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The development of an insolvency privilege for derivatives in German law

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Abstract. The article outlines the development of insolvency privilege with respect to derivatives under German law in its historical perspective. It traces the evolution of special privilege from the moment when it was first announced in the German insolvency statute (*Insolvenzordnung*) and came into force on August 1, 1994, up to the moment when legislative provisions securing the functioning of derivatives in insolvency context were amended in response to the 2016 Federal Court of Justice Verdict. This court ruling ended the long-standing consensus on “friendliness” of the German insolvency law to derivatives and other financial transactions. German highest court concluded that contractual clauses on the termination of obligations under derivative contracts in the event of bankruptcy are invalid unless their legal result is identical to the one prescribed by law. This court decision created significant legal uncertainty for recognition of claims under derivative transactions and directly influenced the use of standard master agreement for over-the-counter derivatives. Drafted under the auspices of the German Banking Union (GBU), an organization representing the interests of German financial institutions, German Master Agreement for Financial Derivatives Transactions (*Deutscher Rahmenvertrag für Finanztermingeschäfte*) provided a contractual framework for the relevant market, and it came under significant pressure. Overall, German insolvency rules were significantly enforced to achieve the enforceability of close-out netting thus expanding the insolvency privilege for derivative transactions.

Key words: close-out netting, financial collateral, insolvency, cherry picking

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Развитие привилегии при несостоятельности в отношении деривативов по немецкому праву

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Аннотация. В исторической перспективе описывается развитие привилегии для деривативов по немецкому праву в условиях банкротства. Прослеживается эволюция привилегии с момента, когда она впервые появилась в немецком законе о несостоятельности (*Insolvenzordnung*) и вступила в силу 1 августа 1994 г., до момента внесения изменений в законодательные положения, обеспечивающие функционирование деривативов в контексте несостоятельности в ответ на решение Верховного суда Германии 2016 года. Это судебное решение положило конец давнему консенсусу в отношении «дружественности» законодательства Германии о несостоятельности по отношению к деривативам и другим финансовым сделкам. Высший суд Германии пришел к выводу о том, что договорные положения о прекращении обязательств по деривативным договорам в случае банкротства недействительны, если их юридический результат не идентичен предусмотренному законом. Это решение суда создало значительную правовую неопределенность в отношении признания требований по сделкам с производными финансовыми инструментами и напрямую повлияло на использование стандартного генерального соглашения для внебиржевых производных финансовых инструментов. Разработанное под эгидой Немецкого банковского союза (*GBU*), организации, представляющей интересы немецких финансовых учреждений, немецкое генеральное соглашение о сделках с производными финансовыми инструментами (*Deutscher Rahmenvertrag für Finanztermingeschäfte*) обеспечило договорную основу для соответствующего рынка и подверглось значительному давлению. В целом, немецкое законодательство о несостоятельности было значительно усилено для обеспечения возможности принудительного исполнения ликвидационного неттинга, что расширило привилегию для сделок с производными инструментами при несостоятельности.

Ключевые слова: привилегия в банкротстве, ликвидационный неттинг, финансовое обеспечение, неплатежеспособность, cherry picking

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Introduction

Financial contracts concluded on exchanges and in the over-the-counter market became widespread in modern economy. Not surprisingly, they attract a lot of attention from practicing lawyers and academics. While the former draft standard documentation and give legal advice to market participants, the latter evaluate regulatory and statutory measures aimed at risk mitigation and protection of weak parties to financial transactions. Notwithstanding this attention, the notions of “financial transaction” and “financial contract” are far from being clear. 2013 Principles on the Operation of Close-out Netting Provisions, an international instrument developed by UNIDROIT and aimed at

harmonization of certain insolvency law provisions, deal with financial contracts directly. Nevertheless, it addresses difficulties to distinguish between financial contracts and commercial contracts in general.

The category of “financial contracts”

Speculatively, financial contracts may be defined as those concluded, altered, and discharged in financial markets. The main function of those markets is the exchange of capital between its participants (Molyneux & Valdez, 2010:3) and transfer of financial positions together with associated risks and returns from person to person (Benjamin, 2007:14). P. Paech mentions derivative and repo transactions as belonging to the category of “financial contracts” although the researcher leaves the list of financial contracts open to other transactions (Paech, 2016:855). Thus, one may consider derivatives or derivative financial instruments as an example of a financial contract. While financial contracts serve as a generic term for derivatives, repos and other contracts existing in financial markets, “derivative” is a generic term for describing futures, options, swaps and similar instruments (Wood, 1995:207)¹. From contract law perspective, derivatives are defined as bilateral (synallagmatic) contracts with a postponed maturity date (Benzler, 1999:29)².

To function smoothly, financial transactions and derivatives require special insolvency treatment. Contractual arrangements documenting these instruments envisage offset of mutual position values and swift access to financial collateral, i.e., cash and securities transferred to secure obligations in question. These contractual provisions may be compromised by insolvency law rules such as prohibition of insolvency set-off, rights of an insolvency administrator to select transactions, various stays and ban on contractual provisions on early termination of contracts on bankruptcy. Lawmakers and regulators leaning towards favorable treatment of derivatives and other financial transactions shape local insolvency laws in a manner giving rise of a special insolvency privilege for those contracts.

