OTC derivatives and the ISDA Master Agreement: (how) does it work under Dutch law? (part 1)

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[**Summary: Most over-the-counter (OTC) derivatives are entered into under an ISDA Master Agreement. One of the major aims of the Master Agreement is to control the credit risk that the counterparties are mutually exposed to. The early termination and close-out netting provisions form the core of the Master Agreement. A Dutch court may apply elements of Dutch law when interpreting the Master Agreement even when a valid choice for English law or the laws of the State of New York has been made. In general, those elements of Dutch law do not affect the enforceability of the early termination and close-out netting provisions of the Master Agreement. However, there are some important points that may be of interest to market participants entering into transactions with a Dutch counterparty.**]

1. INTRODUCTION

Dutch financial and non-financial counterparties frequently use derivatives. A derivative is a financial instrument which derives its market value from an underlying market value. For instance, the market value of an interest rate swap will depend on the development of the interest rates being 'swapped'. In addition to interest rate swaps, there are many categories of derivatives, such as forwards, foreign exchange rate swaps, options and credit default swaps. Derivatives can be used to mitigate financial risks, for example, the unfavorable development of an interest rate, a foreign exchange rate or the price of a commodity. This is called *hedging*. Derivatives can also be used for speculative purposes. Using derivatives for speculation can result in significant losses.[2] A portion of all outstanding derivatives relates to standardized instruments which are exchange-traded. The remainder of the derivatives market consists of instruments that are tailor made to meet a specific need of the end user.[3] These instruments are entered into by means of bilateral transactions between two counterparties, which is why they are called 'over-the-counter' (**OTC**) derivatives. Most OTC derivatives are concluded under some version of the *Master Agreements*[4] [5] developed by the International Swaps and Derivatives Association (**ISDA**).[6] This article is about rules of Dutch and European law which apply to OTC derivatives and the Master Agreement. It consists of two parts. Part I is about the enforceability of the core provisions of the Master Agreement. Part II will provide an overview of rules of European financial supervisory law applicable in the Netherlands with

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[2] See: *The Financial Crisis Inquiry Report, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, The Financial Crisis Inquiry Commission, January 2011, p. xxiv.

[3] The Bank for International Settlements reported in its semi-annual *OTC Derivatives Statistics* an amount of USD 482,900 billion for the total notional value of OTC derivatives which were outstanding at the end of 2016, about 80% of which relates to interest rate swaps. The OTC Derivatives Statistics can be accessed here: http://www.bis.org/statistics/derstats.htm.

[4] For an overview regarding the development of the Master Agreements, please see: P.C. Harding: *Mastering the ISDA Master Agreements (1992 and 2002)*, United Kingdom, Financial Times-Prentice Hall 2004.

[5] References to 'Master Agreement' in this article are references to the 2002 ISDA Master Agreement. Specific provisions of the 1992 ISDA Master Agreement are not discussed in this article.

[6] More information about the activities of ISDA is available on ISDA's website: www.isda.org.

respect to OTC derivatives and the OTC derivatives market. The key documents developed by ISDA will be discussed in the sections below. The following sections will describe the early termination and close-out netting provisions of the Master Agreement, including the enforceability of such core provisions. The final section includes some practical recommendations.

2. ISDA DOCUMENTATION

Master Agreement

The Master Agreement is a framework agreement under which two counterparties can enter into almost every kind of OTC derivative transaction. The provisions of the Master Agreement are standardized. In that respect, the Master Agreement can be compared to a set of general terms and conditions used by a bank or a large corporate. However, the *Schedule* attached to the Master Agreement includes a number of optional provisions for the counterparties. For instance, the counterparties can agree that certain provisions of the Master Agreement will not apply to their legal relationship. In addition, the Schedule provides room for the counterparties to introduce additional terms and conditions or change the meaning of existing terms and conditions by adding further provisions. That way, adjustments can be made to the commercial relationship between the counterparties without making any changes to the body of the Master Agreement. As a result, the main document continues to be recognizable in the market while all additional or divergent terms and conditions can be found in the Schedule. The Master Agreement contains elements which are typically found in credit agreements, such as definitions, payment obligations, representations and warranties, acceleration mechanics, information undertakings, transfer restrictions and choice of law and jurisdiction clauses. The key difference with a credit agreement is that the credit relationship under the Master Agreement may be mutual. The transactions entered into under the Master Agreement may result in payment obligations for both counterparties, which is why the Master Agreement was developed as a starting point to provide both counterparties with identical rights and obligations. Exceptions to this principle are documented in the Schedule.

Confirmations

The economic and financial terms and conditions of individual OTC derivatives, such as maturity, payment dates, notional value and underlying rates are documented by means of *Confirmations*. According to the Master Agreement, all transactions are entered into on the basis that the Master Agreement and all Confirmations together constitute one and the same agreement.

