Derivatives: Practices and Principles
Appendix II: Legal Enforceability: Survey of Nine Jurisdictions

Global Derivatives Study Group

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Appendix II
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This Appendix is a compilation of legal memoranda discussing issues of enforceability in nine jurisdictions: Australia, Brazil, Canada, England, France, Germany, Japan, Singapore, and the United States. The Group of Thirty gratefully acknowledges the work of the nine law firms identified above that prepared these memoranda.
Global Derivatives Study Group

Enforceability Survey — Australia

prepared by Mallesons Stephen Jaques

April 29, 1993
SUMMARY

This is a report on enforceability issues which arise in respect of derivatives in Australia. We concentrate on areas where legislative change is necessary or desirable.

1. NETTING

A "master netting agreement" containing certain provisions can result in a party being entitled to net its obligations under derivatives with a counterparty. However, legislation dealing expressly with the ability of a party to net its obligations under derivatives would help. Having such legislation (similar to that enacted in the USA) would mean that both the Reserve Bank of Australia and participants in the market would have an express legislative framework in which to authorise and create netting arrangements.

There are some unsatisfactory aspects of section 16 of the Banking Act when one seeks to apply it in the context of risk management contracts in the absence of a netting agreement.

It would be helpful if section 16 were amended to make it clear that in both section 16(1) and section 16(2) "assets" means assets which, in the case of section 16(1) remain, and, in the case of section 16(2) would remain after the application of statutory set-off rules.

2. CAPACITY

Similar issues arise in Australia as in other jurisdictions in relation to the existence of the capacity and power of certain bodies (in particular, government and semi-government authorities) to enter into derivatives. A third party will often be put on enquiry as to the purpose for which a counterparty is exercising a power. Legislation is required providing express power for certain entities to enter into derivatives, and providing that a third party need not enquire as to the purpose for the exercise of the power.

3. WAGERING/INSURANCE CONTRACTS

Some derivatives may be classified as wagering or insurance contracts. The Corporations Law only provides limited exceptions from that classification. Legislative change providing that derivatives do not fall within the laws regulating wagering or insurance contracts is desirable.

4. FUTURES CONTRACTS/UNAUTHORISED FUTURES MARKETS

The legislation regulating futures contracts contains wide definitions (and only limited exceptions from those definitions) with the result that a number of commonly traded over-the-counter derivatives are arguably subject to the regulatory provisions contained in that legislation. Legislative change is expected to result from a current inquiry into the operation of the futures contract provisions.

* * * * *
PART 1 – NETTING AND ENFORCEABILITY

General

We have concluded\(^1\) that, in order to achieve a legally binding netting agreement, it is not necessary to use the technique of netting by novation. If a master netting agreement was entered into between the parties which had the features set out below:

(a) pre-insolvency, it will operate to reduce the risk between the parties to a net amount; and

(b) post-insolvency, although the contractual arrangements would disappear, the statutory provisions relating to set-off would operate to reduce the risk between the parties to a net amount.

The main features of the "master netting agreement" must be that:

(a) it is governed by the law of a State or Territory of Australia;

(b) a party may terminate all derivatives early on a close-out basis if an event of default occurs, including the insolvency of one party;

(c) the termination value is calculated in a manner that does not give rise to a penalty;

(d) all obligations under all derivatives are converted on termination into Australian dollars;

(e) obligations under all derivatives are to be netted on close out;

(f) the rights of the parties under derivatives are part of a single contract, are closely connected and are incapable of being assigned; and

(g) either:

   (i) the right of a party to seek specific performance of a particular obligation is negated unless all obligations under all derivatives entered into under the master netting agreement are to be performed; or

   (ii) each obligation of each party to pay an amount in respect of a derivative is subject to the condition precedent that no event of default has occurred in respect of the other party.

These conclusions have been reached in relation to companies incorporated or deemed to be incorporated under the Corporations Law.

To a large extent the conclusions turn on the applicability to companies of section 86 of the Bankruptcy Act (1966) (Cwlth). There are many entities which engage in the derivatives markets which are not subject to section 86 of the Bankruptcy Act (such as the Crown, statutory authorities and building societies). There is no specific law in Australia for netting of obligations following insolvency of entities other than companies or natural persons.
We have concluded that the general law of contract should operate to bind a party to a contractual netting arrangement if that party is not subject to section 86. However, it would be an improvement if a code were established which applied to all parties irrespective of their status or capacity and governed the ability of a party to net its obligations. This would clarify in particular the position where no specific law currently regulates netting.

**Banking Act and Bankruptcy Act**

There is a possible interrelationship between section 16 of the Banking Act 1959 (Cwlth) and section 86 of the Bankruptcy Act 1966 (Cwlth) where one party to a derivative is a bank. We have analysed this issue and have concluded that it would be preferable if the Banking Act were amended to clarify its operation. However, we are of the view that any difficulty arising from the potential interrelationship can be overcome by the parties entering into a master netting agreement on the terms set out above.

**Enforceability**

To support a netting arrangement, it is important that a party has the right to terminate a derivative following the insolvency of the counterparty. We have concluded that such a right exists if a master netting agreement has been entered into by the parties on the terms set out above. The master netting agreement will operate to overcome any problem which may restrict the right of a party to terminate the derivative on the insolvency of the counterparty.

**Capacity of Parties**

The ability of a party to net all obligations with a counterparty arising under derivatives will only be available where there is "mutuality" between the parties - that is, where obligations are owed by each party to the other in the same capacity. A problem will arise where one party enters into some derivatives in its personal capacity and others in the capacity as trustee of a trust or as an agent for an undisclosed principal. This is not a matter which can be addressed by legislation.
PART II - CAPACITY

Apart from companies incorporated or taken to be incorporated under the Corporations Law, Australian bodies which are most likely to enter into derivatives are government and semi-government authorities (such as statutory corporations), certain banks which are not companies and non-bank financial institutions (such as building societies and credit unions).

We have no reason to believe that the findings in the Hammersmith and Fulham case would not be applied in Australia in relation to the power of these bodies to enter into derivatives.

Government and semi-government authorities

The power of government and semi-government authorities to enter into derivatives will depend on the legislation establishing the relevant authority. Each piece of legislation must be considered on a case-by-case basis to determine first, if the authority has the power to enter into derivatives and secondly, if the relevant power must be exercised for a specified purpose. In Australia:

(a) if the authority does not have the power to enter into a derivative but in fact does so, the resulting contract will be void; and

(b) if the authority does have power to enter into a derivative for a specified purpose, but the transaction entered into fails to satisfy that purpose, the resulting contract will be void or voidable depending on the extent to which the power is linked to that purpose.

This is relevant in considering whether there has been an "abuse of power" in entering into the derivative.

The capacity of government and semi-government authorities to enter into derivatives should be clarified by legislative amendment which would expressly provide that:

(a) the relevant authority has the power to enter into derivatives; and

(b) a counterparty can rely on a certificate given by an appropriate officer of the authority to the effect that the power is being exercised for the proper purpose, unless the counterparty has knowledge to the contrary.

These amendments would provide authorities with the same capacity to enter into derivatives as a company incorporated under the Corporations Law.

To date, only one state in Australia has specifically enacted legislation to address these concerns. That legislation specifies which derivatives an authority may enter into and includes provisions to the effect that each derivative may be treated as if it were within the power of the relevant authority where the counterparty deals with the body in good faith and has no reason to suspect that the derivative was not within power.

* * * * *
Banks

The majority of banks in Australia are companies incorporated or taken to be incorporated under the Corporations Law and have the powers of a natural person. These powers include the power to enter into derivatives. Even if the constituent documents of the bank prohibited the entry into of derivatives, the resulting contract will not be void against the bank under the Corporations Law.

Westpac Banking Corporation is an exception to this principle as it is established under an act of parliament and is governed by a "deed of settlement". It has the power to enter into derivatives under that document.

Non-bank financial institutions

This category includes building societies and credit unions.

These bodies were previously regulated under the laws of each State and Territory of Australia. In 1992, the Financial Institutions Code was introduced and now regulates the entry into of derivatives falling within the definition of "approved financial contracts" by these institutions. Under the Financial Institutions Code, a non-bank financial institution cannot enter into a derivative unless:

(a) the derivative is an "approved financial contract"; 9 and

(b) the derivative is entered into for the purpose of reducing the risk of adverse variations in borrowing costs or in revenue from investments or financial accommodation.

The problem is that a party must enquire as to whether the derivative is being entered into by the institution for a proper purpose. It would be preferable if the Financial Institutions Code were amended to provide that a counterparty had no duty to enquire as to the purpose for which the power is being exercised and could rely on a certificate provided by an appropriate officer.

* * * * *
PART III - GAMING AND WAGERING,
INSURANCE CONTRACTS

Gaming and Wagering

All States and Territories in Australia have legislation which invalidates agreements which are classified as gaming or wagering contracts.\textsuperscript{10}

It is a recognised concern in Australia that a derivative may be classified as a gaming or wagering contract.\textsuperscript{11} The concern stems from the fact that the State and Territory legislation does not define the term "gaming" or "wagering".

There is a view held by a number of commentators that derivatives are protected from invalidity under the gaming and wagering legislation where one party enters into the derivative on a genuine commercial basis – for example, to hedge its risk. However, we are unable to find authority which expressly supports that proposition.\textsuperscript{12} The problem is that this raises a degree of uncertainty for a party who is entering into a derivative for purely speculative purposes as that party will have to take steps to ensure that the counterparty has a genuine commercial basis for entering into the derivative.

The Corporations Law provides only a specific and an extremely limited exception\textsuperscript{13} in relation to contracts of gaming and wagering. The exception only applies if the derivative is a futures contract traded on a futures exchange and therefore will not apply to derivatives which are traded over-the-counter. There is widespread support for the approach that the Corporations Law should be amended to exempt all over-the-counter derivatives from the gaming and wagering legislation of each State and Territory of Australia.

Insurance Contracts

The Insurance Act 1973 (Cwlth) provides that it is an offence for a person to carry on an insurance business unless that person is authorised to do so.\textsuperscript{14}

There is a risk that certain derivatives could be classified as an insurance contract, especially where there is an amount (which can be likened to a premium) paid at the time the derivative is entered into and where the derivative reasonably accurately reimburses a counterparty for any loss it may suffer due to an adverse movement in the market.

This has been an issue for a long period in Australia and the widely adopted approach is to ignore the terms of the Insurance Act when considering trading in derivatives. However, the problem remains and it would be helpful if the Insurance Act were amended to provide that derivatives were excluded from its provisions.

* * * * *
The Corporations Law regulates the trading of "futures contracts" and imposes various regulatory requirements on a participant in that market. A futures contract is defined broadly as a standardised agreement to take or give delivery of a commodity or to make a cash adjustment based on the change to a price or stated index. The Corporations Law prohibits a person from establishing or conducting an "unauthorised futures market". The problem is that merely making available a facility whereby the clients of a company enter into derivatives with that company can breach this prohibition, as a "futures market" is defined as a "market, exchange or other place at which, or a facility by means of which, futures contracts are regularly acquired or disposed of".\textsuperscript{15}

It is widely accepted that the provisions regulating futures contracts were drafted at a time when the scope of derivatives trading was far more limited than it is today. Therefore, the exceptions contained in the Corporations Law provisions are extremely limited. That fact, when coupled with the extremely broad definition of a "futures contract" and several unsatisfactory court rulings (which have not provided any real guidance as to the interpretation of the provisions), has the result that a number of commonly traded over-the-counter derivatives are arguably caught by the provisions contained in the Corporations Law. The only derivatives which are expressly not subject to the Corporations Law are currency swaps, interest rate swaps, forward exchange rate contracts and forward interest rate contracts to which an Australian bank, or merchant bank, is a counterparty.

There is a strong argument that certain categories of commodity and equity derivatives are regulated by the Corporations Law. Regulation depends on whether the derivative falls within the requirements of the definition of "futures contract" contained in the Corporations Law.

The Australian Securities Commission is currently conducting a review of these provisions. Market participants have called for amendments similar to those recently made in the United States which provide a "safe harbour" for derivatives trading.\textsuperscript{16}
FOOTNOTES


2. See Schedule 2 to the Legal Issues Arising from Netting in Appendix 2 and, in particular, the discussion as to what constitutes "assets".

3. See paragraph 8 to schedule 2 to the Legal Issues Arising from Netting (Appendix 2).

4. See "Legal Issues Arising From Netting" from the 1992 Australian Guide to Completion of AFMA/ISDA Standard Documentation, contained in Appendix 2 (particularly paragraph [2.08]).

5. See Footnote 3A to the Legal Issues Arising From Netting in Appendix 2.

6. Appendix 1 contains a listing of the capacity of various government and semi-government authorities to enter into derivatives.

7. The case of Rolled Steel Products (Holdings) Limited v British Steel Corporation and Ors [1986] 1Ch 246 discusses these issues. That case was decided in the context of a corporation. We are not aware of any fact that would result in similar principles not applying to a statutory authority.

8. The Borrowing and Investment Powers (Further Amendment) Act 1991 (Victoria). The New South Wales government takes the view that the Public Authorities (Financial Arrangements) Act 1987 already provides the power to enter into derivatives. We agree with that view provided the derivative is entered for the purpose of the authority exercising its functions and with the Treasurer's approval.