Such a privilege is even more striking given that it serves as an exception from the principle of *par condition creditorum* (Paulus, 2015:533), almost universally accepted cornerstone of insolvency law. This article traces the development of insolvency privilege for derivatives under German insolvency law. In Western legal thought the privilege is evaluated through the lens of the fall of Lehman Brothers, a leading investment bank whose bankruptcy became the biggest in history of the United States (Johnson, 2015:120; Paech, 2016:880). Due to Lehman insolvency some notable case law in the field of derivatives

¹ A definition of a “derivative” coined by Global Derivatives Study Group suggests that a derivative is “a bilateral contract or payment exchange whose value derives, as its name implies, from the value of an underlying asset or underlying rate or index” Derivatives: Practices and Principles. Global Derivatives Study Group. 28. Available at: https://group30.org/images/uploads/publications/G30_Derivatives-PracticesandPrinciples.pdf. [Accessed 29th October 2022].

² G. Reiner distinguishes between derivative and derivative-like transactions depending on the manner of their performance (Reiner, 2002:29). Also, the researcher provides a list of characteristic features pertaining to derivative transactions including (i) giving rise to mutual contractual obligations, (ii) producing stochastically determined cash flows, (iii) cash settlement, (iv) ability to be reproduced at any moment of time, and (v) giving rise to certain risks (Reiner, 2002:29).

emerged³. On top of it, the fall of this global financial powerhouse resulted in a law reform of an insolvency privilege for financial transactions in Germany in the aftermath of the Federal Court of Justice Verdict dated 9 June 2016 (the “FCJ Decision”)⁴.

The initial development of the privilege

Konkursordnung of 1877 (KO)⁵, the first insolvency statute of the German Empire, did not bestow any privileges on parties to financial transactions *per se*. The only article applying to financial transactions was §16 as it addressed the delivery of goods having a market or exchange price in case those obligations matured once the insolvency proceedings were introduced. After the opening of insolvency proceedings performance of those obligations was not permitted. Rather, the supplier was entitled to a claim representing the difference between the market and exchange price and the price of the goods embedded in the relevant contract. Meanwhile, KO contained §17 which applied solely to lease and rental arrangements and allowed the insolvency administrator (*Konkursverwalter*) to terminate those agreements before their maturity. According to §103 of the *Insolvenzordnung* (InsO)⁶, an insolvency statute that was adopted in 1994 and fully replaced KO in 1999, the right of the insolvency administrator to reject or keep contractual obligations (*Konkursverwalterwahlrecht*) became broader to encompass other types of transactions.

In turn, the said right may have resulted in a practice known as “cherry picking” (*Rosinenpicken*) (Reiner, 2002:184) whereby transactions unprofitable for the insolvency estate are rejected while those bringing additional funds and assets to the insolvent debtor stay in force. In international and local contractual practice, derivative transactions rarely exist in a standalone form. Rather, multiple trades are negotiated between the same counterparties based on a master agreement (*Rahmenvertrag*) with a view to ease the conclusion of single transactions and manage credit risks (Reiner, 2002:183). Such master agreements are widespread in the derivatives markets (Benzler, 1999:37) and envisage a single contractual arrangement notwithstanding the existence of a whole portfolio of a variety of derivative transactions; however, cherry picking by the insolvency administrator may undermine those principles. Underlying assets for derivative transactions include shares, bonds and share indices (Köbler, 2016:96). Increased volatility of those assets incentivizes an insolvency administrator to cherry pick certain transactions.

To illustrate the danger of cherry picking one may refer to the ISDA master agreement drafted by International Swaps and Derivatives Association, Inc. (ISDA). The agreement contains a so-called single agreement clause uniting separate derivative trades into one contractual arrangement. To provide an example, it is necessary to quote section 1(c) of the 2002 ISDA Master Agreement, the latest framework agreement prepared by the International Swaps and Derivatives Association: “*All Transactions are entered into in*

³ See, e.g., *Lehman Brothers International (Europe) (In Administration)*, Re 2016. EWHC 2417 (Ch); 2017, 2 All E.R. (Comm) 275; 2017, Bus. L.R. 1475; Official Transcript.

⁴ Urteil des Bundesgerichtshofs vom 9. Juni 2016 (IX ZR 314/14). Available at: <http://juris.bundesgerichtshof.de/cgi-bin/rechtsprechung/document.py?Gericht=bgh&Art=en&nr=74978&pos=0&anz=1>. [Accessed 29th October 2022].

⁵ Deutsches Reichsgesetzblatt Band 1877, Nr. 10 Seite 351-389.

⁶ Insolvenzordnung vom 5. Oktober 1994 (BGBl. I S. 2866).

reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties (collectively referred to as this “Agreement”), and the parties would not otherwise enter into any Transactions”⁷. According to the clarification produced by ISDA itself, this clause has a crucial character, and each confirmation (e.g., legal document containing the terms of single trades) does not represent a separate agreement between the parties⁸.