Definitional Booklets

Although the Master Agreement itself contains a list of defined terms, ISDA has published various *Definitional Booklets*. These Definitional Booklets include general and transaction-specific definitions. Quite often the parties add a provision to the Schedule under which one or more sets of general definitions are incorporated into their legal relationship. Transaction-specific definitions are customarily incorporated pursuant to a provision in a Confirmation. Most transaction-specific Definitional Booklets include a form of Confirmation which is used for confirming transactions for which the relevant Definitional Booklet is written.

Credit Support Annex

Furthermore, ISDA has published several standardized *Credit Support Documents*. Credit Support Documents are used by market participants to post and accept collateral as security for payment and delivery obligations under transactions. The most frequently used Credit Support Document in

Europe is the *1995 Credit Support Annex (Transfer – English law)* (**CSA**), under which one party must transfer collateral to the other party as security for its obligations under the Master Agreement. The CSA qualifies as a title transfer financial collateral arrangement within the meaning of Article 2(1)(b) of the Directive on Financial Collateral Arrangements.[7] In general, the collateral consists of cash or sovereign debt securities issued by countries with the highest credit rating. In anticipation of the variation margin requirements for non-centrally cleared derivatives coming into effect under EMIR[8], ISDA has recently published a new version of the *2016 Credit Support Annex for Variation Margin (VM) (English law)*.[9]

3. CORE PROVISIONS OF THE MASTER AGREEMENT

General

The Master Agreement consists of fourteen clauses which are called *Sections*.[10] [11] One of the major aims of the Master Agreement is to mitigate the credit risk that the counterparties are mutually exposed to. The early termination and close-out netting provisions are instrumental for that aim. These provisions are generally regarded as the core of the Master Agreement.

Events of Default and Termination Events

Section 5 (*Events of Default and Termination Events*) of the Master Agreement contains the grounds for early termination of transactions. A distinction is made between *Events of Default* and *Termination Events*. Events of Default are categorized as follows: *Failure to Pay or Deliver*, *Breach of Agreement*, *Repudiation of Agreement*, *Credit Support Default*, *Misrepresentation*, *Default under Specified Transaction*, *Cross-Default*, *Bankruptcy* and *Merger Without Assumption*. The parties have the option to add additional Event of Default provisions to the Schedule. Termination Events are categorized as follows: *Illegality*, *Force Majeure Event*, *Tax Event*, *Tax Event Upon Merger* and *Credit Event Upon Merger*. The parties may decide to include *Additional Termination Events* in the Schedule.

Early termination

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[7] Directive 2002/47EG of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements (*PbEG* 2002, L 168/43).

[8] The European Markets Infrastructure Regulation (**EMIR**) will be discussed in part II of this article.

[9] For a thorough discussion of the consequences of EMIR on the CSA for non-centrally cleared derivatives, see: R.A. Stegeman, D.A. Gerrits and A. Berket, 'De gevolgen van EMIR op de ISDA Credit Support Annex voor niet-geclearde otc-derivaten (Deel I)', in: *TFR* 2017 (6).

[10] (1) *Interpretation*, (2) *Obligations*, (3) *Representations*, (4) *Agreements*, (5) *Events of Default and Termination Events*, (6) *Early Termination; Close-out Netting*, (7) *Transfer*, (8) *Contractual Currency*, (9) *Miscellaneous*, (10) *Offices: Multibranch Parties*, (11) *Expenses*, (12) *Notices*, (13) *Governing Law and Jurisdiction* and (14) *Definitions*. In addition, the Schedule consists of five clauses that are called parts: (1) *Termination Provisions*, (2) *Tax Representations*, (3) *Agreement to Deliver Documents*, (4) *Miscellaneous* and (5) *Other Provisions*.

[11] For an extensive practical guide to the ISDA Master Agreements: P.C. Harding: *Mastering the ISDA Master Agreements (1992 and 2002)*, United Kingdom, Financial Times-Prentice Hall 2004. In addition: C.F. Leeger and N.C.J. Renkens, 'De nieuwe 2002 ISDA Master Agreement: een vlaggenschip in revisie', in: *TvE* 2003 (4), p. 64-77.

Section 6 (*Early Termination; Close-Out Netting*) of the Master Agreement deals with the early termination of transactions. The distinction between Events of Default and Termination Events is relevant to determine the applicable termination and close-out regime. The Event of Default provisions imply an element of failure. For that reason, only the *Non-defaulting Party* is entitled to determine an *Early Termination Date* with respect to the outstanding transactions if an Event of Default has occurred. By contrast, termination Events are typically regarded as neutral grounds for early termination. Furthermore, a Termination Event does not necessarily affect all transactions between the parties. In the case of a Termination Event, the *Non-affected Party* or, in some situations, each party is entitled to designate an Early Termination Date with respect to one or more affected transactions. In addition, the Schedule provides the parties with an option to decide that in certain insolvency scenarios, for example, if the other party is declared bankrupt, all transactions are automatically terminated without any action being required. This is called *Automatic Early Termination*. If Automatic Early Termination applies, the Early Termination Date occurs at the same time as the relevant insolvency scenario, whether the parties are aware of this or not. In all of the scenarios discussed above, the parties are no longer obligated to effect payments or deliveries in respect of terminated transactions after the Early Termination Date. Instead, one of the parties will be obligated to pay the *Early Termination Amount*. This system is referred to as *close-out netting*.

