INTERNATIONAL FINANCIAL LAW: THE CASE AGAINST CLOSE-OUT NETTING

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INTRODUCTION

A. The Rise of Close-out Netting

In financial transactions today, a practice called "close-out netting" plays a key role in controlling and allocating risks.[1] If anchored in the parties'

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1 *See* Ole Böger, *Close-out Netting Provisions in Private International Law and*

chosen contractual language[2] and recognized by law, close-out netting can circumvent normal bankruptcy processes by providing for the acceleration of mutual obligations and the efficient calculation and settlement of the net balance.[3]

In effect, close-out netting puts certain fortunate creditors into a position of super-priority far preferable to the position of most creditors of a bankrupt estate. When correctly implemented, close-out netting can eliminate the risk that arises under ordinary bankruptcy principles—that a solvent party might incur "a loss equivalent to the gross value of its claims" against an insolvent counterparty, yet be required to honor its obligations to that same counterparty in full.[4]

Of course, everything hinges on whether the transactions are properly structured and legally permissible. Contractual provisions for the close-out netting of numerous Lehman Brothers' transactions did not save either that firm or its multitude of counterparties from extensive losses when they collapsed during the financial crisis of 2007-2009.[5] Improper collateralization of underlying transactions constituted one of the main problems in that debacle.[6] The significance of collateral hinges on its value, which normally reduces or increases the net amount owed by one of the parties to the other under a close-out netting agreement.[7]

International Insolvency Law (Part I), 18 UNIF. L. REV. 232, 233 (2013) ("Close-out netting provisions are among the main legal institutions used in market practice to manage and minimize credit risk.").

[2] *See* Ole Böger, *Close-out Netting Provisions in Private International Law and International Insolvency Law (Part II)*, 18 UNIF. L. REV. 532, 534 (2013). In England, "even in the absence of a contractual agreement . . ., broad rules on statutory, automatic set-off in insolvency are applicable, the effects of which are often regarded as equivalent to a close-out netting mechanism." *Id.*

[3] *See* Robert R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout*, 2 J. FIN. STABILITY 55, 56 (2006) (close-out netting "effectively places these contracts outside the normal bankruptcy process").

[4] *See* Böger, *supra* note 1, at 234.

[5] *See* SYLVIE A. DURHAM, DERIVATIVES DESKBOOK: CLOSE-OUT NETTING, RISK MITIGATION, LITIGATION 1-26 to -27 (Kelliann Kavanagh ed., 2d ed. 2014); Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 1044-45 (2009) (discussing the subprime financial crisis that began in 2007).

[6] *See* DURHAM, *supra* note 5 ("Lehman Brothers either was not required to post collateral . . . on derivative transactions or posted too little collateral. . . . In other cases, parties lost collateral . . . held by Lehman Brothers or its affiliates."). "From both Lehman Brothers' perspective and that of its counterparties, close-out netting did not achieve the optimal results that were intended." *Id*. at 1-29. Lehman Brothers and its affiliates were parties to 930,000 derivatives contracts, 733,000 of which were terminated immediately at the time of the bankruptcy filing. *Id*. at 6-49.

[7] *See id*. at 6-48 (discussing collateral).

In developed countries, close-out netting is now a pillar of the law governing financial markets.[8] Interestingly, only a few decades ago, both the practice and the terminology of close-out netting were essentially unknown.[9]

Although close-out netting is linked to centuries of banking practices that deal with the setting-off and netting[10] of obligations in general, it differs from those relatively simple accounting tools in important respects. The soundness of basic set-off and netting principles therefore does not mean that close-out netting is a prudent practice. In addition, the lessons that can be drawn from international financial crises dating back as far as 1345[11] only indirectly shed light on the wisdom and efficacy of close-out netting. Close-out netting is a modern phenomenon and, thus, not fully tested[12] in the demanding and ever-changing environment of global financial practices.[13]

B. Sound Public Policy

Lenders, scholars, regulators, and policy makers all support close-out netting.[14] They assert so frequently that close-out netting plays a vital

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8 Philipp Paech, *Enforceability of Close-Out Netting: Draft UNIDROIT Principles to Set New International Benchmark*, BUTTERWORTH'S J. INT'L BANKING & FIN. L. 13, 14 (Jan. 2013) ("[C]lose-out netting is the legal mechanism underlying the largest part of modern wholesale financial services.").

9 *See* Böger, *supra* note 1, at 234 ("The use of close-out netting has become common practice . . . in the last few decades."); Bliss & Kaufman, *supra* note 3, at 56 ("[Close-out] . . . is a more recent concept.").

10 *See* JOANNA BENJAMIN, FINANCIAL LAW 263 (2007) ("Set off and netting are related legal techniques, applied between persons with mutual rights and liabilities [that] permit such rights to be used to discharge such liabilities."). "The precise meaning of 'setoff' and 'netting' have generated a large debate and no conclusions." *Id*. at 265.

11 *See* STEPHEN VALDEZ & PHILIP MOLYNEUX, AN INTRODUCTION TO GLOBAL FINANCIAL MARKETS 15 (2013) (explaining how the default on a loan by Edward III in England caused a crash of banking families in Florence and was the "world's first . . . international banking crisis"); *see also The Slumps that Shaped Modern Finance*, ECONOMIST, Apr. 12-18, 2014, at 49, 51 (stating that in 1857, "[a] shock in the [American] Midwest tore across the country and jumped from New York to Liverpool and Glasgow, and then London," and "led to crashes in Paris, Hamburg, Copenhagen and Vienna").

12 *See* Bliss & Kaufman, *supra* note 3, at 56 ("[T]here has been very little rigorous analysis of the economic implications of these provisions for netting.").

13 *Cf.* HOWARD DAVIES & DAVID GREEN, GLOBAL FINANCIAL REGULATION: THE ESSENTIAL GUIDE 8 (2008) ("[A]ny major shock or prolonged downturn will test the [new] financial architecture in ways for which the existing arrangements may be unprepared.").

14 *See* EVA H.G. HÜPKES, THE LEGAL ASPECTS OF BANK INSOLVENCY: A COMPARATIVE ANALYSIS OF WESTERN EUROPE, THE UNITED STATES AND CANADA 152 (2000) ("In the field of international financial transactions . . . netting is important because it reduces credit and

role[15] in the operation of modern financial markets that this proposition is now a "truism."[16] Nevertheless, a few attentive observers of financial law disagree. They argue that, in its current configuration, close-out netting is unsound,[17] or at least that it is "not clear"[18] whether close-out netting increases or decreases risk in the financial system.[19] When these criticisms resonate with readers, it is often because close-out netting is aimed not at protecting troubled firms facing insolvency, but their solvent counterparties. Significantly, some key players in international finance, such as the People's Republic of China,[20] are as yet undecided about whether to

liquidity risk and, ultimately, systemic risk."); Bliss & Kaufman, *supra* note 3, at 56 (noting that "a regulatory and legislative consensus . . . strongly supports" close-out netting); Böger, *supra* note 1, at 236-37 ("[I]ndustry representatives and banking regulators alike support the enforceability of close-out netting . . . [and] this positive view . . . is shared by national legislators worldwide.").

[15] *Cf*. BENJAMIN, *supra* note 10, at 21 ("Netting has assumed systemic importance in the management of financial market credit risk."); Schuyler K. Henderson, *Credit Derivatives*, *in* MODERN FINANCIAL TECHNIQUES, DERIVATIVES AND LAW 7, 44 (Alastair Hudson ed., 2000) ("Termination netting . . . is one of the most significant risk reducing techniques in the derivatives market.").

[16] Bliss & Kaufman, *supra* note 3, at 67.

[17] *See* Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253, 289 (2009) (arguing against changes in U.S. bankruptcy law over the past thirty years and in favor of a public recordation system).

[18] *See* Bliss & Kaufman, *supra* note 3, at 56; *see also* DURHAM, *supra* note 5, at 1-29 (asking whether the fall of Lehman Brothers indicates that close-out netting is fundamentally flawed).