Another example of the same approach is the German Master Agreement for Financial Derivatives Transactions (*Deutscher Rahmenvertrag für Finanztermingeschäfte*) (the “DRV”)⁹, a framework contract under German law that is going to be considered in detail in this research. Under section (2) of the of DRV 1993/2001 “*The terms and conditions set out below shall apply to each transaction that is entered into pursuant to this Master Agreement (hereinafter called a “Transaction”). All Transactions among themselves and together with this Master Agreement shall constitute a single agreement (hereinafter called the “Agreement”); they shall be entered into in accordance with and in reliance on this principle, to achieve an aggregated risk assessment*”. Therefore, the drafters of DRV proposed to treat single financial operations (“*Einzelabschlüssen*”) as a single agreement (*einheitlichen Vertrag*) citing risk concerns as an incentive.

Thus, an insolvency administrator may reject the whole portfolio of transactions concluded under the same master agreement or abstain from exercising relevant selection rights. According to G. Reiner, the “cherry picking” danger is overestimated as the rationally acting insolvency administrator would not cancel unprofitable transactions as market volatility may result in them becoming beneficial for the insolvency estate in the future (Reiner, 2002:198)¹⁰. By the same token, due to moves in asset prices, currency and exchange rates as well as interest rates unprofitable transactions may prove to bring profits to the troubled debtor allowing the insolvency supervisor appointed by the court to perform its functions more efficiently.

Stephen J. Lubben, professor at Seton Hall Law School, provides other arguments to the sceptic view of cherry-picking rights stating that the reasons why it is considered “bad” are of a rather vague nature (Lubben, 2009:61)¹¹. Meanwhile, other researchers of derivatives and financial transactions, such as Joanna Benjamin, Emeritus Professor of Law at London School of Economics (Benjamin, 2007:269) and Bob Wessels, professor

⁷ International Swaps and Derivatives Association, Inc. (ISDA). Available at: <https://www.isda.org/book/2002-isd-master-agreement-mylibrary/> [Accessed 29th October 2022].

⁸ User’s Guide to the ISDA 2002 Master Agreement, 2003 edition. Available at: <https://www.rbccm.com/assets/rbccm/docs/legal/doddfrank/Documents/ISDALibrary/Users%20Guide%20to%20the%202002%20ISDA%20Master%20Agreement.pdf> [Accessed 29th October 2022].

⁹ Deutscher Rahmenvertrag für Finanztermingeschäfte. Available at: https://bankenverband.de/media/contracts/RV-FTG-44015_1201_Muster.pdf [Accessed 29th October 2022].

¹⁰ Also, the author notes that the position in a derivative contract may be extended in the market (“*die Position jederzeit am Markt zu prolongieren*”) (Reiner, 2002:198). The ability to be reproduced in the market of underlying assets (*jederzeitige Reproduzierbarkeit*) is one of the fundamental features of derivatives alongside including giving rise to mutual contractual obligations and producing certain risk. However, the key question is the possibility of reproducing the contract with the same financial result, and such reproduction may seem problematic (Reiner, 2002: 21).

¹¹ These concerns seem even more sound given that cherry picking rights are not confined to German law or the law of other civil law jurisdiction. For instance, the right of insolvency trustee to “get rid” of executory contracts is a feature of U.S. Insolvency Law. See, e.g., 11 U.S. Code § 365 — Executory contracts and unexpired leases. Available at: <https://www.rbccm.com/assets/rbccm/docs/legal/doddfrank/Documents/ISDALibrary/Users%20Guide%20to%20the%202002%20ISDA%20Master%20Agreement.pdf> [Accessed 29th October 2022].

emeritus of international insolvency law at Leiden University (Wessels, 1997:187), take cherry picking seriously. The same view is shared by the drafters of the UNIDROIT Netting Principles as this harmonization instrument contains several clauses addressing the consequences of cherry picking. In a commentary to principle 7(1)(b), the authors of the document clarify that the “bundle of transactions would be disassembled and the solvent party would be required to perform its obligations under all the transactions that were unfavorable from its perspective, whereas the insolvency administrator would not perform the obligations under the favorable transactions”.

The approach of the German legislator was incapable of citing as it decided to introduce a special insolvency privilege into InsO, and such privilege was embedded into §104. Notably, that paragraph came into force on August 1, 1994 five years before InsO fully replaced KO (Wood, 1995:176). The said article clause (1) of §104 resembled §16 KO to the extent that the claims contracts for delivery of goods with a market or exchange value and a fixed performance date were replaced by a monetary claim for non-performance. However, under clause (2) of §104 the transactions on financial services combined in a framework contract shall be regarded as a mutual contract in the meaning of §103 and §104. Thus, in case of insolvency grounds the calculation of non-performance claim and the selection of transactions by the insolvency administrator required honoring the single agreement principle in the first place. The said rule encompassed, *inter alia*, precious metals and securities transactions, options and financial transactions affected by exchange rates¹².

