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The netting decision of the German Federal Court of Justice – key issues

The decision of the German Federal Court of Justice (*Bundesgerichtshof*, "**BGH**") on the invalidity of netting agreements deviating from section 104 of the German Insolvency Code (*Insolvenzordnung*, "**InsO**") has prompted immediate reactions from the market, the supervisory authorities and the German government, as reported in our newsletter of 10 June 2016 (available here). We are now taking a closer look at the reasoning of the BGH in the context of previous judgements and possible conclusions to be drawn from this decision.

The case

Two German companies (as plaintiffs in the BGH proceedings) had entered into stock option agreements for shares in SAP AG with Lehman Brothers International (Europe) (the defendant), a company organised under the laws of England and Wales, under the German Master Agreement for Financial Derivatives Transactions (*Deutscher Rahmenvertrag für Finanztermingeschäfte,* "**DRV**"). The stock options were secured by a pledge over SAP shares in favour of Lehman.

As administration proceedings over the defendant were instituted in the UK, the defendant demanded, against return of the pledged shares, a compensation claim calculated on the basis of the close-out provisions of the DRV in its favour, as the market value of the SAP shares at the time of the close-out was higher than the agreed option price. The plaintiffs refused payment.

Following an initial ruling in favour of the plaintiffs by the Regional Court (*Landgericht*) in Frankfurt, the Higher Regional Court (*Oberlandesgericht,* "**OLG**") in Frankfurt as competent court of appeal in principle ruled in favour of the defendant, awarding a compensation claim based on the close-out netting provisions of the DRV, which it classified as standard business terms imposed by Lehman.

While the BGH followed the OLG Frankfurt in that it decided that the defendant has a compensation claim for payment of the close-out amount, it held that such claim needs to be calculated on the basis of section 104 paras. 2 and 3 InsO rather than on the contractually agreed close-out netting provisions of the DRV. It has therefore repealed the decision of the OLG Frankfurt and referred the case back to the court for a new decision.

Background

Netting agreements – definition and scope of application

Netting agreements are commonly referred to as agreements under which a number of claims or obligations can be converted into a single net claim, including close-out netting agreements under which the parties' reciprocal obligations are accelerated and terminated for

Key issues

- A contractually agreed early termination of a transaction covered by section 104 InsO based on the filing for the opening of insolvency proceedings is generally valid
- However, the valuation method to determine a close-out amount and the timing of the valuation must not deviate from the method set out in section 104 para. 2 and 3 InsO
- The conflict of law provision in section 340 para. 2 InsO refers to the relevant applicable substantive insolvency law of the jurisdiction governing the netting agreement

purposes of calculating a single net claim, usually under master agreements such as the DRV. For purposes of minimising risk, the master agreements provide that, in the event of a default, all individual outstanding transactions are terminated, the value of such transactions is determined (including, where applicable, the value of any collateral posted to secure the exposure under such transactions), and a net settlement amount is calculated on the basis of the valuation, payable by the party which is 'out-of-the-money'. Such close-out or liquidation netting is a standard method to manage market and counterparty credit risk and is also a mechanism to minimize adverse effects of the insolvency administrator's selection or 'cherry picking' right, as a German insolvency administrator may, based on the volatility, be tempted to speculate for an improvement of the value of the transactions for the insolvency estate. Should the value not improve there is no risk for the insolvency administrator as he may still refuse performance. Therefore, German insolvency law contains a mandatory provision in section 104 InsO pursuant to which certain transactions are terminated automatically upon the opening of insolvency proceedings.

Cherry picking right of the insolvency administrator

Under German insolvency law, an insolvency administrator is generally entitled to a 'cherry picking' right, i.e. to decide whether or not to enforce executory contracts which have not been fully performed by one party (section 103 InsO). Section 119 InsO provides that agreements excluding or limiting the application of sections 103 to 118 InsO in advance are void and therefore protects the Insolvency administrator's 'cherry-picking' right arising in relation to such executory contracts.