Close-out netting

In brief, the Early Termination Amount is equal to the sum of the *Close-out Amounts*[12] determined for the terminated transactions, with a correction for any amounts that were due but not paid before the Early Termination Date. The parties agree and acknowledge that the Early Termination Amount is a reasonable pre-estimate of loss and not a penalty. The Early Termination Amount is payable for the loss of bargain and the loss of protection against future risk. Neither party will be entitled to recover any additional damages as a consequence of the termination of transactions.

4. ENFORCEABILITY

General

The proper functioning of the early termination and close-out netting provisions of the Master Agreement is crucially important to mitigate the credit risk that the parties are mutually exposed to, especially in insolvency situations.[13] For this reason, ISDA has requested reputable law firms in

[12] For any party, the Close-out Amount with respect to each terminated transaction is equal to the amount of the losses or costs of that party that are or would be incurred under then prevailing circumstances (expressed as a positive number) or gains of that party that are or would be realized under then prevailing circumstances (expressed as a negative number) in replacing, or in providing for that party the economic equivalent of, (a) the material terms of that terminated transaction, including the payments and deliveries by the parties in respect of that terminated transaction that would, but for the occurrence of the relevant Early Termination Date, have been required after that date and (b) the option rights of the parties in respect of that terminated transaction. Each Close-out Amount must be determined in good faith and on the basis of commercially reasonable procedures in order to produce a commercially reasonable result. Unless the parties have agreed otherwise, the Close-out Amounts are determined by the Non-defaulting Party in case of an Event of Default or the Non-affected Party in case of an Early Termination Event with one *Affected Party*. In case of an Early Termination Event with two Affected Parties, the Close-out Amounts are in principle determined by both parties on the basis of the arithmetic mean between (i) the sum of the Close-out Amounts determined by one party and (ii) the sum of the Close-out Amounts determined by the other party. In case of *Illegality* or *Force Majeure* the Close-out Amounts must be determined on a neutral basis, i.e. without taking into account the creditworthiness of the other party.

[13] For clarification: W.A.K. Rank, 'Een paarlen jubileum voor de ISDA Master Agreement: 30 jaar contractszekerheid voor OTC-derivaten', in: *TFR* 2017 (4), p. 131-138.

many jurisdictions, including the Netherlands, to render legal opinions on the enforceability of these provisions.[14] These legal opinions are available for ISDA's members to enable them to assess the legal risks involved in entering into transactions with a foreign counterparty. This section addresses the enforceability of the early termination and close-out netting provisions of the Master Agreement against Dutch counterparties. But first we must determine which law governs the Master Agreement. There is a standard choice of law provision in the Master Agreement for English law or the laws of the State of New York.[15] To what extent the choice of law is recognized and upheld in the Netherlands is a matter of private international law, which will be discussed directly below. Because we cannot rule out the possibility that a Dutch court may (and in certain cases must) apply Dutch law regardless of whether the parties have chosen the laws of another jurisdiction, the extent to which the early termination and close-out netting provisions comply with Dutch law will be discussed later in this article.[16]

Rome I Regulation

Under the Rome I Regulation[17] an agreement is governed by the law which the parties have chosen.[18] [19] [20] However, where all other elements relevant to the situation at the time the choice of law was made are located in a country other than the country whose law has been chosen, the choice of the parties will not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement.[21] And where all other elements relevant to the situation at the time the choice of law was made are located in one or more EU member states, the parties' choice of applicable law other than that of an EU member state will not prejudice the application of provisions of EU community law which cannot be derogated from by agreement.[22] In addition, a Dutch court is always free to apply the overriding mandatory provisions of Dutch law regardless of a valid choice of law for the laws of another jurisdiction.[23] Furthermore, a court may

[14] In the Netherlands, the legal opinion on close-out netting has been issued by De Brauw Blackstone Westbroek. The legal opinion on ISDA collateral documentation including the CSA has been issued by NautaDutilh.

[15] I have seen instances in which parties have elected Dutch law as the governing law of their ISDA Master Agreement. That scenario is outside the scope of this article.