The new rule of §104 directly regulated the validity of close-out netting (*Liquidationsnetting*) (Böhm, 2001:172), a contractual practice allowing the parties to financial transactions to terminate their relationship and offset the transaction values subject to the occurrence of insolvency or other event of default evidencing the deterioration of financial status with respect to a counterparty (Rauch, 2017:252). In the German doctrinal sources, the practice may be reduced to two essential stages, such as the termination of financial contracts (*Beendigung*) and the offset (*Verrechnung, Saldierung*) of relevant claims (Casper, 1996:34, Fuchs, 2013:46). The provisions on close-out netting are closely related to insolvency (Casper, 2005:252) and are typically present in master agreements for financial transactions (Wessels, 1997:188, Johnson, 2015:112), however they may also be found in exchange trading rules adopted in organized markets¹³.

Although §104 introduced an insolvency privilege for certain types of financial transactions and secured close-out netting, it did not take into consideration the transfers of financial collateral in the form of cash and securities which is a common feature of contemporary financial markets. Relevant contractual arrangements are commonly used by ISDA¹⁴ and other associations uniting the participants of over-the-counter financial

¹² The non-performance claim should have been calculated based on prices and rates as may have been mutually agreed by the parties themselves, however, on the fifth business day of the insolvency commencement date. In case such agreement between the parties is not in place, the calculation of the non-performance claim should have been carried out using the second business day quotes.

¹³ Levels of Protection associated with the different levels of Segregation. Available at: <https://www.euronext.com/en/media/4538/download>. [Accessed 29th October 2022].

¹⁴ See, e.g., 1995 ISDA Credit Support Annex (Transfer — English Law). Available at: <https://www.isda.org/book/1995-isda-credit-support-annex-english-law/> (date of access — 29.10.2022)

markets¹⁵. As far as German law contractual instruments are concerned, one may refer to an annex to DRV facilitating collateral transfers among German banks between themselves and their clients¹⁶.

Driven by the necessity to broaden the insolvency privilege to include financial collateral arrangements amidst the growth of local financial markets in the 90s (Yeoward & Parsons, 2016:5), the authorities of the European Union adopted Directive No 2002/47/EC (the “Collateral Directive”)¹⁷. The issue required consideration on the EU level as legislation earlier introduced by separate countries varied greatly leading to the legal uncertainties (Chun, 2012:138). Collateral Directive implementation process took several years and ended in 2005 (Lober & Klima, 2006:203) thus setting up a minimal regime of regulating all types of obligations related to currency and securities trading where collateral is involved (Rusen, 2007:250). Being faced with the necessity to implement the Collateral Directive into its domestic legislation, German authorities adopted an amendment to §104 InsO¹⁸.

In essence, §104 InsO enhanced with provisions relating to collateral transfers, was considered an efficient safe harbour and a privilege for derivatives and other financial contracts in insolvency context under German insolvency laws. According to Paech, three methods of insolvency privilege exist in insolvency laws: a carve-out, a reference to the agreement of the parties and, in the case of Germany, the assimilation of netting with set-off in insolvency context (Paech, 2014:431). Ph. Wood came to conclusion that German insolvency law allowed close netting under §104 InsO before the new German insolvency statute came into full force and effect (Wood, 1995:200).

Deutsche DRV

As the insolvency privilege constitutes a reaction to contractual arrangements already exiting in commercial practice, it requires careful consideration of DRV, and standard framework contract in German financial market drafted under the auspices of German Banking Union (GBU). In general, European banking associations are very active in the field of standard documentation development in the interests of their members. For instance, the French Banking Federation authored FBF Master Agreement Relating to Transactions on Forward Financial Instruments (*Convention-Cadre relative aux Opérations de Marché à Terme*)¹⁹. Swiss Framework Agreement for Over-the-counter

¹⁵ FXC 1999 Collateral Annex. Available at: <https://www.newyorkfed.org/fmlg/documentation/collateral.html> [Accessed 29th October 2022]; EMA Margin Maintenance Annex (Title Transfer). Available at: https://www.ebf.eu/wp-content/uploads/2020/06/EMA-Margin-Maintenance-Annex_-2020.pdf. [Accessed 29th October 2022].

¹⁶ Besicherungsanhang. Available at: https://bankenverband.de/media/uploads/2017/09/13/besicherungsanhang-44020_1001_muster.pdf. [Accessed 29th October 2022].

¹⁷ Directive No 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements. Available at: <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32002L0047>. [Accessed 29th October 2022].

¹⁸ Insolvenzordnung vom 5. Oktober 1994 (BGBl. I S. 2866), Par. 104. Abs. 3. Stand vom 9 April 2004. Available at: <https://www.jurion.de/document/show/1:140031,109,20040409/?from=1%3A7586658%2C0>. [Accessed 29th October 2022].

¹⁹ A new master agreement for the french derivatives market. Available at: <http://www.jonesday.com/a-new-master-agreement-for-the-french-derivatives-market-07-11-2013/>. [Accessed 29th October 2022].

Derivatives (*Schweizer Rahmenvertrag für OTC-Derivate*)²⁰ and Framework Contract for Financial Operations (*Contrato Marco de Operaciones Financieras*)²¹ play the same role on local markets of Spain and Switzerland.