9. "Approved financial contracts" are defined as:

"(a) futures contracts relating to:

(i) securities issued or guaranteed by the Treasurer or the Government of this State or by the Commonwealth or another State; or

(ii) bills of exchange that have been accepted or endorsed by a prescribed bank and are payable within 200 days;

but only if made or dealt in on a futures market of a futures exchange within the meaning of the Corporations Law; or

(b) interest rate swap contracts, or forward interest rate contracts, to which a bank, or other body approved by AFIC for the purpose, is a party;
(c) options relating to contracts mentioned in (a) or (b); or
(d) other contracts of a kind approved by AFIC ".

In addition, the following transactions may be entered into only with the approval of AFIC and subject to any conditions it may impose:

(a) transactions relating to financial or other futures;
(b) options in futures transactions;
(c) forward interest rate transactions;
(d) interest rate swap transactions;
(e) other financial transactions of a kind specified in a standard.


Gaming and Betting Act 1912 (New South Wales); Gaming and Betting (Contracts and Securities) Act 985 (Western Australia); Gaming Act 1972 (Queensland); Lottery and Gaming Act 1936 (South Australia); Gaming Act 1983 (Tasmania); Lotteries, Gaming and Betting Act 1966 (Victoria); Games, Wagers and Betting-houses Ordinance and Gaming and Betting Ordinance 1945 (Australian Capital Territory); Lotteries and Gaming Act 1982 (Northern Territory).


The proposition should be considered in light of the judgements in the Hammersmith and Fulham case, and in particular the disapproving view taken of interest rate swaps in general and Lord Templeman's speech which described such transactions as speculative and imprudent. See also Lord Templeman's comment that interest rate swaps were "more akin to gambling than insurance". However, in Jackson Securities Limited v Cheeseman (1986) 4 NSWLR 484, a derivative was held to fall outside the definition of gaming and wagering contract as one party was speculating and the other party did not stand to gain or lose anything under the contract. That case must be considered in light of the transactions entered into by the party (essentially back-to-back arrangements) which meant that the party did not stand to gain or lose anything under the contract under consideration.

Section 1141 of the Corporations Law provides that no State or Territory law about gaming or wagering affects the validity of a "futures contract" made on a "futures market" of a "futures exchange".

The Insurance Act defines an "insurance business" to be "... the business of undertaking liability, by way of insurance (including reinsurance) in respect of any loss or damage, including liability to pay damages or compensation, contingent upon the happening of a specified event, and includes any business incidental to insurance business as so defined ...".
In Carragreen Currency Corporation Pty Limited v The Corporate Affairs Commission (NSW), it was held that the term "facility" could include the infrastructure of a company which enabled the client of that company to acquire and sell futures contracts.

# APPENDIX 1

## CAPACITY OF AUTHORITIES TO ENTER INTO DERIVATIVES

<table>
<thead>
<tr>
<th>Authority</th>
<th>Capacity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Australian Airlines Limited</td>
<td>Express</td>
</tr>
<tr>
<td>2. Australian Broadcasting Commission</td>
<td>Express</td>
</tr>
<tr>
<td>3. Australian Dairy Corporation</td>
<td>None</td>
</tr>
<tr>
<td>4. AIDC Limited</td>
<td>Express</td>
</tr>
<tr>
<td>5. Australian Meat &amp; Live-stock Corporation</td>
<td>None</td>
</tr>
<tr>
<td>6. Australian Shipping Commission</td>
<td>Express</td>
</tr>
<tr>
<td>7. Australian National Railways Commission</td>
<td>None</td>
</tr>
<tr>
<td>8. Australian Postal Corporation</td>
<td>Express</td>
</tr>
<tr>
<td>9. Australian and Overseas Telecommunication Corporation Limited</td>
<td>Express</td>
</tr>
<tr>
<td>10. Australian Trade Commission</td>
<td>None</td>
</tr>
<tr>
<td>11. Australian Wheat Board</td>
<td>Express, but is subject to compliance with Treasurer's guidelines and approval</td>
</tr>
<tr>
<td>12. Australian Wool Commission</td>
<td>Express, but is subject to compliance with Treasurer's guidelines and approval</td>
</tr>
<tr>
<td>13. Commonwealth Bank of Australia</td>
<td>Express</td>
</tr>
<tr>
<td>14. Commonwealth Development Bank</td>
<td>Express</td>
</tr>
<tr>
<td>15. Commonwealth Savings Bank</td>
<td>Express</td>
</tr>
<tr>
<td>16. Export Finance and Insurance Corporation</td>
<td>None</td>
</tr>
<tr>
<td>17. Federal Airports Corporation</td>
<td>None</td>
</tr>
<tr>
<td>18. Joint Coal Board</td>
<td>None</td>
</tr>
<tr>
<td>19. The Electricity Commission of New South Wales</td>
<td>Express, but requires the approval of the Treasurer</td>
</tr>
<tr>
<td>20. Hunter Water Board</td>
<td>Express, but requires the approval of the Treasurer</td>
</tr>
<tr>
<td>21. Qantas Airways Limited</td>
<td>Express</td>
</tr>
<tr>
<td>Authority</td>
<td>Capacity</td>
</tr>
<tr>
<td>-----------------------------------------------</td>
<td>----------------------------------------------------</td>
</tr>
<tr>
<td>21. The Maritime Services Board of New South Wales</td>
<td>Express, but requires the approval of the Treasurer</td>
</tr>
<tr>
<td>22. New South Wales Dairy Corporation</td>
<td>None</td>
</tr>
<tr>
<td>23. New South Wales Treasury Corporation</td>
<td>Express, but requires the approval of the Treasurer</td>
</tr>
<tr>
<td>24. State Authorities Superannuation Board</td>
<td>Express, but requires the approval of the Treasurer</td>
</tr>
<tr>
<td>25. State Bank of New South Wales Limited</td>
<td>Express</td>
</tr>
<tr>
<td>26. State Rail Authority of New South Wales</td>
<td>Express, but requires the approval of the Treasurer</td>
</tr>
<tr>
<td>27. Sydney Electricity</td>
<td>Express, but requires the approval of the Treasurer</td>
</tr>
<tr>
<td>28. Water Board</td>
<td>Express, but requires the approval of the Treasurer</td>
</tr>
<tr>
<td>29. Gas and Fuel Corporation of Victoria</td>
<td>Express</td>
</tr>
<tr>
<td>30. Melbourne and Metropolitan Board of Works</td>
<td>Express</td>
</tr>
<tr>
<td>31. Port of Melbourne Authority</td>
<td>None</td>
</tr>
<tr>
<td>32. State Electricity Commission of Victoria</td>
<td>Express</td>
</tr>
<tr>
<td>33. Victorian Public Authorities Finance Agency</td>
<td>Express</td>
</tr>
<tr>
<td>34. Australian Barley Board</td>
<td>Express, but may need to comply with Ministerial guidelines and satisfy purpose</td>
</tr>
<tr>
<td>35. South Australian Government Financing Authority</td>
<td>None</td>
</tr>
<tr>
<td>36. South Australian Superannuation Fund Investment Trust</td>
<td>None</td>
</tr>
<tr>
<td>37. State Government Insurance Commission</td>
<td>None</td>
</tr>
<tr>
<td>38. State Bank of South Australia</td>
<td>Express</td>
</tr>
<tr>
<td>39. The Electricity Trust of South Australia</td>
<td>None</td>
</tr>
</tbody>
</table>
Authority

40. Queensland Industry Development Corporation

41. Queensland Treasury Corporation

42. Suncorp Insurance and Finance

43. Queensland Investment Corporation

44. Queensland Sugar Corporation

45. R&I Bank of Western Australia

46. Western Australian Treasury Corporation

47. State Energy Commission of Western Australia

Capacity

None

Express

None

None

Express, but requires the consent of the Treasurer

Express

None

None

NOTE:

1. This is not an exhaustive list of all authorities.

2. This list is intended to provide only a brief guide as to the power of authorities to enter into derivatives and should not be relied on as a conclusive guide on power.

   It may be the case that the power of an authority, although stated to be "express", may have to be exercised for a stated purpose or comply with official guidelines or policies.
APPENDIX 2

LEGAL ISSUES

ARISING FROM NETTING

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1 September 1992
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Summary of the issues [1.02]
Summary of conclusions [1.03]
Assumptions [1.04]
Features of netting agreement [1.05]

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Payments netting [2.02]
Credit exposure netting [2.03]
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Can Contracts be terminated following an event of default? [2.06]-[2.08]

Pre-insolvency [2.07]
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Interrelation between section 16 of the Banking Act and section 86 of the Bankruptcy Act [2.18]

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LEGAL ISSUES ARISING FROM NETTING

PART 1 - INTRODUCTION

Purpose

[1.01] This analysis comments on the legal issues under Australian law which arise for institutions wanting to set off (that is, net) their obligations with counterparties under treasury risk management transactions.

Summary of the issues

[1.02] Broadly the following issues are covered:

(a) the law of netting before insolvency;
(b) the ability of a non-defaulting party to terminate contracts following an event of default;
(c) the approach which should be adopted in terminating contracts;
(d) how to calculate the amount payable after termination;
(e) the law of set-off which applies after insolvency (in particular section 86 of the Bankruptcy Act and section 16 of the Banking Act);
(f) whether “netting by novation” as a technique of netting is necessary in Australia.

Summary of conclusions

[1.03] We have concluded that, in order to achieve a legally binding netting agreement, it is not necessary to use the technique of netting by novation. If a master netting agreement (Netting Agreement) was entered into between two parties which had the features set out in [1.05]:

(a) pre-insolvency it would operate to reduce the risk between the two parties to a net amount; and
(b) post-insolvency, although the contractual arrangements would disappear, the statutory provisions relating to set-off would take effect to reduce the risk between the two parties to a net amount.

Assumptions

[1.04] The conclusions set out in this analysis are based on the assumptions that:

(a) a Netting Agreement which contains the features described in [1.05] is entered into between two parties who want to net;
(b) each party enters into each contract in the same capacity (eg. it does not act as a trustee for some contracts and in its own right for others);

(c) each party is incorporated or taken to be incorporated under the Corporations Law;

(d) the Netting Agreement relates to treasury risk management products ("Contracts") covering one or a combination of two or more of the following product types:

Swaps: both interest rate and cross currency
FX Contracts: both spot and forward
Options: both interest rate and currency

Forward Rate Agreements:

Forward Security Contracts: agreements relating to the forward purchase and/or sale of bills, bonds or coupon securities

(e) the Contracts the subject of the Netting Agreement are not void under gaming and betting legislation and are not contracts of insurance;

(f) none of the circumstances are present which could affect the availability of set off (these circumstances are described in [2.14], [2.15] and [2.16]).

Features of Netting Agreement

[1.05] The main features of the Netting Agreement are that it would:

(a) be governed by the law of a state or territory of Australia;

(b) allow early termination on a close out basis of all Contracts if an event of default occurs (eg. the insolvency of one of the parties);

(c) allow for the termination value to be calculated in a manner which does not give rise to a penalty (described more fully at [2.10]);

(d) allow for the obligations under all contracts to be converted on termination into Australian dollars;

(e) allow for obligations under all Contracts to be netted on close out;

(f) provide that the rights under Contracts form part of a single overall contract, are closely connected and are incapable of being assigned;

(g) either:

(i) negate the right of a party to seek specific performance of a particular obligation unless all obligations under all transactions governed by the Netting Agreement are to be performed; or

(ii) make each obligation of each party to pay an amount in respect of a transaction subject to the condition precedent that no event of default has occurred in respect of the other party.
PART 2 - LEGAL COMMENTARY

Types of netting

[2.01] We commence our analysis of the law of netting by explaining the two generic types of netting:

- payments netting
- credit exposure netting

[2.02] Payments netting. Payments netting refers to an arrangement which simply matches opposite payments. For example, if there are opposite obligations in the same currency between the same parties involving the same risk management product on a common due date, then, on the due date, the amounts due for payment between the parties are netted off and only the difference is paid by one of the parties to the other.

Payments netting thus results in simple set off at the time of payment without altering the contractual rights of the parties under the contract.

[2.03] Credit exposure netting. Credit exposure netting may be achieved by using either of two legal techniques:

- netting by master agreement
- netting by novation

Netting by master agreement. In this technique, it is agreed under the terms set out in a master agreement that if certain events (such as insolvency) occur in relation to one of the parties, the outstanding obligations between the parties under all contracts can be terminated. An amount of damages on termination is then determined. These amounts are converted into a single currency (if denominated in different currencies) and then set off against each other to determine the net amount due.

Netting by novation. This technique of close out refers to a process whereby, again usually under a master contract between two parties, any new obligation between them in respect of a specified product is automatically amalgamated with all other obligations under the agreement for the same product.

[2.04] The use of the phrase "netting by novation" is something of a misnomer. Generally, the word "novation" is used in legal parlance to refer to a three party agreement whereby a contract between two parties is rescinded in consideration of a new contract being entered into on the same terms between one of the two original parties and a third party. In other words, it involves the substitution of one party to a contract by another person and its effect is to release the obligations of one of the former parties and to impose them on the new party.

"Netting by novation" does not involve any substitution of a third party. Rather, an existing contract between two parties is "discharged" or "cancelled" and replaced by a new contract between the same parties. Thus, for example, in the case of foreign exchange contracts, instead of there being several foreign exchange contracts in existence between two parties at any point in time, there is only ever one contract in
existence under which obligations are extinguished and replaced by a new contract for the net obligation. This takes place each time a new foreign exchange transaction occurs.

Thus in "netting by novation" there is in fact no novation in the generally accepted legal sense. Rather, there is a substitution of new contractual obligations for old contractual obligations between the same two parties. However, we will continue to use the term "netting by novation" to refer to this process.

