

German Supreme Court Decides on Close-out Netting

June 10, 2016

The German Supreme Court (*Bundesgerichtshof* – BGH) decided on June 9, 2016 that certain aspects of the close-out netting provisions contained in the German Master Agreement for Financial Derivatives Transactions (a widely used German law-governed standard agreement for financial derivatives transactions similar to the ISDA Master Agreement) violate German mandatory insolvency law and are, thus, unenforceable in the insolvency of one of the counterparties.

The full decision is not yet publicly available, but according to the BGH's press release,¹ the court held that the option transactions on which the court decided did not terminate on the date the insolvency filing was made (as provided for in the German Master Agreement), but by operation of German insolvency law on the date the insolvency proceedings were opened. In addition, the court held that the close-out amount was to be calculated in accordance with German insolvency law and that conflicting contractual provisions have to be ignored. In the case at hand, this led to the close-out amount to be calculated two days later than pursuant to the German Master Agreement. Depending on when the insolvency filing is made and when insolvency proceedings are opened, this time difference can be significantly greater. Moreover, the BGH indicated that the methodology for calculating the close-out amount according to German insolvency law deviates from the contractual provisions contained in the German Master Agreement.

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¹ <http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=pm&Datum=2016&Sort=3&nr=74933&pos=0&anz=102>



Also on June 9, 2016, but even before the BGH's press release was published, the German Ministries of Finance and Justice published a joint statement² that they intend to initiate legislative action quickly to ensure the validity of contractual close-out netting provisions in the insolvency of one of the counterparties should that be necessary in light of the BGH's decision. Such legislative action would in particular be aimed at ensuring that the widely used master agreements could continue to be used for bank regulatory purposes.

Finally, the German bank regulator Bafin (*Bundesanstalt für Finanzdienstleistungsaufsicht*) issued on June 9, 2016 a general administrative order (*Allgemeinverfügung*)³ to the effect that contractual close-out netting arrangements within the meaning of the Capital Requirements Regulation (CRR) shall continue to be performed in accordance with their terms (despite the BGH's decision). That way, the BaFin intends to ensure that parties (also) continue to calculate close-out amounts in accordance with the relevant contractual provisions, and not statutory rules set forth in German insolvency law, should one of the counterparties become insolvent. The order is based on a general authorization of the BaFin to take action to prevent or remedy certain risks for the stability of the financial market or the confidence in the functioning of the financial market. It does not apply to already pending proceedings, including insolvency proceedings, that concern claims under master agreements.

The BGH's decisions does not directly apply to master agreements that are not governed by German law (such as the ISDA Master Agreement), but its effects on such master agreements (as well as on German law-governed master agreements) will need to be further analyzed once the reasoning of the BGH's decision becomes available. Also, the impact of the general administrative order needs to be reviewed further.

We will keep you informed as soon as the judgment's reasoning becomes available.

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²http://www.bundesfinanzministerium.de/Content/DE/Standardartikel/The men/Internationales_Finanzmarkt/2016-06-09-gemeinsame-erklarung.html

³http://www.bafin.de/SharedDocs/Aufsichtsrecht/DE/Verfuegung/vf_160609_allgvfg_nettingvereinbarungen.html