In general, the phenomenon of industry master agreements is a characteristic feature of modern financial markets. The success and universal use of framework contracts prepared, maintained and updated by professional associations uniting the participants of modern financial markets is determined by a number of factors such as cost saving and cost efficiency, risk mitigation, predictability, availability of case law and support in litigation. Established in Koln in 1951, GBU considers itself a successor of Central Association of the German Banking and Financing Industry ("*Centralverbandes des deutschen Bank- und Bankiergewerbes*"), a union having the same function in the pre-war era²². According to the charter of GBU²³, it claims to achieve its aims, inter alia, through interacting with authorities, informing the public about German financial industry, and cooperation with other banking associations.

Even though the by-laws of the association do not mention the development of legal documentation for commercial transactions of its members as an objective of the organization, GBU achieved an undisputable success in that area through the implementation of DRV into daily activities conducted in domestic financial market. Notably, the activities of GBU in this field are not limited to derivatives only — the association published, inter alia, German Agreement for Securities Lending (*Deutscher Rahmenvertrag für Wertpapierdarlehen*), and German Master Agreement for Repurchase Transactions (*Deutscher Rahmenvertrag für Wertpapierpensionsgeschäfte (Repos)*). Thus, it is fair to say that GBU performs the functions of ISDA, International Capital Markets Association²⁴ and International Securities Lending Association²⁵ in the German market considering the peculiarities of German contract and insolvency law and practice.

As for derivatives, the German counterparties initially used a Master Agreement for Swap Transactions published in 1990 (Benzler, 1999: 46), however as it was limited in scope, GBU published the first version of DRV in 1993 and subsequently amended it in 2001²⁶. The latest amendment was promulgated in 2018, i.e., after the publication of FCJ Decision, therefore we shall begin with the 1993 version to shed light on the decision and

²⁰ Schweizer Rahmenvertrag OTC-Derivate. SwissBanking. Available at: https://ub.unibas.ch/digi/a125/sachdok/2014/BAU_1_6283478_3.pdf. [Accessed 29th October 2022].

²¹ Contrato marco de operaciones financieras — 2020. Available at: https://www.ceca.es/eng/wp-content/uploads/2021/06/01_Contrato_Marco_2020.docx [Accessed 29th October 2022].

²² Available at: <https://bankenverband.de/service/rahmenvertraege-fuer-finanzgeschaefte/rahmenvertrag-fur-finanztermingeschaefte/>. [Accessed 29th October 2022].

²³The association is responsible for publication of Global Master Repurchase Agreement, an international standard for repo transactions. Available at: https://bankenverband.de/media/publikationen/200811_BDB_Satzung_web_ES.pdf. [Accessed 29th October 2022].

²⁴ The association is responsible for publication of Global Master Repurchase Agreement, an international standard for repo transactions. Available at: https://bankenverband.de/media/publikationen/200811_BDB_Satzung_web_ES.pdf. [Accessed 29th October 2022].

²⁵ The association published a contractual framework instrument for securities lending agreement. Available at: <https://www.islaemea.org/legal-services/>. [Accessed 29th October 2022].

²⁶ [Electronic Resource]. Available at: https://bankenverband.de/media/contracts/RV-FTG-44015_1201_Muster.pdf [Accessed 29th October 2022]. English version of the DRV is also available through GBU website. Available at: https://bankenverband.de/media/uploads/2019/05/15/drv-rv-2001-eng_muster-korr-15-04-2019.pdf [Accessed 29th October 2022].

motivation of the court. As in the case of other master agreements, documenting over-the-counter financial transactions under the DRV leads to reduction of the so-called transaction costs due to the presence of standard provisions universally accepted by the market participants (Fuchs, 2013:42, Böhm, 2001:60).

Many contractual provisions of “standard” or “industry” master netting agreements produced by these trade associations seem to overlap and are “taken for granted” as one could most surely come across them in a contractual template of any financial market association no matter what the applicable law and jurisdiction is. For instance, such provisions may include single agreement clause, representations and warranties, undertakings of the parties, liability and default interest provisions, events of default, the means of transactions execution, collateral clauses, and several others. Not surprisingly, at least in the derivatives domain, the authors of local standard documentation would follow ISDA Master Agreement as an example²⁷.

As shall be proved below, DRV serves a valuable example of an industry master agreement not influenced by English law approaches generally and particularly ISDA documentation. Comprised of 13 sections, DRV 1993/2001 provides a legal framework to an arrangement between a “Counterparty” and a “Bank” emphasizing the purpose to serve the interests of German banks and their clients. 1992²⁸ and 2002²⁹ ISDA Master Agreements refer to the parties as “Party A” and “Party B” thus not limiting its application to relations arising in the banking industry. Comparing DRV to the ISDA Master Agreement, it is worth noting that ISDA is lengthier in terms of volume. Moreover, the differences between the agreements produced by those associations become essential when it comes to the incentives for entering transactions.

