

Contractual Netting under German law: New Netting Legislation Passed by Parliament

1 Decision on Netting under German insolvency law: Background

On 9 June 2016, the German Federal Court of Justice (*Bundesgerichtshof*, "**BGH**") handed down a decision on the validity of contractual close-out netting under German insolvency law (the "**Decision**"). In the Decision by the IXth BGH senate (IX ZR 314/14), the BGH gave guidance on the extent to which contractual netting arrangements were void due to deviations from the mandatory statutory netting and valuation provisions set out in Section 104 German Insolvency Code (*Insolvenzordnung*, "**InsO**"). Due to the importance of a functioning close-out netting regime for financial and commodity trading markets, the Decision attracted a high degree of attention in Germany and internationally.¹

The importance of the Decision was underlined by the immediate supervisory and governmental reactions.

In order to ensure legal certainty until changes to the InsO could take effect, the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "**BaFin**") issued, on the date of the Decision, a general decree (*Allgemeinverfügung*, the "**Decree**") stating in particular that contractual netting agreements, as described in Article 295 CRR, shall continue to be settled in accordance with their respective contractual arrangements.

On the same day, the Ministry of Finance (*Bundesministerium der Finanzen*, "**BMF**") and the Ministry of Justice and Consumer Protection (*Bundesministerium der Justiz und für Verbraucherschutz*, "**BMJV**") issued a joint statement announcing that the German government would, if needed, initiate a change of the relevant InsO provisions in order to ensure that close-out netting arrangements commonly used in master agreements remain valid under German insolvency law.

¹ For an overview of the scope of the Decision, see our newsletter from June 2016, available at http://www.linklaters.com/pdfs/mkt/frankfurt/Validity_of_Contractual_Netting_under_German_law.pdf

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2 Completion of Legislative Process

2.1 Government Draft and Legislative Procedure

Following a consultation process on the basis of a draft act prepared by the BMF and the BMJV in August 2016, a government draft (*Regierungsentwurf*) was published on 14 September 2016 (the "**Government Draft**").² Its main aim was to enhance legal certainty for contractual netting by revising Section 104 InsO ("**Section 104 InsO-new**") and certain other provisions. The amendments were accompanied by detailed reasoning.

On 23 September 2016, the German government passed on the Government Draft to the Federal Council (*Bundesrat*), classifying the legislative project as urgent (in accordance with Article 76(2) sentence 4 Constitution of the Federal Republic of Germany, *Grundgesetz*, "**GG**").³ The opinion (*Stellungnahme*) of the Federal Council was published on 4 November 2016,⁴ however, the issues brought forward by the Federal Council (*Bundesrat*) did not lead to any further amendments of the draft.⁵ The recommended resolution and report of the Legal Committee (*Rechtsausschuss*) of the Federal Parliament (*Bundestag*) published on 29 November 2016 did not include any amendments to the Government Draft either.⁶

2.2 Adoption by Federal Parliament (*Bundestag*) and Federal Council (*Bundesrat*)

The Federal Parliament (*Bundestag*) adopted the Third Amendment Act to the Insolvency Code and to the Introductory Act to the Code of Civil Procedure (*Drittes Gesetzes zur Änderung der Insolvenzordnung und zur Änderung des Gesetzes, betreffend die Einführung der Zivilprozessordnung*) ("**New Legislation**") on 1 December 2016.⁷

On 16 December 2016, the Federal Council (*Bundesrat*) approved the New Legislation in accordance with Article 78 GG.⁸

The New Legislation now has to be executed by the Federal President (*Bundespräsident*) and will become effective on the day after the promulgation in the Federal Law Gazette (*Bundesgesetzblatt*) ("**Effective Date**").⁹

² <http://dipbt.bundestag.de/dip21/btd/18/099/1809983.pdf>

³ <http://www.bundesrat.de/SharedDocs/beratungsvorgaenge/2016/0501-0600/0548-16.html>

⁴ [http://www.bundesrat.de/SharedDocs/drucksachen/2016/0501-0600/548-16\(B\).pdf?__blob=publicationFile&v=1](http://www.bundesrat.de/SharedDocs/drucksachen/2016/0501-0600/548-16(B).pdf?__blob=publicationFile&v=1)

