

THE 2002 MODEL NETTING ACT: A SOLUTION FOR INSOLVENCY UNCERTAINTY

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This article discusses the privately negotiated derivatives markets and the risks their participants face and then focuses on the international movement to pass and update netting and collateral legislation and the role the 2002 Model Netting Act can play in that process.

INTRODUCTION

Increasingly, insolvencies of banks, corporations and financial institutions have a global reach. As financial markets expand across borders and into new markets, the trading positions and credit exposures of parties, whether they be small players in the emerging markets or large international institutions with offices in many jurisdictions, can be dramatically affected by events which occur on the other side of the world. The recent experiences of participants in the debt and derivatives markets with Enron's insolvency are a prime example of how this can happen.

Although the globalisation of finance continues to increase, in each jurisdiction insolvency issues are determined by the national laws of that jurisdiction. While insolvency in its own right has become more important than ever in international commercial law, there is no multinational structure or multinational regime to deal with the failure of an international financial institution. Indeed, there is a striking discrepancy between the internationalisation of financial transactions on the one hand and the lack of international approaches to deal with the insolvency of a global financial institution on the other.

In no area is this globalisation trend more apparent than in the privately negotiated derivatives markets (including those for interest rate swaps, currency swaps, equity options, energy derivatives, credit derivatives, etc which are used to manage the risks associated with traditional financial activities). The growth of the privately negotiated derivatives markets has led to large, variable credit exposures between many financial institutions. These credit exposures are substantially reduced through the netting of these obligations under master agreements and the collateralisation of the remaining exposures. Netting and collateralisation are keys to maintaining the stability of the international markets and preventing cascading insolvencies in jurisdictions around the world resulting from the failure of a major participant in the international markets.

Netting and collateralisation can only achieve these ends, however, if the parties can be certain that the terms of their netting and credit support agreements will be upheld in the relevant jurisdictions. The International Swaps and Derivatives Association Inc ('ISDA') has, for many years, been involved in the promotion of law reform in many jurisdictions, with the aim of ensuring that the netting provisions of the documentation which is most commonly used in the privately negotiated derivatives markets are enforceable. Increasingly, ISDA has also become a driving force

behind the clarification and, to the extent possible, standardisation of the laws applicable to collateral arrangements commonly used in international financial transactions. As a part of this endeavour, ISDA has recently published the 2002 Model Netting Act, a document designed to assist governments in developing legislation which will ensure that the protections of netting and title transfer collateral arrangements are available to participants in their financial markets.

THE PRIVATELY NEGOTIATED DERIVATIVES MARKETS

Since the late 1980s, the privately negotiated derivatives markets have seen exponential growth in several dimensions. In addition to growth in the aggregate values of trades, the privately negotiated derivatives markets have seen rapid growth in the number and type of market participants and in the variety of instruments being traded, with recent developments including an explosion in the volume and variety of credit derivatives-based transactions and the development of new types of derivatives transactions tied to certain industries, such as bandwidth derivatives, carbon emissions derivatives, freight derivatives and a wide array of weather-based products.

Outstanding notional amounts, gross exposures and net credit exposures have all increased dramatically. These figures have now all reached trillions of dollars. The following table summarises information contained in a May 2001 report by the Bank for International Settlements.

Global Credit Exposures in the Privately Negotiated Derivatives Markets	
Global Outstanding Notional Amounts	\$95,200,000,000,000
Actual Global Gross Exposure (ie replacement value of the transactions)	\$3,200,000,000,000
Credit Exposure After Netting	\$1,080,000,000,000

The first figure in the table, \$95.2 trillion, represents total outstanding notional amount of privately negotiated

derivatives transactions in existence at the time of the BIS survey. The notional amount of money involved in a derivatives transaction generally does not change hands and only a portion of the notional amount is usually ever at risk. The second figure, \$3.2 trillion, represents the replacement value of the privately negotiated derivatives transactions in existence at the time of the BIS survey. The replacement value is also the total credit exposure between parties to derivatives transactions. The final figure, \$1.08 trillion, is the total remaining exposure between parties to privately negotiated derivatives transactions after allowing for netting.

The loss a party will experience from the default of a counterparty is equivalent to the cost of replacing the transaction, less any recovery. The replacement cost for a derivatives transaction represents the present value, at the time of default, of the expected future net cash flows. Those future net cash flows may fluctuate over time with the variables that determine the value of the underlying financial instrument. As a result, replacement costs, and therefore credit exposure under derivatives transactions, can exhibit significant volatility.

There are various techniques to reduce credit risk with respect to privately negotiated derivatives transactions. The simplest and most effective means is netting. The use of bilateral netting allows financial institutions to calculate counterparty exposure with respect to derivatives master agreements on a net basis. In addition, this means that gross replacement costs can be replaced by net replacement costs for capital adequacy purposes. There is an increasing demand for risk reduction methods in addition to netting. These additional methods include provision of credit support by third parties (such as parent company guarantees or letters of credit) and, with increasing frequency, the posting and maintaining of collateral by the counterparty at a level necessary to cover the net exposure.

NETTING

Bilateral Close-Out Netting

Bilateral close-out netting provisions are found in master agreements, such as the 1992 International Swaps and Derivatives Association Master Agreement (the 'ISDA Master Agreement'), which are used in privately negotiated derivatives transactions. Bilateral close-out netting provisions are contractual terms calling for netting or set off of amounts due to and from the two parties to the contract.