Section 1 “Purpose and Scope of the Agreement” DRV 1993/2001 mentions the management of risks arising due to price risks within their commercial activities as a motivation to enter financial transactions. Therefore, DRV 1993/2001 have hedging as a purpose, and this representation also does not align with the approach adopted in ISDA Master Agreements that do not have limitations on the reasons for conclusion of transactions. For instance, 2002 ISDA Master Agreements does not mention the exact purpose of the agreement stating that the parties “have entered and/or anticipate entering into one or more transactions”³⁰. This difference becomes even more important considering the general purposes of dealers in derivatives. Alongside hedging risks associated with

²⁷ The most recent version of Spanish master agreement *Contrato Marco de Operaciones Financieras* (CMOF) published in 2020 largely follows the structure of ISDA documentation *García-Fuertes G. Equity Derivatives in Spain*. Available at: <https://www.lexology.com/library/detail.aspx?g=9341cccf-9c86-41af-9728-02683be444fe> [Accessed 29th October 2022]. FBF Master Agreement Relating to Transactions on Forward Financial Instruments. [Accessed 29th October 2022]. Annexes to Swiss directly use the language of ISDA documentation and contains the references to them. Available at: https://ub.unibas.ch/digi/a125/sachdok/2014/BAU_1_6283478_3.pdf. [Accessed 29th October 2022]. Russian derivatives master agreement proposed by several industry bodies is also based on ISDA Master Agreement. Available at: [https://content.next.westlaw.com/5-375-8191?_lrTS=20200904190947322&transitionType=Default&contextData=\(sc.Default\)&firstPage=true](https://content.next.westlaw.com/5-375-8191?_lrTS=20200904190947322&transitionType=Default&contextData=(sc.Default)&firstPage=true). [Accessed 29th October 2022].

²⁸ ISDA Master Agreement. Available at: <https://www.isda.org/book/1992-iswa-master-agreement-multi-currency/>. [Accessed 29th October 2022].

²⁹ Preamble to the 2002 ISDA Master Agreement. Available at: <https://www.isda.org/book/2002-iswa-master-agreement-mylibrary/>. [Accessed 29th October 2022].

³⁰ Preamble to the 2002 ISDA Master Agreement. Available at: <https://www.isda.org/book/2002-iswa-master-agreement-mylibrary/> [Accessed 29th October 2022].

underlying assets, derivatives are used for purely speculative purposes. Legal entities and individuals may take risks to benefit from the moves of underlying assets (speculation or “trading”) and the difference between prices on the same asset in various markets (Reiner, 2002:5).

The objects of financial derivatives transactions under DRV 1993/2001 include (i) the exchange of monetary amounts in various currencies or those calculated by reference to various underlying assets³¹ or (ii) “the delivery or transfer of securities, other financial instruments or precious metals, or the performance of similar obligations”. As a third category of derivatives under DRV, the drafters mention “options, interest rate protection and similar transactions” requiring making “performance on advance” or under a “condition”. Sub-section 1(2) of DRV 1993/2001 contains the single agreement clause which is typical for master agreements in general, including those under English or US law. Section 2 sets out the way transactions under the master agreement are concluded — the parties agree on the terms of the trade, and a party to the trade shall deliver a confirmation of the transaction by electronic means. Although each party may request a signed confirmation of the transaction, absence of such confirmation does not influence its legal validity.

Section 4 of DRV 1993/2001 gives a definition of a banking day, while section 5 sets out an obligation of a bank entering a transaction providing for calculations of interest rates, exchange rates, prices and other variables to notify its non-professional counterparty of the amounts determined under those transactions, as well as fall-back and rounding provisions. Section 6 is devoted to calculation methods under interest rate transactions and contains the definitions of day count fractions and calculation periods. As set in section 10 of DRV 1993/2001, transfer of rights or obligations under the master agreement is subject to consent of the counterparty, and such a consent may be given either by telex, telegraph, facsimile or by other similar means. Miscellaneous provisions of section 11 include severability clause³², governing law³³ and jurisdiction³⁴, as well as application of the new version of the master agreement to previously concluded transactions that are listed in section 11 of the DRV 1993/2001.

Section 12 “Special Provisions” contains clauses applicable to the relations of the parties on the condition that they are explicitly selected in the agreement. Among other things, these provisions contain cross-border provisions related to international transaction such as taxation and the appointment of a process agent. Although international derivatives trading in the over-the-counter market predominantly takes place based on ISDA Master

³¹ Section 1(a) of DRV 1993/2001 provides a non-exclusive list of such assets “Floating or fixed interest rates, exchange rates, prices or any other calculation basis, including average values (indices) relating thereto”.

³² According to section 11(1), the “invalidity of separate DRV provisions does not render the other provisions invalid”. If any provision of the Agreement is void or unenforceable, the remaining provisions shall remain unimpaired. Such deficient provision shall be substituted by a provision which reflects appropriately the parties’ intent”.

³³ According to section 11(2) DRV 1993/2001 is governed by German law. Private international law of the European Union whose contract law is unified based on Rome I Regulation allows the parties of cross-border contracts to choose any applicable law to their contractual arrangements. 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). Available at URL: <http://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A32008R0593> [Accessed 29th October 2022].

³⁴ The disputes between the parties DRV 1993/2001 are resolved by the court located in the place of residence of the Bank according to section 11(3) of DRV 1993/2001.

Agreement, DRV may also be used for this purpose and the FCJ Decision gives evidence to such contractual arrangement. Section 11(3) sets out the jurisdiction for settling the disputes arising out of or in connection with the agreement. To protect the interests of professional parties to the DRV, the place of dispute resolution is the court at the location of banking counterparty to the German master agreement.

