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C H A N C E

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German Bank Restructuring Act Impact on Netting

On 25 August 2010, the German Federal Government (*Bundesregierung*) published a government draft of an Act for the Restructuring and Orderly Liquidation of Credit Institutions, for the Establishment of a Restructuring Fund for Credit Institutions and for the Extension of the Limitation Period of Corporate Law Management Liability (*Restrukturierungsgesetz*, "Bank Restructuring Act"). The main purpose of the Bank Restructuring Act is to introduce a new set of pre-insolvency measures in order to limit systemic risks resulting from financial difficulties of German credit institutions. Some provisions of the Bank Restructuring Act provide restrictions on termination rights which may have negative impacts on netting arrangements.

In particular, the Bank Restructuring Act provides, *inter alia*, for limitations of the rights of counterparties to terminate contractual relationships with a German bank that becomes subject to such pre-insolvency proceedings. This client briefing discusses how these proposed limitations on contractual termination rights would affect the early termination and close-out netting under master agreements for derivatives transactions such as the ISDA Master Agreement or the German Master Agreement for Financial Derivatives Transactions (*Rahmenvertrag für Finanztermingeschäfte*, "***Rahmenvertrag***").

Key Issues

1. The Proposed Measures

The Bank Restructuring Act includes, *inter alia*, a new Bank Reorganisation Act (*Gesetz zur Reorganisation von Kreditinstituten*, "**KredReorgG**") which would essentially introduce three measures, namely:

– a (voluntary) restructuring proceeding (*Sanierungsverfahren*) involving the appointment of a restructuring advisor (*Sanierungsberater*) to implement a restructuring plan in close consultation with the Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "**BaFin**");

– if restructuring proceedings have failed or are without prospect of success, a reorganisation proceeding (*Reorganisationsverfahren*) similar to an insolvency plan proceeding which may also provide for measures that affect the rights of the bank's creditors and/or its shareholders; and

– if BaFin determines (in consultation with the German Central Bank – *Deutsche Bundesbank*) that the ongoing existence of the bank is endangered and this in turn endangers the stability of the financial system, a transfer order (*Übertragungsanordnung*) by which BaFin may force the bank to transfer all or parts of its (systemically important) business to another entity (so-called 'bridge bank').

It is important to note that in principle all German credit institutions could become affected by these measures (not just "systemically important" banks as provided for in two earlier discussion drafts of 2009). However, reorganisation proceedings or a transfer order may only be initiated if BaFin determines (in

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consultation with the *Bundesbank*) that (i) the ongoing existence of the bank is endangered, in particular that the bank's own funds or liquidity have fallen below 90 per cent of the required ratios, or that there is reason to believe that such a situation will occur, and that (ii) this in turn endangers the stability of the financial system. Whether the stability of the financial system is endangered shall be assessed based on

- the type and scope of institutions' liabilities towards other credit institutions or financial sector entities,
- the volume of customer deposits,
- the type, scope and composition of risks assumed in off-balance-sheet business,
- connections to other financial market participants and
- the situation on the financial markets, for example consequences expected for other market participants in case of a failure of the institution and the trust in the financial market stability.

	Restructuring	Reorganisation	Transfer Order
Trigger	Application by bank, positive assessment by BaFin	Notification by bank or application by BaFin if endangerment to bank's existence that could endanger stability of financial system	Order by BaFin due to endangerment to bank's existence that endangers stability of the financial system
Measures	Limited to internal restructuring measures not affecting creditors' rights	Restructuring of the bank's obligation towards creditors, transfer of assets/ business to another entity (bridge banks)	Transfer of assets/business to another entity (bridge bank) and further measures as appropriate
Applicant	Bank	Bank/restructuring advisor, BaFin (in consultation with *Bundesbank*)	BaFin (in consultation with *Bundesbank)*

2. Limitations on Termination

Generally, the initiation of restructuring proceedings or reorganisation proceedings or the transfer of certain assets or business activities to another institution on the basis of a transfer order may trigger contractual termination rights of the counterparties of the relevant bank under the existing contractual documentation, most notably because the creditworthiness of the bank might deteriorate or because the relevant transactions themselves might become subject to the measures. This is especially true for financial transactions such as derivatives, securities lending and repurchase transactions which are usually concluded on the basis of standardised master agreements such as the ISDA Master Agreement, the Global Master Securities Lending Agreement (GMSLA), the Global Master Repurchase Agreement (GMRA) or the German *Rahmenvertrag*, etc.