Under a master agreement, the parties will enter into multiple derivatives transactions, each calling for payments to or from one or both of the parties over time; each of these transactions is economically independent of the other, but all are subject to the master agreement that contains the bilateral close-out netting provisions. The master agreement generally calls for the close-out or termination of all transactions following certain events of default, including the

insolvency of one of the parties. Following close-out or termination of each transaction, a close-out or termination amount is calculated for each transaction or group of transactions. These amounts represent the lost value to one of the parties for terminating the transactions prior to their intended maturity, which is the amount it would cost the party to replace all of the transactions in the market with other counterparties. The bilateral close-out netting provisions call for the netting or set off of all the close-out or termination amounts for all transactions. These provisions thereby reduce all the close-out or termination amounts to a single net number due to or from one of the parties.

Cherry Picking

Generally, where an insolvency official has the power to reject or affirm contracts, a counterparty to a rejected contract must file a claim for moneys owed (or for damages) against the estate of the insolvent company in respect of the rejected contract, for which it can expect to receive no more than a fraction of the value, while continuing to perform its obligations to the insolvent company under any affirmed contracts. The term 'cherry picking' refers to a power that some insolvency officials have under the insolvency laws of certain jurisdictions to reject certain contracts burdensome to the insolvent company while affirming contracts beneficial to the insolvent company.

If a bank has a number of swaps with an insolvent company, cherry picking results in those swaps which are out-of-the-money to the insolvent company being rejected and those swaps which are in-the-money being affirmed. Assuming the swaps are unsecured, the counterparty is in the disastrous position of being forced to pay full value in respect of the swaps which are out-of-the-money to itself, while being likely to receive only part value (if any) in respect of the swaps which are in-the-money to itself.

Master agreements, including the ISDA Master Agreement, attempt to overcome this problem by making it clear that the master agreement and all transactions entered into under it constitute a single agreement between the parties which must therefore be affirmed or rejected as a whole by the insolvency official. Normally, upon declaration of an early termination date for a master agreement by reason of an insolvency default, all transactions are terminated and their value is determined. The values for the swap transactions are converted to a single currency and netted against each other to produce a single 'settlement amount'.

Close-Out Netting and Systemic Risk

The widespread use of master agreements providing for close-out netting also has an important beneficial effect on systemic risk. Market participants face a considerable exposure to risks stemming from the failure of a major market participant causing cascading insolvencies through counterparties. The substantial credit risk reduction achieved by

close-out netting considerably lessens this consequential effect by reducing counterparty exposure at each node in the network of relationships between market participants and by encouraging best practices by properly documenting trades at the earliest possible time.

Where credit risk is reduced, banks are able to use their capital more efficiently. Credit lines can be freed up and reserves may be reduced so as to allow a more productive use of capital which would otherwise be allocated inefficiently. Recognising these advantages, the Group of Ten central banks and central banks of other leading jurisdictions have permitted, subject to prudent conditions, the recognition of close-out netting for capital adequacy and large exposure purposes. Under such conditions, banks find it more efficient to enter into trading relationships with counterparties in jurisdictions where netting is enforceable because any liabilities under such relationships can be calculated on a net, rather than a gross, basis. Trading relationships with counterparties in jurisdictions where netting is not certain require greater allocations of capital, making them more expensive.

Multibranch Close-Out Netting

To minimise legal uncertainty in transactions with parties doing business in more than one jurisdiction, parties may provide for multibranch close-out netting to pre-empt contractually the problems of cross-border insolvencies. Multibranch close-out netting provisions operate in the same way as bilateral close-out netting provisions, except that they permit the netting or set off of all close-out or termination amounts due to or from all the pre-designated branches of a multibranch party (usually a bank or other financial institution with offices in several jurisdictions). Again, the intent of the multibranch close-out netting provisions is to reduce all the close-out or termination amounts for all transactions to a single net number due to or from one of the parties, regardless of the branch through which any or all of the transactions are booked. By use of multibranch netting provisions in master agreements, parties define the nature and location of assets in cross-border insolvency proceedings. Their widespread use and the legal certainty as to their enforceability make them an important risk management tool for any market participant.¹

COLLATERALISATION

Despite some disadvantages, such as the need for operational and legal support, the use of collateralisation has increased dramatically in the last few years, both among dealers and between dealers and end users. The 2001 ISDA Margin Survey indicated that over \$250 billion worth of collateral is currently in circulation in the privately negotiated derivatives markets, a rise of 25 per cent over the amount in circulation in 2000, most of which consists of government securities and cash. Collateral arrangements are entered into

mainly as a method of credit enhancement to cut the credit risk remaining under derivatives master agreements once the effects of close-out netting are taken into account. Where they require periodic transfers of collateral between the parties, they allow for smooth adjustment of fluctuations in counterparties' credit exposures. In addition to the risk management benefits, collateralisation reduces the capital adequacy risk weighting of exposures under derivatives transactions to the risk weighting of the collateral itself, providing a direct financial benefit to banks which are subject to regulatory capital requirements. Collateralisation also frees up counterparty credit lines to support a greater volume of dealing.

Collateral is most often provided either through the use of a traditional pledge or security interest or else, increasingly, through outright transfer of title in the collateral. Where securities are provided as collateral by way of outright transfer, the collateral taker acquires complete ownership of the securities. Any right of the collateral giver to the return of the securities is merely a contractual right against the collateral taker. In other words, the collateral giver has no direct or proprietary rights against the collateral securities in the hands of the collateral taker. A great advantage of outright transfer is that the collateral taker is free to pass on the collateral it receives to third parties as collateral for its own obligations, to sell it or otherwise to dispose of it. This disposal of collateral by the collateral taker is referred to as 'rehypothecation'.