DRV early termination provisions and FCJ Decision

M. Böhm, German researcher of derivatives and netting, mentioned back in 2001 that globalization in international financial markets was expected to grow in the coming years (Böhm, 2001: 19). First and foremost, such globalization resulted in cross-border financial transactions involving counterparties from different jurisdictions. As the FCJ Decision is related to DRV 1993/2001 close-out netting provisions, it makes sense to scrutinize them in a more detailed manner. In general, netting is a very complex instrument as its definition is hard to articulate (Paulus, 2015:542). Much debate has been made over netting with little result (Benjamin, 2007:265).

Although not defining close-out netting itself, principle 2 of UNIDROIT Netting Principles suggests the definition of “close-out netting provision”³⁵. Close-out netting provision is typically present in a master agreement (Böger, 2013: 237), and DRV is a good example of such framework contract. Generally, they contain a governing law clause which is applicable, *inter alia*, to close-out netting procedure (Böger, 2013:237). Generally, international and domestic markets use several types of netting (Benjamin, 2010:800). Close-out netting is limited to a crisis scenario when a party to financial transaction is either insolvent or experiencing significant financial hardship. Two remaining types of netting, payment netting and netting by novation, are invoked in the course of the regular interaction between the parties.

Section 3 (payments and performance of other Obligations) is a crucial element of the DRV since it establishes the two ways for the discharge of obligations under that master agreement. Obviously, the first one is the payment to the account specified by the receiving party on a due date (section 3(2)). The second one (section 3(3)) requires some additional attention since it contains payment netting provisions mechanism which is different from close-out netting. Under DRV whenever both parties are required to make payments in the same currency on the same date, the party owing the lesser amount is entitled to receive the difference between the payments while the obligation of second party to deliver is extinguished completely. This contractual concept is known as payment netting³⁶.

DRV 1993/2001 outlines close-out netting provisions in several sections including sections 7, 8 and 9. In accordance with section 7(1) of the German master agreement, in case of outstanding transactions are present the DRV shall be terminated whenever there is

³⁵ ‘Close-out netting provision’ means a contractual provision on the basis of which, upon the occurrence of an event predefined in the provision in relation to a party to the contract, the obligations owed by the parties to each other that are covered by the provision, whether or not they are at that time due and payable, are automatically or at the choice of one of the parties reduced to or replaced by a single net obligation, whether by way of novation, termination or otherwise, representing the aggregate value of the combined obligations, which is thereupon due and payable by one party to the other.

³⁶ DRV does not encompass the concept of netting by novation, however it is used in the master agreements produced by the Foreign Exchange Committee. See, e.g., Available at: URL: <https://www.newyorkfed.org/medialibrary/microsites/fmlg/files/icom.pdf> [Accessed 29th October 2022].

a breach of payment obligations or other material reason for termination. The termination is possible once 5 business days after the delivery of the notice on violation of obligations pass. Such notice may be sent via telex, telegraph, fax or in any other form³⁷. This makes a huge difference to other standard master agreements, especially those governed by English law. For example, 2002 ISDA Master Agreement contains a list of events of default and termination events while the drafters of DRV preferred to use general wording without specifying event (other than non-payment or non-delivery) leading to early termination of transactions concluded under the framework agreement.

However, in the case of bankruptcy (*Insolvenzfall*) the way close-out netting is conducted changes as the transactions under DRV 1993/2001 are deemed to be terminated when the relevant insolvency event occurs. In other words, bankruptcy of a counterparty to DRV 1993/2001 leads to automatic termination of transactions, and the delivery of a termination notice is not required. The possibility of terminating transactions in the automatic manner is a universally recognized feature of close-out netting, as it allows the non-defaulting party to avoid insolvency law rules forbidding closing out transactions after the commencement of insolvency proceedings (Böger, 2013:235).

Notably, insolvency event under the DRV 1993/2001 is rather broad — the relevant term includes the filing of an insolvency application, the general inability to pay debts when they are due or any other satiation justifying the commencement of such proceedings. However, if compared to ISDA Master Agreements, one would note that such a description is rather short as ISDA standard contains 6 types of insolvency procedures. Arguably, this difference comes from the desire of DRV 1993/2001 authors to concentrate on domestic imposed insolvency law procedures rather than a wish to follow an international approach embracing insolvency procedures adopted in maximum number of jurisdictions.

Under DRV 1993/2001 section 7(3), upon insolvency or in the event transactions are terminated based on a notice neither party is required to make payments and deliveries under outstanding transactions as they are replaced by the damages claim coming into existence. The damages amount is determined based on replacement transactions (*Erzatsgeschäften*) allowing the solvent counterparty or the counterparty sending the relevant termination notice to receive payments and deliveries as if the obligations under the agreement were not violated and the default did not occur. Such a party may conclude replacement transactions in practice, however, if it chooses not to do so, the calculation may involve the interest rates, indices, currency exchange rates and other data that would have been used in case such transactions were really concluded (section 8(1) of the DRV 1993/2001).