Section 104 InsO provides for two major exceptions to this rule:

- One exception relates to outstanding transactions on the sale of tangible goods where the obligations must be fulfilled by a particular date as otherwise their fulfilment becomes useless (fixed date transactions - *Fixgeschäfte*) (section 104 para. 1 InsO).
- The other exception relates to financial transactions within the meaning of section 104 para. 2 InsO (covering a range of derivative instruments).

The 2012 BGH Decision

Based on the purpose of section 119 InsO, the BGH held in its decision of 15 November 2012 that insolvency-related termination provisions are invalid if they *a priori* exclude the insolvency administrator's 'cherry picking' right. According to the BGH, insolvency-related termination clauses are clauses under which a contract may be terminated upon a stoppage of payment (*Zahlungseinstellung*), the filing for insolvency proceedings (*Insolvenzantrag*) or the opening of insolvency proceedings (*Insolvenzeröffnung*). In this respect, section 119 InsO applies from the point in time when, based on a valid application for the opening of insolvency proceedings, such opening of insolvency proceedings is to be seriously expected (*mit der Eröffnung eines Insolvenzverfahrens ernsthaft zu rechnen ist*). The BGH ruled that insolvency-related termination provisions would only be upheld if the contractual termination right corresponds to a statutory termination right.

Conclusions from the 2016 decision

Continuation of previous BGH decision

In our view, the June 2016 decision can be regarded as a continuation of the 2012 decision of the BGH, as the BGH has concluded from section 119 InsO that a netting agreement (*Abrechnungsvereinbarung*) for the event of an insolvency deviating from section 104 InsO is void in this respect and the provisions of section 104 InsO are directly applicable.

Direct application of Section 104 InsO – what does this mean?

The BGH ruled in its decision that a contractually agreed close-out netting agreement is void insofar as:

- the agreed valuation method deviates from the valuation method set out in section 104 paras. 2 and 3 InsO; and
- the point in time for the determination of the relevant values deviates from section 104 para. 3 InsO, which provides for a determination on the second working day after the opening of insolvency proceedings, unless the parties have agreed on another date within the period starting from the opening and ending on the fifth working day after the opening of insolvency proceedings.

In this context, the BGH has explicitly ruled that, irrespective of the fact that section 104 para. 2 sentence 3 InsO expressly refers to master

agreements, contractual provisions in such master agreements may not deviate from section 104 InsO.

Conflicts of law: Section 340 InsO

Reference to substantive insolvency law

Section 340 para. 2 InsO, which contains a special insolvency conflict of laws rule, provides that netting agreements shall be governed by the "laws of the country governing the agreement". Section 340 para. 2 InsO however only applies if the insolvency proceedings are subject to the conflict of law regime under sections 335 *et seqq*. InsO and not to the Council Regulation (EC) No.1346/2000 of 29 May 2000 on insolvency proceedings ("**EUIR**"). The EUIR is not applicable, *inter alia*, to insolvency proceedings concerning insurance companies, credit institutions, investment firms which provide services involving the holding of funds or securities for third parties, and collective investment undertakings (UCITS).

It was previously discussed whether "laws of the country governing the agreement" refers to the substantive insolvency law, the substantive contract law or the terms of the agreement. The BGH has now ruled that section 340 para. 2 InsO refers to the relevant applicable substantive insolvency law.

In the present case, this meant that, despite the insolvent entity being subject to administration proceedings in the UK, the BGH applied German substantive insolvency laws as the DRV is governed by German law.

Implications on Master Agreements

It follows from the above that, as a general rule, all (master) agreements containing contractual close-out netting agreements would potentially be affected by the principles set forth in the BGH's decision. This may be the case (i) where German insolvency law applies to the insolvent party on the basis of such party's centre of main interest being in Germany (other than in case of non-German counterparties to which the EUIR is not applicable as listed above, where not the centre of main interest is decisive, but the relevant home state) (*lex fori concursus*) or (ii) on the basis of German conflict of insolvency law provisions if the parties have chosen German law to govern the agreement.

As a result, section 104 InsO does not apply, for example, in the case of a German credit institution and a UK credit institution entering into a netting agreement governed by English law, such as under an ISDA Master Agreement.

