT, 'Principles on the Operation of Close-Out Netting Provisions. Explanation and Commentary', 2013, para. 1, accessible at https://www.unidroit.org/instruments/capital-markets/netting (accessed 19 February 2018), pp. 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.'

[26] See, for further elaboration of the theoretical foundations, F.J. Garcimartín, 'Resolución de entidades de crédito, contratos de derivados y garantías financieras: regreso a los principios concursales', *Revista de Derecho Bancario y Bursátil* 2014, p. 105; Skeel and Jackson 2012 (*supra* n. 1).

5.1 The Substantive law level

Indeed, the privileged status for derivatives described above (see section 4) does not fit well within the new resolution framework. Financial contracts are core assets for any credit institution and their early termination 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 could harm the resolution in an orderly fashion as it limits the possibility for successful reorganizations or going concern sales (see e.g. Recital 94 BRRD).[27] 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.[28] 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 section 5.1.1 (i)). 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 section 5.1.1 (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.[29] 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 (re-capitalization measures). This latter aspect is analysed separately in section 5.1.2 below.

5.1.1 General and temporary disapplication of termination rights linked to resolution

(i) Firstly, Article 68 BRRD establishes that the mere opening of a resolution process or the adoption of resolution tools cannot in itself be characterized by the parties as a termination event. Hence derivatives, like other contracts, are subject to the general framework on '*ipso facto* clauses', where 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. Similarly, 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 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.[30]

(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 terminated immediately after the transfer. The BRRD ensures this objective in Article 71(5)(a) BRRD: the counterparty can only trigger the close-out netting provision on occurrence of any continuing or subsequent enforcing event by the recipient.

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[27] See also FSB 2014 (*supra* n. 25), I-Annex 5 'Temporary stay on early termination rights', para. 1.1.

[28] F.J. Garcimartin, 'Resolution Tools and Derivatives', in: M. Haentjens and B. Wessels (eds.), *Bank Recovery and Resolution: A Conference Book*, The Hague: Eleven International Publishing 2014, p. 179 at pp. 187-190; M. Lehmann, 'La resolution et le droit international privé', *RDBE* 2014, p. 88 at p. 93.

[29] See, FSB, 'Principles for Cross-Border Effectiveness of Resolution Actions', November 2015, p. 7, available at http://www.fsb.org/wp-content/uploads/Principles-for-Cross-border-Effectiveness-of-Resolution-Actions.pdf (accessed 19 February 2018).

[30] See Art. 68(6) BRRD, which qualifies itself as an overriding mandatory rule for the purposes of Art. 9 Rome I. See also Art. 118 BRRD amending the FCD which now expressly states that the FCD shall not apply to any restriction on the enforcement of financial collateral arrangements or any close out netting imposed by the BRRD.

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 section 2.2). 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 (the '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 the split-up and separation of 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.[31] 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 (Article 78 BRRD).

5.1.2 Bail-in and derivatives

The new resolution framework, and particularly the application of the bail-in tool, may have an impact on the ordinary functioning of close-out netting provisions and the triggering events.

In principle, the BRRD does not exclude derivatives contracts from the scope of bail-in. It is true that there may be grounds for such exclusion, since they are not *usually* designed as funding transactions. 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). 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. Several reasons may justify this extension. The extension could be justified, *inter alia*, if bail-in of the liability is not possible within a reasonable time, when the 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. Indeed, Article 49(2)(II) BRRD mentions this possibility *expressis verbis*. On the one hand, the application of bail-in powers to derivatives may require the close-out of a large number of outstanding transactions (*infra* section 5.2.2), which may be difficult to do in a reasonable timeframe. On the other hand, the high degree of interconnectedness among institutions and the large amounts of money at stake may significantly increase the contagion effect and, therefore, the systemic risk. Nevertheless, the 'test of exclusion' is very demanding, and resolution authorities may only exclude derivatives 'in exceptional circumstances'.[32]

[31] See also, albeit in the context of Art. 76 BRRD, European Banking Association, 'Technical Advice by the European Banking Authority in Classes of Arrangements to Be Protected in a Partial Property Transfer', EBA/Op/2015/15, 14 August 2015, available at https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-15+Opinion+on+protected+arrangements.pdf (accessed 19 February 2018).

[32] See also Art. 44(12) BRRD, foreseeing a certain intervention of the EU Commission.