[19] *See* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1049 (2007) (doubting the standard explanation for special treatment of credit derivatives).

[20] Paget Dare Bryan & Gregory J. Lyons, Regulatory Reform Update: Where Are We Today?, 10th Annual PASLA/RMA Conference on Asian Securities Lending 172 (Mar. 7, 2013), *available at* http://www.rmahq.org/securities-lending/2013-pasla-rma-conference-on-asian-securities-lending-summary-and-presentations (indicating that in China the "enforceability of close-out netting is still a question"). *But see Memorandum on Enforceability of Close-Out Netting in China*, INT'L SWAPS AND DERIVATIVE ASSOC. (Feb. 25, 2014), http://www2.isda.org/news/memorandum-on-enforceability-of-close-out-netting-in-china ("With the Chinese Supreme Court's interpretation of the Enterprise Bankruptcy Law regarding insolvency set off right issued in 2013, China has made great progress toward becoming a netting enforceable jurisdiction."); *see also ISDA Published the New Legal Memorandum on Enforceability of Close-out Netting of Privately Negotiated Derivatives Transactions under ISDA Master Agreements in the PRC Prepared by King&Wood Mallesons*, KING&WOOD MALLESONS (Feb. 2014), http://www.kingandwood.com/bulletin.aspx?id=banking-newsletter-2014-02-25&language=en (last visited Jan. 5, 2015) (opining that while "[c]lose-out netting is not a legal concept expressly recognized under the PRC law, nor is it a concept addressed under the Bankruptcy Law," the "election of Automatic Early Termination in respect of a Chinese

endorse close-out netting.

This Article considers whether there is a persuasive case against close-out netting. Part I briefly describes the landscape of international financial law, the operation of close-out netting, and the legal recognition of such practices under national and international regimes as well as in widely used master agreements. Part II then examines the policy arguments in support of close-out netting, in particular the role that close-out netting plays in minimizing credit risk[21] for participants in financial transactions and in reducing systemic risk to financial institutions. Part III presents the strongest arguments against close-out netting, focusing on how close-out netting allows excessive externalization of risks, lacks transparency, operates inconsistently, impacts financial transaction participants disparately, and creates systemic risk by accelerating insolvency and undercutting efforts to save troubled institutions.

I. THE OPERATION OF CLOSE-OUT NETTING

A. Financial Law and Its International Aspects

As a jurisprudential field, financial law has been described by a leading scholar as "fragmented," "muddled," and "not universally accepted . . . as a distinct subject."[22] Even if this is true, however, the charge is not that coherent principles are lacking, but that the law governing financial transactions is exceedingly complex.

Financial law includes aspects of the "law of the insurance, derivatives, commercial banking, capital markets and investment management sectors,"[23] not to mention basic principles of insolvency, commercial, and property law. The practice of financial law traditionally involved bank lending and debt securities underwriting, but now includes a third, important practice area: derivative transactions,[24] often known simply as

counterparty would not be subject to the administrator's cherry-picking right under Article 18 of the Bankruptcy Law, and would be enforceable and upheld by PRC courts" under certain circumstances).

[21] *See* ERIK BANKS, THE CREDIT RISK OF COMPLEX DERIVATIVES 38 (3d ed. 2004) ("Credit risk losses can arise from failure by a counterparty to perform on its contractual . . . obligations, as a result of unwillingness or inability to pay what is due.").

[22] BENJAMIN, *supra* note 10, at 8.

[23] *See* Lord Woolf, *Foreword* to BENJAMIN, *supra* note 10, at vii.

[24] *See* Henderson, *supra* note 15, at 8-9 ("[T]he term 'derivatives' includes three very different groups of financial products: exchange traded futures and options; debt securities with an 'unusual' rate of return, where the rate is based on something other than a fixed rate of interest or a commonly recognized floating rate such as the London interbank offered rate (LIBOR) . . .; and over-the-counter (OTC), individually negotiated, bilateral notional amount agreements including swaps, providing for cash flows based on movements in interest,

"derivatives."[25]

"Financial law" is shaped by, but is distinct from, the law of "financial regulation." The latter deals, to a great extent, with bank supervision, including conditions of entry, capital ratios, liquidity rules, large exposure rules, foreign exchange controls, and rights of inspection. It also addresses accounting standards, inside dealer conduct, money laundering, and investor protection.[26] In contrast, financial law is more about the rights and obligations of the players in financial transactions than about the administrative structure and operation of banks and other financial institutions.[27]

The twin goals of financial law are to foster economic security and wealth creation by allowing risks to be transferred freely from protection buyers to risk takers.[28] These transfers occur in financial markets in the form of contractual arrangements called "financial positions."[29] Those positions—which are sometimes divided into "simple,"[30] "funded,"[31] "asset-backed,"[32] and "net"[33] subcategories—are accorded varying degrees of freedom and legal protection.[34] Financial positions are traded on stock

currency, equity, commodity or other indices . . . and swap-related products which are, or have characteristics similar to, options.").

[25] *Id.* at 7-8. A derivative is "an instrument the value of which is derived from another instrument or product." *Id.* at 18; *see also* PHILIP WOOD, LAW AND PRACTICE OF INTERNATIONAL FINANCE 425 (2008) ("Most derivative contracts are contracts for differences—the difference between the agreed future price of an asset on a future date and the actual market price on that date.").

[26] *See* DAVIES & GREEN, *supra* note 13, at 8 (describing financial regulation).

[27] *See generally* BENJAMIN, *supra* note 10 (discussing financial law as a field of study).

[28] The goals of financial law are sometimes stated more broadly. *See* WOOD, *supra* note 25, at 13-14 (arguing that financial law should lower the risks and costs flowing from the use of credit be reasonably stable, predictable, comprehensible, and nondiscriminatory; respect contract and property rights and private ordering; enhance information for investors; foster investor confidence; mitigate the risk of bank insolvency; and permit a widening range of transactions).

[29] *See* BENJAMIN, *supra* note 10, at 14 ("The business of financial institutions is to take risks in exchange for rewards, and they do this by entering into financial positions.").

[30] In "simple positions," such as "guarantees, insurance, derivatives, standby credits, and performance bonds," there is a risk that the beneficiary of the position will not be paid, but the beneficiary has not made a capital investment that is at risk. *Id.* at 20.

[31] In "funded positions," such as "bank loans, capital market investments, and units in collective investment schemes," the risk is not just that the risk taker will not be paid, but that the risk taker's capital will be lost. *Id*. at 21.

[32] An "asset-backed position" is a funded position in which assets are identified and earmarked to meet the claim. *Id.*

[33] A "net position" is one that "arises only where the parties have mutual obligations, and this mutuality enables each party to use its claim to discharge its obligation." *Id*.

[34] *See id.* at 3 ("[T]he function of financial law is to permit risks (and the rewards

exchanges, money markets, bond markets, foreign exchanges, and the interbank market.[35] The aggregate amounts are often staggeringly large, sometimes running into the trillions of dollars.[36] Viewed broadly, financial law is increasingly important because securitization[37] and credit derivatives[38] draw "ever more categories of business into the capital markets as an ever-wider range of assets and risks are economically converted into asset-backed securities."[39]

Some aspects of financial law are undoubtedly "international" in the sense that legal complexities arise from the global flow of financial assets in a world that is now highly interconnected,[40] both institutionally[41] and technologically.[42] In particular, banks are more operationally intertwined

associated with taking them) to be transferred from protection buyers to risk takers, and to circulate . . . in financial markets . . . [via] financial positions.").

35 *See* VALDEZ & MOLYNEUX, *supra* note 11, at 3.

36 *See* WOOD, *supra* note 25, at 6-7 ("Foreign exchange turnover on major exchanges is probably over $1000 trillion per year. . . . In 2005, seven banks had balance sheets larger than $1 trillion.").