In this context, the Bank Reorganisation Act provides for certain limitations of the rights of counterparties to terminate contractual relationships with a German bank that becomes subject to reorganisation proceedings or a transfer order, respectively. However, there are no such limitations in regard of restructuring proceedings.

In detail, contractual relationships with a bank becoming subject to reorganisation proceedings are subject to a temporary suspension of termination rights. Contracts may not be terminated starting from the day on which the proceedings are applied for until the next following business day (this refers to the settlement system of the relevant clearing system). The effectiveness of other termination events (such as non-payment, change-of-control or breach-of-representation provisions) occurring during this period shall be postponed until its expiration.

Contractual relationships may not be terminated at all on occasion of a transfer order. The transfer order shall also not result or give rise to an automatic termination. In both cases, contractual clauses that provide for the contrary shall be invalid. However, if the reason for the termination is related to the bridge bank (for example as the lender would otherwise breach a large exposure limit), or if a termination is not simply based on the transfer itself (for example in case of violation of contractual obligations), termination shall be permitted.

In the case of a partial transfer, i.e. where only part of the business of the transferring bank is to be transferred, termination rights are not suspended

- where financial collateral is not transferred together with the assets it relates to,

- where assets that are part of a payment or settlement system are not transferred together with the relevant collateral, or
- where assets that are part of netting agreements within the meaning of section 206 para. 1 of the Solvability Regulation (*Solvabilitätsverordnung*, "**SolvV**") are not transferred in their entirety or without the relevant netting agreement and the relevant master agreement.

According to the official reasoning of the Bank Restructuring Act this ensures efficient proceedings and facilitates a prognosis whether an institution should be restructured or liquidated. In the eyes of the legislator, a (temporary) suspension of termination rights seems to be an effective means to prevent the termination of contracts which are essential for the continuation of the business activities of the institution. In addition, the official reasoning of the Bank Restructuring Act explains that these rules limiting the termination of contracts shall be mandatory law on an international level pursuant to German conflict of law rules.

3. Analysis of Impact on Netting Agreements

Netting agreements are an integral part of international agreements such as the ISDA or the *Rahmenvertrag*. They mitigate risks connected with the unexpected default of one of the parties and are taken into considerations when managing risks related to such contacts.

Therefore, any significant restriction on the enforceability of close-out netting provisions or any legal uncertainty in this respect would, first of all, have serious consequences for the risk management of the relevant counterparties. In addition, any German institution falling into the potential ambit of the proposed measures (in particular a suspension of termination rights) could face serious disadvantages in the financial markets. Counterparties might not be prepared to enter into financial transactions with such institutions or would do so only on significantly less favourable terms because their risk management would need to take into account the potential non-enforceability or postponement of close-out netting.

Close-out netting is recognised and privileged under the Basel II framework, the European Banking Directive 2006/48/EC and their national implementations to reduce counterparty risks since banks as counterparties to netting agreements only need to hold regulatory capital in respect of their net exposure that would result from a close-out netting of all transactions under a master agreement, rather than in respect of the aggregate exposure. If enacted, the proposed exclusion or suspension of termination rights could create serious doubts as to whether close-out netting is still fully enforceable in a crisis scenario.

In summary, in comparison with the discussion draft previously published by the Federal Ministry of Finance (dated 10 July 2010), the new government draft reflects concerns by market participants as regards termination rights. In particular, exemptions from the suspension or exclusion of termination rights in situations where a termination is not simply based on a transfer have been incorporated.

4. Bank Resolution Regimes in the US and the UK

Concerns in particular of institutions acting in international financial markets should be seen in light of existing bank resolution regimes in the US and the UK.

In particular, the now proposed temporary suspension of termination rights in the context of reorganisation measures seems to be based to some extent on the US Federal Deposit Insurance Act ("**FDICA**") as codified in title 12 of the United States Code ("**USC**").

Under the FDICA, a counterparty to a "qualified financial contract" (this term includes master agreements on certain financial instruments) may not exercise any right to terminate, liquidate, or net such contract solely by reason of, or incidental to, the appointment of a receiver for the relevant institution until the next following business day, 12 USC 1821 (e) (10) (B). However, this provision must be read in connection with 12 USC 1821 (e) (9) (A) pursuant to which the receiver may choose to transfer either all or none (but not only some of the) existing "qualified financial contracts" between the defaulting institution and a particular counterparty to another institution.