Secured liabilities are exempted from the bail-in powers, although, in principle, only up to the value of the collateral. Derivatives secured by a security interest (e.g. a pledge) qualify as secured liabilities and are therefore 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 in accordance with 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 cause severe valuation and operational difficulties. The application of the bail-in powers to derivatives may only be conceived when the failing institution is 'out of the money'. This may be determined with regard to (i) the periodic payment amount—i.e. the amount that is due and payable on a date specified under the derivatives—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. Naturally, determining whether a derivative contract gives rise to 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. 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 correspond to 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 the application of that clause. Article 49(2) BRRD expressly recognizes that such authorities '[…] shall be empowered to terminate and close out any derivative contract' (see also Article 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*.[33] 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 (Article 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, particularly 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, Article 49(4) and (5) BRRD, alongside a

[33] See e.g. and with further references, F. Robert-Tissot, 'The Effects of a Reorganization on Executory Contracts: A Comparative Law and Policy Study', available at https://www.iiiglobal.org/sites/default/files/effects_of_reorganizationonexecutorycontracts.pdf (accessed 19 February 2018); or Recommendation 73 and 82 of the UNCITRAL Legislative Guide (*supra* n. 12).

reference to the agreement, also includes a reference to certain objective parameters and EBA standards for the valuation of liabilities arising from derivatives.[34]

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

5.2 The Conflict-of-laws level

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. The same holds true 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 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.[35]

5.2.1 Resolution stay

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

In addition, the BRRD modifies the conflict-of-laws rules laid down by the CIWUD. 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 domestic law of the failing institution but to the law chosen by the parties in the agreement, excluding the effects of those measures insofar as they would not have been adopted under the *lex contractus*. To prevent this conclusion, the BRRD—in addition to clarifying that the CIWUD includes resolution tools and the exercise of resolution powers[36]—amends Articles 25 and 26 CIWUD, to carve out resolution measures from the scope of the *lex contractus*. Consequently, the effects of entry into resolution, restructuring or winding-up proceedings upon netting and repurchase agreements shall be governed by the law applicable to those agreements, but 'without prejudice to Articles 68 and 71' BRRD. The latter provisions establish, respectively, (i) the general exclusion of the entry into resolution as a termination event, and (ii) the power to temporally

[34] 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', EBA/CP/2015/10, 13 May 2015, available at https://www.eba.europa.eu/documents/10180/1073039/EBA-CP-201-10+CP+on+RTS+on+derivatives+valuation.pdf (accessed 19 February 2018).

[35] See, FSB 2015 (*supra* n. 29); G.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', *Journal of International Banking Law and Regulation* (*JIBLR*) 2015, p. 276 at pp. 281-282; Lehmann 2014, p. 88 (*supra* n. 28); A. Wilkinson, A. Wood and P. Bagon, 'Can ISDA's Close-out Protocol Stay the Next Lehman Brothers?', *International Corporate Rescue* (*ICR*) 2015, p. 143 at pp. 145-146.

[36] See the new definition of *reorganization* measures.

suspend other termination rights exercised by the resolution authorities of the home Member State.

> **Example**
> Let us imagine that the home Member State of the failing institution, in accordance with CIWUD, is Spain. Derivatives are 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 could not be invoked to trigger the close-out netting. This would be the case even though the contract would be governed by English rather than Spanish law, and irrespective of whether the exception had been included in the agreement. For the same reason, if the Spanish authorities were to exercise the suspension rights set out by Article 71 BRRD, this measure could not trigger the close-out netting either, even though the contract is subject to English law. The same would be true of a contract governed by e.g. New York law.

Note that, as discussed in section 4 *supra*, Articles 25 and 26 CIWUD 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 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 Article 118 BRRD, see above section 5.1.1) are sufficient to ensure the effectiveness of the resolution measures.

> **Example**
> Let us imagine that the ISDA Master agreement in the previous example, was accompanied by a pledge over a securities account located in Germany. In principle, since the agreement could not be terminated, it would not be possible to enforce the pledge. In any event, regarding 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 Article 1(6) FCD). As regards other types of collateral, the issue could be more problematic.

5.2.2 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, naturally including foreign derivative transactions or financial collateral located in another jurisdiction. The same holds *mutatis mutandi* in relation to the bail-in tool. Actually, 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.[37] The combination of these two provisions implies that the obligation to the host

[37] See Lehmann 2014, p. 89 (*supra* n. 28).

Member State is 'to ensure' the mutual recognition principle.[38] Therefore, in this example, Member State B must recognize the decisions made by the resolution authority of Member State A (see Article 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 (Article 66(6) BRRD). In principle, the exclusive jurisdiction clause that may be included in the agreement 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, and probably the United Kingdom in a post-Brexit scenario), 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 by including a third-country jurisdiction, and/or locating the assets there.[39] Naturally, the home Member State cannot guarantee the world-wide effectiveness of the resolution measures.

Theoretically, there are two approaches to address this problem, legal or contractual. The legal approach would entail a change in the third-country law 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'). The contractual approach would entail an agreement by the bank and its counterparties to expressly recognize such regime and to restrict their contractual rights accordingly (= 'contractual recognition').[40]

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.[41] According to Article 55 BRRD, Member States shall require financial institutions to include a

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[38] 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 2014, p. 90 (*supra* n. 28). A broad approach in F.J. Garcimartín, 'Company Restructuring and Universal Transfer of Assets: Proposal to Deal with the Conflict of Law Problem', *International Insolvency Law Review* (*IILR*) 2013, p. 149.