[16] In my analysis, I have assumed that the transactions are concluded under a Master Agreement entered into with a Dutch public limited liability company (*naamloze vennootschap*) or private company with limited liability (*besloten vennootschap*) as counterparty which is subject to the Insolvency Regulation or is a bank, an investment firm of insurance undertaking with its center of main interest (COMI) in the Netherlands.

[17] 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) (*PbEU* 2008, L177/6).

[18] The matter of whether or not the parties have validly agreed a choice of law is governed by Articles 10, 11 and 13 of the Rome I Regulation.

[19] Certain transactions, such as credit default swaps, may qualify as insurance contracts. Such cases are governed by Article 7 of the Rome I Regulation. If the transaction qualifies as an 'insurance contract covering a large risk' the contract will be governed by the law chosen by the parties in accordance with and subject to Article 3 of the Rome I Regulation.

[20] The Rome I Regulation applies to agreements entered into after 17 December 2009. Situations in which a Master Agreement was entered into before that date are not discussed in this article.

[21] Article 3(3) Rome I Regulation.

[22] Article 3(4) Rome I Regulation.

[23] Article 9(2) Rome I Regulation.

give effect to the overriding mandatory provisions of the law of the country where the obligations arising out of a contract have been or have to be performed, in so far as those overriding mandatory provisions render the performance of the contract unlawful.[24] Finally, the application of a provision of the law of any country specified by the Rome I Regulation may be refused if such application is manifestly incompatible with the public policy of the forum.[25]

It would go beyond the scope of this article to provide an extensive overview of Dutch rules of law which may potentially apply regardless of a valid choice of law for the laws of another jurisdiction or situations in which the chosen law cannot be applied because it would be incompatible with Dutch public policy. What first comes to mind is that the Dutch rules of insolvency law seem relevant because they contain elements of public policy. Especially in insolvency situations one might expect that a Dutch court on the basis of the Rome I Regulation would apply Dutch law regardless of a valid choice of law for the laws of another jurisdiction. The choice of law rules of the Insolvency Regulation[26] are also relevant in such scenarios.

Insolvency Regulation

Under the Insolvency Regulation, the law applicable to insolvency proceedings[27] and their effects is the law of the EU member state in which such proceedings are opened.[28] Among the effects of insolvency proceedings are the consequences with respect to current contracts to which the debtor is a party. The courts of the EU member state within which the centre of the debtor's main interests is situated has jurisdiction to open insolvency proceedings.[29] Hence, a bankruptcy (*faillissement*) or suspension of payments (*surséance van betaling*) with respect to a Dutch debtor will be governed by Dutch law. A choice of law for the laws of another jurisdiction will not affect this principle. The Insolvency Regulation includes a limited number of exceptions to this rule. One of those exceptions relates to set-off. The opening of insolvency proceedings does not affect the right of creditors to demand the set-off of their claims against the claims of a debtor, where such set-off is permitted by the law applicable to the insolvent debtor's claim.[30]

Banks, investment firms and insurance undertakings

The Insolvency Directive does not apply to winding-up proceedings[31] with respect to banks, investment firms and insurance undertakings.[32] Winding-up proceedings with respect to an

[24] Article 9(3) Rome I regulation.

[25] Article 21 Rome I Regulation.

[26] Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) (*PbEG* 2006, L160/1).

[27] The following Dutch insolvency proceedings are subject to the Insolvency Regulation: bankruptcy (*faillissement*), suspension of payments (*surséance van betaling*) and debt management for natural persons (*schuldsanering natuurlijke personen*).

[28] Article 7(2) Insolvency Regulation.

[29] The centre of main interests is the place where the debtor conducts the administration of its interests on a regular basis and which is ascertainable by third parties (Article 3(1) Insolvency Regulation).

[30] Article 9(1) Insolvency Regulation.

[31] The term 'winding-up proceedings' is taken from Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganization and winding up of credit institutions and Directive 2001/17/EC of the European Parliament

insurance undertaking, a bank or an investment firm are governed by the laws of the home member state.[33] Similar to the exception under the Insolvency Regulation discussed above, winding-up proceedings with respect to an insurance undertaking, a bank or an investment firm do not affect the right of creditors to demand the set-off of their claims against the claims of a debtor where such set-off is permitted by the law applicable to the insolvent debtor's claim.[34]

Suspension of payments (*surséance van betaling*) is not available for banks and insurance undertakings.[35] Instead, the District Court of Amsterdam may declare that emergency proceedings (*noodregeling*) apply with respect to an insolvent bank or insurance undertaking following a request from the Dutch Central Bank.[36] All remediation measures (*saneringsmaatregelen*) including emergency proceedings and the effects thereof are governed by the laws of the EU member state in which the remediation measure has been declared.[37] However, the right of creditors to demand the set-off of their claims against the claims of the insolvent bank or insurance undertaking remains unaffected where such set-off is permitted by the law applicable to the claim of the insolvent bank or insurance undertaking.[38]