37 BENJAMIN, *supra* note 10, at 28 ("[S]ecuritization involves the economic translation of a portfolio of income producing assets into debt securities."); VALDEZ & MOLYNEUX, *supra* note 11, at 284 ("Before securitization, banks could only make a limited number of loans based on the size of their balance sheets; however, . . . [securitization] allowed lenders to sell off their loans to other banks or investors, and the funds raised could be . . . [used] to make more loans.").

38 BENJAMIN, *supra* note 10, at 73 ("'Credit derivative' is a general term used to describe various swap and option contracts designed to assume or lay off credit risk on loans, debt securities and other assets, or in relation to a particular reference entity or country, in return for either swap payments or payment of premiums.").

39 Letter from Advocis, to Ontario Sec. Comm'n [OSC] (June 1, 2009), *available at* https://www.osc.gov.on.ca/documents/en/Securities-Category1-Comments/com_20090601_11-753_pollockg.pdf (commenting on the OSC's 2009-2010 Statement of Priorities); *see also* BENJAMIN, *supra* note 10, at 25 (stating that an "asset-backed security" is "a form of investment security in which the rights of investors to payment are defined and supported by underlying assets").

40 Global economic interconnection has a long history. *See, e.g.*, STEPHEN R. PLATT, AUTUMN IN THE HEAVENLY KINGDOM: CHINA, THE WEST, AND THE EPIC STORY OF THE TAIPING CIVIL WAR xxiv (2012) ("Karl Marx, in 1853, a London correspondent for the New-York Daily Tribune" considered the British involvement in the Taiping rebellion in China and its consequences in the United States to be a sign "that demonstrated the interconnectedness of the industrial world").

41 One example of institutional global interconnectedness is the rise in transnational outsourcing of production of goods and services. *See, e.g.*, Vincent R. Johnson & Stephen C. Loomis, *Malpractice Liability Related to Foreign Outsourcing of Legal Services*, 2 ST. MARY'S J. LEGAL MAL. & ETHICS 262, 265 (2012) ("American law firms increasingly outsource client-related tasks to service providers in foreign countries.").

42 *See* FAYE FANGFEI WANG, LAW OF ELECTRONIC COMMERCIAL TRANSACTIONS: CONTEMPORARY ISSUES IN THE EU, US AND CHINA 6-13 (2d ed. 2014) (discussing the

than other firms because of the interbank market, derivatives markets, credit default swaps,[43] and related practices.[44] Financial assets[45] are easily transferred across borders, sometimes in milliseconds.[46]

However, despite the international aspects of financial transactions, the legal principles that lie at the heart of financial law are comprised almost entirely of national law.[47] When cross-border issues arise, the relevant question is typically not what international agreement governs the dispute, but whose national law applies.[48] Choice-of-law issues are resolved under the principles of "private international law,"[49] which differ from one

development of the Internet, electronic commerce, cloud computing, and emerging technologies); DANIEL C.K. CHOW & THOMAS J. SCHOENBAUM, INTERNATIONAL BUSINESS TRANSACTIONS: PROBLEMS, CASES, AND MATERIALS 14 (2d ed. 2010) ("[T]he information technology revolution, started in the United States in the 1990s, created opportunities for trade and world integration that seemed impossible only a decade before.").

[43] *See* JEROLD A. FRIEDLAND, UNDERSTANDING INTERNATIONAL BUSINESS AND FINANCIAL TRANSACTIONS 29 (3d ed. 2010) ("[A] credit default swap . . . insures one party (*protection buyer*) against the risk that a debtor entity (*reference entity*) specified in the contract will lose value because of an event that impairs its credit, such as a bankruptcy default and credit rating downgrade.").

[44] *See* VALDEZ & MOLYNEUX, *supra* note 11, at 128.

[45] Financial assets are intangible assets such as bank deposits, commercial bank loans, and securities (including bonds and shares). *See* WOOD, *supra* note 25, at 3.

[46] *See id.* at 4.

[47] In contrast, many aspects of "financial regulation" are international. *Cf.* FRIEDLAND, *supra* note 43, at 17 (discussing "an expanding framework of national, regional and international rules and enforcement mechanisms to regulate cross-border financial transactions and institutions").

[48] *See* Philipp Paech, *Cross-Border Issues of Securities Law: European Effects to Support Securities Markets with a Coherent Legal Framework, Briefing for the European Parliament ECON Committee*, at 21-22 (May 2011) (discussing the law related to securities holding).

[49] Chow and Schoenbaum offer a particularly clear definition of private international law: "[P]rivate international law . . . refers to the use of domestic choice of law rules by domestic courts to resolve issues of conflicts of laws and the recognition and enforcement of judgments in the international context." CHOW & SCHOENBAUM, *supra* note 42, at 23; *see also* John R. Stevenson, *The Relationship of Private International Law to Public International Law*, 52 COLUM. L. REV. 561, 561-62 (1952) (defining "private international law" to mean "the body of norms applied in international cases to determine the judicial jurisdiction of a State, the choice of the particular system or systems of law to be applied in reaching a judicial decision"). Other definitions vary. *See* Alex Mills, *The Identities of Private International Law: Lessons from the U.S. and EU Revolutions*, 23 DUKE J. COMP. & INT'L L. 445, 472 (2013) ("[T]here is a considerable range of different ideas of what private international law 'is' in the sense of how we should understand its purpose and function."); Rahim Moloo, *Introductory Remarks*, 107 PROCEEDINGS OF THE ANNUAL MEETING (AM. SOC'Y INT'L L.) 337 (2013) (discussing competing definitions and referring to a panel that considered "private international law: (a) as dealing with conflicts between laws, and as a

country to the next.[50] Because financial transactions often span borders, choice of law is an issue of recurring importance. The parties to close-out netting agreements are often located in different jurisdictions.[51]

There have been efforts to harmonize financial law, particularly within the countries of the European Union. Various European Community Directives deal with settlement finality, protection of dealings in financial collateral, and close-out arrangements.[52] The International Institute for the Unification of Private Law's ("UNIDROIT") draft principles for close-out netting may set a new benchmark that will inspire legislators and regulators worldwide to "remove legal inconsistencies."[53] However, at present, national law is still dominant in financial law, including the law governing close-out netting.[54]

B. How Close-out Netting Works

In the usual case, close-out netting "serves to close the course of dealings"[55] between parties to a master agreement, which contractually provides for the closing to occur through an acceleration of obligations. The key elements of close-out netting are "[the] default, the acceleration of the time for performance of obligations to the time of default, [the] conversion of non-cash obligations into debts, . . . and [the] set-off."[56] The master agreement defines what constitutes a "default," such as the failure to make a required payment, a credit downgrade, or the breach of an obligation to a third party. As discussed below, the acceleration of obligations is normally not automatic, but occurs only when the non-defaulting party elects to exercise its rights to terminate the agreement.

Close-out netting differs from ordinary principles regarding set-off in that the relevant agreement "includes elements of termination and acceleration, usually providing for the obligations concerned to become due and payable upon the occurrence of predefined events, such as default under one of the

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technique to deal with those conflicts; and (b) as a system of law that governs transnational private relations"). Private international law is called "conflict of laws" in the United States. *See* RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 101 cmt. c (1987).

50 *See id.*

51 *See* Stephanie Loizou, *Close-out Netting and an Introduction to the UNIDROIT Principles on Its Enforceability*, 27 J. INT'L BANKING L. & REG. 429, 430 (2012).

52 *See* ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 48 (4th ed. 2011).

53 Paech, *supra* note 8, at 13.

54 *See* Philipp Paech, *Close-Out Netting, Conflict of Law and Insolvency*, (Law Soc'y Econ., Working Paper No. 14/2014, 2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2414400.