A further advantage of an outright transfer is that the collateral will not be subject to competing security interests or a stay of enforcement (unless the arrangement is recharacterised as a security interest, as discussed below). However, there are particular legal issues relating to the proprietary aspects of achieving an effective outright transfer. Importantly, the effectiveness of transfer, the availability of set off and the risk of recharacterisation must be considered.

When the collateral taker acquires outright title to the collateral securities, he or she also assumes a contractual obligation to return to the collateral giver securities *equivalent* to the original collateral securities at the end of the transaction. Upon a default of the collateral giver, such obligation typically can be set off against the unpaid obligations of the defaulting party. There remains, however, a risk that the insolvency official of the collateral giver may argue that set off is not effective to discharge collateral redelivery rights. Whether or not set off is available in counterparty insolvency will generally depend on the law governing that insolvency.

There is a risk that a court may not allow an agreement for the outright transfer of collateral to take effect in accordance with its terms and would recharacterise the interest of the collateral taker in the securities as a security interest instead of outright title. Many jurisdictions require security interests to comply with perfection requirements such as

registration and the danger is that any security interest may be void for want of registration, leaving the collateral taker as an unsecured creditor of a defaulting, and possibly insolvent, counterparty.

ENFORCEABILITY OF CLOSE-OUT NETTING PROVISIONS AND COLLATERAL ARRANGEMENTS

There is an inherent tension between netting and the provisions of many jurisdictions' insolvency regimes. Bankruptcy receivers may attempt to ignore close-out netting provisions in a master agreement and cherry pick individual transactions or close-out netting may be viewed as resulting in an invalid unequal treatment of creditors. On the other hand, some jurisdictions, such as England, explicitly endorse set off, an insolvency concept closely related to netting, by which outstanding obligations under separate agreements between an insolvent party and a creditor may be set off or netted against one another. As a result, it is important for parties to master agreements which include close-out netting provisions to be certain that their netting agreement will be enforceable in jurisdictions in which an insolvency of a party might occur.

In addition, in order to use netting in calculating their credit exposure for capital adequacy purposes, banks must not only have a netting agreement in place, but must also obtain a legal opinion stating that that netting agreement will be upheld in all relevant jurisdictions. ISDA, on behalf of its member institutions, has commissioned legal opinions as to the enforceability of the ISDA Master Agreement from law firms in 36 jurisdictions. The opinions cover, among other jurisdictions, the United States, England, Switzerland, Germany, France, Hong Kong, Japan, Italy and the Netherlands. These opinions can be used by ISDA members to meet the opinion requirements included in the 1994 Amendment to the Basle Accord. The process of obtaining legal opinions regarding the enforceability of the netting provisions of various master agreements has also been extremely useful in helping proactively to identify and resolve potential legal problems in the context of privately negotiated derivatives transactions in various jurisdictions.

With regard to collateral, in response to the legal uncertainties facing would-be collateral takers, there have been a number of law reform initiatives both in the public and private sectors. For example, in early 1999, in the wake of the 1998 collapse of Long-Term Capital Management and the Russian financial crisis, which highlighted the extent to which participants in the financial markets were exposed to one another, members of ISDA formed the Collateral Law Reform Group. The group, which was made up of internal and external financial markets lawyers, set out to examine in detail the case for national collateral law reforms in order to make the cross-border use of collateral practically efficient and legally sound.

The group developed a set of goals for collateral law reform, which included the development of simple, clear and cost effective rules for implementation of collateral arrangements, ensuring the ease and speed of enforcement of collateral, allowing collateral takers to take possession directly or indirectly, allowing collateral takers freedom to use the collateral, protecting collateral arrangements from attacks by third parties during insolvencies, allowing parties to choose the law which governs their collateral arrangement and protecting mark-to-market margining arrangements. In addition, ISDA commissioned a series of collateral opinions, currently covering 27 jurisdictions, similar to those regarding the enforceability of netting.

NETTING LEGISLATION AND COLLATERAL LAW REFORM

The work undertaken by different industry associations, such as ISDA, has encouraged the use of master agreements and collateral in international financial transactions. Nevertheless, in certain jurisdictions, the enforceability of close-out netting and collateral arrangements remains unclear.

To improve the current status, the remaining uncertainties must be removed as soon as possible. There is consensus among the financial community that the most effective way to increase legal certainty is the adoption of specific legislation that recognises the enforceability of bilateral and multibranch close-out netting provisions and the enforceability of certain collateral arrangements, particularly those based on outright transfer of collateral.

NETTING LEGISLATION

A number of jurisdictions have adopted laws that protect the enforceability of netting agreements upon the insolvency of one of the parties. Netting legislation, which began in the United States, has been spreading to other jurisdictions throughout the world, at first slowly and now more rapidly. Since 1989, laws expressly protecting the enforceability of netting for privately negotiated derivatives transactions in local insolvency proceedings have been enacted in many jurisdictions, including Belgium, Canada, the Cayman Islands, Denmark, France, Germany, Ireland, Luxembourg, South Africa, Sweden, Switzerland and the United States.