Assumptions

[2.05] In [1.04] we set out the assumptions on which this analysis is based. The emphasis is on assessing the legal issues which could affect an assessment of credit exposure risk if two parties entered into a master netting agreement.

As stated at [1.04] the analysis assumes that the parties enter into a master Netting Agreement with certain features. We analyse each of these features and express our conclusions on its enforceability.

Also we compare the legal effectiveness of a master netting agreement with a netting by novation agreement.

Clearly, the time when netting is most likely to become an issue is after one of the parties defaults. Most of the analysis centres around this possibility.

Can Contracts be terminated following an event of default?

[2.06] The Netting Agreement will describe a number of events of default including failure to pay under a Contract, representations or warranties becoming incorrect and an insolvency event occurring.

In this analysis we use the term insolvency to describe events such as the presentation of a petition to wind up, a resolution to enter into a scheme of arrangement, the appointment of an official manager or a winding up order being made.

The first issue which arises is whether there is any law which invalidates a contractual right to terminate a Contract after an event of default occurs. To answer this it is helpful to draw a distinction between events of default which occur before insolvency and events of default which occur because of insolvency.

[2.07] Pre-insolvency. We know of no principle which invalidates a right to terminate a Contract because an event of default occurs which is not related to insolvency. Parties are free to contract on whatever terms they see as being appropriate. We comment below (see [2.09]) on the techniques which could be used to give the right to terminate.

Post-insolvency.

Statute. Section 301 of the Bankruptcy Act 1966 (Cwlth)* makes void provisions in certain contracts which provide for the contract to terminate if an individual becomes bankrupt. The issue is whether this provision is made applicable to the insolvency of companies by section 533(2) of the Corporations Law.

* There are numerous references throughout this analysis to sections of the Bankruptcy Act and the Corporations Law. Relevant extracts of these sections are set out in schedule 1.
Section 301 only applies to leases, licences, hire purchase agreements and sales of property.

None of the Contracts constitute a lease, licence or hire purchase agreement.

There are three types of Contract which could be "sales of property" - Forward Securities Contracts, FX Contracts and currency swaps.

Forward Securities Contracts clearly involve a sale of property.

In the case of FX Contracts and currency swaps, the issue is whether they are contracts for making money payments (albeit in different currencies) or contracts for the sale of property (ie. currency) in return for a sum of money (ie. another currency)\(^1\). There are grounds for arguing that they are sale contracts.

Even though Forward Securities Contracts certainly, and FX Contracts and currency swaps possibly, involve the sale of property, we know of no authorities stating that section 553(2) has the effect of applying section 301 to companies. The various events mentioned in the concluding paragraph of section 301(1), particularly the consequences flowing from the word "bankrupt", appear to be limited to natural persons.

Further, at least the first part of section 553(2) appears to be dealing with the rights of creditors as between themselves, not as between a creditor and a debtor. And the second part of the subsection appears to be an enabling provision assisting persons seeking to prove in the liquidation of the company, rather than a provision seeking to destroy the rights of creditors.

We have concluded that the better view is that section 301 of the Bankruptcy Act does not apply to companies.

There is no other statutory provision which invalidates a contractual right of the solvent party to terminate Contracts if the other party becomes insolvent.

Common law. There is a common law principle that a court will not give effect to a contract which provides that if one party becomes bankrupt, the other party (ie. the solvent party) is then to get some additional advantage which prevents the property of the bankrupt party being distributed under the bankruptcy laws\(^2\).

We do not consider that it could be successfully argued that, by using insolvency as a ground to terminate a Contract, the solvent party was evading the regime for distributing the insolvent party's property in liquidation.

The solvent party would still be bound by the law relating to voidable preferences and set-off. It could not, by terminating the Contracts, remove any of the insolvent party's property from the liquidation which would otherwise be available for distribution\(^3\). Also, the termination would not necessarily result in a reduction of the insolvent party's property. The termination may prevent a greater loss to the insolvent party and therefore actually benefit the insolvent party.

An argument which could possibly succeed in relation to infringing this common law principle is set out in footnote 3A. In that footnote we set out a solution to avoid the argument succeeding.

In summary therefore we have concluded that the right of the solvent party to terminate Contracts under the Netting Agreement would be enforceable.
Method of terminating Contracts

[2.09] The next issue involves the technique which should be used or relied on to entitle the solvent party to terminate Contracts following an event of default (including insolvency).

Contractually, an event of default could be treated as:

(a) a breach of an essential or fundamental term (i.e. a repudiation); or
(b) a breach of a non-essential term; or
(c) an event which gives rise to a right to terminate by prior agreement. (Sometimes this is referred to as termination on the occurrence of a condition subsequent. However, because the term “condition subsequent” also may have connotations of breach, we have adopted the less confusing description of “termination by prior agreement”).

Another possibility in the case of events of default arising out of insolvency would be not to have an express contractual right to terminate following insolvency but to rely on an implied right to treat insolvency as a repudiation. We do not recommend this alternative because the law is not certain that such an implied right exists.

For this reason the Netting Agreement will provide an express contractual right to terminate Contracts.

Provided the amount payable by one party to the other as a consequence of the termination of a Contract is not a penalty, it does not matter which contractual technique is used for terminating Contracts.

In summary therefore the Netting Agreement should provide for a contractual right to terminate.

Calculating amounts payable on close out

[2.10] How should the amount payable by one party to the other as a consequence of the termination of a Contract be calculated?

The Netting Agreement will provide that if a Contract is terminated, a replacement value for the terminated Contract must be calculated. This amount would represent the cost or profit to the solvent party to enter into another Contract that would have the effect of preserving the economic equivalent of the future payment obligations under the original Contract had termination not occurred. It would be calculated as an average of offers made by other institutions involved in the market for Contracts of the type terminated.

The Netting Agreement will also provide an alternative method of calculating profit or loss if market quotations cannot be obtained. The amount would equal the actual profit or loss of the solvent party of making alternative arrangements. If alternative arrangements are not available, the solvent party would make an estimate of its profit arising or loss incurred as a result of termination.

The replacement value which would be calculated on termination of a Contract is effectively calculated in the same way as the “mark to market” value of Contracts is calculated.
We consider that this method of calculating the loss or profit arising on the termination of a Contract would result in a reasonable pre-estimate of loss and not be a penalty\(^4\). This is because it is designed to produce an amount which reflects the loss or gain to the solvent party of preserving the economic equivalent of the future payment obligations under the terminated Contracts. This equates with loss of bargain damages.

A replacement value would be expressed as a positive amount (ie. a loss) if the solvent party would have to pay to enter into the replacement Contract or as a negative amount (ie. a profit) if the solvent party would receive an amount to enter into a replacement Contract.

The Netting Agreement will provide that, if a replacement value is expressed other than in Australian dollars, it is to be converted into Australian dollars. This is important for the reasons set out in paragraph (c) of [2.12].

In summary therefore it is essential that the amount payable not be a penalty. A "replacement value" concept would be enforceable.

**Contractual netting rights**

[2.11] The Netting Agreement will provide that on early termination an account must be taken of all amounts due from one party to the other with the total sum due from one party to be set-off against the total sum due from the other party. Only the balance is payable one to the other.

It is important to note that the Netting Agreement gives the defaulting party full value for terminated Contracts which are "in the money" for the defaulting party. Thus the termination of Contracts could result in the non-defaulting party becoming obliged to make a payment to the defaulting party.

These contractual netting rights will be enforceable until the winding up of one of the parties commences.

The contractual rights entitling the parties to terminate contracts, calculate replacement values and, if necessary, convert amounts outstanding into Australian dollars are not affected by Australian insolvency laws relating to set-off. Therefore, even after insolvency, these aspects of the Netting Agreement will remain enforceable.

However, after the winding up of one of the parties commences the contractual netting rights will not be enforceable at least to the extent that they produce a different result from the statutory set-off rules\(^5\).

Therefore it is necessary to consider whether the netting mechanism in the Netting Agreement will produce a different result.

To do so we must first explain the statutory set-off rules.

**Section 86 of the Bankruptcy Act**

[2.12] The law in Australia relating to set-off in a winding-up is contained in section 86 of the Bankruptcy Act (which applies to companies by virtue of section 553(2) of the Corporations Law). Section 86 provides that where there have been "mutual credits,
mutual debts and other mutual dealings" between an insolvent company and one of its creditors, then the total sum due from one party must be set-off against the total sum due from the other party. Only the balance is payable by or to the liquidator.

For set-off to apply under section 86 the following requirements must be met.

(a)  **Mutuality between the parties**

Set-off is not permitted in respect of debts owing to and from a person in different capacities. Mutuality would not exist, for example, in respect of contracts entered into by a party in its own right and those entered into by a party as trustee. Nor will mutuality exist if a party has assigned its rights under a contract to another person (see [2.16]).

"Mutual dealings" include whatever comes within the description of a commercial or an ordinary business transaction provided it results in merely a monetary liability.

(b)  **Existence of a claim**

Section 86 covers not only debts existing at the date of liquidation but also debts which arise later out of rights and liabilities existing at that time.

(c)  **Commensurability**

"Commensurability" means that the mutual debts must be capable of being brought together ultimately into a money account, establishing a liability on each side which is pecuniary in nature.

The primary obligations under some Contracts (eg. FX Contracts, Currency Swaps and Forward Securities Contracts) arguably might offend against the requirement that they can be measured in money terms. This is because arguably they are obligations to deliver commodities rather than money.

However, even if this is the case, a simple mechanism in the Netting Agreement which would apply after insolvency occurs would overcome this difficulty. The mechanism would:

(a)  in the case of an FX Contract, require amounts payable in non-Australian dollars to be converted into amounts payable in Australian dollars; and

(b)  in the case of a Forward Securities Contract, provide a method of calculating liquidated damages in Australian dollars if the security is not delivered; and

(c)  in the case of any other type of Contract which arguably involves delivery of a commodity, provide a method for converting the obligation into an Australian dollar obligation.

Applying this mechanism following a winding up order would ensure that obligations under all Contracts are measured in Australian dollars and thus satisfy the test of commensurability.

**Date by which obligations must exist**

Debts or liabilities must exist at the date of liquidation.
In the case of a voluntary winding up, sections 492 and 465(1) of the Corporations Law establish that this is the time the resolution to wind up is passed.

In the case of an involuntary winding up the position is less clear. However, the better view is that the debt or liability must exist at the time the winding up order is made.

In other words, if obligations which arise under Contracts are to be set off under section 86, the Contracts must be entered into before a resolution to wind up is passed (in the case of voluntary windings up) or before a winding up order is made (in the case of involuntary windings up).

In summary therefore for debts to be set-off under section 86:

- the parties must have created all the debts in the same capacities
- the debts or liabilities must exist at the date of liquidation (but they need not be debts actually existing at that time)
- they must be "money" claims

Comparison between s. 86 and netting under the Netting Agreement

The Netting Agreement will provide for netting two categories of debts. First there are the "unpaid amounts". These are amounts which become due and payable under a Contract before it is terminated (they may also include interest on those amounts). Secondly, there are the replacement values (if a replacement value is calculated other than in Australian dollars it will be converted into Australian dollars before the netting takes place).

The unpaid amounts and replacement values would qualify as mutual debts and mutual credits for the purpose of section 86.

As the Netting Agreement provides for a complete set-off between these amounts in exactly the same way that section 86 operates we consider that the Netting Agreement would produce a result consistent with section 86.

What circumstances could affect the availability of set-off?

Section 86(2). Under section 86(2), set-off will not be available to a creditor if it has notice of an "available act of bankruptcy" at the time of giving credit to, or receiving credit from, the insolvent party.

For companies "an available act of bankruptcy" means "an act or omission of the company related to its solvency or insolvency which would found a petition to wind-up the company on the ground that the company was unable to pay its debts".

We consider that the expression "at the time of giving credit" in the context of a Contract means the time when the Contract is entered into and not the time the closing gain or loss is netted off. Otherwise section 86 could never operate to provide a set-off.

Accordingly, any profit or loss arising in respect of a Contract entered into at a time when the solvent party had notice of an available act of bankruptcy committed by the insolvent party will not be permitted to be set-off against profits and losses under other Contracts.
Each institution which enters into a Netting Agreement will need to have a system in place which ensures that its treasury department is immediately notified of any “available act of bankruptcy”. Any further trading with the other entity should not be taken into account in the Netting Agreement but be treated as a separate obligation for both capital adequacy and credit purposes.

**Voidable preferences.** Section 565 of the Corporations Law incorporates section 122 of the Bankruptcy Act into the provisions relating to winding up of companies. Among other things, section 122 renders void against the liquidator payments made or obligations incurred by a debtor which have the effect of preferring a creditor. The section applies if the debtor cannot pay its debts at the time the payment is made or obligation incurred and the payment is made or obligation incurred within six months of the date an application is filed for a compulsory liquidation or during the period between filing and winding up. It is open to the creditor to establish the “good faith” defence (see section 122(2) of the Bankruptcy Act).

The netting mechanism involves replacing obligations under Contracts with new obligations to deliver a net amount. This could be characterised as the incurring of an obligation or possibly a payment by the insolvent party. Equally, it seems arguable that the relevant time for determining whether a payment has been made or obligation incurred for the purpose of s.122 of the Bankruptcy Act is the time each Contract is entered into and not the time the netting takes place. However, for the purpose of this analysis we will assume that the relevant time is when the netting takes place.