55 BENJAMIN, *supra* note 10, at 267.

56 *Id.* at 268.

obligations covered."[57] Moreover, close-out netting "requires neither connexity nor maturity, and the objects of the obligations . . . need not be identical."[58]

The close-out netting process is now "routine in financial markets and elsewhere."[59] It has become particularly important in the financial world, however, because, unlike other businesses, financial institutions engage in a vast number of bi-directional transactions.[60] In fact, close-out netting is applicable to various types of financial arrangements, provided that the claims can be reduced to monetary obligations.[61] Thus, if properly structured, "securities lending and repo[62] enjoy similar protection by equal closeout netting provisions."[63] That is, if the applicable netting statute applies to both types of contracts.[64]

C. The Legal Foundations of Close-out Netting

The legal effectiveness of close-out netting arrangements depends on what (if any) legislation has been enacted in the relevant country. Many developed countries have passed laws to ensure that netting arrangements are enforceable in cases where one of the parties becomes insolvent.[65] In Europe, a "major incentive" in implementing legal recognition of close-out netting was that "netting would be taken into account in the calculations of capital requirements [of banks] provided that certain qualifying factors were met."[66] European legislation nonetheless remains only partially

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[57] Böger, *supra* note 1, at 235-36.

[58] *Id*. at 236.

[59] Comm'rs for Her Majesty's Revenue & Customs v. Enron Eur. Ltd., [2006] EWHC 824 (Ch) (Eng.).

[60] *See* Bliss & Kaufman, *supra* note 3, at 58 (commenting that in ordinary business relations, "firms either buy or sell to other firms, but rarely do both simultaneously").

[61] *See* GOODE, *supra* note 52, at 285 ("[I]nsolvency set-off . . . requires that claims and cross-claims be monetary claims.").

[62] "Repo" is short for "sale and repurchase transaction." BENJAMIN, *supra* note 10, at 308. "A repo is an agreement that *A* will purchase securities from *B* at a certain date, with a simultaneous agreement that *B* will repurchase equivalent securities from *A* at a later date. . . . The traditional function of a repo is to serve as an informal alternative to a secured loan." *Id.*

[63] Andre Ruchin, *Can Securities Lending Transactions Substitute for Repurchase Agreement Transactions?*, 128 BANKING L.J. 450, 462 (2011).

[64] *Cf*. Henderson, *supra* note 15, at 45 (discussing how netting statutes vary in terms of what kinds of financial contracts are covered).

[65] *See* HÜPKES, *supra* note 14, at 153 (point stated); *Netting Legislation – Status*, INT'L SWAPS AND DERIVATIVES ASSOC., http://isda.org/docproj/stat_of_net_leg.html (last visited Jan. 5, 2015) (listing countries that have adopted or are considering close-out netting legislation).

[66] *See* HÜPKES, *supra* note 14, at 153.

harmonized.[67]

In some countries, special netting provisions have been added to banking laws or bankruptcy laws.[68] For example, the United States has a federal netting statute,[69] and special netting provisions have been added to state laws.[70] American laws generally exempt close-out netting agreements "by means of specific safe harbor provisions"[71] from the usual principles governing insolvency. The federal law that deals with close-out netting specifies which financial institutions and obligations are covered,[72] provides that bilateral[73] and multilateral clearinghouse[74] netting arrangements are enforceable, preempts inconsistent injunctive relief,[75] and elaborates the relationship of these provisions to other laws.[76]

The European Commission has stated that "[c]lose-out netting is important for the efficiency of financial markets, as it reduces credit risk and enables financial institutions either to reduce their regulatory required capital and/or increase their exposure."[77] In fact, several EU measures afford legal protection to close-out netting, including the Settlement Finality Directive,[78] the Winding Up Directive,[79] the Insolvency Regulation,[80] and the Financial Collateral Directive.[81] Today, the principle of close-out netting is "well established" in all EU Member States, although legal specifics and their applications vary.[82]

One author estimates that there is "a clear trend" towards the

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[67] Böger, *supra* note 2, at 533. For a survey of the law of England, France, Germany, and Spain, see *id*. at 533-47.

[68] HÜPKES, *supra* note 14, at 154.

[69] 12 U.S.C. §§ 4401-4407 (2006).

[70] Böger, *supra* note 2, at 548.

[71] *Id.*

[72] 12 U.S.C. § 4402 (2006).

[73] *Id.* § 4403.

[74] *Id.* § 4404.

[75] *Id.* § 4405.

[76] *Id.* §§ 4406-4407.

[77] *Report from the Commission to the Council and European Parliament, Evaluation Report on the Financial Collateral Arrangements Directive*, at 10, COM (2006) 833 final (Dec. 20, 2006).

[78] Council Directive 98/26, 1998 O.J. (L 166) 45 (EC).

[79] Council Directive 2001/24, 2001 O.J. (L 125) 15 (EC).

[80] Council Regulation 1346/2000, 2000 J.O. (160) 1 (EC).

[81] Council Directive 2002/47, 2002 O.J. (L 168) 43 (EC). The named Directives are examples of the European Union's continuing efforts to grapple with the legal consequences of globalization. *See also* Vincent R. Johnson, *Regional Sales Law in a World of Global Transactions*, 1 CHINESE J. COMP. L. 426, 426 (2013) (discussing the proposed Common European Sales Law ("CESL")).

[82] BENJAMIN, *supra* note 10, at 270.

enforceability of close-out netting agreements internationally.[83] However, close-out netting provisions are so commonly used in cross-border transactions, and relevant national laws vary to such an extent,[84] that parties must carefully structure their close-out netting agreements in ways that maximize the likelihood of enforceability.[85] This is because "the determination of the law governing the operation of a close-out netting provision remains of core importance."[86] Major trade associations offer legal opinions on "the effectiveness of the close out [netting] provisions of their standard documentation" under the law of a wide range of jurisdictions.[87] This makes it easier for lawyers to craft close-out netting agreements that will be enforceable.

D. The Role of Master Agreements

In international financial transactions by banks and other institutions, close-out netting is usually based on master agreements. Master agreements are designed to minimize or eliminate legal uncertainties.[88] The 2002 International Swap Dealers Association ("ISDA") Master Agreement, based largely on New York law,[89] is "one of the most widely used in the world and contains detailed provisions on netting."[90] Whatever the form of the master agreement, the parties usually choose English or New York law to govern their close-out netting activities.[91]

II. THE CASE FOR CLOSE-OUT NETTING

The case for close-out netting is twofold. Close-out netting is said to mitigate both "counterparty risk on particular transactions" (i.e., "credit risk") and "systemic risk to the entire financial system."[92]

A. Reducing Credit Risk

Close-out netting contractual arrangements greatly reduce credit risk[93]

[83] Böger, *supra* note 1, at 234.

[84] Paech, *supra* note 8, at 17 (stating that in about forty jurisdictions, "the scope and legal effects of close-out netting differ significantly").

[85] Böger, *supra* note 1, at 234.

[86] *Id*. at 237; *see also id*. at 238-50 (discussing private international law aspects of close-out netting provisions).

[87] BENJAMIN, *supra* note 10, at 269.

[88] *See* Bliss & Kaufman, *supra* note 3, at 58.

[89] HÜPKES, *supra* note 14, at 153.

[90] *See* GOODE, *supra* note 52, at 286.

[91] *See* Böger, *supra* note 1, at 237.

[92] DURHAM, *supra* note 5, at 6-2.

