

# The German Netting Decision

The Enforceability of  
Contractual Netting in light of  
the Decision of the German  
Federal Supreme Court (BGH)  
dated 9 June 2016

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# Agenda



# General Background

Netting under DRV, ISDA and German statutory law

# General Background

## Contractual Netting under DRV

- German Master Agreement for Financial Derivatives Transactions (*Deutscher Rahmenvertrag für Finanztermingeschäfte - DRV*)
  - Clause 7 (2): Automatic early termination in an insolvency event (defined by reference to the filing of an insolvency petition)
  - Clause 8 (1): Claims for damages by solvent party, determined on the basis of actual or hypothetical replacement transactions, having as result that the solvent party receives all payments and performances it would have been entitled to had the transactions been properly performed
  - Clause 8 (2): Claims for recovery of benefits (*Vorteilsausgleich*) owed by solvent to insolvent counterparty, but not exceeding amount of damages incurred by insolvent counterparty
  - Clause 9: Final payment (=close out netting), taking into account unpaid amounts, unsettled performances and damages, amount calculated in Euro

# General Background

## Contractual Netting under ISDA Master

- International Swaps and Derivatives Association (ISDA) Master Agreement
  - Master Agreement and all confirmations form a single agreement between the parties
  - Section 5 (a) (vii): Insolvency related Events of Default
  - Automatic Early termination (optional)
  - Section 6: Close-out netting
  - Calculation methods:
    - 1) 1992 ISDA Master: Market quotation/ Loss
    - 2) 2002 ISDA Master: Costs/ gains realised under replacement transaction (to be determined in good faith and using commercially reasonable procedures)
  - Determined as of the Early Termination Date

# General Background

## Statutory Netting - Section 104 (2), (3) German Insolvency Code

- In a nutshell:
  - Statutory automatic termination of all outstanding transactions under a Master Agreement as of the date of the opening of insolvency proceedings, provided such transactions meet the following criteria:
    - 1) Contract provides for reciprocal obligations
    - 2) Transactions qualify as ‘financial services’ as defined in Sec. 104 (2)
    - 3) Transactions have a market or exchange price
    - 4) Transactions must be due to be performed at a certain time or within a certain timeframe
    - 5) Transactions must provide for settlement date(s) after the opening of insolvency proceedings
  - Netting of all reciprocal claims in accordance with statutory regime

# The Decision of the German Federal Supreme Court

Ref. No: IX ZR 314/14

Date: 9 June 2016

# Lead sentence of the German Federal Supreme Court

- *“Treffen Parteien von Aktienoptionsgeschäften, die dem deutschen Recht unterliegen, für den Fall der Insolvenz einer Partei eine Abrechnungsvereinbarung, die § 104 InsO widerspricht, ist diese insoweit unwirksam und die Regelung des §104 InsO unmittelbar anwendbar.”*
- “If parties to German law governed stock option transactions agree to a settlement arrangement in an insolvency event which conflicts with Section 104 InsO, such settlement arrangement is insofar invalid and the provision of Section 104 InsO applies directly.”

German law governed contractual netting arrangement

Invalid as far as it conflicts with Sec. 104 InsO

Statutory netting applies instead

# Facts

- Lehman Brothers, London, entered into option transactions based on the German law governed Master Agreement (DRV) with two German corporate counterparties (, **Counterparties** ').
- Transactions provided for put options for Lehman for a fixed price at a fixed strike date. Lehman's insolvency occurred prior to the strike date.
- At the time of the opening of the insolvency proceedings Lehman was ,in-the-money', whereas at strike date Lehman was ,out-of-the-money'.
- Lehman calculated a positive close-out amount based on the standard close-out provisions under the DRV.
- The Counterparties filed for a declaratory judgment stating that Lehman would not have any claims.

# Reasoning of the Federal Court of Justice

## International Jurisdiction of the German Courts

- EU Insolvency Regulation (‘**EIR**’) is not applicable as Lehman is an investment firm within the meaning of Article 1 (2) EIR.
- International jurisdiction is with the German courts based on jurisdiction clause providing for non-exclusive jurisdiction of the courts in Frankfurt/Main, Germany.



# Reasoning of the Federal Court of Justice

## German law as applicable law

- Clause 11 (2) DRV: Governing law = German law
- BGH confirmed validity of choice of law set forth in DRV.
- Sec. 335 InsO: Insolvency proceedings are governed by the laws of the opening State.
- **But:** Sec. 340 (2) InsO: For set-off arrangements (*Aufrechnungsvereinbarungen*) the laws of the State which applies to the agreements shall apply.
- BGH confirmed that Sec. 340 (2) InsO applies to netting agreements.
- BGH confirmed that the choice of law not only covers contract law but also the respective insolvency law.

# Reasoning of the Federal Court of Justice

## German insolvency law on netting (1)

- Sec. 104 (2) (3) InsO: Mandatory termination and statutory netting.
- Sec. 119 InsO: Contractual arrangements excluding or limiting the scope of Sec. 104 InsO are invalid.