Presumably, the methodology suggested by DRV 1993/2001 should be compared with the one embedded in 1992 ISDA Master Agreement which was published a year before its German analogue appeared. 1992 ISDA Master Agreement³⁸ outlines two ways in which the close-out amount (e.g., the estimate of existing transactions whose

³⁷ Usually, the relevant events include cross-default, default under specified transaction, invalidation and ISDA Master Agreements also provide a list of so-called termination events differing from events of default in terms of their nature and consequences. The drafters of DRV refrained from the said division of close-out netting triggering events putting more trust into the imperative norms of German contract law rather than their English law qualified peers.

³⁸ ISDA Master Agreement. Available at: <https://www.isda.org/book/1992-isda-master-agreement-multi-currency/> [Accessed 29th October 2022].

performance date is yet to occur). The “Loss” method is based on the losses and gains obtained by the party due to termination of transactions while the “Market Quotations” assumes obtaining the quotes from reference dealers, i.e., the leading market makers (Lennon, 2001:85). It is up to the parties’ choice to decide which method is applicable to their contractual relationship (Lennon, 2001:84). However, should they fail to make a choice, Market Quotation applies (Lennon, 2001:84)³⁹.

DRV follows a mixed approach where an attempt to conclude replacement transactions and thus approaching market dealers shall be made, which is close to the Market Quotation approach. However, the non-defaulting party is entitled to refrain from interacting with other market participant and determine the damages itself using various market data. In absence of replacement transactions, the non-defaulting party may base its calculations on “interest rates, forward rates, exchange rates, market prices, indices, and any other calculation basis, as well as costs and expenses, at the time of giving notice or upon becoming aware of the insolvency, as the case may be” (section 8(1) of the 1993/2001). Under the same clause of German master agreement, in case of insolvency the determining party shall consider the data as of the date when it became aware of the insolvency of its counterparty while when terminating transactions on other grounds it shall use the figures available at the date of a termination notice.

These provisions were tested by the highest court of Germany in cross-border context and evaluated in FCJ Decision. According to the case file, the limited liability company located in England, a part of the financial group Lehman Brothers (defendant), entered DRV 1993/2001 with a German limited company liability (*GmbH*) and limited partnership (*Kommanditgesellschaft*) (plaintiffs). On 26 October 2005 the defendant and each of the plaintiffs concluded four option transactions envisaging the right to purchase SAP40 shares from German companies on certain dates at predetermined prices. On 15 September 2008, the directors of the English party applied for introduction of external management (administration) in accordance with English bankruptcy law, which was satisfied in the same day as the defendant was part of the troubled Lehman group.

However, option agreements with an expiration date of 18 December 2009 remained in force and set forth the obligation to deliver 2 million SAP shares at a price of EUR 32.205 per share. Exchange price as of the date of submission of the application for the introduction of external administration was 38.15 euros. The Federal Court of Justice upheld the position of the lower Court of Appeal in respect of the defendant's right to receive compensation equal to the market value of the options. However, the judges of the highest court in Germany noted that this right does not arise based on the provisions of the DRV but follows from §104 InsO directly. Accordingly, the price of shares relevant for determination of close-out amount shall be 17 September 2008 (that is, on the second business day after the introduction of insolvency proceedings) and not the share price as of 15 September 2008, which is the insolvency application filing date. In other words, the

³⁹ In 2002 ISDA Master Agreement the association updated the methodology for determining the amount payable by a party in case of default and introduced a unified approach to close-out netting. To allow the parties to 1992 ISDA Master Agreement ISDA published a special protocol that brings its provisions in compliance with a more recent methodology. Available at: <https://www.isda.org/traditional-protocol/isda-close-out-amount-protocol/> [Accessed 29th October 2022].

⁴⁰ SAP SE is a multinational software company based in Germany. Available at: <https://www.sap.com/about/company/what-is-sap.html> [Accessed 29th October 2022].

court determined that the law governing termination of transactions under the DRV is the law chosen by the parties in the agreement, and its imperative rules should be override DRV contractual provisions⁴¹.

Conclusion

Although FCJ Decision did not make close-out netting unenforceable per se, it dealt with the ability of the parties to set out the moment for the valuation of mutual obligations. As the efficiency of insolvency privilege for derivatives is of great importance, the reaction of German authorities to the controversial ruling was rather prompt. German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzaufsicht*) adopted a decree providing the treatment of netting arrangements under article 295 of Regulation (EU) No. 575/2013 to minimize the impact of FCJ Decision on the regulatory capital of credit institutions. Subsequently, the third edition of §104 InsO, which entered into force on 10 June 2016, allowed to adjust the German insolvency law privilege to the best practices set out in international instruments such as UNIDROIT Netting Principles.

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⁴¹ Although the court ruling in question does not influence master agreements for derivatives governed by the law other than German, international law firms published legal alerts on the subject. Available at: <https://www.clearygottlieb.com/~media/organize-archive/cgsh/files/publication-pdfs/alert-memos/alert-memo-pdf-version-201658.pdf> [Accessed 29th October 2022]. Available at: <https://www.allenoverly.com/en-gb/global/news-and-insights/publications/bafin-reduces-risks-under-bgh-judgment-on-netting-agreements> [Accessed 29th October 2022]. Available at: <https://www.simmons-simmons.com/en/publications/ck0azids9nsg80b33o3o4xfk2/10-german-federal-supreme-court-verdict> [Accessed 29th October 2022].

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