[93] "Credit risk" is the "risk of a debt not being paid or another obligation not being

for participants in financial transactions by minimizing "exposures on open contracts if one party should become insolvent or a like event occurs before the settlement date."[94] Thus, such provisions make it easier for persons to take financial positions that they believe will maximize their wealth. By doing so, close-out netting produces a private good for the parties to financial transactions, and a public good, to the extent that a greater volume of transactions is likely to produce greater wealth in general.[95] These benefits may be considerable because estimates suggest that close-out netting reduces total credit risk by as much as eighty-five percent.[96]

The absence of close-out netting would produce inefficiencies. Close-out netting enables parties to a derivatives contract to avoid future fluctuations in value by closing out their positions when a counterparty becomes insolvent.[97] If that option were not available, these market participants would constantly have to spend resources to rebalance hedged positions during the "long and unpredictable" period of time that bankruptcy proceedings might be pending.[98] In addition, during that period, collateral posted against net positions "would effectively become useless if it were frozen."[99]

B. Minimizing Systemic Risk

The strongest argument for close-out netting is that close-out netting is an efficient process that reduces systemic risk, which could otherwise lead to failure of the financial system.[100] "Systemic risk occurs where market participants are exposed to each other's failure in such a way that the inability of one financial market participant to meet its obligations when

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performed." BENJAMIN, *supra* note 10, at 3.

[94] Comm'rs for Her Majesty's Revenue & Customs v. Enron Eur. Ltd., [2006] EWHC 824 (Ch) (Eng.).

[95] *See* Bliss & Kaufman, *supra* note 3, at 60 ("Closeout makes netting and collateral more effective, and thus leads to further expansion of the market."); Paech, *supra* note 8, at 15 ("The widespread use of netting agreements . . . could free funds, which would in turn increase market liquidity . . . [as well as] the competitiveness of individual banks and of entire financial market places.").

[96] Böger, *supra* note 1, at 234.

[97] Bliss & Kaufman, *supra* note 3, at 64.

[98] *Id*. "The solvent party would not know whether it was hedged or not." *Id.* at 65.

[99] *Id.* at 64.

[100] *See id*. at 66-67 (discussing that as applied to derivatives, "[p]roponents of legal protection of closeout netting . . . argue that: (1) derivatives markets are especially critical to the smooth functioning of the financial system; (2) derivatives markets are particularly susceptible to systemic failures due to the volatile nature of the value of derivatives contracts; and (3) closeout netting and collateral protection ameliorate these risks and so are justified on public policy grounds").

due will cause other participants to fail to meet their obligations when due."[101]

In the banking sector of financial law, the underlying regulatory structure is "fragile by design."[102] The legal requirements that govern the operation of banks have been shaped by political compromise[103] and are often far from ideal. This makes banking systems particularly vulnerable to the problems that systemic risk creates. Bank "liquidity problems can lead to solvency problems . . . [and a] relatively small shock can cause liquidity to dry up and create [a] financial cris[i]s."[104] Bank payment systems and interbank deposit markets are tightly linked, especially in the context of short-term borrowing.[105] Such linkages create the risk that a "domino effect" will otherwise cause problems of an essentially local nature to spread systemic risk throughout the banking system.[106] Today, systemic risk can topple banking institutions regionally, nationally, and even globally.[107]

The resulting reduction in total credit risk "also effectively reduces the risk of creating or increasing financial difficulties for counterparties caused by the inability of one of the market participants to meet its obligations."[108] That risk to counterparties can lead to successive "failures of other market participants."[109] A chain of defaults caused by the failure of one major participant in derivative transactions might "lead to turmoil in the underlying securities, commodities, or interest rate markets from which

[101] Paech, *supra* note 8, at 16; *see also* Bliss & Kaufman, *supra* note 3, at 66 (asserting that there is "[n]o single generally-agreed [upon] definition of what constitutes systemic risk," but discussing "three potential types of market disruption: cascading failures, large macro-economic shocks, and common-shock market disruption/liquidity contraction").

[102] *See generally* CHARLES W. CALOMIRIS & STEPHEN H. HABER, FRAGILE BY DESIGN: THE ORIGINS OF BANKING CRISES & SCARCE CREDIT 12 (2014).

[103] *See id*. at 3-4 ("[P]olitics . . . determines whether societies suffer repeated banking crises.").

[104] VALDEZ & MOLYNEUX, *supra* note 11, at 132.

[105] WOOD, *supra* note 25, at 11; *see also* ROY GOODE, HERBERT KRONKE, EWAN MCKENDRICK & JEFFREY WOOL, TRANSNATIONAL COMMERCIAL LAW: INTERNATIONAL INSTRUMENTS AND COMMENTARY 691 (2004) (noting that "settlement arrangements involve[] systemic risks" that "are heightened in the context of transnational transactions").

[106] *See* VALDEZ & MOLYNEUX, *supra* note 11, at 133. "[C]ross-border claims between banks at the end of 2009 reached US $5.9 trillion." *Id*. at 135.

[107] *Id*. at 132 ("[S]ystemic risk in a global context did not materialize until 2007."); DURHAM, *supra* note 5, at 7-3 ("The bankruptcy filing of Lehman Brothers Holdings Inc. . . . on September 15, 2008, illustrated the global financial risk that a single market participant could pose to the global financial system when entering insolvency proceedings.").

[108] Böger, *supra* note 1, at 234.

[109] *Id*.

derivatives derive their value."[110]

Avoiding this "contagion effect" and the related "systemic risk" is what makes close-out netting important from a financial institution perspective.[111] The 2007-2009 financial crisis might have been "far worse" if a bankruptcy stay had prevented the parties to nearly three quarters of a million Lehman Brothers contracts from closing out their obligations.[112] Just as the tort systems in many developed countries work reasonably well because most cases settle,[113] the financial and insolvency systems in developed countries may operate efficiently only because a vast multitude of obligations are resolved via close-out netting.

The ability of close-out netting to minimize the risk of systemic failure largely depends on whether the relevant legislation effectively immunizes close-out netting from the "so-called cherry-picking provisions typically found in national bankruptcy laws."[114] Such provisions normally allow a receiver or liquidator in bankruptcy to affirm executory contracts that are favorable to the bankruptcy estate, and to disaffirm transactions that are disadvantageous. If such "cherry-picking" is allowed, some argue, a "solvent counter-party may not be able to absorb the shortfall and may default on its own obligations."[115] This default may cause a dangerous chain reaction throughout the financial system. That kind of domino effect can be prevented by exempting close-out netting transactions from the bankruptcy rules that otherwise allow "cherry-picking" to maximize the size of the bankruptcy estate for purposes of reorganization or for the benefit of creditors. In sum, the argument for close-out netting is that applying the usual rules of insolvency law to certain financial transactions "could adversely affect the efficient functioning of the market and thereby produce systemic risk."[116]

III. THE CASE AGAINST CLOSE-OUT NETTING

Despite the role that close-out netting plays in minimizing credit risk and

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[110] DURHAM, *supra* note 5, at 6-2.

[111] Böger, *supra* note 1, at 234.

[112] DURHAM, *supra* note 5, at 7-3.

[113] *See* VINCENT R. JOHNSON, STUDIES IN AMERICAN TORT LAW 38 (5th ed. 2013) ("The vast majority of tort cases are resolved through settlement rather than litigation; the percentage is often put at 95 percent or higher.").

[114] HÜPKES, *supra* note 14, at 153; *see also* DURHAM, *supra* note 5, at 7-6 ("Absent the special protections afforded to derivative contracts and other financial arrangements, a debtor may 'cherry-pick' the contracts it wishes to assume, creating an inequitable opportunity for use of hindsight by the debtor and the shifting of market risk of open transactions to counterparties.").

[115] *See* HÜPKES, *supra* note 14, at 153.

[116] GOODE, *supra* note 52, at 48.

systemic risk, it is still unclear whether the benefits of close-out netting outweigh the costs. This is true because close-out netting allows risk-takers to externalize the costs of their activities to innocent third persons. The close-out netting process also lacks transparency, operates inconsistently, disparately impacts participants in financial transactions, and creates systemic risk by accelerating insolvency and impeding the rescue of troubled institutions.

A. Excessive Externalization of Risk

The strongest argument against close-out netting is that the process does little or nothing to minimize the risks that large-scale financial transactions create; rather, close-out netting merely shifts those risks to other persons who have no choice in the matter.[117] Thus, close-out netting "between *A* and *B* transfers credit risk from *A* to *B*'s general creditors, and from *B* to *A*'s general creditors."[118] This shift is unfair because *A* and *B* will retain, to a great extent, the potential benefits of the underlying transactions, while their general creditors, who do not directly benefit from the creation of those positions, will bear much of the cost if the transactions fail.