⁵ <http://dip21.bundestag.de/dip21/btd/18/102/1810263.pdf>

⁶ Except for the inclusion of an unrelated provision in the field of civil procedure (Art. 4 New Legislation). The name of the draft was therefore changed to Third Amendment Act to the Insolvency Code and to the Introductory Act to the Code of Civil Procedure (*Drittes Gesetzes zur Änderung der Insolvenzordnung und zur Änderung des Gesetzes, betreffend die Einführung der Zivilprozessordnung*), <http://dip21.bundestag.de/dip21/btd/18/104/1810470.pdf>

⁷ <http://dipbt.bundestag.de/dip21/btp/18/18206.pdf#P.20634>

⁸ [http://www.bundesrat.de/SharedDocs/drucksachen/2016/0701-0800/724-16\(B\).pdf?__blob=publicationFile&v=1](http://www.bundesrat.de/SharedDocs/drucksachen/2016/0701-0800/724-16(B).pdf?__blob=publicationFile&v=1)

⁹ Subject to the phrasing in described in 4 below and the provision on civil procedure (see footnote 10 below; this provision is unrelated to netting issues).

It is expected that the effective date will be on or prior to 1 January 2017.¹⁰ This timing ensures an uninterrupted transition from the Decree (expiring on 31 December 2016) to the New Legislation.

3 Overview of Key Content of New Legislation

The scope of Section 104 InsO-new remains based on the current version of Section 104 InsO. The treatment of fixed-date transactions (*Fixgeschäfte*) and of financial services (*Finanzleistungen*) upon the opening of insolvency proceedings is still covered. It continues to set out the framework for statutory netting (effective upon the opening of insolvency proceedings, if not terminated earlier) and contractual netting (effective upon the occurrence of a contractually agreed early-termination trigger).

The reasoning by the legislator states that legal certainty for contractual netting arrangements had always been the intention and the revisions were clarifications rather than substantial changes. The reasoning also makes reference to market-standard agreements in general (without naming specific types of agreements). It is highlighted that such agreements are required in the financial sector to comply with specific regulatory requirements.

The following further elements of Section 104 InsO-new are worth noting:

- > *Updated List of Financial Services.* The non-exclusive list of financial services (*Finanzleistungen*) contained in Section 104 InsO is updated. One example is an additional reference to financial services consisting of a "delivery of financial instruments or comparable rights". The term "financial instrument" refers to Annex I Section C MiFID's list of financial instruments, which cover a wide range of different transaction types. The list covers, for example, repurchase and securities lending agreements, instruments for the transfer of credit risk and certain types of physically settled commodity derivatives.
- > *Maintained Scope for Fixed-Date Commodity Delivery Transactions.* Just as under the current version of Section 104 InsO, deliveries of commodities (*Waren*) are only covered if certain preconditions are met. In particular, the (maintained) requirement to have fixed-date transactions (*Fixgeschäfte*) ensures that the privileges under Section 104 InsO do not impair the administrator's election rights under Section 104 InsO in connection with, for example, ordinary commodity sale and purchase transactions where the strict requirements for fixed-date transactions (*Fixgeschäfte*) are not met.

¹⁰ Cf. Art. 5(3) of the New Legislation which states that Art. 4 (the provision on civil procedure) shall become effective on 1 January 2017.

- > *Preservation of Single-Agreement Concept and Guidance for Mixed Master Agreements.* As before, the combination of transactions under a master agreement will create a single agreement. One new feature of the New Legislation is that not only financial services (*Finanzleistungen*) but also fixed-date transactions (*Fixgeschäfte*) can be validly combined under master agreements. Transaction types not qualifying as either of these types may still be validly included in a master agreement, although these types will not form part of the privileged netting set. Consequently, these so-called "mixed master agreements" will now be treated as two sets of portfolios with different consequences in an insolvency scenario. In cases where all transactions under a master agreement qualify as transactions under Section 104(1) InsO-new, the mixed master agreement issue is not relevant. The practical relevance of "mixed master agreements" should be reduced by the broader updated list of financial services (*Finanzleistungen*) and the inclusion of fixed-date transactions (*Fixgeschäfte*) in the scope of transactions covered by Section 104(1) InsO-new.
- > *Enhanced Legal Certainty for Valuation Methods.* One of the key practical implications of the Decision was the restrictive guidance for the valuation of transactions after an insolvency-related close-out. The New Legislation contains guidance for more flexible valuations following a statutory or contractual close-out (Sections 104(2) and (4) number 3 InsO-new). Valuations are no longer restricted to market or exchange prices but may also use values from actual replacement transactions. In addition, model-based prices may be used under certain circumstances. The period for actual replacement transactions following a contractual close-out may be extended by the parties up to twenty business days following the termination of the contract, provided this extension is required for a value-conserving settlement.
- > *Deviating contractual provisions.* Section 104(4) InsO-new allows contracting parties to agree on deviations from the statutory termination and valuation provisions, provided that these are compatible with the material principles (*wesentliche Grundgedanken*) of the relevant statutory provisions from which they deviate.
- > *Clarification of Early Termination and Valuation Timing.* Section 104(4) sentence 2 InsO-new lists examples of contractual arrangements providing for early terminations and concurrent valuations, provided that certain preconditions are met. It is specifically mentioned that the filing of an insolvency petition (*Antrag auf Eröffnung eines Insolvenzverfahrens*) or the existence of reasons for the commencement of insolvency