In this context, a narrow temporary suspension of contractual termination rights seems not unreasonable since the exercise of such termination rights might possibly interfere with the transfer of the relevant transactions to the receiving institution. However, it needs to be noted that the temporary suspension only extends to termination rights which purport to be triggered specifically by the appointment of a receiver for the defaulting institution. In contrast, the right of the counterparty to exercise other contractual termination rights (including termination rights based on non-performance of contractual obligations) remains unaffected by the suspension provision. The government draft now follows this concept of suspended and exempted termination rights.

In the UK, the special resolution regime under the UK Banking Act 2009 provides, *inter alia*, for the option of the UK banking supervisory authorities to transfer all or part of a defaulting bank's business to a private sector purchaser or a bridge bank (i.e. a company wholly owned by the Bank of England) on the basis of a (partial) property transfer order.

Moreover, the UK Banking Act 2009 provides that a property transfer may override termination and change of control clauses ("default event provisions") if so specified in the relevant transfer order. However, the potential negative consequences of these powers on UK banks in respect of netting agreements – including increased cost of capital and higher regulatory capital requirements – had been identified early in the consultation process and were discussed between the UK authorities and market participants. As a result, the UK Treasury enacted specific legislation that protects all kinds of set-off or netting agreements (including bespoke agreements as well as those made under industry standards), with specific "carve-outs" for necessary exceptions.

Pursuant to the relevant Banking Act 2009 (Restriction of Partial Property Transfers) Order 2009 (the "**Safeguards Order**"), a partial property transfer (i) may not provide for the transfer of some, but not all, of the protected rights and liabilities between a counterparty and the institution under a set-off arrangement, netting agreement or financial collateral arrangement, (ii) may not terminate or modify the rights and liabilities which either the counterparty or the institution is entitled to set-off or net under a set-off arrangement, netting agreement or financial collateral arrangement, and (iii) may not restrict the ability to terminate a set-off arrangement, netting agreement or financial collateral arrangement on the basis that a partial property transfer is ordered. This has now at least partially been incorporated in the new government draft.

5. Conflict of Law Issues

The new draft provisions on the limitation of contractual termination would apply to agreements under German law (for example, the intention of the legislator is that they are to be applied with respect to the *Rahmenvertrag*), in particular if they are also subject to the jurisdiction of German courts. However, it is doubtful whether they would also be given effect by non-German courts (for example, in the case of the ISDA Master Agreements by English or New York courts).

The Bank Restructuring Act does not provide for the mandatory jurisdiction of German courts in respect of disputes over the assets of the affected bank. Hence, outside formal insolvency proceedings against the affected bank, disputes regarding close-out netting under a netting agreement following the commencement of reorganisation proceedings or a transfer order would be brought before the courts according to the parties' contractual choice of jurisdiction (for example, in the case of an ISDA Master Agreement, the courts of England or New York). In deciding on whether to give effect to the German law limitations on termination, the competent court would generally look at the conflict of law rules applicable at the place of jurisdiction (i.e. English or New York conflict of law rules).

5.1 Rome I

If English courts have jurisdiction, it seems that there is limited scope for an English court to apply the German law provisions under the EU Rome I Regulation[1] which applies to contracts concluded after 17 December 2009. Even if German law stipulates that the limitation on termination is an overriding mandatory provision (see article 9.1 of Rome I), this would not require an English court to apply such provision in relation to matters heard by it, unless Germany would be the place of performance of the contract. Even then the English courts would have a discretion (article 9.3 of Rome I). Outside the EU, courts might give effect to the German law provisions according to private international law principles of comity, which would need to be analysed for each relevant jurisdiction separately.

5.2 Winding-Up Directive

Another question is whether the EU Winding-Up Directive[2] would require English courts to give effect to the German law provisions. If the German measures are "reorganisation measures" (*Sanierungsmaßnahmen*) within the meaning of the Winding-Up Directive, article 3(2) of the Winding-Up Directive provides that they are:

"fully effective in accordance with the legislation of that Member State throughout the Community without any further formalities, including as against third parties in other Member States, even where the rules of the host Member State

[1] Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations ("**Rome I**").

[2] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions.

applicable to them do not provide for such measures or make their implementation subject to conditions which are not fulfilled."

The Bank Restructuring Act seems to be based on the notion that reorganisation proceedings and transfer orders are in fact "reorganisation measures" (*Sanierungsmaßnahmen*) within the meaning of the Winding-Up Directive since it provides for a duty of BaFin to notify other regulatory authorities within the EEA in respect of such measures (according to article 4 of the Winding-Up Directive and section 46d paras. 1 and 2 of the German Banking Act (*Kreditwesengesetz*, "**KWG**"), respectively). However, the Bank Restructuring Act does not provide that reorganisation proceedings and transfer orders are explicitly mentioned as reorganisation measures within the meaning of section 46d para. 3 of the KWG according to which other (more substantial) effects of reorganisation measures apply.

