

# Decision of the German Federal Court of Justice on netting arrangements in a financial contract subject to German law

In a decision of 9 June 2016, the German Federal Court of Justice (*Bundesgerichtshof*, "BGH") has ruled that, if parties to a stock option transaction governed by German law entered into a netting arrangement for the event of an insolvency which is contradictory to sec. 104 of the German Insolvency Code (*Insolvenzordnung*, "InsO"), the netting arrangement is void in this respect and the provisions of sec. 104 InsO are directly applicable.

## Implications of the decision

**The decision has prompted immediate responses from supervisory authorities and the German government.**

The BGH has not yet published the reasoning underlying its decision. Accordingly, the scope and consequences of the decision can only be assessed in detail once the full written judgement is available. With its decision, the BGH has repealed the decision of the Higher Regional Court of Frankfurt (*Oberlandesgericht Frankfurt*) of 5 December 2013.

## Preliminary conclusions

### BGH's press release

The BGH has, however, issued a press release in which it has stated that the contractual provisions of the German Master Agreement for Financial Derivatives Transactions (*Rahmenvertrag für Finanztermingeschäfte*, "DRV"), under which the stock option was entered into and which is widely used in the market, are invalid where the method for determination of the close-out amount and the point in time when such close-out amount is determined deviate from sec. 104 InsO.

### Methodology of Section 104 InsO

Sec. 104 InsO provides for a termination of transactions falling within its scope upon the opening of insolvency proceedings and that the parties may agree on a point in time

## Key issues

- Contractual netting arrangements in contradiction to sec 104 InsO are void and in such case sec 104 InsO is directly applicable
- Supervisory authorities and legislator have announced to take action
- Further developments will be reported on once the written reasoning of the judgement is available

for the determination of the close-out amount within a period of up to 5 business days after the opening of the insolvency proceedings (or, if the parties do not agree on a point in time, the determination will be made on the second business day after the opening of the insolvency proceedings). While sec. 104 InsO does not provide for further details the valuation method is based on the difference between the agreed price

and the market or exchange price at such point in time.

By way of further background, while the insolvent party was a party not based in Germany, the BGH applied German insolvency laws on the basis of the conflict of law rule under sec. 340 para 2 InsO, which provides that netting agreements shall be governed by the laws of the country governing the agreement. As sec. 104 InsO is a material insolvency law provision, it will apply in all insolvency proceedings governed by German law, also in cases where a non-German counterparty is subject to such proceedings.

## Response from the government

In response to the decision, the German Federal Ministry of Finance (*Bundesministerium der Finanzen*) and the German Federal Ministry of Justice and Consumer Protection (*Bundesministerium der Justiz und für Verbraucherschutz*) have issued a joint statement on 9 June 2016. Pursuant to this statement, if it is found that the BGH's decision has implications for the general acceptance in the market and by supervisory authorities of the DRV above and beyond the particular case decided by the BGH, the German government will initiate immediate legislative measures which clarify the relevant provisions of German insolvency law to ensure continuous acceptance of such master agreements in the market and by supervisory authorities. This should ensure that Germany will continue to be a jurisdiction where financial transactions can validly be entered into under master agreements.

## BaFin's general decree

In the meantime, the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "BaFin") has reacted quickly and promptly issued a general decree (*Allgemeinverfügung*) based on sec. 4a of the German Securities Trading Act (*Wertpapierhandelsgesetz*). Such provision empowers the BaFin to eliminate or prevent irregularities which may adversely affect the stability of the financial markets or the confidence in their functioning.