We will assume that netting occurs during the preference period and that the insolvent party is insolvent at that time. The issue then is whether the netting mechanism confers a preference.

A preference will be conferred only if, as a result, the statutory order of priorities would not be followed. The netting mechanism would create a preference only if section 86 of the Bankruptcy Act would not provide the same result as the netting mechanism.

Section 86 would not provide the same result only if “at the time of giving or receiving credit” the insolvent party had notice of “an available act of bankruptcy” of the insolvent party. As stated above at [2.14], we consider that the “time of giving or receiving credit” must be read as the time of entering into the Contract which gives rise to the closing gain or loss.

Accordingly, provided the solvent party is not aware of “an available act of bankruptcy” of the insolvent party at the time a Contract is entered into, the netting mechanism will be valid under section 86. Therefore no preference is conferred on the solvent party as against the insolvent party’s other creditors. The parties have merely agreed to produce the result which would have been achieved anyway under section 86.

Clearly section 122 could prevent a particular debt being included in a set-off under a transaction which, when examined in isolation, constitutes a preference. However, it is difficult to see how the entry into a particular Contract would be caught by section 122 assuming it is entered into for full consideration and not in respect of any existing indebtedness.

**Assignments.** Mutuality for the purpose of section 86 of the Bankruptcy Act would be destroyed if a party to a Contract successfully assigned its rights under the Contract.
An assignment might occur through:

(a) an absolute assignment (eg a factoring of book debts); or
(b) an equitable assignment (eg by a declaration of trust); or
(c) an assignment by way of security.

A fundamental principle of the law of assignment is that an assignee (ie, the third party who acquires the rights) takes subject to all independent rights of set-off available to the debtor which arise before the debtor receives notice of the assignment\(^{16}\).

An independent set-off arises when the liability owed to the party claiming the set-off becomes a presently existing debt. It does not matter that the debt is payable in the future.

The liabilities which can arise under Contracts are not all presently existing from the time they are created.

Therefore it is necessary to consider the question whether an assignee would be subject to set-off rights in respect of liabilities under Contracts which had not matured into presently existing debts at the time the debtor receives notice of the assignment.

Generally, the answer to that question is - no. But there are well established exceptions to this general rule which we consider could be successfully used in relation to the liabilities which arise under Contracts.

The principles are that an assignee takes subject to a set-off whether or not the debtor has received notice of the assignment if the debt to be set-off:

(a) arises out of the same contract which has been assigned\(^{17}\); or
(b) is "closely connected" with the contract which has been assigned\(^{18}\).

We consider that if the parties included in the Netting Agreement:

(a) a provision which states that all Contracts form part of a single overall contract; and
(b) all Contracts are closely connected,

then the better view is that the court would give effect to those principles.

It is, of course, preferable to ensure that an assignment never takes place. Accordingly, as a further protection, the Netting Agreement should render unassignable (whether at law or in equity (eg by declaration of trust)) the rights which arise under Contracts. Although there is no Australian case which expressly supports the enforceability of such a provision, there is English authority which supports it. We consider that the better view is that it would be enforced under Australian law\(^{19}\). It would be helpful if, in addition, the parties expressly agree that such a provision is fundamental to the agreement and that neither party would enter into any Contract unless assured of strict observance of it\(^{20}\).
Before the Netting Agreement is entered into each party should search the records of the Australian Securities Commission to ascertain whether any security interest has been registered against the other party which discloses an assignment of rights under present or future Contracts. If so, a release of such rights from the terms of the security interest should be obtained.

**Liquidator's right to disclaim unprofitable contracts**

Section 568(1) of the Corporations Law allows a liquidator to disclaim unprofitable contracts.

Generally, this section will not be applied in respect of Contracts governed by the Netting Agreement because the solvent party will terminate the Contracts immediately following the winding up order being made. Thus, the liquidator will not have an opportunity to disclaim any of them under section 568.

But what would be the position if a liquidator could decide whether to disclaim one or more Contracts? There is a concern that the liquidator could:

(a) identify which Contracts were “in the money” and which Contracts were “out of the money”;  

(b) disclaim those Contracts which were “out of the money” as being unprofitable contracts; and  

(c) elect to keep on foot those Contracts which were “in the money”.

This process is sometimes referred to as "cherry picking". The concern is that it would override and render ineffective a contractual netting agreement.

It is important to realise that under Australian law (as distinct from the position which applied until recently under United States bankruptcy law) a liquidator does not have a power to “affirm” or “elect to keep on foot” Contracts. In other words, a liquidator does not have power to override contractual rights to terminate Contracts. This is a very important distinction between Australian law and the position which previously applied under US law.

If a Contract is disclaimed by a liquidator, the liquidator becomes liable to the solvent party under section 568(12) of the Corporations Law for the damages suffered by the solvent party. The damages are measured in the same way as if the insolvent party were liable for damages for breach of contract i.e. the solvent party is entitled to loss of bargain damages.

The solvent party would be entitled to lodge a proof for the damages suffered because the liquidator disclaims (section 568(12) of the Corporations Law). It would also be entitled to terminate all Contracts which were not disclaimed by the liquidator. The amount of damages payable in respect of disclaimed Contracts and all amounts payable in respect of Contracts terminated by the solvent party would all be set-off under section 86 of the Bankruptcy Act.

But we repeat that the issue of cherry picking simply should not arise under the Netting Agreement. The solvent party should terminate all Contracts. Even if, before that termination takes place, the liquidator disclaimed those Contracts which were “out of
the money”, the damages claims arising out of the disclaimers will be set-off against the amounts due to the liquidator under Contracts which were “in the money”.

Interrelation between section 16 of the Banking Act and section 86 of the Bankruptcy Act

[2.18] In schedule 2 we set out a detailed analysis of this issue.

We have concluded that there are some unsatisfactory aspects to section 16 of the Banking Act when one seeks to apply it in the context of risk management contracts in the absence of a netting agreement.

It would be helpful if section 16 were amended to make it clear that in both section 16(1) and section 16(2) “assets” means assets which, in the case of section 16(1) remain, and, in the case of section 16(2) would remain, after the application of statutory set-off rules.

But in the absence of such an amendment we have concluded that the better view is that any potential difficulties with section 16 can be avoided by an appropriately worded netting agreement.

Is a “netting by novation” agreement necessary under Australian law?

[2.19] The Explanatory Memorandum issued by the Reserve Bank in connection with Prudential Standard No. 16 (Capital Adequacy of Banks) dated 23 August 1988 states that netting by novation “legally extinguishes the previous obligations and hence reduces the credit risk”.

The rationale underlying “netting by novation” is to enable two parties which deal with each other under Contracts to assert that their “credit risk” to each other under those Contracts is not the gross amount of the obligations under the Contracts but a net amount. The term “credit risk” refers to the amount of the loss which a party stands to suffer if the other party with which it is contracting were to become insolvent. Thus, it is argued that the effect of “netting by novation”:

(a) is to substitute for certain gross obligations a net obligation;

(b) allows each party to such an arrangement to measure its credit risk against the other party having regard to the net amount of the relevant obligations netted by novation.

It is argued that insofar as “netting by novation” is effective against a liquidator of the insolvent party, it avoids certain difficulties which would otherwise arise in the liquidation of the insolvent party. In the absence of “netting by novation”, it is argued that the obligations of each party to the other party would be gross obligations (rather than net obligations) and not all of those gross obligations could be set-off against each other in the liquidation of the insolvent party because:

(a) under relevant insolvency laws, it is not clear whether amounts payable under contracts with settlement dates occurring after liquidation commences can be set-off (cf amounts payable under contracts which have matured before liquidation commences); and
(b) the insolvent party's liquidator may choose to disclaim certain Contracts as unprofitable (ie the liquidator could elect to perform the profitable contracts and disclaim the unprofitable contracts - ie "cherry pick").

In our view, careful analysis of these concerns, having regard to the principles of Australian law set out in this analysis, shows that the concerns have no basis in law in that:

(a) under Australian law, there is no doubt section 86 of the Bankruptcy Act requires set-off of not only debts existing at the date of liquidation but also debts which arise later out of rights and liabilities existing at that time; and

(b) the concerns about cherry picking which have been expressed in the context of the laws of other jurisdictions (particularly the US before the changes in 1990 to its Bankruptcy Code) have no basis under Australian law.

In our opinion, it is unnecessary to adopt any procedure of "netting by novation" in relation to Contracts. The result which is sought to be achieved by "netting by novation" will occur in any event if a Netting Agreement having the features referred to in [1.05] is entered into.
PART 3

QUALIFICATIONS

[3.1] Mallesons Stephen Jaques is qualified to advise on the laws of the Commonwealth of Australia and of New South Wales, Victoria, Queensland, Western Australia and the Australian Capital Territory. The opinions expressed in this analysis are limited to those laws. However, the Corporations Law is uniform throughout Australia and the statute law relating to bankruptcy (the Bankruptcy Act 1966 (C’wlth)) which applies to corporations incorporated in Australia is a Commonwealth law.

[3.2] It is necessary for participants to determine in each case the suitability of a Netting Agreement to the particular circumstances applicable to that case. This analysis is not intended to be an opinion on which participants can rely in actual transactions. Instead, it is intended as an aid in understanding issues which arise under Australian laws when participants want to enter into netting arrangements. Accordingly, while every care has been taken in preparing this analysis, Mallesons Stephen Jaques do not accept responsibility for any losses suffered by contracting in the manner recommended in this analysis or arising from any error or omission in this analysis.
PART 4

CONCLUSIONS

[4.01] We have concluded that, in order to achieve a legally binding netting agreement, it is not necessary to enter into a netting by novation agreement.

We consider that if a master netting agreement was entered into between two parties which had the features set out in [1.05]:

(a) pre-insolvency it would operate to reduce the risk between the two parties to a net amount; and

(b) post insolvency, although the contractual arrangements would disappear, the statutory provisions relating to set-off would take effect to reduce the risk between the two parties to a net amount.

A party who wants to net should adopt the following procedures:

(a) before entering into the Netting Agreement, search the Australian Securities Commission records to ensure that the other party has not assigned its rights under then existing or future Contracts; and

(b) when entering into the Netting Agreement obtain a warranty from the other party that there has been no such assignment; and

(c) ensure that if it receives notice of:

(i) any actual or purported assignment of rights under Contracts; or

(ii) any "available act of bankruptcy" committed by the other party,

its treasury department is immediately notified. Any further trading with the other party should not be taken into account in the Netting Agreement but be treated as a separate obligation for both capital adequacy and credit purposes.
1. In the case of FX Contracts and Currency Swaps, the question of whether foreign money is money or a commodity is not capable of a rigid solution (see Mann: The Legal Aspect of Money, 4th Ed. P.185). Mann’s basic thesis is that foreign money is money where it functions as such; but it is a commodity where it is an object of commercial intercourse. At p.190 he states:

"Where the payment of a sum of foreign money is promised, a monetary obligation exists, because the foreign money functions as money, the legal character of the obligation being inherently identical with that of an obligation to pay a sum of domestic money. Only where foreign money is the object of commercial intercourse it will, according to the nature of the transaction, be regarded as a commodity."

There is an argument therefore that in the case of FX Contracts and Currency Swaps, the currency to be delivered is a commodity.

2. See Ex parte Mackay (1873) 8 Ch App 643, Whitmore v. Mason (1861) 2 J & H 204 and Ex parte Border re Walker (1884) 26 Ch D 510.

3. In his book “Principles of Corporate Insolvency Law” at p.66 Professor R M Goode notes that there is an unreported English county court decision in which a provision for termination of a hire purchase agreement on bankruptcy was held void as depriving the estate of an asset contrary to bankruptcy law. Professor Goode concludes that this decision would not be followed. In any event we have concluded that the decision is distinguishable because the rights which arise under Contracts are not of the same nature as rights arising under hire purchase agreements. The termination of a hire purchase agreement could deprive the bankrupt of an asset which it could use to create income. This is not the case in respect of Contracts. And, in any event, the bankrupt is given under the Netting Agreement the full benefit of the value of terminated Contracts.

3A It is possible to mount an argument as follows (this argument is more fully expounded in a paper entitled “Set-Off and Netting of Foreign Exchange Contracts in the Liquidation of a Counterparty” by Dr R Derham. September and November 1991 Journal of Business Law p.463):

- Certain obligations under risk management contracts can be classified as obligations to deliver commodities eg the obligation to deliver foreign currency under an FX contract.

- An obligation to deliver a commodity is not capable of being the subject of set-off under section 86 of the Bankruptcy Act. There are two reasons for this:

  (a) the perceived difficulty in producing a balance on the account when one of the demands is not a money claim;

  (b) the wording of section 86 which says that the “sum” due from one party shall be set-off against the “sum” due from the other.

- Accordingly, in the absence of a netting agreement there may be a doubt whether foreign currency obligations under an FX contract can be the subject of a section 86 set-off. Does a netting agreement help? There are a number of cases from
which a principle can be formulated that a contract will be void if it provides for something to occur upon the occurrence of a liquidation which would result in preferential treatment for the creditor as against the general body of creditors.

- A netting agreement which allows you to convert an obligation to deliver a commodity into a money obligation in order to obtain the benefit of a set-off could infringe this principle.

- The infringement could occur as follows. Assume there was no netting agreement and the insolvent had entered into a number of contracts with a particular counterparty. At the time of winding up some were profitable for it and others were not. In such circumstances it would be less advantageous for the solvent party if the liquidator were to disclaim the unprofitable contracts and obtain an order for specific performance of the profitable contracts. This is because the solvent party would be obliged to give full value to the insolvent for the profitable contracts while being entitled only to a dividend in the insolvent’s estate for the damages to which it was entitled in respect of the disclaimed contracts.