proceedings (*Vorliegen eines Eröffnungsgrundes*) are permitted trigger events.

4 Phasing In of New Regime

The New Legislation introduces changes in two steps: Step 1 (Article 1 New Legislation) approves certain contractually agreed early-termination events, a concurrent valuation and certain valuation methods, while Step 2 (Article 2 New Legislation) introduces a more distinct split between statutory and contractual netting rules, the combination of fixed-date transactions and financial services, rules relating to mixed master agreements and the updated list of financial services.

This means that different regimes will apply to different periods. The relevant event which is decisive in determining which time period a close-out case falls into is the filing of the insolvency petition (*Antrag auf Eröffnung eines Insolvenzverfahrens*). The resulting periods can be summarised as follows:

- > *Close-out Cases prior to 10 June 2016:* Close-outs prior to 10 June 2016 will not be affected by the changes, and Section 104 InsO in the form effective on that date will apply.
- > *Close-out Cases during Interim Phase from 10 June 2016 to Effective Date:* The Step 1 amendments will be effective retroactively from 10 June 2016. The retroactive effect shall confirm the legal position created by the Decree issued by BaFin on 10 June 2016.
- > *Close-out Cases from Effective Date:* The Step 2 amendments will be effective from the Effective Date. The Step 2 amendments complement and override the Step 1 amendments and thereby form the new netting regime.

The text of the final version of Section 104 InsO-new that will ultimately apply from the Effective Date can be found in the [Annex](#).

5 Summary

The New Legislation corresponds to the Government Draft and was welcomed by market participants in the commodity trading and the financial sector. The more detailed list of covered transaction types, statements on the treatment of mixed master agreements and the guidance for contractual netting clauses in Section 104(4) InsO-new now set the perimeters for netting provisions.

Annex

English Convenience Translation/German Version

**Section 104 InsO-new after Implementation of Changes
(Effective from the day following publication in the
German Federal Law Gazette (*Bundesgesetzblatt*))**

<p>Section 104 InsO Fixed-date Transactions, Financial Services, Contractual Liquidation Netting.</p>	<p>§ 104 Fixgeschäfte, Finanzleistungen, vertragliches Liquidationsnetting.</p>
<p>(1) If the delivery of goods with a market or exchange price was agreed to take place exactly on a fixed date or within a fixed period, and if such date or expiry of the period occurs after insolvency proceedings were opened, performance may not be claimed, but only a claim for non-performance. This also applies to transactions for financial services which have a market or exchange price and for which a fixed date or a fixed period was agreed that occurs or ends after insolvency proceedings were opened. In particular, the following shall be regarded as financial services:</p>	<p>(1) War die Lieferung von Waren, die einen Markt- oder Börsenpreis haben, genau zu einer festbestimmten Zeit oder innerhalb einer festbestimmten Frist vereinbart und tritt die Zeit oder der Ablauf der Frist erst nach Eröffnung des Insolvenzverfahrens ein, so kann nicht Erfüllung verlangt, sondern nur eine Forderung wegen Nichterfüllung geltend gemacht werden. Dies gilt auch für Geschäfte über Finanzleistungen, die einen Markt- oder Börsenpreis haben und für die eine bestimmte Zeit oder eine bestimmte Frist vereinbart war, die nach der Eröffnung des Verfahrens eintritt oder abläuft. Als Finanzleistungen gelten insbesondere</p>
<p>1. the delivery of precious metals,</p> <p>2. the delivery of financial instruments or comparable rights if it is not intended to create a participation in a company in order to establish a permanent relationship with such company,</p> <p>3. payments in cash</p> <p>a) which have to be made in foreign currency or in a unit of account or</p> <p>b) the amount of which is indirectly or directly determined by the exchange</p>	<p>1. die Lieferung von Edelmetallen,</p> <p>2. die Lieferung von Finanzinstrumenten oder vergleichbaren Rechten, soweit nicht der Erwerb einer Beteiligung an einem Unternehmen zur Herstellung einer dauernden Verbindung beabsichtigt ist,</p> <p>3. Geldleistungen,</p> <p>a) die in ausländischer Währung oder in einer Rechnungseinheit zu erbringen sind oder</p> <p>b) deren Höhe unmittelbar oder mittelbar durch den Kurs einer</p>