# Reasoning of the Federal Court of Justice

## German insolvency law on netting (2)

- Do Clauses 7, 8 and 9 DRV conflict with Sec. 104 InsO?
  - Trigger event under Clause 7 DRV (=insolvency filing) as opposed to opening of insolvency proceedings (Sec. 104 InsO) invalid?
    - ⇒ Question left open by BGH
  - Calculation method under Clauses 8 and 9 DRV invalid?
    - ⇒ Purpose of Sec. 104 (3) InsO is to protect the insolvency estate
    - ⇒ Clause 8 (2) DRV limiting the insolvent counterparty's claims for recovery of the solvent party's benefits (*Vorteilsausgleich*) to the amount of damages incurred by insolvent counterparty lowers the protection level of Sec. 104 (3) InsO

# Reasoning of the Federal Court of Justice

## German insolvency law on netting (3)

- Calculation method under Sec. 104 (3) InsO prevails over DRV
  - Claims for non-performance based on abstract calculation.
  - The counterparty that was ‚in the money‘ at the relevant date shall be compensated for the lost benefit according to market values (*Marktpreis der Optionen*).
  - **Market value:**
    - Value of a Replacement Transaction (*Ersatzeindeckung*) with the same term
    - Relevant: Possibility of entering into replacement transaction
    - Not relevant: Fixed base value
    - Not relevant: Tradeability of the options

# Reasoning of the Federal Court of Justice

## German insolvency law on netting (4)

- Calculation method under Sec. 104 (3) InsO prevails over DRV:
  - Relevant date: 2nd business day following the opening of insolvency proceedings (Sec. 104 (3) sentence 2 InsO).
  - No interest is payable following due date, as Sec. 104 does not provide for such interest claims.
  - Clause 3(4) DRV providing for such interest claims is invalid as it conflicts with Sec. 104 (3) InsO.



## Wider Impact?


	<b>German Insolvent counterparty, EIR applicable</b>	<b>German Insolvent counterparty, EIR not applicable</b>	<b>Non German Insolvent counterparty, EIR applicable</b>	<b>Non German Insolvent counterparty, EIR not applicable</b>
German law governed Master Agreement	Decision applies	Decision applies	Decision does not apply	Decision applies
Foreign law governed Master Agreement	Decision applies	Decision does not apply	Decision does not apply	Decision does not apply

# Further Implications

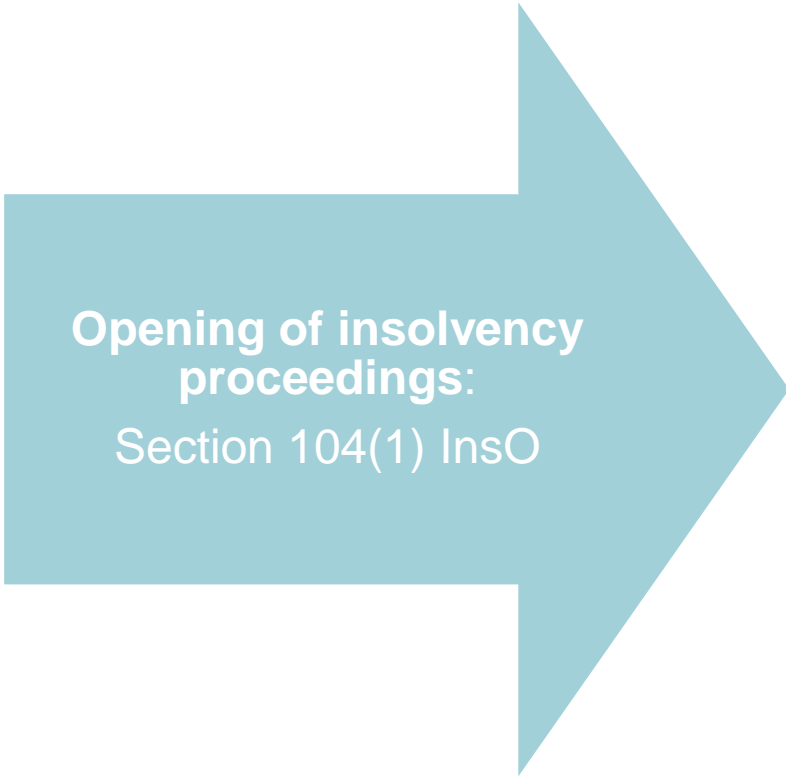
CRR, Reaction of BaFin and  
Political Stakeholders

# CRR Implications

## Contradiction to CRR



**Insolvency filing:**  
Article 178(3)(e)(f) CRR;  
Section 7(2) Master  
Agreement



**Opening of insolvency  
proceedings:**  
Section 104(1) InsO

# General Administrative Act

## Federal Financial Supervisory Authority (BaFin)

- On the basis of section 4a of the German Securities Trading Act (*Wertpapierhandelsgesetz* – WpHG), the following is ordered:
- The contractual netting agreements described in Article 295 CRR, for which it has been agreed that in the event of default by one of the two parties, the institute or its counterparty would be entitled to receive or obliged to pay only the net sum of the positive and negative mark-to-market values of included individual transaction **are to be settled as agreed** by the counterparties, including persons, who as parties with particular duties act for and against a counterparty.



# General Administrative Act

## Federal Financial Supervisory Authority (BaFin)

- Act does not apply to agreements which are subject to on-going court or insolvency proceedings.
- Also not applicable for netting agreements between corporates.



# Ministerial press release

## Federal Ministries of Justice and of Finance

- The Ministries will examine the case closely.
- If the sentence has consequences beyond the individual case in question, the German Federal Government will directly initiate legislative measures in order to ensure that the common master agreements continue to be recognised on the market and by supervisory authorities.
- Germany shall remain – alongside all other EU Members States – a jurisdiction where financial futures transactions can be effectively included in the common master agreements.



# Outlook

- Immediate public announcements by the German Ministry of Finance, Ministry of Justice and the BaFin are strong signs and help to reduce the impact of the ruling.
- Announcements confirm the general political intention that contractual netting will remain possible under German law.
- The ruling by the Federal Court of Justice can be seen as a chance to promote necessary legal and regulatory changes for future cases.



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