However, a netting agreement usually adopts one of the following approaches:

(a) the solvent party would be entitled to terminate all contracts and prove for the sum of damages due to it on profitable contracts and not give value to the insolvent for unprofitable contacts (the so called “limited two way payments” approach); or

(b) the solvent party would be entitled to terminate all contracts and set-off the values of profitable contracts against the values of unprofitable contracts (the so called “full two way payments” approach).

In either of these cases the solvent party would be in a better position than if it was forced to perform contracts profitable to the insolvent.

Accordingly, it could be concluded that the termination right under the netting agreement is unenforceable because the contract provides for something to occur upon the occurrence of a liquidation which would result in a different distribution in the liquidation in comparison to what would have been the case if the change had not occurred.

- Although there are a number of aspects of this argument which can be challenged (e.g. that foreign currency obligations should be viewed as obligations to deliver commodities (or, at least, non monetary obligations) and whether a court is likely to order specific performance), there is enough authority to support the argument to warrant closing off the risk that the argument could be successful.

Solution. The suggested solution is to have all contracts documented as part of a single contract with an express provision under which the parties agree either:

(a) that the right to seek specific performance is negated unless all obligations under the contract are to be performed; or
(b) that each obligation of each party to pay an amount in respect of a transaction is subject to the condition precedent that no event of default (one of which would be the making of a winding up order) has occurred in respect of the other party.

Two things would flow from this approach:

(a) because all transactions would form part of a single contract a liquidator would be obliged to disclaim all transactions (including those which were profitable for the insolvent); and

(b) the arguably objectionable element of the netting agreement would not apply because, since a liquidator would not be able to seek specific performance of profitable contracts, the insolvent would not be able to improve its position by keeping those contracts on foot.

The argument set out in this footnote 3A is the reason for our suggestion in paragraph (g) of [1.05].

4. If termination occurs because the solvent party accepts the repudiation of the Contracts by the insolvent party, the solvent party would be entitled to loss of bargain damages.

If the event of default is treated as a breach of a non-essential term and the solvent party terminates, the solvent party is entitled to loss of bargain damages only if those damages flow from a liquidated damages clause which is not a penalty or if there is otherwise an express contractual indemnity to that effect (Esanda Finance Corporation Ltd v Plessnig (1989) 63 ALJR 238). For the reasons set out in [2.05] we consider that the amount payable under the Netting Agreement following termination would equate with loss of bargain damages. Accordingly, it would not matter if the termination right flowed out of the breach of a non-essential term.

If an event of default is treated as an event which gives rise to a right to terminate by prior arrangement and the solvent party terminates, the law of penalties does not apply and the amount specified in the Netting Agreement as being payable on termination should be enforceable.

5. There may be minor discrepancies between the two methods because a "mark to market" valuation is not generally calculated by reference to quotes from other institutions. Rather it is calculated by reference to a rate decided on as being the prevailing market rate by the institution doing the calculation. However, the concept is the same. Both methods aim to preserve the economic equivalent of the future payment obligations under the original Contract.

6. The market quotation is an average figure rather than the lowest quote. Although the duty to mitigate as applied to damages would indicate that an average figure gives rise to a higher amount than the loss suffered if the lowest quote were accepted, we consider that this is not sufficient to render such a mechanism in the Netting Agreement a penalty. In our opinion, the parties' intention to pre-assess damages ought to be upheld by a Court unless the amount payable is extravagant and unconscionable in comparison with the greatest loss that could possibly flow from the breach (Dunlop Pneumatic Tyre Company Ltd v. New Garage and Motor Co Ltd [1915] AC 79).


10. This is because there has been some judicial disagreement as to whether the relevant date is the date deemed by virtue of section 465(2) of the Corporations Law to be the commencement date of the winding up (ie. the date when the application for winding up is filed) or the actual date of the winding up order. The provisions of the Corporations Law relating to computation of debts support the view that the relevant date is the date of the winding up order (see sections 554(1) and the definition of "relevant date" in section 9). The weight of case law authority also favours the date of the winding up order. (See for example obiter dictum of Mason J in Day and Dent Constructions Pty Ltd (in liquidation) v Nth Aust Properties Pty Ltd (provisional liquidator appointed) (1982) 40 ALR 399 at pp 408 and 409; Stephen and Aickin JJ agreed with this view at pp 406 and 419.)


12. Re Hardman (1932) 4 A.B.C. 207 at 210 where it was held that it covered all forms of payment including a mere entry or transfer of figures in an account unaccompanied by the passing of any payment in cash. In Re Deagure, Burns v Commonwealth Bank of Australia (1951) 15 A.B.C. 198 it was held that the transfer by the Bank of £700 from one account to another where the Bank was obliged to keep the accounts separate was a voidable preference.

13. In Burns v Stapleton (1959) 102 CLR 102 at 104 the court stated:

"It is necessary to observe that section 95(1) [the predecessor of section 122] avoids, not instruments but certain kinds of changes in the legal situation of the person unable to pay his debts. What the sub-section clearly intends to make void, where it applies, is the change which, if allowed to be effectual, would dislocate the statutory order of priorities amongst creditors".

14. Washington Diamond Mining Company (1893) 3 Ch 95 per Vaughan Williams J who stated (at p 104) that you “cannot prefer a man... by merely putting him in the very position in which he would be if a Bankruptcy followed”.

15. See Re Grezzana; Painter & Anor v Charles Whiting & Champers Ltd (1932) 4 ABC 255.

16. Watson v Mid Wales Railway Co [1867] LR 2 CP 593; Re Pinto Leite and Nephew [1929] 1 Ch 221; Roxburghe v Cox [1881] 17 Ch D 520.


   In Watson v Mid Wales Railway Co (1867) LR 2 CP 593 Bovill CJ stated:
   
   "In all the cases cited [where set-off was permitted after notice] some qualification occurred in the original contract, or the two transactions were in some way connected together, so as to lead the court to the conclusion that they were made with reference to one another".

19. In Helstan Securities Ltd v Hertfordshire County Council [1978] 3 ALL ER 262 Croom-Johnson J stated:

   "There are certain kinds of choses in action which, for one reason or another, are not assignable and there is no reason why the parties to an agreement may not contract to give its subject matter the quality of unassignability".


21. Although not licensed to comment on US law we understand that, until amended in June 1990, section 362 of the US Bankruptcy Code placed an automatic stay on contracts the moment a petition was filed. This prevented the solvent party from, among other things, declaring a contract to be in default or realising any security held by it to fund the required termination payment. The stay applied until lifted by the bankruptcy court.

   Section 365 of the US Bankruptcy Code operated to prevent termination of an executory contract by reason of the insolvency proceedings or financial condition of the insolvent party where the contract was not a contract to make a loan, extend other debt financing or financial accommodation to or for the benefit of the debtor and was not a security or within any other exception. The consequence of this was that where section 365 applied, the solvent party could not unilaterally terminate the contract and the trustee in bankruptcy had the sole right to decide whether to assume or reject the contract. This is the so called right to “cherry pick” ie. to assume profitable contracts and to reject unprofitable contracts.

   On 25 June 1990 President Bush signed into law an amendment to the US Bankruptcy Code dealing expressly with risk management treasury products defined as “swap agreements” (the definition covers a wide range of Contracts). The principal features of the amendment are:

   • Express exemption from the automatic stay contained in Section 362 to allow non-bankrupt parties to exercise contractual rights to terminate swap agreements following a bankruptcy filing and to use any collateral held to satisfy amounts due from the bankrupt party.

   • Express recognition that parties will be entitled to exercise contractual rights to net out or off set termination values and payment amounts in connection with the termination of one or more swap agreements.

   • Express protection for transfers under a swap agreement against a trustee’s normal power to avoid payments and other transfers made within 90 days (or in some cases one year) before the bankruptcy filing.

SCHEDULE 1

RELEVANT LEGISLATION

BANKRUPTCY ACT

Definition of Bankrupt

"Bankrupt" is defined in section 5(1) of the Bankruptcy Act as meaning:

"a person -

(a) against whose estate a sequestration order has been made; or

(b) who has become a bankrupt by virtue of the presentation of a debtor's petition".

Section 86

86(1) Subject to this section, where there have been mutual credits, mutual debts and other mutual dealings between a person who has become a bankrupt and a person claiming to prove a debt in the bankruptcy:

(a) an account shall be taken of what is due from the one party to the other in respect of those mutual dealings;

(b) the sum due from the one party shall be set-off against any sum due from the other party; and

(c) only the balance of the account may be claimed in the bankruptcy, or is payable to the trustee in the bankruptcy, as the case may be.

(2) A person shall not be entitled under this section to claim the benefit of set-off if, at the time of giving credit to the person who has become a bankrupt or at the time of receiving credit from that person, he had notice of an available act of bankruptcy committed by that person.
Section 122

Section 122 of the Bankruptcy Act relevantly provides:

122(1) A conveyance or transfer of property, a charge on property, or a payment made, or an obligation incurred, by a person who is unable to pay his debts as they become due from his own money (in this section referred to as "the debtor"), in favour of a creditor, having the effect of giving that creditor a preference, priority or advantage over other creditors, being a conveyance, transfer, charge, payment or obligation executed, made or incurred:

(a) within 6 months before the presentation of a petition on which, or by virtue of the presentation of which, the debtor becomes a bankrupt; or

(b) on or after the day on which the petition on which, or by virtue of presentation of which, the debtor becomes a bankrupt is presented and before the day on which the debtor becomes a bankrupt

is void as against the trustee in the bankruptcy.

(1A) Sub-section (1) applies in relation to a conveyance or transfer of property, a charge on property or a payment made, or an obligation incurred, by the debtor in favour of a creditor:

(a) whether or not the liability of the debtor to the creditor is his separate liability or is a liability with another person or other persons jointly; and

(b) whether or not:

(i) the property conveyed, transferred or charged is his own property or is the property of the debtor and of another person or other persons;

(ii) the payment is made out of his own moneys or out of moneys of the debtor and another person or other persons; or

(iii) the obligation is incurred by the debtor on his own account only or on account of himself and another person or other persons

as the case requires.

(2) Nothing in this section affects:

(a) the rights of a purchaser, payee or encumbrancer in good faith and for valuable consideration and in the ordinary course of business;

(b) the rights of a person making title in good faith and for valuable consideration through or under a creditor of the debtor; or

(c) a conveyance, transfer, charge, payment or obligation of the debtor executed, made or incurred under or in pursuance of a maintenance agreement or maintenance order.
Section 301

Section 301 of the Bankruptcy Act relevantly provides:

301(1) A provision in a contract or agreement for the sale of property, in a lease of property, in a hire-purchase agreement or in a licence to the effect that:

(a) the contract, agreement, lease, hire-purchase agreement or licence is to terminate, or may be terminated by the vendor, lessor, owner or licensor;

(b) the operation of the contract, agreement, lease, hire-purchase agreement or licence is to be modified; or

(c) property to which the contract, agreement, lease, hire-purchase agreement or licence relates may be repossessed by or on behalf of the vendor, lessor, owner or licensor

if the purchaser, lessee, hirer or licensee becomes a bankrupt or commits an act of bankruptcy or executes a deed of assignment or a deed of arrangement under this Act is void.

CORPORATIONS LAW

Definition of “relevant date”

“relevant date”, in relation to a winding up means:

(a) in the case of a company ordered to be wound up by the Court that has not previously commenced to be wound up voluntarily - the date of the winding up order; or

(b) otherwise - the date of the commencement of the winding up.

Section 465

465(1) [Prior resolution for voluntary winding up]

Where, before the filing of the application, a resolution has been passed by the company for voluntary winding up, the winding up of the company shall be deemed to have commenced at the time of the passing of the resolution and, unless the Court on proof of fraud or mistake thinks fit otherwise to direct, all proceedings taken in the voluntary winding up shall be deemed to have been validly taken.

465(2) [Deemed commencement when application filed]

In any other case the winding up shall be deemed to have commenced at the time of the filing of the application for the winding up.
Section 492

492 A voluntary winding up commences at the time of the passing of the resolution for voluntary winding up.

Section 553(2)

(2) ... in the winding up of an insolvent company the same rules shall prevail and be observed with regard to the respective rights of secured and unsecured creditors and debts provable and the valuation of annuities and future and contingent liabilities as are in force for the time being under the Bankruptcy Act 1966, in relation to the estates of bankrupt persons, and all persons who in any such case would be entitled to prove for and receive dividends out of the property of the company may come in under the winding up and make such claims against the company as they respectively are entitled to by virtue of this section.

Section 554(1)

554(1) [Computation as at relevant date]

The amount of a debt of a company (including a debt that is for or includes interest) is to be computed for the purposes of the winding up as at the relevant date.
Section 565

565(1) A settlement, a conveyance or transfer of property, a charge on property, a payment made, or an obligation incurred, by a company that, if it had been made or incurred by a natural person, would, in the event of his or her becoming a bankrupt, be void as against the trustee in the bankruptcy, is, in the event of the company being wound up, void as against the liquidator.