Exception for set-off

It follows from the rules discussed above that a liquidation procedure with respect to a Dutch counterparty does not affect the right of creditors to demand the set-off of their claims against the claims of that counterparty where such set-off is permitted by the law applicable to those claims of the counterparty. In the event of a Master Agreement with a choice of law for English law or the laws of the State of New York, a court would apply the chosen law to determine whether the other party is entitled to set-off. However, as discussed in the next paragraph, it is uncertain whether the close-out netting provisions of the Master Agreement qualify as a type of set-off within the Dutch legal meaning. Because of this uncertainty the exception for set-off may not apply. In that case one would need to fall back on the regular conflict-of-law rules, under which a Dutch court may apply Dutch law to determine whether or not close-out netting under the Master Agreement is allowed.

Early termination under Dutch law

Under Dutch law the parties to a contract are in principle free to determine the conditions for early termination of that contract. More specifically, the parties can agree that the contract is entered into

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and of the Council of 19 March 2001 on the reorganization and winding-up of insurance undertakings. A bankruptcy (*faillissement*) qualifies as winding-up proceedings.

[32] In addition, the Insolvency Regulation does not apply to other firms, institutions and undertakings to the extent that they are covered by Directive 2001/24/EC or collective investment undertakings. Such firms, institutions and undertakings are not included in the scope of this article.

[33] Sections 212t, 212oo and 213o BA.

[34] Sections 212w, 212oo and 213r BA.

[35] Section 214 lid 4 BA.

[36] Section 3:160 of the Dutch Financial Markets Supervision Act (**FMSA**).

[37] Section 3:240 FMSA.

[38] Section 3:243 FMSA. The exception does not apply to remediation measures with respect to an insurance undertaking with a limited risk exposure.

for a limited period of time and that it will terminate at a specific moment in time or following a particular event.[39] Under the Master Agreement, a party becomes entitled to designate an early termination date with respect to the outstanding transactions if, among other things, an insolvency event occurs with respect to the counterparty. There are no rules of Dutch law that prevent the parties from validly agreeing that such designation would qualify as a particular event as referred to above. Even the Dutch Bankruptcy Act (**BA**) does not restrict the parties from doing so. Although a Dutch bankruptcy receiver (*curator*) cannot be forced to perform the obligations of the bankrupt entity under a contract[40], the bankruptcy itself does not affect the validity of the contract, including any termination provisions forming part thereof. However, within the context of the Master Agreement there may be an issue if the parties have not elected Automatic Early Termination in the Schedule. If Automatic Early Termination has not been selected and one of the parties is declared bankrupt, the other party has some discretion to determine when the Early Termination Date is designated to occur. During the period between the bankruptcy and the designated Early Termination Date the Early Termination Amount may vary as a result of market developments. This effect may be at odds with the fixation principle that applies in Dutch bankruptcies. For this reason, a Dutch court may possibly rule that the Early Termination Amount must be determined on the basis of the obligations as they were on the date of the bankruptcy and not on the basis of the obligations as they were on the Early Termination Date. With this uncertainty in mind, parties entering into a Master Agreement with a Dutch counterparty are often advised to elect Automatic Early Termination in the Schedule.[41]

On this basis, Dutch law does not affect the validity of the early termination provisions of the Master Agreement, whether or not they concern bankruptcy or other insolvency proceedings with respect to a Dutch counterparty.

Close-out netting under Dutch law

The close-out netting provisions may be regarded as a contractual arrangement for compensation of damage resulting from an early termination following a default under an agreement. According to the Master Agreement, any amount to be received in connection with the early termination of a transaction is a reasonable pre-estimate of loss and not a contractual penalty. Notwithstanding the obligation to pay the Early Termination Amount, all other forms of liability for damage of the other party in connection with the early termination of transactions are excluded. In this respect, the close-out netting provisions of the Master Agreement are similar to the Dutch codified rules of law on breach of contract. Under these rules, the debtor that has breached its obligation under an agreement must compensate the creditor for damage resulting from that breach.[42] Furthermore, Dutch law allows the parties to a contract to agree additional arrangements with respect to compensation for damage resulting from a breach of obligation. The definition of Close-out Amount is based on the amount of loss or costs a party suffers or incurs to replace a transaction which is

[39] Section 3:38 Dutch Civil Code (**DCC**).

[40] I have assumed that the Master Agreement and each transaction qualifies as a mutual contract, that none of the parties has fully performed its obligations at the time of the Dutch counterparty being declared bankrupt and that section 37b BA does not apply.

[41] There is no reason to assume that Automatic Early Termination upon a bankruptcy of the counterparty could not qualify as an event determined by the parties resulting in early termination of their contractual arrangement. Hence the analysis with respect to early termination as a result of Automatic Early Termination is essentially identical to what has been discussed in respect of early termination as a result of one of the parties designating an Early Termination Date.