Further core findings

Further core findings can be summarised as follows:

- The BGH has not expressly ruled on this question in its decision, but a contractually agreed early termination of a transaction covered by section 104 InsO based on the filing for the opening of insolvency proceedings is valid, as such early termination right *per se* does not modify the legal consequences under section 104 InsO – section 104 InsO refers directly to the opening of insolvency proceedings.
- When analysing whether the DRV constitutes a netting agreement, the BGH emphasised the possibility of "balancing" or "netting" (*Saldierung*) of payment streams (irrespective of such netting actually occurring) (but did not refer to any other features, including those mentioned under section 104 para. 2 sentence 3 InsO) and hence adopted a wide interpretation of the term netting.
- The limiting of the amount of the solvent party's obligation to pay the benefit (*Vorteil*) to the insolvent party to the insolvent party's damage (*Schaden*) as provided for in the DRV conflicts with section 104 para. 3 InsO and is therefore invalid, as this could undermine the level of protection afforded to the insolvency estate where a close-out amount is calculated in the insolvent party's favour.
- As section 104 para. 3 InsO provides that the amount of any claim for non performance is the difference between the agreed price and such a market or exchange price which is applicable at the place of performance, the valuation is based on an abstract method and thus parties may claim for compensation of the costs for entering into replacement transactions (*Deckungsgeschäfte*). Accordingly:
  - When establishing the difference, the agreed price at the outset relates to the relevant transaction as such and not only to the underlying and the market price at the time of the close-out needs to reflect the value of the transaction on the basis of its then current market value.
  - Whether or not any replacement transactions have actually been entered into is not decisive for the

valuation, as the calculation of the compensation claim for the party who is "in the money" is to be made on an abstract basis at market prices.

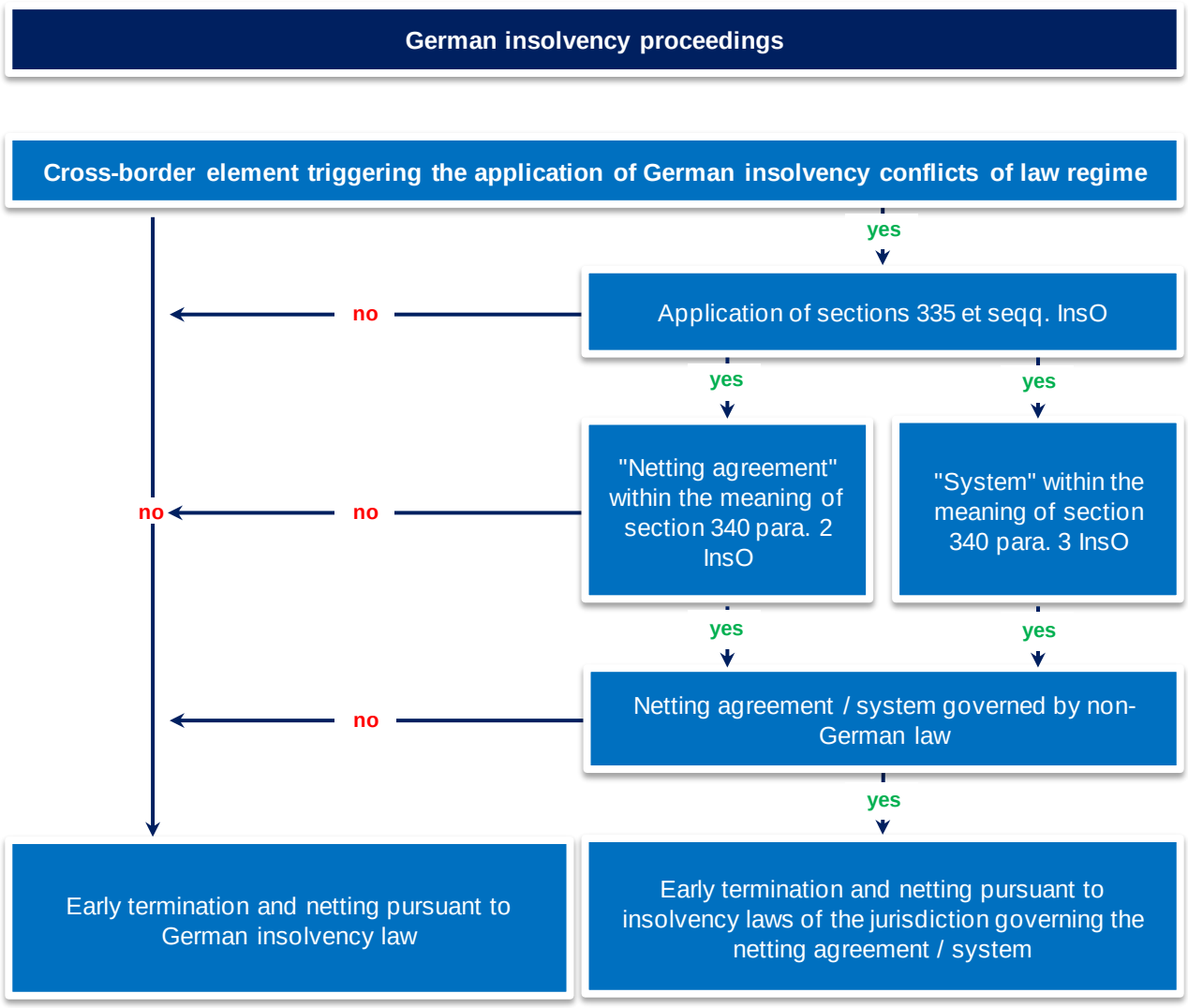
– It does not matter whether the underlying instruments are actually tradeable.