In other words, close-out netting creates a world that bears little resemblance to reality. By accelerating mutual obligations and reducing all liability to the calculation of a net sum that is to be paid or received, close-out netting pretends that a multitude of transactions between the parties to a close-out netting agreement only creates risks to those parties. In fact, those transactions create numerous other risks, including the risk that persons outside the transactions, who otherwise deal with those parties, will be adversely affected if the transactions fail.[119] Moreover, in the case of banks, close-out netting often results in understated capitalization requirements and thus makes it more likely that individual banks will collapse and jeopardize the global financial system.

Under basic principles of tort jurisprudence, enterprises should be forced to internalize the costs of their activities because only then will those enterprises make an honest calculation of whether risky activities—such as transactions involving credit derivatives and asset-backed securities—are truly worthwhile.[120] It makes little sense for the law to allow financial

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[117] *See* BENJAMIN, *supra* note 10, at 266 ("[F]inancial law cannot reduce risk, but only moves it from person to person."); *see also id*. at 16.

[118] *Id*. at 266.

[119] *Cf.* DAVIES & GREEN, *supra* note 13, at 8 ("[W]hen risks [created by derivatives] crystallize, they may have an impact in hitherto unfamiliar places, anywhere in the globe.").

[120] *Cf.* Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: A Response to Market Manipulation*, 6 ROGER WILLIAMS U. L. REV. 239, 284 (2000) (explaining how requiring persons to internalize the costs of their activities influences both

institutions to create instruments that entail substantial risks and, at the same time, immunize those institutions from the very bundle of risks that they have created while leaving nonparties vulnerable.

The institutions that are likely to benefit from marketing a bewilderingly complex array[121] of risky financial products should be required to bear a fair share of the risks and the resulting losses. However, close-out netting severs the critical link between potential benefits and potential losses. This disconnection not only threatens to distort major players' exercise of judgment in the financial markets, but also unfairly thrusts the costs of risky financial practices on unwitting general creditors who will never enjoy a fair share of the potential benefits and have no say in the transfer of risk.

The way to mitigate the frequency and severity of future financial crises is to put "risk back into the private sector."[122] Far from doing that, close-out netting increases the likelihood that future crises will occur and cause unnecessary losses by disconnecting the potential for profit from the potential for loss in financial transactions that often involve vast amounts of money.

B. Lack of Transparency

The applicable law in many countries minimizes legal formalities for the creation of close-out netting agreements.[123] No public declarations or filings are required. It is unlikely that the general creditors of a financial institution will ever know the magnitude of the risks to which they are being subjected to by the existence of close-out-netting agreements between that institution and its favored counterparties.[124] This is particularly true where the transactions underlying such agreements, e.g., credit default swaps, are themselves "an ideal vehicle for hidden leverage and secret liens because of their inherent complexity . . . [and] limited disclosure."[125] In addition, basic information about over-the-counter derivatives is difficult to

activity levels and care levels).

[121] *See* DAVIES & GREEN, *supra* note 13, at 8 ("New instruments have emerged which make it possible to transfer risk of all kinds on a far larger scale and in more complex ways, not solely through standardized exchange-traded derivatives, but through an almost infinite range of bespoke, over-the-counter arrangements.").

[122] *The Slumps that Shaped Modern Finance*, *supra* note 11, at 54.

[123] *Cf.* Paech, *supra* note 8, at 17 (indicating that recent intergovernmental negotiations settled on the principle that "no formal requirement other than writing should be required").

[124] *Cf.* DURHAM, *supra* note 5, at 8-14 ("Parties to highly confidential derivative transactions may not want to file UCC financing statements that will identify the existence and main collateral terms of the derivative transaction, because these filings become a matter of public record.").

[125] Simkovic, *supra* note 17, at 272; *cf. id.* at 284-85 (explaining why AIG's creditors were unaware of AIG's credit default swap exposure).

obtain and mandatory disclosures are rare.[126]

Close-out netting arrangements lack transparency. Thus, without any meaningful consent on their part, general creditors are forced to bear a larger share of the losses that occur soon after a party that is protected by a close-out agreement defaults, cashes in its chips, and leaves the table, even as its counterparty fails.

Although financial law is animated by arm's length, *caveat emptor* principles, rather than by fiduciary or pro-consumer ideals,[127] many well-established legal rules—namely, good faith disclosure requirements, prospectus laws, and market transparency standards—support the idea that risk takers should be liable for market losses only if the losses resulted from decisions that were entered into with informed consent.[128] These same considerations make it unfair for general creditors of an insolvent institution to bear an enhanced share of the losses that result from insolvency that occurs in the context of close-out netting.

Typically, close-out netting agreements are secret and essentially undiscoverable by third parties. Yet, transparency plays an important role in guiding the operation of financial markets.[129] The lack of transparency in close-out netting agreements, and the danger that it poses to market participants, is a legitimate reason for the law to decline to honor such highly preferential arrangements that are intended to circumvent well-established bankruptcy principles.[130] Those principles are rooted in the sound idea that, in cases of insolvency, the greatest good will be achieved by mustering the assets of the insolvent party and salvaging that enterprise if possible.[131] In contrast, close-out netting is a self-interested practice, which allows a counterparty to dismember and abandon an entity at the first sign of distress that amounts to any one of several kinds of default, such as a credit downgrade.[132]

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[126] *Id*. at 274-75.

[127] BENJAMIN, *supra* note 10, at 16 (differentiating approaches to regulation).

[128] *Id*. at 17 (offering these examples).

[129] *Cf*. FIN. STABILITY FORUM, REPORT OF THE FINANCIAL STABILITY FORUM ON ENHANCING MARKET AND INSTITUTIONAL RESILIENCE 57 (2008) (setting forth recommendations for improving transparency in securitization processes and markets).

[130] *See* Simkovic, *supra* note 17, at 289-90 (arguing that creditors seeking priority in bankruptcy need to be forced to disclose publicly their claims in full and that Congress should establish a universal "recordation" system for any instrument that gives a creditor greater priority than that of a general unsecured creditor).

[131] *See* Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61, 63 (2009) ("The cost imposed by chapter 11 is a cost imposed on all unsecured creditors, resulting from a plausible policy judgment that the collective gains from the organization process exceed these costs.").

[132] *See* Robert R. Bliss, *Bankruptcy Law and Large Complex Financial Organizations: A Primer*, ECON. PERSPECTIVES, Q1 2003, at 48, 49 (1Q/2003) (discussing the risk of

C. Inconsistency and Opaqueness

The problems with close-out netting agreements are not merely their lack of transparency and nondisclosure of material information. Far worse, close-out netting agreements are both deliberately opaque and unpredictable in operation. Parties to close-out netting agreements are given a great deal of freedom to define their terms by specifying, for example, what constitutes a default sufficient to trigger the closing-out process.[133] While this flexible arrangement can be praised as consistent with the ideal of "private ordering,"[134] it means that the operation of financial and insolvency law is far from predictable. In some instances, an adverse credit event affecting an affiliated entity is sufficient to justify termination and acceleration of mutual obligations; in other cases, it is not. There is no way for affected third parties to know much about when they are likely to be drawn into a maelstrom of close-out netting which, by accelerating obligations between the parties, may thrust one of those parties into bankruptcy.

The complexities that surround close-out netting agreements are a product not just of the terms of the agreements, but also of the application of those provisions. Without an international convention, the current variations in nationally-based close-out netting laws inject layers of legal uncertainty into global financial transactions. In addition, in many countries, such as the United States, close-out netting is not a mandatory or automatic regime, but an optional process.[135] Parties have the freedom to shape their agreements and rarely apply a rule of automatic early termination to complex derivative transactions.[136]

In cases where an event of default or termination is of a continuing

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dismemberment of an insolvent corporation and loss of value).