[42] Sections 6:74, 6:98 and 6:100 DCC.

being terminated before its maturity. In my opinion, this system complies with the Dutch law principle that financial losses must be estimated on the basis of the reduction of net worth suffered by the creditor as a result of a breach of the debtor's obligation compared to the situation which would have occurred if the debtor had properly performed its obligation.[43] Additionally, the Master Agreement stipulates that any amount of profits or other forms of proceeds, such as a reduction of costs, resulting from the early termination of transactions must be taken into account as a negative number in calculating the Close-out Amount. This element also complies with Dutch codified rules of law on breach of contract, under which all benefits enjoyed by the creditor as a result of a breach of its debtor's obligations must, to the extent possible, be deducted from the total compensation amount.[44] As far as I am aware, there are no rules of Dutch (bankruptcy) law which would preclude the parties from applying close-out netting as a form of contractual arrangement on compensation for damages resulting from a contractual breach. Again, the only issue would be determining which specific moment in time is used to calculate the Close-out Amount. Under the Master Agreement, each Close-out Amount must be determined as of the Early Termination Date or, if that would not be commercially reasonable, as of the date or dates following the Early Termination Date as would be commercially reasonable. This mechanism seems to be at odds with the fixation principle applicable in Dutch bankruptcies. Consequently, it cannot be ruled out that a Dutch court would not apply this mechanism, in which case the Close-out Amount for each terminated transaction will be calculated on the basis of the obligations as they are on the date on which the Dutch counterparty is declared bankrupt, even if the result is not a commercially acceptable outcome (as this term is used in the Master Agreement).

If a negative Close-out Amount is calculated for some but not all of the terminated transactions, close-out netting appears to consist of elements similar to set-off (*verrekening*). The reason for this is that in calculating the Early Termination Amount, the positive equivalent of any negative Close-out Amount must be deducted from the sum of all positive Close-out Amounts. I doubt, however, whether this process would qualify as set-off within the strict sense of the meaning, given that upon early termination of transactions, the original payment obligations under the transactions being terminated are *replaced* with an obligation for one of the parties to pay the Early Termination Amount for those transactions.[45] As explained above, there are no rules of Dutch law which would affect this arrangement.

However, if the calculation of the Early Termination Amount is to be regarded as some form of set-off, the arrangement complies with the Dutch rules of law on set-off, including the requirement that the payment obligations to be offset 'conform' (*beantwoorden*) with each other.[46] This requirement may be expected to be satisfied because in the event of early termination of one or more transactions under the Master Agreement the Close-out Amounts calculated with respect to those transactions are converted in one and the same *Termination Currency equivalent* before they are

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[43] Dutch Supreme Court 26 April 2002, NJ 2004, 210 (*Sparrow/Van Beukering*). Furthermore, see: A.S. Hartkamp, C.H. Sieburgh and *mr. C. Asser's Handleiding tot de beoefening van het Nederlands burgerlijk recht, 6, Verbintenissenrecht, Deel II, De verbintenis in het algemeen*, Deventer: Kluwer 2013, no. 31.

[44] Section 6:100 DCC.

[45] Strictly speaking, the exercise of a right of set-off constitutes a form of satisfaction resulting in full or partial termination of the payment obligations which are subject to that set-off. In my view, close-out netting under the Master Agreement is different given that the payment obligations are not terminated as a result of being satisfied but instead as a result of a specific agreement between the parties. Given this material difference, I do not believe that a Dutch court would apply the Dutch rules of set-off, except perhaps for the purpose of interpretation by analogy.

[46] Section 6:127 DCC.

aggregated for the purpose of calculating the Early Termination Amount.[47] Another requirement is that the financial obligations to be offset are due and payable. This requirement may also be expected to be satisfied given that all Close-out Amounts become immediately due and payable on the Early Termination Date. In this respect, there is little reason to doubt the application of the chosen law with respect to the close-out netting provisions of the Master Agreement. Insolvency proceedings do not result in a different outcome. As discussed above, the reason for this is that insolvency proceedings do not affect the right of creditors to demand the set-off of their claims against the claims of the insolvent counterparty where such set-off is permitted by the law applicable to the claim of the insolvent counterparty. Assuming that the parties have elected English law or the laws of the State of New York to govern the Master Agreement, a Dutch court would need to apply those laws to determine whether the parties are entitled to exercise a right of set-off.