[39] See Financial Market Law Committee (FMLC), Issue 149, February 2013, 'Recovery and Resolution', paras. 8.5-8.7, available at http://web.archive.org/web/20170108031105/http://www.fmlc.org/uploads/2/6/5/8/26584807/issue_149_fmlc_paper_february_2013.pdf (accessed 19 February 2018); Garcimartín 2014, pp. 190-191 (*supra* n. 28); Lehmann 2014, p. 91 (*supra* n. 28).

[40] See FSB, Principles 2015, p. 5 (*supra* n. 29); C. Bates and S. Gleeson, 'Legal Aspects of Bank Bail-ins', *Law and Financial Markets Review* (*LFMR*) 2011, p. 264 at p. 270.

[41] See, on the technical standards envisaged by Art. 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', EBA/RTS/2015/6, 3 July 2015, available at https://www.eba.europa.eu/documents/10180/1132911/EBA-RTS-2015-06+RTS+on+Contractual+Recognition+of+Bail-in.pdf (accessed 19 February 2018); also FSB, Principles 2015, p. 15 (*supra* n. 29); Garcimartín 2014, pp. 182-183 (*supra* n. 28); Lehmann 2014, p. 92 (*supra* n. 28).

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 of resolution authorities 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.[42] Furthermore, EU resolution authorities may require legal opinions on the legal enforceability and effectiveness of these contractual terms (see Articles 45(5) and 55(1) *in fine* BRRD). Conversely, the Directive does not establish any legal requirements 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.[43] 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.[44] The Universal Resolution Stay Protocol expands this approach further.[45]

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 (Article 67(1) BRRD).[46]

This, nevertheless, does not guarantee that the third-country authorities will recognize the bail-in measures adopted by the resolution authorities.[47] The FSB has promoted a sort of mutual recognition principle at a global level, either by formal recognition, i.e. giving effects to the foreign resolution measures in the host State, and/or by taking supportive measures.[48] 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 Articles 93 et seq. BRRD).

6. Conclusion

In derivative contracts (as a whole) it is customary to include a choice of law clause. In the EU, the determination of the applicable law does not give rise to serious problems. Additionally, insofar as the applicable law coincides with the law governing the proprietary aspects of

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[42] See e.g. Association for Financial Markets in Europe (AFME), 'Model Clause for the Contractual Recognition of Bail-in under Article 55 BRRD', August 2016, available at https://www.afme.eu/globalassets/downloads/standard-forms-and-documents/afme-model-clauses-for-contractual-recognition-of-bail-in.pdf (accessed 19 February 2018). 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).

[43] See FSB, Principles 2015, pp. 14-15 (*supra* n. 29): '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, available at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/supervisory-statement/2015/ss4215.pdf?la=en&hash=6D932A8360786F36D2BC392D8435DDD4830CF830 (accessed 19 February 2018).

[44] ISDA 2014 Resolution Stay Protocol, available at http://assets.isda.org/media/f253b540-25/958e4aed-pdf/ (accessed 19 February 2018); sceptical, however, on the effectiveness of this approach, Wilkinson, Wood and Bagon 2015, p. 145 (*supra* n. 35).

[45] Ibid.

[46] See also FSB 2014, I-Annex 2 (*supra* n. 25).

[47] See also Art. 67(2) BRRD stating that if the transfer, write down or conversion is not effective, the resolution authorities 'shall not proceed with them'.

[48] FSB 2015, pp. 5-6 (*supra* n. 29).

financial collateral arrangements in accordance with the FCD, i.e. *lex rei sitae*/*lex conto sitae*, the situation does not pose problems. When it is not the case and the collateral is granted as a title transfer, the issue becomes a bit more complex. Although all obligations are subsumed under the umbrella of the close-out netting provision (including amounts deriving from each derivative settlement and the return of the *tantundem*), if the asset is still in the beneficiary's possession, the validity and enforceability of the collateral, as a 'preliminary issue', is governed by the *lex conto sitae*.

In insolvency scenarios, derivatives have traditionally enjoyed a privileged status from both the substantive and conflict-of-laws perspectives, where these transactions are not part of the normal bankruptcy process. Instead, close-out netting clauses are triggered by the mere entry into insolvency and are governed by the *lex contactus*.

However, this disapplication of the general insolvency law principles has been 're-considered' within the new resolution framework. Derivatives, like other contracts, cannot be terminated solely upon resolution, regardless of the law applicable to the contract. This raises the question of whether the privileged status must be kept and the resolution scenario must be qualified as an exception to them, or whether this is just a first step to reconsidering the whole approach.