### BaFin to ensure stability of the financial markets

In the BaFin's view, the possible invalidity of many contractual netting arrangements as a result of the BGH's decision may be in contradiction to, inter alia, the provisions of the Financial Collateral Directive, the Winding-Up Directive on Credit Institutions, the BRRD and most importantly the provisions on the recognition of contractual netting arrangements for supervisory purposes under the CRR and, accordingly, may possibly cause a loss of confidence in the financial markets and further adversely affect the stability of the financial markets. The BaFin has therefore issued the general decree clarifying that contractual netting arrangements in existing master agreements should continue to be settled as agreed. The general decree is also intended to provide further certainty to non-German counterparties as the terms institutions and counterparties as defined in the general decree include institutions located outside Germany.

### Limits of the general decree

However, the authority of BaFin is limited to prudential supervision and

courts are generally not bound by BaFin's view or its interpretation of German law. In addition, the general decree does not apply in circumstances where a binding court decision has already been issued, where court proceedings are pending or where insolvency proceedings have been opened. The decree will remain in force until 31 December 2016, unless previously repealed (which could, for example, be expected in case of amendments to the relevant insolvency provisions).

## Next steps

The full written judgment is expected shortly and will be analysed by the market, supervisory and legislators in detail.

## Background information

The text of the BGH's press release, the joint statement by the Federal Ministry of Finance and the Federal Ministry of Justice and Consumer Protection, BaFin's press release and BaFin's general decree can be downloaded under the following links:

- The BGH's press release (currently only available in German):

<http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=pm&Datum=2016&Sort=3&nr=74933&pos=0&anz=102>

- Joint statement by German Federal Ministry of Finance and Federal Ministry of Justice:

[http://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Financial\\_markets/Articles/2016-06-09-Federal-Court-of-Justice-issues.html](http://www.bundesfinanzministerium.de/Content/EN/Standardartikel/Topics/Financial_markets/Articles/2016-06-09-Federal-Court-of-Justice-issues.html)

- BaFin's press release:

<http://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Pressemitteilung/>

[2016/pm\\_160609\\_bgh\\_nettingvereinbarungen2\\_en.html?nn=2821494](https://www.bahf.de/SharedDocs/Aufsichtsrecht/DE/Verfuegung/vf_160609_allgvfg_nettingvereinbarungen.html?nn=2821494)

- BaFin's general decree (currently only available in German):

[http://www.bafin.de/SharedDocs/Aufsichtsrecht/DE/Verfuegung/vf\\_160609\\_allgvfg\\_nettingvereinbarungen.html](http://www.bafin.de/SharedDocs/Aufsichtsrecht/DE/Verfuegung/vf_160609_allgvfg_nettingvereinbarungen.html)

## Your contacts:



**Dr. Marc Benzler**  
Partner

T: +49 69 7199-3304  
E: marc.benzler  
@cliffordchance.com



**Dr. Gregor Evenkamp**  
Partner

T: +49 69 7199-3158  
E: gregor.evenkamp  
@cliffordchance.com



**Dr. Christian Hissnauer**  
Associate

T: +49 69 7199-3102  
E: christian.hissnauer  
@cliffordchance.com



**Dr. Arne Klüwer**  
Partner

T: +49 69 7199-3932  
E: arne.kluewer  
@cliffordchance.com



**Dr. Oliver Kronat**  
Partner

T: +49 69 7199-4575  
E: oliver.kronat  
@cliffordchance.com



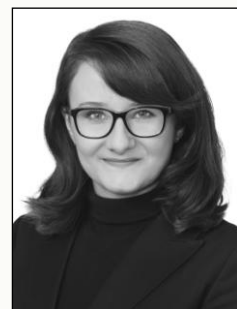
**Sebastian Maerker**  
Partner

T: +49 69 7199-1510  
E: sebastian.maerker  
@cliffordchance.com



**Kerstin Schaepersmann**  
Counsel

T: +49 69 7199-3270  
E: kerstin.schaepersmann  
@cliffordchance.com



**Dr. Helene Uffelmann**  
Associate

T: +49 69 7199-3186  
E: helene.uffelmann  
@cliffordchance.com

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Clifford Chance, Mainzer Landstraße 46, 60325 Frankfurt am Main, Germany

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