565(2) For the purposes of subsection (1), the date that corresponds with the date of presentation of the petition in bankruptcy in the case of a natural person is:

(a) in the case of a winding up by the Court:

(i) where, before the filing of the application for the winding up, a resolution has been passed by the company for winding up the company voluntarily - the date upon which the resolution to wind up the company voluntarily is passed;

(ii) where the company is under official management at the time of the filing of the application for the winding up or had been under official management at any time within the period of 6 months before the filing of the application - the date of the commencement of the official management; or

(iii) in any other case - the date of the filing of the application for the winding up; and

(b) in the case of a voluntary winding up:

(i) where the company is under official management at the time when the resolution to wind up the company voluntarily is passed or had been under official management at any time within the period of 6 months before the passing of that resolution - the date of the commencement of the official management; or

(ii) in any other case - the date upon which the resolution to wind up the company voluntarily is passed.

565(3) For the purposes of this section, the date that corresponds with the date on which a person becomes a bankrupt is the date on which the winding up of the company commences or is deemed to have commenced.

565(4) Any transfer or assignment by a company of all its property to trustees for the benefit of all its creditors is void.
Section 568(1)

568(1) Power of disclaimer

Subject to this section, where part of the property of a company consists of:

(a) land burdened with onerous covenants;
(b) shares;
(c) property that is unsaleable or is not readily saleable; or
(d) unprofitable contracts

the liquidator of the company may, on behalf of the company, subject to subsection (2), notwithstanding that he or she has endeavoured to sell or has taken possession of the property or exercised an act of ownership in relation to it, by writing signed by him or her, disclaim the property.

Section 568(12)

568(12) A person aggrieved by the operation of a disclaimer under this section shall be deemed to be a creditor of the company to the extent of any loss the person has suffered by reason of the disclaimer and may prove the loss as a debt in the winding up.
INTERRELATION BETWEEN
SECTION 16 OF THE BANKING ACT
AND SECTION 86 OF THE BANKRUPTCY ACT

1. Sections 16(1) and (2) of the Banking Act provide as follows:

"16(1) In the event of a bank becoming unable to meet its obligations or suspending payment, the assets of the bank in Australia shall be available to meet that bank’s deposit liabilities in Australia in priority to all other liabilities of the bank.

(2) Unless otherwise authorised by the Reserve Bank, a bank shall hold assets (other than goodwill) in Australia of a value of not less than the total amount of its deposit liabilities in Australia."

2. The fundamental issue is whether “assets” in section 16(1) mean the assets of the bank before section 86 of the Bankruptcy Act is applied or the “assets” remaining after section 86 is applied.

If the former and assuming there is no netting agreement, the argument is that the solvent party would be obliged under section 16 to hand over the mark to market values of all transactions profitable to the bank without being entitled to set-off under section 86 of the Bankruptcy Act the mark to market values of all transactions unprofitable to the bank. The solvent party would be left to prove for the values of transactions unprofitable to the bank.

3. In saying this we have made an assumption that the “asset” in the risk management contract context is the mark to market value of the contract. Herein lies a problem. What if the contracts are not terminated on insolvency of the bank? What then is the asset? Is it the bank’s right to receive a cash flow on its side of the contract? In other words would this mean that the solvent party would be obliged to meet its obligations under the contract but the bank would not be so obliged? This would seem a peculiar result but expressing the problem in those terms does highlight the deficiencies of section 16 when an “asset” is part of a bundle of rights and obligations. We return to this point later but for the moment we will assume that the mark to market value of each transaction profitable to the bank is an “asset” and the mark to market value of each transaction unprofitable to the bank is a “liability”.

4. When section 16(1) is read in isolation from section 16(2) a very strong argument can be mounted that “assets” in section 16(1) is referring to net assets after the application of section 86 of the Bankruptcy Act. This is because there is a very similar phrase used in section 501 of the Corporations Law which states that the “property of a company shall, on its winding up, be applied in satisfaction of its liabilities equally”. Section 501 must be read in conjunction with section 553 of the Corporations Law which imports section 86 of the Bankruptcy Act with the result that it is clear that the words “property of a company” in section 501 of the Corporations Law means that property existing after the application of the set-off rules in section 86 of the Bankruptcy Act.
It can then be concluded that there is no inconsistency between section 16 of the Banking Act and section 86 of the Bankruptcy Act. Section 16 is dealing with priorities in the distribution of assets in the context of an insolvency administration. Section 86 is dealing with what constitutes assets. Therefore “assets” in section 16(1) should mean assets remaining after the application of the set-off rules in section 86.

5.

However, the issue is complicated by section 16(2). Section 16(2) imposes an obligation on a bank always to be holding assets (other than goodwill) in Australia of a value of not less than the total amount of its deposit liabilities in Australia.

The argument can be made that “assets” in section 16(1) must have the same meaning as “assets” in section 16(2) otherwise there would be no point in including section 16(2) in the legislation. The argument goes therefore that because “assets” in section 16(2) must be measured pre-insolvency without the application of set-off rules, similarly assets in section 16(1) must be so measured.

This would mean that a solvent party could not set-off the mark to market values of profitable and unprofitable contracts in a bank’s insolvency and only be obliged to pay over the net amount. This is said to be consistent with the fundamental purpose of section 16 being to maximise use of the insolvent bank’s assets to meet deposit liabilities.

6.

If this argument is correct there are some interesting aspects to it:

(a) If it was the legislature’s intention to override section 86 of the Bankruptcy Act which is a fundamental principle of bankruptcy law it could have been expected that this intention would have been expressly stated;

(b) A court might have to selectively apply section 86. For instance, what would be the position if a bank had breached section 16(2) and a depositor with the bank also had a loan from the bank? The depositor could recover all its money through a set-off but if it could not set-off, it would recover less than 100 cents in the dollar. It is unclear whether the court would grant it a set-off in these circumstances;

(c) It seems reasonable to conclude that “assets” which comprise part of a bundle of rights and obligations were not in the contemplation of the drafter of section 16. This is clear when one examines Form D in the Banking Act which lists as assets things such as coin and bullion, Australian notes, cash with the Reserve Bank, Australian public securities, loans to authorised dealers, bank premises etc. These are all items which have a clear independent value. The final item on the list is “all other assets”. Risk management contracts will fall into this category. But it is not clear how they should be valued.

Interestingly, the current practice of the Reserve Bank is that the value of risk management contracts is not taken into account in the section 16(2) calculation. However, it could be expected that if a bank became unable to meet its obligations, the Reserve Bank or the liquidator would seek to apply the proceeds of such assets in meeting deposit liabilities. This gives force to the argument that a different meaning of “assets” can apply as between section 16(1) and section 16(2);
(d) A bank could comply with section 16 and actually be less prudent overall. Here is a very simple example. We realise that it ignores the capital adequacy guidelines and it ignores the Reserve Bank's practice of not taking risk management contracts into account for section 16(2) purposes. However, the example still illustrates what we consider to be a valid point. Assume the only assets and liabilities of a bank were:

(1) A deposit of $1m.

(2) An in the money FX contract having a mark to market value of $1,100,000.

(3) Ten out of the money FX contracts having an aggregate mark to market liability of $10m.

If the overall net position of the FX contracts was applied, clearly the bank would be in breach of section 16(2). But if only the asset in (2) is compared with the liability in (1), the bank would not be in breach. It seems curious that an interpretation of section 16(2) could be supported which allowed a bank to be less prudent than if the net position was used for section 16(2) purposes. We realise that there is a counter argument to this being that section 16(2) is not concerned with non-deposit liabilities - it is only concerned with ensuring that depositors are repaid. But it still seems a curious result.

7. Our conclusion is that there are some unsatisfactory aspects of section 16 when one seeks to apply it in the context of risk management contracts in the absence of a netting agreement.

It would be helpful if section 16 were amended to make it clear that in both section 16(1) and section 16(2) "assets" means assets which, in the case of section 16(1) remain, and, in the case of section 16(2) would remain after the application of statutory set-off rules.

8. SOLUTION

In the absence of an amendment referred to in 7 above we consider that the better view is that any potential difficulties with section 16 of the Banking Act can be avoided by an appropriately worded netting agreement. If all transactions form part of a single contract such that the "value" of the contract if there is a default at any point in time both before and after insolvency is the overall net mark to market position, it is difficult to see how a court could go behind the terms of the contract and rewrite it so that each transaction had its own value for the purpose of section 16. True it is that each transaction has its own consideration and that it is possible to argue that each constitutes a separate asset. However, if the parties expressly agree that performance of one obligation is dependent on performance by the other party of all obligations under all of the transactions or that it is a condition precedent to performance of an obligation that no Event of Default has occurred in respect of the other party, then it is difficult to see how a court could properly override the expressed intention in order to allow section 16 to operate.
APPENDIX 3

AUSTRALIAN SECURITIES COMMISSION

REVIEW OF OFF-EXCHANGE TRADING
IN DERIVATIVE FINANCIAL PRODUCTS

SUBMISSION

BY

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REVIEW OF OFF-EXCHANGE TRADING IN DERIVATIVE FINANCIAL PRODUCTS

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AUSTRALIAN SECURITIES COMMISSION

REVIEW OF OFF-EXCHANGE TRADING IN
DERIVATIVE FINANCIAL PRODUCTS

SUBMISSION

BY

MALLESONS STEPHEN JAQUES

1. INTRODUCTION

1.1 This submission has been prepared in response to the Discussion Paper released by the Australian Securities Commission (ASC) on off-exchange trading in derivative financial products ("derivatives").

1.2 The focus of this submission is on some of the legal issues raised by the existing regulation of derivatives. It is for others to comment on the size of the derivatives market, the practical operation of that market and the reasons for the growth of the market. We can however make some comment on the relationship between the exchange traded market and the off-exchange market (known as the "OTC Market").

2. EXECUTIVE SUMMARY

We summarise our submission as follows:

(a) a class exempt markets declaration be recommended to the Minister which would permit a "wholesale" OTC Market in derivatives to be carried on without breach of section 1123 of the Corporations Law;

(b) the "retail" OTC Market in derivatives continue to be regulated under the Corporations Law;

(c) the definitions of the terms "securities" and "futures contract" be amended to ensure that there is no gap between them, so that derivative which seem to be presently unregulated come within the appropriate regulatory regime;

(d) an appropriate provision be inserted into the Corporations Law to protect derivatives from invalidity under state gaming and wagering legislation; and

(e) the requirement to be a member of the Sydney Futures Exchange ("SFE") or the Australian Financial Futures Market ("AFFM") in order to obtain a futures broker's licence be withdrawn.
3. REGULATION AND THE FUTURES MARKET

3.1 Government regulation of a market, or a segment of a market, must serve some useful social or economic purpose. In the Australian securities market, regulation is supported in order to ensure investor protection and the integrity of Australian securities markets. In applying the same principles to regulation of Australian future markets, the legislators have included in the Corporations Law the following types of provisions:

- market regulation provisions;
- issue regulation provisions;
- participant regulation provisions.

Market Regulation Provisions

3.2 Market regulation provisions include:

(a) a prohibition on the establishment of an unauthorised futures market;

(b) a prohibition on futures market manipulation;

(c) a prohibition on false trading and market rigging; and

(d) a prohibition on false and misleading statements and dissemination of information about illegal transactions.

3.3 These provisions regulate the market in which futures contracts are created, bought and sold. Generally, we have no problem with these provisions (apart from the prohibition of unauthorised futures markets) as they serve a useful purpose in ensuring fair trading in the market for all.

3.4 However, the emphasis of the Corporations Law is on the regulation of on-exchange trading of futures contracts and the prohibition of off-exchange trading of futures contracts unless an exempt market declaration is in place. This is a proposition which needs to be critically analysed (see para 4).

Issue Regulation Provisions

3.5 Unlike an issue of securities, it is not necessary to lodge or register a prospectus with the ASC when issuing a futures contract. However, a futures broker is required before accepting a person as a client to give that person a document that explains the nature of futures contracts, explains the nature of obligations assumed by a person who instructs the futures broker to enter into a futures contract, sets out a risk disclosure statement in a prescribed form and sets out the specifications, and details of the essential terms, of each kind of futures contract in which the broker deals on behalf of the client. The broker is also required to give a copy of the broker/client agreement (see section 1210 of the Corporations Law).
3.6 Under the securities provisions of the Corporations Law, a prospectus is not required to be registered or lodged in respect of an excluded issue of securities, an excluded offer of securities for subscription or purchase or an excluded invitation to subscribe for or buy securities. There is currently no such exemption from section 1210 in the Corporations Law for a futures broker dealing with a sophisticated financial institution in the wholesale OTC Market for derivatives. Such an exemption should be allowed.

Participant Regulation Provisions

3.7 These regulations control the participants in the market. The main requirement is for participants in the market to have a futures broker's licence or a futures adviser's licence if they are acting as a broker or an adviser. Under these licensing provisions there are additional requirements:

- specific surplus liquid funds ratios;
- appropriate qualifications and experience of licensees;
- requirement for licensees to issue contract notes; and
- provisions dealing with principal trading, segregation of client funds, auditing requirements, requirements for margin calls and deposits.

3.8 The participant regulation provisions are not generally objectionable. However, there should be no requirement for a futures broker to be a member of the SFE or AFFM during the currency of its licence (see section 1144A(2) of the Corporations Law).

4. DEREGRULATION OF THE "WHOLESALE" OTC MARKET

4.1 We favour the deregulation of the "wholesale" OTC Market. What we mean by this is that participants in the "wholesale" OTC Market should be allowed to transact with each other without the need to comply with the disclosure statement provisions and not have to make an application for an exempt markets declaration to the Minister. The requirement to make an application to the Minister for an exempt markets declaration is an impediment to the efficient operation of the "wholesale" OTC Market, serving, it seems to us, no useful purpose in dealings between sophisticated investors.