A review of netting legislation enacted in various jurisdictions shows some generic patterns. Typically, netting legislation creates a specific insolvency rule under which close-out netting is clearly enforceable. This specific insolvency regime, however, often applies only to certain specified types of transactions. Those specified transactions are described in a list of enumerated transactions. To the extent this list is exhaustive enough to include any and all transactions that are documented under a master agreement, the netting legislation establishes legal certainty as to the enforceability of close-out netting.

The use of a fixed list of transactions may cause some problems, however. For example, over the last decade, the variety of transactions documented under the ISDA Master Agreement has steadily expanded to include additional derivative instruments and completely new contract types such as credit derivatives. In the absence of clarifying amendments, it may be uncertain whether new types of derivatives transactions, such as credit derivatives, are covered by the existing list of enumerated transactions in an applicable netting law. Moreover, additional uncertainty may arise as to whether the documentation of new types of derivatives transactions that may not be covered by the netting legislation under a master agreement would affect the enforceability of the other transactions documented under that master agreement.

Some netting laws may also contain entity limitations, thus only upholding close-out netting provisions in master agreements for certain entities. For example, the Belgian and French laws apply only to certain types of financial institutions.

ISDA has attempted to communicate its experiences with netting legislation to regulators and legislators in order to help ensure that the limitations of some existing statutes do not get imported into new netting laws. Clearly, updating of lists would be unnecessary if netting laws utilised functional definitions rather than, or in addition to, lists of types of transactions. These experiences are also reflected in the 2002 Model Netting Act that was published recently by ISDA.

COLLATERAL LAW REFORM

Collateral law reform, much of it targeted at issues such as those identified by ISDA's Collateral Law Reform Group, has occurred or is ongoing in Europe and in North America. In the US, the recently revised art 8 of the Uniform Commercial Code now protects rehypothecation of collateral and clarifies various conflict of laws issues confronting takers of collateral.

In Europe, the process of collateral reform is ongoing. Between June and December 2000, a group of government legal experts and central bank representatives chaired by the European Commission examined legal issues surrounding collateral use in Europe. During the process, the European Commission reached the conclusion that the most appropriate way forward would be the adoption of an EU Directive on the use of collateral.

In March 2001, the Commission released a draft proposal for a Directive of the European Parliament and of the Council on financial collateral arrangements. In late 2001, after some amendments, ECOFIN reached unanimous political agreement to approve the draft. Implementation of the Directive may occur as early as 2003. Some of the key provisions of the Directive include recognition of the validity of agreements which permit the reuse of collateral, the elimination of formal perfection requirements for certain collat-

eral arrangements, the formal recognition of close-out netting under collateral agreements, the elimination of certain notice and consent requirements for the enforcement of collateral and the clarification of conflict of laws issues in cross-border collateral arrangements.

THE 2002 MODEL NETTING ACT

In an ideal world for derivatives, law makers everywhere would adopt a uniform international bankruptcy statute recognising close-out netting. That statute would be broad enough to cover the unceasing innovations in the privately negotiated derivatives markets. Parties to local and cross-border derivatives transactions would also be able to reduce credit risk through the use of collateral arrangements based on the outright transfer of collateral without fear that those arrangements will be recharacterised.

From a practical perspective, such an international harmonisation of insolvency and collateral law is unlikely to happen in the near future. As was discussed in the preceding two sections, however, there have been ongoing efforts at law reform in many jurisdictions which have moved closer to this ideal. To support this process and to assist in the drafting and adoption of specific netting legislation in countries where there is still doubt about the enforceability of close-out netting, ISDA has recently published the 2002 Model Netting Act, the text of which follows this article. The Act is a model law that would ensure the enforceability of both bilateral and multibranch close-out netting, as well as the enforceability of pledge and title transfer collateral arrangements.

BACKGROUND

The 2002 Model Netting Act is an update of the 1996 Model Netting Act, also published by ISDA. The 1996 Act has been used successfully as a model law in countries which have recently adopted netting legislation, such as Mexico. It has also been a teaching tool for educating regulators and legislators in jurisdictions, such as Brazil, which are currently developing netting legislation. The 1996 Act was divided into Part I, which addressed the enforceability of bilateral netting, and Part II, which addressed multibranch netting. The 2002 Model Netting Act has maintained this structure, while integrating into Part I provisions related to collateral arrangements. In addition, the 2002 Act includes new provisions designed to facilitate its use in civil law jurisdictions. These modifications are the product of ISDA's experiences helping to develop netting legislation for civil law jurisdictions like Mexico and Argentina.

A discussion of the key provisions of the 2002 Model Netting Act follows.

KEY PROVISIONS

Part I: Bilateral Netting Provisions

The first part of the 2002 Model Netting Act presents the

essential elements of a bilateral netting regime. Like many netting statutes, the 2002 Act contains a list of transaction types which fall within its scope, called 'qualified financial contracts'. The length and detail of the list illustrates how much innovation has occurred within the derivatives markets in the last two decades. The number of additions since the 1996 Act is also an indication of the limitations of a list-based approach. To keep an adequately detailed list up to date would require frequent amendment of a netting statute. In order to avoid this problem, the 2002 Act also uses a functional approach. Under the functional approach, any financial contract pursuant to which money payment or delivery obligations that have a market or an exchange price are due to be performed at a certain time or within a certain period of time would be treated as a qualified financial contract. This definition should include any and all derivatives transactions documented under, for instance, ISDA Master Agreements because any derivatives transaction is time sensitive. Finally, as an added measure of flexibility, the 2002 Act gives the central bank the power to designate additional transactions or types of transactions as qualified financial contracts. This permits the list to be updated through regulatory action without requiring the passage of a new law.