<p>rate of a foreign currency or unit of account, by the interest rate prevailing for claims or by the price of other goods or services,</p> <p>4. deliveries and payments in cash arising out of derivative financial instruments which are not excluded pursuant to number 2,</p> <p>5. options and other rights to deliveries pursuant to sentence 1 or deliveries, payments, options and other rights within the meaning of numbers 1 to 5,</p> <p>6. financial collateral within the meaning of Section 1(17) of the German Banking Act.</p>	<p>ausländischen Währung oder einer Rechnungseinheit, durch den Zinssatz von Forderungen oder durch den Preis anderer Güter oder Leistungen bestimmt wird,</p> <p>4. von Nummer 2 nicht ausgeschlossene Lieferungen und Geldleistungen aus derivativen Finanzinstrumenten,</p> <p>5. Optionen und andere Rechte auf Lieferungen nach Satz 1 oder auf Lieferungen, Geldleistungen, Optionen und Rechte im Sinne der Nummern 1 bis 5,</p> <p>6. Finanzsicherheiten im Sinne des § 1 Absatz 17 des Kreditwesengesetzes.</p>
<p>Financial instruments within the meaning of sentence 3 nos. 2 and 4 are the instruments specified in Section C of Annex I of the Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173 dated 12 June 2014, p. 349, L 74 dated 18 March 2015, p. 38, L 188 dated 13 July 2016, p. 28), which has been amended by Directive (EU) 2016/1034 (OJ L 175 dated 30 June 2016, p. 8).</p>	<p>Finanzinstrumente im Sinne von Satz 3 Nummer 2 und 4 sind die in Anhang I Abschnitt C der Richtlinie 2014/65/EU des Europäischen Parlaments und des Rates vom 15. Mai 2014 über Märkte für Finanzinstrumente sowie zur Änderung der Richtlinien 2002/92/EG und 2011/61/EU (ABl. L 173 vom 12.6.2014, S. 349; L 74 vom 18.3.2015, S. 38; L 188 vom 13.7.2016, S. 28), die zuletzt durch die Richtlinie (EU) 2016/1034 (ABl. L 175 vom 30.6.2016, S. 8) geändert worden ist, genannten Instrumente.</p>
<p>(2) The claim for non-performance is determined by the market or exchange price of the transaction. The market and exchange price are</p>	<p>(2) Die Forderung wegen Nichterfüllung bestimmt sich nach dem Markt- oder Börsenwert des Geschäfts. Als Markt- oder Börsenwert gilt</p>
<p>1. the market or exchange price for a replacement transaction which is entered into without undue delay, but not later than on the fifth</p>	<p>1. der Markt- oder Börsenpreis für ein Ersatzgeschäft, das unverzüglich, spätestens jedoch am fünften Werktag nach der Eröffnung des Verfahrens</p>