In the unlikely event that a Dutch court decides to apply Dutch law irrespective of the rules discussed above, the following applies. There are two additional requirements for a successful invocation of a right of set-off in bankruptcy: (i) that the creditor is also a debtor of the bankrupt counterparty and (ii) that both the claim of the creditor and the claim of the bankrupt counterparty have come into existence prior to the declaration of bankruptcy or have resulted from actions performed by the creditor with the bankrupt party prior to the declaration of bankruptcy.[48] Both requirements may be expected to be met if the claims have resulted from transactions concluded under the Master Agreement prior to the counterparty having been declared bankrupt, which is normally the case. Finally, I would like to mention the possibility that the creditor of a bankrupt Dutch counterparty may be temporarily barred from exercising its right of set-off as a result of a statutory freeze period (*afkoelingsperiode*) ordered by a bankruptcy judge. It is unlikely that a right of set-off will be affected by the statutory freeze period.[49]

It follows from the foregoing that insolvency or winding-up proceedings will not affect a right of set-off if such a right exists under the chosen law and, to the extent the effects of close-out netting must be determined by reference to Dutch law, that no rules of Dutch law conflict with close-out netting, in or out of insolvency or winding-up proceedings, with respect to a Dutch counterparty.

Intervention Act

The Financial Institutions Special Measures Act (the **Intervention Act**) introduces two special instruments which could have negative effects on the application of close-out netting under the Master Agreement vis-à-vis Dutch financial institutions.[50] The first instrument can be used by the Dutch Central Bank in connection with a request for application of the emergency regulations (*noodregeling*) or a motion for bankruptcy of a bank, an investment firm[51] or an insurance

[47] The parties may agree an alternative *Termination Currency* with respect to individual or groups of transactions. If the parties have done so, the exercise of a right of set-off would not be possible between Close-out Amounts denominated in one Termination Currency and Close-out Amounts denominated in an alternative Termination Currency.

[48] Section 53 BA.

[49] See also: Faber 2005 (diss.), no. 437-438.

[50] For a discussion, see: R.P. Vrolijk, 'De Interventiewet: een uitgebreider toezichtinstrumentarium', in: *Vennootschap & Onderneming* 2011 (6). See also: J.A.M.A. Sluysmans and M.J.W. Timmer, 'De interventiewet en de SNS-onteigening', in: *MvV* 2013 (7).

[51] Investment firm within the meaning of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

undertaking. In such cases, the Dutch Central Bank is entitled to submit a transfer plan (*overdrachtsplan*) which, subject to approval from the court, provides for the transfer of selected assets and liabilities to a third party.[52] Under the second instrument, the Dutch Minister of Finance has the ability to expropriate assets of, securities issued by or receivables against a Dutch financial institution if the stability of the financial system is materially jeopardized by the state of affairs of that financial institution.[53] The exercise of certain contractual rights against a financial institution that is subject to one of these instruments is restricted. For example, a creditor can no longer validly invoke a provision under which such creditor would, but for this rule, become entitled to exercise certain rights against, or terminate its legal relationship with, that financial institution for reason of an instrument under the Intervention Act becoming applicable.[54] An exception has been made for the exercise of rights under a contractual netting provision included in an agreement with respect to financial instruments. The exercise of such rights is not affected by an expropriation or the approval of a transfer plan.[55] There can be little doubt that the close-out netting provisions of the Master Agreement fall within the scope of the exception.[56]

On this basis, it follows that neither an appropriation nor the approval of a transfer plan under the Intervention Act would affect the close-out netting provisions of the Master Agreement.

Recovery and resolution of credit institutions and investment firms

The financial supervision toolbox with respect to banks, investment firms and certain financial holdings has been expanded to include four additional instruments following the implementation of the Banking Recovery and Resolution Directive (**BRRD**)[57] and the entry into force of the Single Resolution Mechanism Regulation (**SRM**)[58]. Among these are the asset separation tool and the bail-

[52] Sections 3:159c et seq. FMSA, sections 212hc, 212oo and 213ac BA.

[53] Section 6:2 FMSA. For a discussion of the potential impact of a partial transfer of assets and liabilities under a transfer plan on the effectiveness of close-out netting, please see W.A.K. Rank, *Interventie bij banken en verzekeraars, Rechten van crediteuren en wederpartijen*, The Hague: Boom Juridische Uitgevers, 2015.

[54] Section 3:267f FMSA.

[55] Sections 3:159o(2) and 6:2(7) FMSA.

[56] Section 3:159o(3) FMSA defines a contractual netting provision as: a provision pursuant to which (a) the obligations of the parties become immediately due, are converted into an obligation to pay an amount which represents the aggregate estimated value of such obligations or terminate and are replaced with an obligation to pay such amount or (b) those obligations are set off and only the result of such set-off becomes due and payable, in each case upon one or more conditions being met.

[57] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (*OJEU* 2014, L173/190).

[58] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (*OJEU* 2010, L331/12).

in tool.[59] [60] [61] These tools could in theory have negative effects on the application of the close-out netting provisions of the Master Agreement.