Section 4 of Pt I of the 2002 Act contains the key provisions which establish the enforceability of netting agreements. For the purposes of the 2002 Act, a netting agreement includes (i) any netting agreement in connection with one or more qualified financial contracts, (ii) any master-master netting agreement (ie a netting agreement which encompasses other netting agreements) and (iii) any collateral arrangement related thereto.

Section 4 creates a carve out from other regulations which protects netting agreements from regulatory stays which might otherwise be imposed upon the insolvency of one of the parties to the netting agreement. In addition, s 4 includes provisions which affirm that the only obligation or entitlement due to or from a party to a netting agreement is its net obligation or entitlement as determined in accordance with the terms of that agreement. It also specifically limits the powers of a liquidator to cherry pick individual transactions covered by a netting agreement by protecting the ability of the parties to the netting agreement to terminate and close out their qualified financial contracts. Any power of a liquidator to assume or repudiate contracts is limited to assumption or repudiation of the net amount due under the netting agreement.

Provisions in s 4 also prevent laws generally prohibiting set off from being interpreted so as to interfere with the operation of netting (specifically the offset of close-out values within the confines of the netting agreement) and protect payments under qualified financial contracts from being treated as preferences in the absence of evidence that such payment was made with intent to hinder, delay or defraud other creditors. Finally, it provides that, where certain

transactions covered by a netting agreement are not qualified financial contracts, the validity of the netting agreement with respect to those transactions which are qualified financial contracts will not be jeopardised.

Part I: Collateral Provisions

In addition to the provisions addressing the enforceability of bilateral close-out netting, Part I of the 2002 Act also contains provisions which deal with the enforceability of collateral arrangements in insolvency. The majority of the protections contained in the 2002 Act apply to a wide variety of collateral arrangements, including title transfer collateral arrangements (arrangements which involve the outright transfer of collateral), collateral arrangements which involve a security interest or pledge, guarantees and other forms of credit enhancement. As discussed below, certain protections apply specifically to title transfer collateral arrangements. The range of collateral which may be transferred or pledged pursuant to a collateral arrangement under the 2002 Act is also quite broad.

There are two key protections provided for collateral arrangements under the 2002 Act. First, collateral arrangements are included in the definition of 'netting agreement'. The effect of this inclusion is that the enforceability of collateral arrangements, whether pledge or title transfer, is protected in the same manner as that of other netting agreements. This, for example, includes the protections against stays and avoidance by liquidators. Secondly, title transfer collateral arrangements are included in the list of qualified financial contracts. This permits obligations under a title transfer collateral arrangement to return collateral of equivalent value to a counterparty to be netted under a netting agreement which covers both the collateral arrangement and other derivatives transactions. This would, for instance, apply to most credit support annexes based on title transfer which are commonly used in conjunction with ISDA Master Agreements in the privately negotiated derivatives markets.

In addition, the 2002 Act contains several other provisions which protect collateral arrangements in the event of an insolvency. In order to ensure that collateral takers may realise collateral quickly, specific provisions protect collateral takers from requirements that they obtain consent from other parties or liquidators or provide notice prior to the realisation of collateral in relation to a netting agreement. As it does for netting agreements, s 4 also provides that, where a collateral arrangement covers some transactions which are qualified financial contracts and some which are not, the collateral arrangement will remain protected with respect to the qualified financial contracts.

Part II

In its second part, the 2002 Act addresses specific issues arising under netting agreements that include multibranch provisions. The 2002 Act provisions are based on the New

York Banking Law provisions² adopted in 1993 that expressly enforce multibranch close-out netting for derivatives transactions in a constructive attempt to reconcile the ring fencing of New York branches and the interest in enforcing multibranch close-out netting. Under the 2002 Act, following the termination of a multibranch master agreement that is a 'qualified financial contract', the single net termination amount is calculated on both a global and local basis.

The global net amount is the amount owed by or to the foreign party as a whole if *all* transactions across *all* branches subject to the multibranch netting agreement are considered (the 'Global Net Payment Obligation' or 'Global Net Payment Entitlement'). The local net amount is the amount owed by or to the foreign party after netting only the transactions entered into by the local branch or agency of the foreign party (the 'Branch/Agency Net Payment Obligation' or 'Branch/Agency Net Payment Entitlement'). The liquidator shall only be liable to pay to a non-defaulting counterparty the lesser of the Global Net Payment Obligation and the Branch/Agency Net Payment Obligation. Likewise, when a counterparty owes a net amount pursuant to a repudiated or terminated qualified financial contract, the liquidator may demand from the counterparty a payment of the lesser of the Global Net Payment Entitlement and the Branch/Agency Net Payment Entitlement. Any amounts to be collected or paid by the counterparty are reduced by amounts that have been collected or paid in other jurisdictions pursuant to the same qualified financial contract, thereby foreclosing the potential for double recovery or payment.

Under the multibranch provisions of the 2002 Act, the insolvency officials in each country would exercise insolvency jurisdiction over the assets present in that country, but would recognise at the same time the interests of foreign representatives of creditors. From the perspective of equal treatment of creditors, the multibranch provisions of the 2002 Act contain – at least for the particular creditors to which they apply – a distribution principle that produces a predictable and clearly determinable result. Legal certainty in these situations is often preferable to elaborate attempts to provide equal treatment.