133 *See* DURHAM, *supra* note 5, at 8-3 (discussing "which entities should be utilized as specified entities for purposes of default"). There are numerous events that may be deemed to be a default of a master agreement, including failure to pay or deliver, breach or repudiation of the agreement, credit support default, misrepresentation, default under specific transactions, cross-default, bankruptcy, and merger with assumption. *See id.* at 2-25 to -30 (setting forth a chart).

134 *See* Jay M. Feinman, *The Economic Loss Rule and Private Ordering*, 48 ARIZ. L. REV. 813, 814 (2006) (discussing the logic of private ordering).

135 *See* DURHAM, *supra* note 5, at 1-28 ("A non-defaulting party has the option to terminate a derivative contract but is not obliged to do so."). "One important feature of the master agreements is that an event of default can only occur if the non-defaulting party *elects* to declare an event of default or termination event. Unless the parties have negotiated automatic early termination . . . derivative transactions do not terminate automatically." *Id.* at 2-22; *see also id.* at 8-17 (discussing the option of non-termination).

136 *See id.* at 2-14 (indicating that "most parties elect not to"); *id.* at 2-15 (discussing difficulties caused by automatic termination).

nature, a non-defaulting party to a master agreement ordinarily can elect not to accelerate and close out, if that would be disadvantageous to that party. That might be true, for example, when the non-defaulting party would owe a net balance to the insolvent party. The right to close out can therefore be reserved for a later, more advantageous moment. In such instances, from the standpoint of the non-defaulting party, the operation of close-out netting is likely to be wholly self-interested. If it is better for the non-defaulting party to close out, that party will probably choose to close out. If it is better for the non-defaulting party not to close out, the party may not choose to close out. The non-defaulting party has no obligation to consider the welfare of the defaulting party or of potentially affected creditors. The consequences of ignoring the welfare of third parties can be considerable. Lehman Brothers' bankruptcy counsel estimated that "billions of dollars were lost to the bankruptcy estate" because "[s]ome counterparties who owed Lehman Brothers money on derivative transactions simply chose not to terminate the derivative transactions."[137]

If it is wrong for a bankruptcy administrator to "cherry pick" transactions to save a distressed entity, it is doubly wrong for a party to a close-out netting agreement to decide whether to accelerate obligations in a way that increases the likelihood that a distressed institution will fail.[138] Reflecting a modicum of skepticism about according selected categories of counterparties a preferential right to close out and avoid bankruptcy obligations, some courts have held that if a party to a close-out netting agreement fails to close out promptly when a counterparty becomes insolvent, the party waives the right to do so at a later time even if the default is of a continuing nature.[139]

D. Disparate Treatment

Close-out netting disproportionately favors large institutions. Banks are eligible to enter into close-out netting agreements in all "netting friendly" jurisdictions.[140] In many such places, so are "insurance companies, investment firms, hedge funds, proprietary traders, pension funds, central banks, public authorities, [and] international financial institutions."[141] In contrast, non-financial corporate entities are eligible only in certain

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[137] *Id*. at 1-28.

[138] In some instances, driving a business into insolvency may give rise to tort liability. *See* Vincent R. Johnson, *Tortious Interference with Business Interests: An American Perspective*, 3 J. BUS. & L. 29 (2014) (discussing relevant factors).

[139] *See* DURHAM, *supra* note 5, at 2-25 (discussing the United States).

[140] Paech, *supra* note 8, at 16.

[141] *Id*.

cases.[142] Even if small institutions qualify for the favored treatment of close-out netting under insolvency laws, the transactional costs are often so prohibitive as to effectively exclude them.[143] Further, "[i]ndividual natural persons . . . are generally only eligible under limited circumstances."[144]

It is possible to defend the close-out netting eligibility requirements that favor large institutions on the ground that it is large institutions, not small ones, whose potential failure poses the greatest threat to the financial system. Yet it is easy to see the legal disparity and the problems that flow from disparate treatment. There are costs inherent in the idea that some institutions are above the law (of bankruptcy), entitled to preferential treatment (via accelerated close-out netting), and too big to fail. Equality before the law is a principle widely honored and easily understood.[145] According super-priority to large institutions by allowing them to engage in close-out netting under conditions largely exempt from insolvency law[146] is a suspect practice because it offends the equality principle.

Exceptionally large entities that are sometimes known as "systemically important financial institutions" ("SIFIs") transfer vast quantities of capital and related risks across international borders.[147] For example, banks perform key roles as depositories for savings, conduits for linking borrowers and lenders, suppliers of credit, and providers of payment facilities.[148] SIFIs are typically "very big and international," as well as "extremely complex," often with "at least 100 subsidiaries."[149] It is not clear how they should be regulated. Yet, a system that insulates SIFIs from widely applied principles of insolvency law, and allows them to externalize the risks of failure that are inherent in their complex transactions, creates an inevitable moral hazard that will likely harm the operation of those

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142 *Id*. at 17.

143 *See* DURHAM, *supra* note 5, at 8-2 ("A single financing and related hedging derivative contract would not warrant the time and cost of putting a master netting agreement in place."). "For parties with multiple financial agreements and derivative contracts . . . a master netting agreement should be considered." *Id*. at 8-3.

144 Paech, *supra* note 8, at 17.

145 *Cf.* Vincent R. Johnson & Stephen C. Loomis, *The Rule of Law in China and the Prosecution of Li Zhuang*, 1 CHINESE J. COMP. L. 1, 12 (2013) ("[T]he rule of law demands that a legal system . . . treat all persons equally.").

146 *See* Böger, *supra* note 1, at 236 ("Close-out netting provisions have been argued to be in conflict with the general system of insolvency preferences.").

147 VALDEZ & MOLYNEUX, *supra* note 11, at 136.

148 *See* WOOD, *supra* note 25, at 9. It is argued that credit "alleviates poverty," "facilitates development," "stimulates investment, production, buying power and economic growth," encourages savings by providing revenues for savers, and locates resources where they are needed. *Id*. at 9-10.

149 VALDEZ & MOLYNEUX, *supra* note 11, at 136.

institutions.[150] Moreover, if laws give the largest institutions favorable special treatment, banks and other financial entities will have a troublesome incentive to become large and take on too much risk.[151]

In addition, the preferential treatment of large institutions erodes public respect for both the government and the justice system because it undermines the ideal of equality before the law.[152] Thus, aside from whether close-out netting creates systemic risks, close-out netting threatens the legal[153] and political systems, which require public confidence to function effectively.[154]

Moreover, even if a case can be made for protecting the largest and most vital financial institutions, there is a problem of "mission creep." In the United States, for example, aggressive lobbying[155] caused a vast expansion of the "safe harbor" provisions in the bankruptcy code,[156] so that close-out netting agreements related to most forms of derivatives are now exempt from ordinary insolvency principles.[157] The widening of the bankruptcy exceptions for derivatives "degraded the value of those exceptions as protection against investment bank failures"[158] and produced "windfall gifts to the financial industry."[159] Those "reforms" appear to be better explained

[150] *Id*. at 138 ("If SIFIs cannot fail, government support is inevitable and the problem of moral hazard is exacerbated.").

[151] *Id*. at 130.

[152] *See* Vincent R. Johnson, *Corruption in Education: A Global Legal Challenge*, 48 SANTA CLARA L. REV. 1, 23 (2008) ("[P]erceived unfairness, dishonesty, or unequal treatment threatens public confidence in, and indeed the survival of, important institutions.").

[153] *Cf.* Vincent R. Johnson, *The Rule of Law and Enforcement of Chinese Tort Law*, 34 T. JEFFERSON L. REV. 45, 75 (2011) ("Rule of Law demands that a legal system operate in a way that commands public respect. This is true because the success of a peaceful substitute for unlawful forms of dispute resolution depends upon the perceived legitimacy of the alternative.").