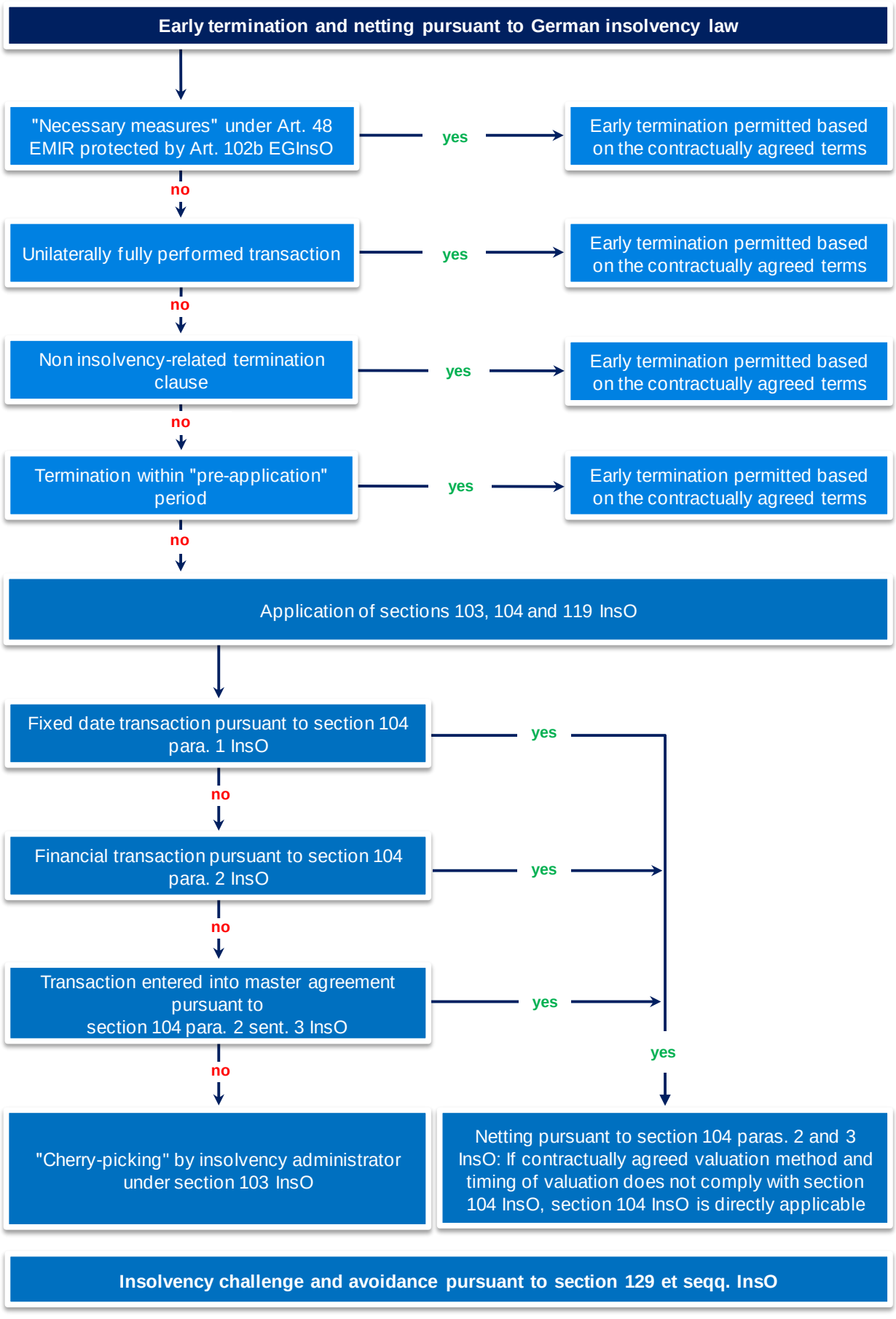
From the above it appears that the close-out amount calculations on the basis of market quotations would be viewed less critical than those on the basis of the losses / costs or gains of the relevant determining party. However, since the BGH has ruled in favour of a strict application of the valuation method provided for in section 104 para. 3 InsO, ultimately also a contractually agreed market quotation based method would not appear to be in strict compliance and therefore might be invalid in situations where section 104 InsO applies.