If reorganisation proceedings and transfer orders are reorganisation measures, they would be subject to the conflict of law rule in article 25 of the Winding-Up Directive which provides that "netting agreements shall be governed solely by the law of the contract which governs such agreements" (see also section 340 para. 2 of the German Insolvency Code). Hence, the proposed limitations on termination rights might not have effect with respect to netting agreements governed by a law other than German law. However, the impact of applicable conflict of law rules need to be checked in each case.

In contrast, netting agreements in regard of which the parties have agreed on the jurisdiction of German courts (for example, the German *Rahmenvertrag*) would be subject to the jurisdiction of German courts. In that case, a German court would have to apply the statutory limitation on termination as an overriding mandatory provision (according to the official reasoning of the Bank Restructuring Act).

5.3 Recognition of Judgments

If the counterparty of the affected bank has obtained a judgment from a non-German court that affirms the validity of close-out netting, such judgment will need to be formally recognised by the German courts in order to initiate enforcement proceedings with respect to assets of the affected bank that are located in Germany.

Generally, judgments against a German party from a court in an EU member state are recognised in accordance with the EU Regulation on the Recognition and Enforcement of Judgments[3] ("**Brussels I**") without examination of the merits of the case. As an exemption from this rule, article 34 of Brussels I provides that a judgment shall not be recognised if such recognition is "manifestly contrary to public policy in the Member State in which recognition is sought". Hence, even if the relevant non-German court would not give effect to the German law limitation on termination and affirm the validity of close-out netting under the relevant agreement, the enforcement of such judgment in regard of assets of the affected bank located in Germany might be problematic on the basis that a German court might not be willing to recognise the foreign judgment.

6. Impact on German Insolvency Proceedings

In principle, assuming that the German measures qualify as "reorganisation measures" (*Sanierungsmaßnahmen*) under the Winding-Up Directive (see item 5.2 above) and that the affected bank is a deposit-taking credit institution or e-money institution, the effects of netting caused by such measures would have to be determined by the German insolvency court on the basis of the law the parties have chosen to govern the agreement, for example English law or New York law in the case of an ISDA Master Agreement (section 46d para. 3 sentence 3 of the KWG in connection with section 340 para. 2 of the German Insolvency Code). In the case of banks other than deposit-taking credit institutions or e-money institutions, the general conflict of law rules under Rome I would apply and provide that rights to set-off and termination are governed by the law the parties have chosen to govern the relevant agreement.

Despite these conflict of law rules a German court would have to apply the statutory limitation on termination as an overriding mandatory provision (according to the official reasoning of the Bank Restructuring Act).

In such a case, counterparties of the affected bank could only argue that the netting agreement, if not already upon the commencement of the reorganisation measures or the transfer order, had been terminated "at the latest" upon the opening of the insolvency proceedings themselves. However, this would require that the effects of the measures (and thus the limitation on termination) can be construed in a way that they are lifted at least one logical second prior to the opening of insolvency proceedings.

[3] Council Regulation (EC) No 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

7. Partial (Re-)Transfer of Assets

A spin-off of assets in the context of reorganisation proceedings or a transfer order might provide that only some (but not all) of the assets of the relevant bank are transferred to a bridge bank. In certain circumstances, transferred assets could also be re-transferred from the bridge bank to the affected bank. In this context, the Bank Restructuring Act provides that transactions collateralised by financial collateral or included in a payment or settlement system or forming part of netting agreements within the meaning of section 206 para. 1 of the SolvV may only be transferred to, or re-transferred from, the bridge bank together with the relevant collateral and with the relevant netting agreement under the relevant master agreement, alternatively (section 48k para. 2 of the KWG and section 48j para. 3 of the KWG).

Moreover, the Bank Restructuring Act provides that contractual relationships which have been transferred on the basis of a transfer order to a bridge bank and the termination of which has been declared or purported by the counterparty by reason of the transfer order can be re-transferred by BaFin to the endangered institution within ten business days after receipt of the relevant declaration (section 48j para. 5 of the KWG). The same applies to a contractual relationship forming part of netting agreements within the meaning of section 206 para. 1 of the SolvV. This possibility of re-transfer has to be considered when deciding whether to terminate any agreement.

8. Timing

According to the new government draft, the proposed date for the entering into force of the new regime is 1 January 2011.