[154] *Cf.* Vincent R. Johnson, *Regulating Lobbyists: Law, Ethics, and Public Policy*, 16 CORNELL J.L. & PUB. POL'Y 101, 115-16 (2006) [hereinafter Johnson, *Regulating Lobbyists*] ("Perceived corruption, like corruption itself, can destroy a democratic institution."); *see also* Vincent R. Johnson, *Ethics in Government at the Local Level*, 36 SETON HALL L. REV. 715, 735 (2006) ("[T]he appearance of impropriety is often as destructive of public confidence in government as impropriety itself.").

[155] *See* Simkovic, *supra* note 17, at 279 ("[T]he derivatives industry has sought to protect itself by persuading Congress to amend the Bankruptcy Code.").

[156] *See* Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319, 319 (2010) (referencing the expansion of safe harbor provisions).

[157] *See id*. at 324-26 (establishing that derivatives contracts are exempt from the provision in the U.S. Bankruptcy Code prohibiting the termination of most contracts simply because the debtor has filed a bankruptcy petition).

[158] Simkovic, *supra* note 17, at 279.

[159] Lubben, *supra* note 156, at 321.

by the political power of large institutions and their lobbyists[160] than by their functionality in the financial world.

Close-out netting also adversely impacts trade in financial services with less developed countries because netting-friendly law is found mostly in the industrialized world. The very favorable legal treatment available to financial institutions in developed countries undoubtedly discourages financial institutions from doing business with financial services providers located in the comparatively netting-unfriendly developing world.

E. Accelerated Insolvency and Systemic Risk

Close-out netting agreements pose a great risk of thrusting some financial institutions prematurely into bankruptcy. This not only endangers specific institutions, but also creates a risk of precipitating an adverse domino effect of firm failures throughout financial systems. Despite these dangers, the law in netting-friendly jurisdictions insulates the financial institutions that assert their close-out rights from obligations under the law of insolvency. This is true regardless of the magnitude of the risks created by their activities and financial products. The special treatment accorded to credit derivatives by applicable insolvency laws may well increase systemic risk "because it eliminates a possible curb on counter-parties' rush to close out their contracts in the event of a wave of failures."[161]

Risks related to accelerated insolvency arise from the broad definitions that are employed in widely used master agreements. Those definitions sometimes define "default" as including "events of default under other financial agreements or instruments with the same party or with a party's credit support provider or other related parties."[162] The standard definitions are so broad that they capture transactions that are done with entities other than the parties to the master agreement. Thus, if *A* and *B* are parties to a master agreement, *A* can close out all transactions with *B* simply because *B* has defaulted under a separate, unrelated transaction with *C*.[163] Armed with these kinds of potentially far-reaching provisions, a non-defaulting party can launch a "preemptive" strike by treating a counterparty's default on an unrelated agreement as a "red flag" indicating that it may also default on its transactions and then initiating the close-out netting process.[164]

Thus, the consequences of a party being declared in default under one

[160] *Cf.* Johnson, *Regulating Lobbyists*, *supra* note 154, at 112-13 (discussing the "dark side of lobbying").

[161] Partnoy & Skeel, *supra* note 19, at 1049.

[162] DURHAM, *supra* note 5, at 2-7.

[163] *Id.* at 2-8 (offering a similar illustration).

[164] *Id.* at 2-7.

close-out netting agreement can be "catastrophic."[165] The "cross-default provisions in [other] master agreements virtually ensure" that "all [other] counterparties will close out."[166]

The risk is not only that technically solvent financial institutions will be thrust into bankruptcy,[167] but that valuable assets may be lost at "fire-sale" prices.[168] In addition, the preferential treatment accorded to parties exercising their rights under close-out netting agreements will impede the mustering of assets and make it more difficult for bankruptcy administrators to manage insolvency.[169] Thus, the system decreases the likelihood that distressed institutions will be restored to economic viability.

The danger is really two-fold. First, harm will be produced by a party's *proper* exercise of its rights under a close-out netting agreement. Second, harm will also result from *erroneous* assertions of rights. Parties who erroneously declare counterparties to be in default may trigger "cascading chain[s] of cross-defaults."[170] A leading treatise suggests that a party to a close-out netting agreement "faces significant liability if it terminates on the basis of a default . . . which has not occurred."[171] In fact, that is not true under American law, where negligent interference with economic interests is generally not actionable,[172] and a good faith assertion of legal rights, even if erroneous, is normally protected by at least a qualified privilege.[173] There is little reason to think that a party who incorrectly declares a default will be liable for economic harm caused to third persons. Consequently, under American jurisprudence, the prospect of tort liability does little to deter parties to financial transactions from entering into or exercising their actual or perceived rights under close-out netting agreements. The threat of tort liability does not significantly minimize the risk of harm to third

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[165] *Id*. at 2-3.

[166] Bliss & Kaufman, *supra* note 3, at 68 (discussing demands for collateral).

[167] *See id.* ("Even if the firm is technically solvent . . . the closeout process can nonetheless harm the economic viability of the firm.").

[168] *Id*.

[169] Bliss, *supra* note 132, at 56 ("[T]he combination of rapidly developing insolvency, opaque financial instruments positions, and the exemption from stays of contracts has the potential to preempt the usual options open to regulators and courts."); *cf*. Paech, *supra* note 8, at 18 ("[T]he unrestricted exercise of termination rights . . . has the potential of harming the competent authority's aim of ensuring the orderly resolution of the relevant institution.").

[170] DURHAM, *supra* note 5, at 2-10.

[171] *Id*. at 2-10 to -11.

[172] *See* RESTATEMENT (SECOND) OF TORTS § 766C (1979); *see also* VINCENT R. JOHNSON, ADVANCED TORTS: A PROBLEM APPROACH 443-44 (2d ed. 2014) (discussing tortious interference with networks of contracts).

[173] *See* Texas Beef Cattle Co. v. Green, 921 S.W.2d 203, 215 (Tex. 1996); RESTATEMENT (SECOND) OF TORTS § 773 (1979).

persons who may become the casualties of a sequence of financial failures precipitated by close-out netting.

The close-out netting process entails many risks. The process makes it difficult for troubled financial institutions to avoid insolvency, difficult for insolvency administrators to salvage distressed firms and their assets, and difficult for the financial system to insulate sound entities from systemic risks. Viewed holistically, the close-out netting process is itself a source of systemic risk.

CONCLUSION

Although there are legitimate arguments in favor of close-out netting, there are also real concerns about whether those arguments have been overstated and whether expansive legal protection for close-out netting exacts too high a cost. These competing considerations cannot be mathematically weighed and balanced because the relevant risks (financial and otherwise) are difficult or impossible to measure.[174]

In the end, lawmakers must exercise sound judgment regarding the degree of legal recognition that should be afforded to close-out netting. There are no clear answers, but there are certainly red flags.

The danger signals include aggressive lobbying by financial institutions for special treatment; lack of transparency regarding the terms of close-out netting agreements and underlying transactions; inconsistency, haste, and opaqueness in closing-out processes; disparate legal treatment favoring large institutions and allowing excessive externalization of risk by certain financial transaction participants; and obstacles that render insolvency resolution processes more necessary but less effective. These are legitimate concerns that cannot be ignored.

Every proposed change to the law on close-out netting must be carefully scrutinized. Any proposed expansion of close-out netting should be presumed to be unwarranted unless there is compelling evidence to the contrary. In addition, lawmakers must periodically review the efficacy of all close-out netting laws now in place, particularly those that exempt derivative transactions from the usual provisions of insolvency law.

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[174] *Cf.* Philipp Paech, *Market Needs as Paradigm: Breaking Up the Thinking on EU Securities Law*, *in* INTERMEDIATED SECURITIES: THE IMPACT OF THE GENEVA SECURITIES CONVENTION AND THE FUTURE EUROPEAN LEGISLATION 22, 42-43 (2013), (discussing difficulties in quantifying risk and cost).