<p>business day following the commencement of insolvency proceedings, or</p> <p>2. in case no replacement transaction pursuant to number 1 has been entered into, the market or exchange price for a replacement transaction, which could have been entered into on the second business day after the insolvency proceedings were commenced.</p>	<p>abgeschlossen wird, oder</p> <p>2. falls kein Ersatzgeschäft nach Nummer 1 abgeschlossen wird, der Markt- oder Börsenpreis für ein Ersatzgeschäft, das am zweiten Werktag nach der Verfahrenseröffnung hätte abgeschlossen werden können.</p>
<p>If market conditions prevent entering into replacement transactions within the meaning of sentence 2 numbers 1 or 2, the market or exchange price shall be determined on the basis of procedures and methods that warrant an adequate valuation of the transaction.</p>	<p>Sofern das Marktgeschehen den Abschluss eines Ersatzgeschäfts nach Satz 2 Nummer 1 oder 2 nicht zulässt, ist der Markt- und Börsenwert nach Methoden und Verfahren zu bestimmen, die Gewähr für eine angemessene Bewertung des Geschäfts bieten.</p>
<p>(3) If transactions pursuant to paragraph 1 are combined into a single agreement pursuant to a master agreement or the rulebook of a central counterparty within the meaning of Section 1 (31) of the German Banking Act, which provides that the transactions included can only be terminated uniformly under certain circumstances, then the entirety of the transactions included shall be deemed to be a single transaction within the meaning of paragraph 1. This also applies if other transactions are also included; the latter transactions are subject to the general rules.</p>	<p>(3) Werden Geschäfte nach Absatz 1 durch einen Rahmenvertrag oder das Regelwerk einer zentralen Gegenpartei im Sinne von § 1 Absatz 31 des Kreditwesengesetzes zu einem einheitlichen Vertrag zusammengefasst, der vorsieht, dass die einbezogenen Geschäfte bei Vorliegen bestimmter Gründe nur einheitlich beendet werden können, gilt die Gesamtheit der einbezogenen Geschäfte als ein Geschäft im Sinne des Absatzes 1. Dies gilt auch dann, wenn zugleich andere Geschäfte einbezogen werden; für letztere gelten die allgemeinen Bestimmungen.</p>
<p>(4) The contracting parties may agree on deviating provisions provided that these are compatible with the material principles of the relevant statutory provisions from which they deviate. In particular,</p>	<p>(4) Die Vertragsparteien können abweichende Bestimmungen treffen, sofern diese mit den wesentlichen Grundgedanken der jeweiligen gesetzlichen Regelung vereinbar sind, von der abgewichen wird. Sie können</p>

they may agree	insbesondere vereinbaren,
<p>1. that the effects under paragraph 1 already occur prior to the opening of insolvency proceedings, in particular when a contracting party files a petition for the opening of insolvency proceedings in relation to its own assets or when a reason for the opening of insolvency proceedings occurs (contractual termination),</p> <p>2. that transactions pursuant to paragraph 1 are also subject to contractual termination, if claims relating to the delivery of goods or to the performance of financial services become due prior to the opening of proceedings but after the point in time agreed for the contractual termination,</p> <p>3. that for the purpose of determining a market and exchange price of the transaction</p> <p>a) the point in time of the contractual termination replaces the point in time of the opening of proceedings,</p> <p>b) a replacement transaction in the meaning of paragraph 2 sentence 2 number 1 can be executed until the end of the twentieth business day following the contractual termination, if necessary for a value-conserving settlement,</p> <p>c) instead of the point in time pursuant to paragraph 2 sentence 2 number 2, another point in time or timeframe between the</p>	<p>1. dass die Wirkungen nach Absatz 1 auch vor der Verfahrenseröffnung eintreten, insbesondere bei Stellung des Antrags einer Vertragspartei auf Eröffnung eines Insolvenzverfahrens über das eigene Vermögen oder bei Vorliegen eines Eröffnungsgrundes (vertragliche Beendigung),</p> <p>2. dass einer vertraglichen Beendigung auch solche Geschäfte nach Absatz 1 unterliegen, bei denen die Ansprüche auf die Lieferung der Ware oder die Erbringung der Finanzleistung vor der Verfahrenseröffnung, aber nach dem für die vertragliche Beendigung vorgesehenen Zeitpunkt fällig werden,</p> <p>3. dass zwecks Bestimmung des Markt- oder Börsenwerts des Geschäfts</p> <p>a) der Zeitpunkt der vertraglichen Beendigung an die Stelle der Verfahrenseröffnung tritt,</p> <p>b) die Vornahme des Ersatzgeschäfts nach Absatz 2 Satz 2 Nummer 1 bis zum Ablauf des zwanzigsten Werktags nach der vertraglichen Beendigung erfolgen kann, soweit dies für eine wertschonende Abwicklung erforderlich ist,</p> <p>c) anstelle des in Absatz 2 Satz 2 Nummer 2 genannten Zeitpunkts ein Zeitpunkt oder Zeitraum zwischen der vertraglichen Beendigung und dem Ablauf des fünften darauf</p>

contractual termination and the end of the fifth following business day is relevant.	folgenden Werktages maßgeblich ist.
(5) The other party to the contract may assert a claim for non-performance only as a claim in insolvency proceedings.	(5) Der andere Teil kann die Forderung wegen Nichterfüllung nur als Insolvenzgläubiger geltend machen.

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