4.2 The implication from the requirement that an application for an exempt markets declaration must be made by sophisticated investors to deal in the OTC Market is that futures trading on the on-exchange market is to encouraged but that the sophisticated or "wholesale" OTC market is to be discouraged or at the very least needs to be justified.
4.3 This implication does not recognise the differences between on-exchange markets and the OTC Market. Some of the differences are:

(a) futures contracts are traded on the on-exchange market but derivatives in the OTC Market are generally not traded;

(b) derivatives in the OTC Market are tailor-made for the requirements of a particular client. Futures contracts on the on-exchange market are generally fungible;

(c) the OTC Market is an innovative market where new products are developed to meet particular needs. The same range of products is not available on the on-exchange market; and

(d) in the OTC Market each party does a credit analysis on the counterparty. This does not take place on the on-exchange market.

4.4 The OTC Market in derivatives is an integral part of the Australian capital market and complements the on-exchange markets in derivatives.

4.5 We believe that the OTC Market in derivatives should be encouraged not discouraged by the need to make a separate application for an exempt futures market declaration each time that a new derivatives product is sought to be offered to institutions.

Definition of "Futures Market"

4.6 A separate application for an exempt markets declaration is required for each new derivative product because of the wide terms of the definition of "futures market". That term is defined in section 9 of the Corporations Law as:

"A market, exchange or other place at which, or a facility by means of which, futures contracts are regularly acquired or disposed of."

What is a Futures Market?

4.7 The decision in the Carragreen Currency Corporation Pty Ltd v The Corporate Affairs Commission (NSW) 1987 11 ACLR 298 indicates that the reference to a "market exchange or other place" should be given its normal meaning as a market or exchange where a number of persons or companies or businesses operate together. Thus, for there to be a market, exchange or other place there must be a place at which different principals contract with each other.

4.8 The difficulty that arises in most cases is the use of the term "facility by means of which". In the Carragreen case it was held that the infrastructure of a business which enabled clients of the business to acquire and sell futures contracts amounted to a facility for the purposes of the definition of "futures market". Accordingly, the definition of futures market was given a very wide application.
4.9 Given the definition of the terms "futures market", each of the following actions may be technically performed in breach of the Corporations as an unauthorised futures market, namely:

- the transaction that occurs between a broker and its client. Although the broker will ultimately enter into another transaction with a broker on the SFE, the original transaction between a selling broker and its client and the subsequent transaction between a purchasing broker and its client would both be transacted on an unauthorised futures market operated by each broker. That is, the broker provides a place at which futures contracts are regularly acquired or disposed of and also a facility by means of which futures contracts are regularly acquired or disposed of. Only the transaction between the two brokers is permitted as that is conducted on the SFE.

- any financial institution which is involved in marketing over-the-counter derivatives which may be classified as futures contracts runs the risk, in entering into agreements with a number of counterparties (query the number of contracts which is necessary to establish the concept of regularity), of being held to provide a facility by means of which futures contracts are regularly acquired or disposed of and, therefore, create an unauthorised futures market.

4.10 In respect of the first category, although each broker does technically carry on an unauthorised futures market, it is clearly not the intention of the legislation to prohibit such actions. All the brokers are really doing is acting as a broker in the ordinary course in order to facilitate the placement of orders on the SFE.

4.11 The second category discussed above brings up the fundamental proposition behind the ASC Discussion Paper in respect of exempt futures markets. This is a significant problem with the existing regulatory framework. With the uncertainty over whether certain derivatives are futures contracts or securities, each institution which markets derivatives runs the risk of becoming liable to the criminal penalties attaching to contraventions of the prohibition on conducting an unauthorised futures market. In addition, depending on the interpretation that a court would give to section 103 of the Corporations Law which provides that an act done is not invalid merely because it is performed in contravention of Chapter 8 of the Corporations Law (note Chapter 7 is excluded from section 103), the contracts entered into on an unauthorised futures market may be voidable at common law on illegality principles. The implications of this conclusion given the value of derivatives in the market are dramatic to say the least.

4.12 As previously stated, we believe that the "wholesale" OTC Market should be encouraged as it is an innovative market and must necessarily complement the on-exchange markets operating in Australia.

4.13 The ASC should not have difficulty with the concept of a different level of regulation of the "wholesale" and "retail" markets. This is what happens in the securities market. The Corporations Law provides that the prospectus provisions of Division 2 of Part 7.12 do not apply to:
(a) an excluded issue of securities;

(b) an excluded offer of securities for subscription or purchase; or

(c) an excluded invitation to subscribe for or buy securities.

[It should be noted that the prohibition on operating an unauthorised stock market continues to apply to the wholesale market in securities. This is also something that needs to be looked at and we would suggest that the prohibition on establishing an unauthorised stock market be reviewed in light of the changes for futures regulations now suggested.]

4.14 We submit that the prohibition on establishing an exempt futures market (section 1123 of the Corporations Law) should not apply to dealings in the wholesale market for futures contract.

4.15 Further work will need to be done in defining the “wholesale market”, however, the starting point should be the list of exclusions from prospectus regulation set out in section 66 of the Corporations Law. The exemption could be for futures contracts between “Appropriate Persons” contracting as principals. Guidance on who should be “Appropriate Persons” can come from overseas but, as suggested above, should include those organisations already mentioned in section 66 and should include as a general category any individual or corporation with total assets are greater than an agreed amount. Some form of prudential supervision may also be necessary (see Attachment B).

4.16 This proposal is not a suggestion for total exemption from regulation for the “wholesale” OTC Market. We would agree with the continuation of the other market regulation provisions, like the prohibition on market rigging, insider trading and the prohibition on false and misleading trading.

4.17 In addition, we would submit that the requirement for a futures broker to give an “Appropriate Person” a disclosure statement should also be eliminated.

5. REGULATION OF “RETAIL” OTC MARKET IN DERIVATIVES

5.1 Our submission that the “wholesale” OTC Market should be deregulated does not apply to the “retail” OTC Market.

5.2 We understand that part of the reason for the prohibition of unauthorised futures markets was to stop “bucket shop operations” of the type considered in the Carragreen case. We agree with this and the need for a “case by case” analysis of each application to operate an exempt futures market in the “retail” OTC Market.

6. THE PROBLEM WITH THE DEFINITION OF “SECURITIES” AND “FUTURES CONTRACT”

6.1 The definition of “security” is set out in section 92 of the Corporations Law and excludes “futures contracts”. The definition of “futures contract” is set out in section 72 of the Corporations Law and excludes:
"A Chapter 8 agreement:

(i) that is:

(A) a currency swap;
(B) an interest rate swap;
(C) a forward exchange rate contract; or
(D) a forward interest rate contract; and

(ii) to which an Australian bank, or a merchant bank as defined by sub-section (4), is a party"

6.2 In our view, there are a number of questions that can be raised in relation to the definitions of "securities" and "futures contract" and the relationship between them:

(a) whether those derivatives which are not futures contract, nor securities should be subject to regulation under the Corporations Law?

(b) whether the exemption from the definition of "futures contract" quoted in paragraph 6.1 above is appropriate?

(c) whether the definition of "eligible commodity agreement" should be amended?

(d) whether the definition of "standardised agreement" needs to be amended?

Whether those derivatives which are not Futures Contract, nor Securities should be regulated?

6.3 In advising in this area we have seen derivatives which we believe do not fall within the definition of "security" or "futures contract". The question is whether these products should go unregulated. In Attachment A we look at whether an OTC Equity Option is a futures contract or a security and conclude that there is considerable doubt whether it is either. The question is whether OTC Equity Options should be regulated and, if so, whether they should be regulated under the security provisions or the futures provisions of the Corporations Law.

6.4 We believe they should be regulated. The general distinction between futures contracts and securities should be drawn on the basis of products whose price reflects the assets or the financial position of a particular entity or business enterprise and all other risk management products. The former should be regulated by Chapter 7 of the Corporations Law and the latter by Chapter 8.

6.5 The price of an Equity Option will reflect the performance by the company to which the shares the subject of the option relates. Equity Options should, therefore, be classified as securities. Typically the institutions which will be involved in the trading of Equity Options will be involved in the general securities market operated by the ASX and, accordingly, will already
hold the appropriate licences to enable trading to be carried on. As the professional market in Equity Options is concerned, the application of the prospectus provisions should be limited as most offers or invitations to purchase Equity Options will be classified as exempt offers or invitations. On the other hand, retail investors will be protected by virtue of the prospectus provisions and the related disclosure obligations. [But note our comments on exempt stock market in para 4.13.]

6.6 Further work needs to be done on the interface between “securities” and “futures contracts”. A credible argument can be put to support the view that there should be no difference in the regulation of securities and futures contracts and there should be only one category for the purposes of regulation. In the report of the Prospectus Law Reform Sub-Committee (March 1992) the Sub-Committee recommended that options and any other rights or interest in respect of unissued securities and warrants and similar rights in respect of securities be covered by the definition of “securities” in the Corporations Law.

Whether the exception from the definition of “futures contract” should continue?

6.7 Should the exemption for the products referred to in paragraph 6.1 from the definition of “futures contract” continue? If our submission on the deregulation of the “wholesale” OTC Market is accepted the answer is probably no, unless the beneficiaries of the exemption can justify its continuance. There may be additional burdens on these people by reason of the need to hold a futures brokers licence or a futures advisers licence if these products are now deemed to be futures contracts. However, because of the difficulties with the gaming and betting legislation in each state and territory it may not be appropriate to continue the exception.

Eligible Commodity Agreements

6.8 There is currently some confusion as to the inter-relationship between the definitions “eligible commodity agreement” and “commodity agreement”. The definition “commodity agreement” refers to a contract under which a person is under an obligation to make or accept delivery. An eligible commodity agreement is a “commodity agreement” where it appears likely that the contract will be settled other than by physical delivery. In order to exclude a contract being an eligible commodity agreement, therefore, one only has to draft an agreement as a non-deliverable commodity agreement.

6.9 We believe the definition of “eligible commodity agreement” should be altered to cover:

(a) an agreement where it appears likely having regard to all relevant circumstances that the contract will be settled other than by physical delivery; and

(b) an agreement that would be a commodity agreement except that the contract is to be settled other than by physical delivery.
Standardised Agreements

6.10 The term "standardised agreement" is defined in section 9 of the Corporations Law as an agreement that is one or more agreements each of which is an agreement of the same kind as the other. Section 54 of the Corporations Law provides that an agreement is of the same kind as another agreement if and only if the provisions of the first mentioned agreement are the same as, or not materially different from, the provisions of the other agreement, disregarding:

(a) the fact that the parties to the respective agreements are different; and

(b) any difference in the amounts payable under the corresponding provisions of the respective agreements.

6.11 These definitions raise two principal issues, namely:

(a) to be standardised, must a number of contracts be offered by the same institution or is it sufficient that 2 unrelated institutions have entered into agreements "of the same kind"; and

(b) when can an agreement be said to be of "the same kind" as another agreement.

6.12 On the first point it seems to be generally accepted that for products offered by an institution to be standardised, that institution must have entered into two or more agreements of the same kind as each other. We do not believe this interpretation is justified by the legislation. If two unrelated institutions entered into agreements of the same kind as each other, those agreements would be standardised. With the increasing usage of ISDA type documents, institutions may be entering into standardised agreements in ignorance.

6.13 Relevant case law on the meaning of the term "standardised agreement" has given it a broader interpretation than justified. For example, in the Shoreline Currency Case, Lee J stated that two agreements were of the same kind because they dealt with foreign currency purchases in the same way. In the case of CAC v Lombard Nash International Pty Ltd (1987) 5 ACLC 269 Young J stated that the words "of the same kind" mean no more than the agreements are substantially the same and refer to the same type or nature of transaction and the words do not exclude cases where there are different terms in a series of agreements, so long as the reasonable man or woman in the street would say "well, although there are some differences in them, they are substantially of the same nature". In none of the cases concerning the meaning of "standardisation" was section 54 properly analysed. In our opinion, section 54 makes it clear that it is not sufficient for a contract merely to be "of the same nature" as another.

6.14 We suggest that the definition of "standardised agreement" incorporate the concept of fungibility (that is, a position under one contract can readily be exchanged for the same position under another contract with little or no effect on the party's position). This will ensure that the retail market in derivatives is caught by the definition of "standardised
agreement” but that derivatives in the professional market where, although contracts between principals will deal with products in the same way, they will often be substantially negotiated at arm’s length and will not be readily interchangeable.

6.15 The existing definition of “standardized agreement” is very confusing and the cases which have interpreted the provision have done nothing to clarify it. There is a significant risk that the term has been given a meaning much greater than that which is justified and must greater than that intended by the legislation. The definition is clearly important as it is a central feature of a number of the components of the products which comprise futures contracts. The use of the concept of standardized agreement is particularly useful in the context of regulation of futures contracts and we submit strongly that it should be retained. Changing the definition of “standardized agreement” may exclude some products from the definition of “futures contract”. Having regard to the discussion of wagering and gaming in paragraph 7, this is something that will have to be looked at.

7. WAGERING AND GAMING

7.1 Section 1141 of the Corporations Law provides:

“Nothing in a law of this jurisdiction about gaming or wagering prevents the entering into of, or affects the validity or enforcement of, a futures contract made:

(a) on a futures market of a futures exchange or of a recognised futures exchange; or

(b) on an exempt futures market; or

(c) as permitted by the business rules of a futures association, or a futures exchange or of a recognised futures exchange.”