CONCLUSIONS

Like the 1996 Act, the 2002 Act may be either enacted in full or else used as a resource by regulators and legislators in designing their own legislation. It permits participants in the privately negotiated derivatives markets in the jurisdictions in which it is enacted to take advantage of the protections of close-out netting and of collateralisation of exposures through outright transfer of title in collateral. For jurisdictions in which the enforceability of netting and collateral arrangements is unclear, law reform and the 2002 Act provide an opportunity to stabilise their existing domestic markets, protect the current participants from risks associat-

ed with international insolvencies and attract foreign participants and counterparties to their marketplace.

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1 An example helps to illustrate the intended operation of multibranch netting provisions. Party A is a national bank chartered in the United States with branches in England and Japan. Party B is an English bank with branches in the United States (a New York chartered branch), Japan and Spain. Party A and Party B agree to enter into a variety of privately negotiated derivatives transactions and enter into a master agreement to which all those derivatives transactions will be subject. That master agreement contains a multibranch close-out netting provision that provides for the netting or set off of the termination amounts for all transactions booked through any of the designated branches of either Party A or Party B. Party A plans to book transactions through all its branches and therefore Party A lists its New York, London, and Tokyo branches as designated branches for close-out netting. Party B plans to book transactions through all its branches and therefore Party B lists its London, New York, Tokyo and Madrid branches as designated branches for close-out netting.

Subsequent to the execution of the master agreement, Party A and Party B enter into a variety of privately negotiated derivatives transactions, including interest rate swaps, commodity swaps, currency swaps and equity swaps. Each of Party A and Party B books some of these transactions through its head office and some of these transactions through its branches in other jurisdictions. As long as both Party A and Party B are solvent and performing their obligations under the transactions, each of Party A and Party B can make and receive payments through its various branches. Upon an event of default (such as insolvency), however, the parties expect that a single net termination amount will be calculated for all transactions across all branches of both the parties. This expectation (expressed through the multibranch close-out netting provisions of their master agreement) holds for both parties, although neither party can anticipate if it will be the defaulting/insolvent party or the non-defaulting/solvent party. The agreement of the parties provides evidence that both parties believe that it is economically advantageous to effectuate multibranch netting following an insolvency, regardless of which party is insolvent.

2 Section 618-a(2)(c)-(e) of the New York Banking Law.

2002 MODEL NETTING ACT

PART I: NETTING

1 DEFINITIONS

In this Act:

'Bank' means the Central Bank of *[insert applicable jurisdiction]*;

'collateral' means:

- (i) cash in any currency;
- (ii) securities of any kind, including (without limitation) debt and equity securities;
- (iii) guarantees, letters of credit and obligations to reimburse; and
- (iv) any asset commonly used as collateral in *[insert applicable jurisdiction]*;

'collateral arrangement' means any margin, collateral or security arrangement or other credit enhancement related to a netting agreement or one or more qualified financial contracts entered into thereunder, including (without limitation):

- (i) a pledge or any other form of security interest in collateral, whether possessory or non-possessory;
- (ii) a security arrangement based on the transfer of title to collateral, whether by outright sale or by way of security, including (without limitation) a sale and repurchase agreement or an irregular pledge; and
- (iii) any guarantee, letter of credit or reimbursement obligation by or to a party to one or more qualified financial contracts, in respect of those qualified financial contracts;

'insolvent party' is the party in relation to which an insolvency proceeding under the laws of *[insert applicable jurisdiction]* has been instituted;

'liquidator' means the liquidator, receiver, trustee or other person or entity which administers the affairs of an insolvent party during an insolvency proceeding under the laws of *[insert applicable jurisdiction]*;

'netting' means the occurrence of any or all of the following:

- (i) the termination and/or acceleration of any payment or delivery obligations or entitlements under one or more qualified financial contracts entered into under a netting agreement;
- (ii) the calculation or estimation of a close-out value, market value, liquidation value or replacement value in respect of each obligation or entitlement terminated and/or accelerated under (i);
- (iii) the conversion of any values calculated or estimated under (ii) into a single currency; and
- (iv) the offset of any values calculated under (ii), as converted under (iii);

'netting agreement' means (i) any agreement between two parties that provides for netting of present or future payment or delivery obligations or entitlements arising under or in connection with one or more qualified financial contracts entered into thereunder by the parties to the agreement (a 'master netting agreement'), (ii) any master agreement between two parties that provides for netting of the amounts due under two or more master netting agreements (a 'master-master netting agreement') and (iii) any collateral arrangement related to one or more of the foregoing;

'non-insolvent party' is the party other than the insolvent party;

'party' means a person constituting one of the parties to a netting agreement;

'person' includes [individuals], [partnerships], [corporations], [other regulated entities such as banks, insurance companies and broker-dealers], [governmental units];

'qualified financial contract' means any financial contract, including any terms and conditions incorporated by reference in any such financial contract, pursuant to which payment or delivery obligations that have a market or an exchange price are due to be performed at a certain time or within a certain period of time. Qualified financial contracts include (without limitation):