- To the extent that clause 3 (4) of the DRV provides for interest to be payable on any unpaid close-out amount from the due date thereof, this provision deviates from section 104 paras. 2 and 3 InsO and is therefore invalid.
- In contrast to the OLG Frankfurt, which has expressly concluded that the netting provisions in the DRV constitute standard business terms used by the defendant which have to be construed objectively without regard to the specific case and taking into account the commercial purpose and expressions used, the BGH has not made any statements as regards the validity of the provisions of the DRV under aspects of standard business terms laws.

See next page for an overview of the enforceability of netting agreements under German insolvency law.

ANNEX


German insolvency proceedings
Cross-border element triggering the application of German insolvency conflicts of law regime
yes
no
Application of sections 335 et seqq. InsO
yes
yes
no
no
"Netting agreement" within the meaning of section 340 para. 2 InsO
"System" within the meaning of section 340 para. 3 InsO
yes
yes
no
Netting agreement / system governed by non-German law
yes
Early termination and netting pursuant to German insolvency law
Early termination and netting pursuant to insolvency laws of the jurisdiction governing the netting agreement / system


Early termination and netting pursuant to German insolvency law
"Necessary measures" under Art. 48 EMIR protected by Art. 102b EGInsO
yes
Early termination permitted based on the contractually agreed terms
no
Unilaterally fully performed transaction
yes
Early termination permitted based on the contractually agreed terms
no
Non insolvency-related termination clause
yes
Early termination permitted based on the contractually agreed terms
no
Termination within "pre-application" period
yes
Early termination permitted based on the contractually agreed terms
no
Application of sections 103, 104 and 119 InsO
Fixed date transaction pursuant to section 104 para. 1 InsO
yes
no
Financial transaction pursuant to section 104 para. 2 InsO
yes
no
Transaction entered into master agreement pursuant to section 104 para. 2 sent. 3 InsO
yes
no
yes
"Cherry-picking" by insolvency administrator under section 103 InsO
Netting pursuant to section 104 paras. 2 and 3 InsO: If contractually agreed valuation method and timing of valuation does not comply with section 104 InsO, section 104 InsO is directly applicable
Insolvency challenge and avoidance pursuant to section 129 et seqq. InsO

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