However, the Financial Markets Supervision Act (**FMSA**) stipulates that the asset separation tool may not be applied in a manner which would have a negative impact on the rights under netting agreements (*salderingsovereenkomsten*).[62] There can be no doubt that the Master Agreement qualifies as a netting agreement within this meaning.[63] In addition, following a decision to separate assets, separating a portion of the assets or liabilities that are governed by one and the same netting agreement is not allowed.[64]

In accordance with Article 49 BRRD, the bail-in tool can only be applied to derivative transactions after those transactions have been terminated.[65] When applying the bail-in tool, the resolution authorities are entitled to terminate and settle all derivative transactions of a financial institution. The transactions must be valued for the settlement.[66] The BRRD provides for certain principles with respect to the valuation method to be used. In general, such valuation method will not necessarily result in the same outcome as the application of the close-out netting provisions of the Master Agreement would. Further rules for the valuation of transactions are provided in a delegate regulation.[67] The bail-in tool cannot be used with respect to obligations which are secured.[68] As a

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[59] Articles 42, 43 and 49 BRRD and articles 26 and 27 SRM. Under Article 23 SRM any resolution scheme to be adopted by the EU resolution board must at least address the elements of the asset separation tool and the bail-in tool which must be applied by the national resolution authorities in accordance with the BRRD.

[60] For a discussion of the recovery and resolution mechanism, see: G. Kastelein, *De Bankenunie en het vertrouwen in een goede afwikkeling*, Preadvies voor de Vereniging voor Financieel Recht 2014, Serie vanwege het Van der Heijden Instituut, Deventer, Kluwer 2014; M. Haentjens, 'Nieuw afwikkelingsregime als katalysator van Europese integratie', in *TFR* 2017 (7/8) and B.J. Drijber and A. van Toor, 'Van ESA's, SSM en SRM: rechtsbescherming in een labyrint van Europese regels voor het financiële toezicht', in: *Ondernemingsrecht* 2015 (3). With respect tot he bail-in tool: A.D.S. Hoeblal, 'Bail-in: over de (wettelijke) beperking van rechten van crediteuren', in: *MvV* 2013 (10) and B. Bierens, 'Banken in macro-juridische context: over recht, risico, resolutie en financiële stabiliteit', in: *Ondernemingsrecht* 2016 (33).

[61] A legislative proposal with respect to the recovery and resolution of insurance undertakings is being prepared: file://asdfs02/Redirect/steeg/Downloads/Wetsvoorstel%20herstel%20en%20afwikkeling%20van%20verzekeraars%20consultatieversie.pdf. For an overview of the proposal, see: F.W.J. van der Eerden and S. Uiterwijk, 'Consultatie Wetsvoorstel herstel en afwikkeling van verzekeraars', in: *TFP* 2016 (7/8).

[62] Section 3A:60 FMSA.

[63] Section 3A:60 FMSA is based on Article 76(1) and (2) BRRD. Article 4(1) of Commission Delegated Regulation (EU) 2017/867 of 7 February 2017 on classes of arrangements to be protected in a partial property transfer under Article 76 of Directive 2014/59/EU of the European Parliament and of the Council stipulates that contractual netting agreements entered into between the institution and a single counterparty will qualify as netting arrangements pursuant to Article 76(2)(d) of Directive 2014/59/EU where they relate to rights and liabilities arising under financial contracts or derivatives.

[64] Section 3A:61(1) FMSA. This section is based on Article 77 BRRD and must be regarded as a more detailed implementation of the main rule laid down in the BRRD.

[65] Section 3A:44(3) FMSA.

[66] Article 49(3) in conjunction with Article 36 BRRD.

[67] Commission Delegated Regulation (EU) 2016/1401 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms with regard to regulatory technical standards for methodologies and principles on the valuation of liabilities arising

result of EMIR, more and more OTC-derivatives are secured by collateral. In light of this development, the bail-in tool is expected to have a potential effect on only a relatively limited portion of the derivatives portfolio of a typical market participant.

5. PRACTICAL RECOMMENDATIONS

In principle, there are no Dutch rules of law which would affect the enforceability of the early termination and close-out netting provisions of the Master Agreement. However, if a transaction is entered into with a Dutch counterparty, Automatic Early Termination should be selected to avoid any uncertainty about which specific moment in time should be used in determining the extent of the obligations, which forms the basis for the calculation of the Close-out Amounts with respect to the terminated transactions. In addition, each market participant that enters into a derivative transaction with a Dutch bank or investment firm must be made aware of the potential application of the bail-in tool, which may result in early termination of outstanding transactions and valuation on the basis of legislation, the outcome of which may be different than the than the outcome of a valuation process under the close-out netting provisions of the Master Agreement. To fully avoid this risk, all obligations of the counterparty must be secured with sufficient collateral, in which case they would remain outside of the reach of any bail-in measure.

from derivatives (*OJEU* 2016, L228/7).

[68] Article 44(2)(b) BRRD and Article 27(3)(b) SRM.