- (a) a currency, cross-currency or interest rate swap agreement;
- (b) a basis swap agreement;
- (c) a spot, future, forward or other foreign exchange agreement;
- (d) a cap, collar or floor transaction;
- (e) a commodity swap;
- (f) a forward rate agreement;
- (g) a currency or interest rate future;
- (h) a currency or interest rate option;
- (i) equity derivatives, such as equity or equity index swaps, equity options and equity index options;
- (j) credit derivatives, such as credit default swaps, credit default basket swaps, total return swaps and credit default options;
- (k) energy derivatives, such as electricity derivatives, oil derivatives, coal derivatives and gas derivatives;
- (l) weather derivatives, such as weather swaps or weather options;
- (m) bandwidth derivatives;
- (n) freight derivatives;
- (o) carbon emissions derivatives;
- (p) a spot, future, forward or other commodity contract;
- (q) a repurchase or reverse repurchase agreement;
- (r) an agreement to buy, sell, borrow or lend securities, such as a securities lending transaction;
- (s) a title transfer collateral arrangement;

- (t) an agreement to clear or settle securities transactions or to act as a depository for securities;
- (u) any other agreement similar to any agreement or contract referred to in paragraphs (a) to (t) with respect to reference items or indices relating to (without limitation) interest rates, currencies, commodities, energy products, electricity, equities, weather, bonds and other debt instruments and precious metals;
- (v) any derivative or option in respect of, or combination of, one or more agreements or contracts referred to in paragraphs (a) to (u); and
- (w) any agreement or contract designated as such by the Bank under this Act;

'title transfer collateral arrangement' means a security arrangement based on the transfer of title to collateral, whether by outright sale or by way of security, including (without limitation) a sale and repurchase agreement or an irregular pledge.

2 POWERS OF THE BANK

The Bank may, by notice issued under this section, designate as 'qualified financial contracts' any agreement or contract, or type of agreement or contract, in addition to those listed in this Act.

3 ENFORCEABILITY OF A QUALIFIED FINANCIAL CONTRACT

A qualified financial contract shall not be and shall be deemed never to have been void or unenforceable by reason of [insert the applicable law] relating to games, gaming and lotteries.

4 ENFORCEABILITY OF A NETTING AGREEMENT

- (a) General rule. The provisions of a netting agreement will be enforceable in accordance with their terms against the insolvent party and, where applicable, against a guarantor or other person providing security for the insolvent party and will not be stayed, avoided or otherwise limited by any action of the liquidator, by any other provision of law relating to bankruptcy, reorganisation, composition with creditors, receivership, conservatorship or any other insolvency proceeding the insolvent party may be subject to or by any other provision of law that may be applicable to the insolvent party, subject to the conditions contained in the applicable netting agreement.
- (b) Limitation on obligation to make payment or delivery. The only obligation, if any, of a party to make payment or delivery under a netting agreement shall be equal to its net obligation to the other party as determined in accordance with the terms of the applicable netting agreement.
- (c) Limitation on right to receive payment or delivery. The only right, if any, of a party to receive payment or deliv-

ery under a netting agreement shall be equal to its net entitlement with respect to the other party as determined in accordance with the terms of the applicable netting agreement.

- (d) Limitation on powers of the liquidator. Any powers of the liquidator to assume or repudiate individual contracts will not prevent the termination and/or acceleration of any payment or delivery obligations or entitlements under one or more qualified financial contracts entered into under a netting agreement and will apply, if at all, only to the net amount due in respect of all of such qualified financial contracts in accordance with the terms of such netting agreement.
- (e) Limitation of insolvency laws prohibiting set off. The provisions of a netting agreement which provide for the offset of close-out values, market values, liquidation values or replacement values calculated in respect of accelerated and/or terminated payment or delivery obligations or entitlements under one or more qualified financial contracts entered into thereunder will not be affected by any applicable insolvency laws limiting the exercise of rights to set off, offset or net out obligations, payment amounts or termination values owed between an insolvent party and another party.
- (f) Preferences and fraudulent transfers. The liquidator of an insolvent party may not avoid:
 - (i) any transfer, substitution or exchange of cash, collateral or any other interests pursuant to a netting agreement from the insolvent party to the non-insolvent party; or
 - (ii) any payment or delivery obligation incurred by the insolvent party and owing to the non-insolvent party pursuant to a netting agreement

on the grounds of it constituting a [preference] [transfer during a suspect period] by the insolvent party to the non-insolvent party, unless there is clear and convincing evidence that the non-insolvent party (i) made such transfer or (ii) incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the insolvent party was indebted or became indebted, on or after the date (i) such transfer was made or (ii) such obligation was incurred.

- (g) Preemption. No stay, injunction, avoidance, moratorium, or similar proceeding or order, whether issued or granted by a court, administrative agency, liquidator or otherwise, shall limit or delay application of otherwise enforceable netting agreements in accordance with subsections (a), (b) and (c) of this section of this Act.
- (h) Realisation and liquidation of collateral. Unless otherwise agreed by the parties, the realisation, appropriation and/or liquidation of collateral under a collateral arrangement shall take effect or occur without any requirement that prior notice shall be given to, or consent be received from, any party, person or entity, pro-

vided that this subsection is without prejudice to any applicable provision of law requiring that the realisation, appropriation and/or liquidation of collateral is conducted in a commercially reasonable manner.

(i) Scope of this provision.

(i) For the purposes of this section, a netting agreement shall be deemed to be a netting agreement notwithstanding the fact that such netting agreement may contain provisions relating to agreements or transactions that are not qualified financial contracts in terms of Part I section 1 of this Act, provided, however, that, for the purposes of this section, such netting agreement shall be deemed to be a netting agreement only with respect to those contracts that fall within the definition of qualified financial contract in terms of Part I section 1 of this Act.

(ii) For the purposes of this section, a collateral arrangement shall be deemed to be a collateral arrangement notwithstanding the fact that such collateral arrangement may contain provisions relating to agreements or transactions that are not a netting agreement or qualified financial contract entered into thereunder in terms of Part I section 1 of this Act, provided, however, that, for the purposes of this section, such collateral arrangement shall be deemed to be a collateral arrangement only with respect to those contracts that fall within the definition of netting agreement or qualified financial contract entered into under a netting agreement in terms of Part I section 1 of this Act.

(iii) For the purposes of this section, a netting agreement and all qualified financial contracts entered into thereunder shall constitute a single contract.

(iv) For the purposes of this section, the term netting agreement shall include the term multibranch netting agreement (as defined in Part II), provided, however, that in a separate insolvency of a branch or agency of a foreign party (as defined in Part II) in [insert applicable jurisdiction] the enforceability of the provisions of the multibranch netting agreement shall be determined in accordance with Part II of this Act.

PART II: MULTIBRANCH NETTING

1 ADDITIONAL DEFINITIONS

In this Act:

'branch/agency net payment entitlement' means with respect to a multibranch netting agreement the amount, if any, that would have been owed by the non-insolvent party to the foreign party after netting only those qualified financial contracts entered into by the branch or agency and the non-insolvent party under such multibranch netting agreement;

'branch/agency net payment obligation' means with

respect to a multibranch netting agreement the amount, if any, that would have been owed by the foreign party to the non-insolvent party after netting only those qualified financial contracts entered into by the branch or agency and the non-insolvent party under such multibranch netting agreement;

'foreign party' is a party whose home country is a country other than [insert applicable jurisdiction];

'global net payment entitlement' means the amount, if any, owed by the non-insolvent party (or that would be owed if the relevant agreements provided for payments to either party, upon termination thereof under any and all circumstances) to the foreign party as a whole after giving effect to the netting provisions of a multibranch netting agreement with respect to all qualified financial contracts subject to netting under such multibranch netting agreement;

'global net payment obligation' means the amount, if any, owed by the foreign party as a whole to the non-insolvent party after giving effect to the netting provisions of a multibranch netting agreement with respect to all qualified financial contracts subject to netting under such multibranch netting agreement;

'home country' means the country where a party to a netting agreement is organised or incorporated;

'home office' means the home country office of a party to a netting agreement that is a bank;

'multibranch netting agreement' means a netting agreement between two parties under which at least one party enters into qualified financial contracts through – in addition to its home office – one or more of its branches or agencies located in countries other than its home country;

'party' means, for purposes of this Part II, a person constituting one of the parties to a multibranch netting agreement.

2 ENFORCEABILITY OF A MULTIBRANCH NETTING AGREEMENT IN AN INSOLVENCY OF A BRANCH OR AGENCY OF A FOREIGN PARTY

(a) Limitation on the non-insolvent party's right to receive payment.

(i) The liability of an insolvent branch or agency of a foreign party or its liquidator under a multibranch netting agreement shall be calculated as of the date of the termination of such multibranch netting agreement in accordance with its terms and shall be limited to the lesser of (i) the global net payment obligation and (ii) the branch/agency net payment obligation. The liability of the insolvent branch or agency or the liquidator under this section shall be reduced by any amount otherwise paid to or received by the party in respect of the global net payment obligation pursuant to such multibranch netting agreement which if added to the liability of

the liquidator under this section would exceed the global net payment obligation.

- (ii) The liability of the liquidator of an insolvent branch or agency of a foreign party under a multibranch netting agreement to any party thereunder shall be reduced by the fair market value or the amount of any proceeds of collateral that secures and has been applied to satisfy the obligations of the foreign party pursuant to the multibranch netting agreement.
- (b) No limitation on the insolvent party's right to receive payment based on the terms of the multibranch netting agreement. In the event that netting under the applicable multibranch netting agreement results in a branch/agency net payment entitlement, notwithstanding any provision in any such contract that purports to effect a forfeiture of such entitlement, the liquidator may make written demand upon the party to such contract for an amount not to exceed the lesser of (x) the global net payment entitlement and (y) the branch/agency net payment entitlement.
- (c) Limitation on the insolvent party's rights to receive payment based on payments made in accordance with insolvency proceedings relating to the foreign party in other jurisdictions. The liability of the non-insolvent party under this section shall be reduced by any amount otherwise paid to or received by the liquidator or any other

liquidator or receiver of the foreign party in respect of the global net payment entitlement pursuant to such multibranch netting agreement which if added to the liability of the non-insolvent party under this section would exceed the global net payment entitlement. The liability of the non-insolvent party under this section to the liquidator pursuant to such multibranch netting agreement also shall be reduced by the fair market value or the amount of any proceeds of collateral that secures and has been applied to satisfy the obligations of the non-insolvent party pursuant to such multibranch netting agreement to the foreign party.

- (d) Limitation on the terms of the multibranch netting agreement relating to a collateral arrangement. The non-insolvent party to a multibranch netting agreement which has a perfected security interest in collateral, or other valid title, lien or security interest in collateral enforceable against third parties pursuant to such multibranch netting agreement, may retain all such collateral and upon termination of such multibranch netting agreement in accordance with its terms apply such collateral in satisfaction of any claims secured by the collateral, provided that the total amount so applied to such claims shall in no event exceed the global net payment obligation, if any. Any excess collateral shall be returned to the insolvent party.

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