7.2 This is the only protection in the Corporations Law from the wagering and gaming laws of each State and Territory of Australia. Section 1141 requires:

(a) there to be a “futures contract”; and

(b) that the futures contract is traded on a futures market of a futures exchange or a recognised futures exchange or on an exempt futures market.

7.3 The problem with section 1141 is that does not protect from the gaming and wagering legislation:

(a) derivatives which are not futures contracts - see Attachment A; and

(b) derivatives which are futures contracts but which are not traded on a market of the type specified in section 1141.
7.4 Naturally the question that has to be answered is whether there is a risk of invalidity for derivatives that fall within categories (a) or (b) of paragraph 7.3.

7.5 Section 16 of the Gaming and Betting Act provides, relevantly:

"All contracts or agreements, whether parole or in writing, by way of gaming or wagering, shall be null and void, and no suit shall be brought or maintained in any court of law or equity for recovering any sum of money or valuable thing alleged to be won upon any wager or which has been deposited in the hands of any person to abide the event on which any wager has been made."

What is a Wagering Contract?

7.6 The classic formulation of the indicia of a wagering contract was laid down in Carlill v Carbolic Smokeball Co. [1892] QB 484 at 490:

"... a wagering contract is one by which two persons, professing to hold opposite views, touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and that other shall pay or hand over to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party may under it either win or lose, whether he will win or lose being dependent on the issue of the event, and, therefore, remaining uncertain until that issue was known. If either of the parties may win but cannot lose, or may lose but cannot win, it is not a wagering contract."

7.7 Another old but much quoted formulation appears in Thacker v Hardy (1878) 4 QBD 685 and was applied by the High Court in Morley v Richardson (1942) 65 CLR 512:

"The essence of gaming and wagering is that one party is to win and the other party is to lose upon a future event, which at the time of the contract is of an uncertain nature - that is to say, if the event turns out one way A will lose, but if turns out the other way he will win."

7.8 In summary, the elements of a wagering contract are:

(a) one party must win from the other party the sum of money or other stake which is the subject of the transaction;

(b) each party to the transaction may either win or lose depending on the outcome of a future uncertain event; and

(c) the sum of money or other stake in the transaction will be won or lost depending on the outcome of the future uncertain event.
7.9 The classical formulations of the indicia of a wagering contract also establish the circumstances when a transaction superficially like a wagering contract is not a wagering contract:

(a) if either of the parties may win but cannot lose, or may lose but cannot win the sum of money or other stake the subject of the contract;

(b) if the outcome of the future uncertain event results in both parties winning or both parties losing under the contract; or

(c) if either party has "any other interest" in the contract or there is some "other real consideration for the making of" the contract.

Which Derivatives are Wagering Contracts?

7.10 Any derivative containing the elements of a wagering contract set out in paragraph 7.8 above will be a wagering contract and at risk of being held null and void under section 16 of the Gaming and Betting Act, unless one of the elements identified in paragraph 7.9 above is present.

7.11 Dr Chaikin and Mr Moher in their article "Commodity Futures Contracts and the Gaming Act" ([1986] Lloyd's Maritime and Commercial Law Quarterly 390), observe that many derivatives contain the essential elements of a wagering contract. One party is to "win" and the other is to "lose" amounts of money depending on movements in the commodity, the index, the currency or the interest rates concerned. The following examples appear in the cases:

(a) Contracts for Differences

Early cases established that contracts for differences were contracts by way of wagering (Universal Stock Exchange v Strachan [1896] AC 166, followed by the High Court in Morley v Richardson). Contracts for differences are "contracts for the sale and purchase of shares or commodities to be fulfilled by the payment of differences in price and not by delivery" (Lord Donaldson MR in City Index Limited v Leslie [1991] 3 WLR 207).

(b) Contracts in relation to Indices

Another example of derivatives which the cases have held to be wagering contracts are contracts for payments made by reference to share or commodity indices. Halsbury's Laws of England (4th Ed) cites Re Futures Index Limited [1985] PCC 164 as authority that contracts for payments on the movement of indices are "pure wagering contracts and [are] regarded as void and unenforceable". It is implicit in the judgments in the City Index case that the court regarded contracts falling within a provision of the Financial Services Act 1986 (UK) considered in that case as wagering contracts. The relevant provision referred to contracts "the purpose or pretended purpose of which is
to secure a profit or avoid a loss by reference to fluctuations ... in an index or other factor designated for that purpose in the contract”. Certain derivatives offered in Australia would likely fall within this formulation.

Which derivatives are not Wagering Contracts?

7.12 Derivatives containing one of the elements identified in paragraph 7.9 above will not be wagering contracts. Cases have identified several examples:

(a) Contracts intended to be performed by delivery in Universal Stock Exchange v Strachan

It was enough that one of the party’s intended to delivery the security concerned.

(b) “Win/Win” contracts

In the Carragreen case the Judge found that the contract did not fall foul of the gaming and wagering provisions because all of the plaintiff’s possible liability to the customers were fully hedged by off-setting contracts on the Chicago Futures Exchange. Thus, the relevant contracts were not rendered void by section 16. The Carragreen case has been criticised on a number of grounds and thus it may not be safe to rely upon the decision of a single judge given the consequences of being found to be wrong.

(c) Contracts having a valid commercial purpose

Commentators have said that provided one of the party’s has a valid commercial purpose in entering into the contract then it will not be found to be a wagering contract. However, commentators have not put forward any authority to support this proposition nor have we been able to find any authority which supports it. Indeed, in light of the decision of the House of Lords in Hazell v The London Borrough of Hammersmith & Fulham [1992] 2 AC 1 Australian courts may be reluctant to discern a “valid commercial purpose” for many derivatives.

7.13 The House of Lords in the Hammersmith & Fulham case took an unexpectedly disapproving view of interest rate swaps and, by implication, derivatives in general. Lord Templeman, who gave the leading speech, consistently described interest rate swap transactions as speculative and imprudent. Even an interest rate swap in relation to an existing borrowing by the Council in that case was described by Lord Templeman as “a speculation no different in kind though different in magnitude from a swap contract which is not entered into by reference to any existing borrowing”.

Further, His Lordship described interest rate swaps based on notional principal sums as “more akin to gambling than insurance”, when urged to consider the similarities between such swaps and insurance contracts.
7.14 We submit that because of the consequences of invalidity under the Gaming and Betting Act for derivatives that do not come within the requirements of the existing section 1141 of the Corporations Law that:

(a) the definition of "futures contract" be extended to protect derivatives not covered by the existing definition; and

(b) that section 1141 be extended to give protection to futures contracts between "Appropriate Persons".

7.15 If some derivatives are more appropriately not held to be "futures contracts", then there should be a broader exception from the gaming and betting legislation.

8. MEMBERSHIP OF SFE AND AFFM FOR FUTURES BROKERS

We submit that it should not be a pre-requisite for a person to obtain a futures broker licence that it be a member of SFE or AFFM. The minimum requirements for a futures broker should be set down in the Corporations Law. If a futures broker wants to trade on the retail or wholesale OTC Markets it should be allowed to do so without being required to be a member of an on-market exchange futures organisation.

9. OTHER MATTERS

In Attachment B we set out our comments on a number of the specific issues raised by the ASC in its Discussion Paper.

10. CONCLUSION

We would be pleased to discuss any aspect of this submission with the ASC. In this regard please do not hesitate to contact Jeff Mansfield in our Sydney Office (250 3221).

MALLESONS STEPHEN JAQUES
ATTACHMENT A

IS A DERIVATIVE A "FUTURES CONTRACT" OR A "SECURITY"?

1. EQUITY INDEX OPTION

1.1 Is an over-the-counter put or call option in respect of shares in a listed company which may only be settled by the payment of a net cash amount ("Equity Option") a futures contract or a security? An Equity Option may be a futures contract if it is an "adjustment agreement" or an "eligible commodity agreement". Given the decision in Carragreen Currency Corporation Pty Ltd v The Corporate Affairs Commission (NSW) 1987 11 ACLR 298, an Equity Option is not an adjustment agreement because neither the option seller nor the option buyer is in a position that "he will, depending upon circumstances, either have an obligation to pay or have a right to receive an amount of money".

1.2 In the case of an Equity Option which is a put option, the option buyer will have a right to receive money if the price of the underlying security to which the option relates increases above the exercise price. However, as there is no obligation to exercise the call option, the option buyer will never be under an obligation to pay an amount of money if the price of the underlying security decreases. Similarly, the option seller only has an obligation to pay an amount of money if the price of the underlying security increases and the option buyer exercises the option.

1.3 An eligible commodity agreement is a "commodity agreement" where it appears likely having regard to all the relevant circumstances (including the rules and practices of any market) that the contract will be settled other than by physical delivery. A "commodity agreement" in agreement under which a person is under an obligation to make or accept delivery at particular future time of a particular quantity of a particular commodity for a particular price or for a price to be calculated in a particular manner.

1.4 An Equity Option which does not provide for delivery of the relevant securities and which is required to be settled in cash is not a commodity agreement because neither party is under an obligation to make or accept delivery of the underlying shares represented by a share
certificate (being the relevant commodity). It should be noted that an Equity Option agreement can be drafted as an option over the movement in a share price as opposed to the shares themselves.

1.5 We would argue that if an agreement is not a "commodity agreement" then as a definitional issue it cannot be a "eligible commodity agreement". On this basis, any agreement relating to commodities which is fundamentally "undeliverable" is not an "eligible commodity agreement". We are unclear as to whether this is the intention of the legislation or whether the intention is that an eligible commodity agreement should be an agreement which would otherwise be a commodity agreement except that the obligation to effect settlement is other than by delivery.

2. IS AN EQUITY OPTION A SECURITY?

2.1 An Equity Option may be a security if it is a unit of a share, a prescribed interest or an option contract within the meaning of Chapter 7 (see section 92). On settlement, the obligation of the parties under an Equity Option is to calculate a Settlement Amount by reference to the difference at that time between the strike price of the option and the market price of the underlying shares at that time.

2.2 To be classified as a "Unit of a Share" an Equity Option would need to fall within the general description of a right or interest in the underlying shares the subject of the option. However, the parties to a cash settled option never acquire a right or interest in the shares the subject of an option. The only right acquired is a right to demand payment of an amount of money ie: the Settlement Amount. Accordingly, an Equity Option is not a unit of a share.

2.3 As to whether an equity option would amount to a prescribed interest, there would need to be a number of additional factors in existence before the threshold requirements necessary to establish the existence of a prescribed interest could be satisfied. Nevertheless, we think it is unlikely that in any given situation involving a commercial transaction between two principal parties that a prescribed interest situation would arise.

3. IS AN EQUITY OPTION AN OPTION CONTRACT WITHIN THE MEANING OF CHAPTER 7

3.1 The definition of "option contract" is divided into two paragraphs. An Equity Option would not fall within paragraph (b) as it is not an option entered into on the stock market of a securities exchange or an exempt stock market. We believe that the better view is that an Equity Option would also not fall within paragraph (a) of the definition of option contract as the buyer of a call option does not acquire an "option or right to buy from or to sell to the other party a number of specified securities". All the buyer obtains is an option to receive a cash payment as a result of a movement in the share price to which the option relates. There is no option or right to buy or sell the securities the subject of the option.
4. **INTEREST RATE SWAPS**

Is an interest rate swap a futures contract? Interest rate swaps, especially those containing currency elements have the basic features of an adjustment agreement. However, whether or not an interest rate swap is an adjustment agreement will depend on whether the particular swap may be classified as a "standardised agreement". The definition of "standardised agreement" is discussed in paragraph 6.10 to 6.13 of the submission.

5. **COMMODITY BOND**

5.1 Is an instrument in the form of a bond where the redemption value of the bond is linked to the movement in a particular commodity index ("Commodity Bond") a futures contract? Such bonds will not be eligible commodity agreements as the agreement by which they are created will not contemplate the delivery of a "particular quantity of a particular commodity at a particular future time". The actual quantity of money (being the relevant commodity) payable on redemption of the bonds will not be known until their redemption date. In addition, such bonds will not be an adjustment agreement as the person under the obligation to redeem the bond will always be under an obligation to pay money, the amount payable depending on a particular future state of affairs. However, that person will never have any right to receive an amount of money consequential upon that future state of affairs. Likewise, the counterparty to the bonds will always have a right to receive an amount of money but will never be under an obligation to pay money. Accordingly, we believe that the better view is that such bonds are not futures contracts under the definitions in the Corporations Law.

5.2 Is a Commodity Bond a security? A Commodity Bond may be a security if it is a prescribed interest or a debenture. We believe that it is unlikely that Commodity Bonds will be classified as prescribed interests. Commodity Bonds are likely to be classified as debentures because, by the nature of the instrument, a bond evidences indebtedness of the issuer to the purchaser. It may be, however, that it will be possible to structure a bond so that it falls within one of the exemptions set out in the definition of debenture.

6. **IS AN OPTION OVER AN INDEX A FUTURES CONTRACT OR SECURITY?**

6.1 Is an option in respect of the movement in a particular share price index which is traded on an over-the-counter market a futures contract or a security? An index option may be a futures contract if it is an "eligible commodity agreement", "an adjustment agreement" or "eligible exchange-trade option". The better view is that an index option is not an eligible commodity agreement or adjustment agreement for the reasons expressed in paragraph 1 above. In addition, an index option is not an "eligible exchange-traded option" as it is not a contract "that is entered into on a futures market of a futures exchange".

6.2 An index option would be classified as a security if it fell within paragraph (b) of the definition of "option contract". However, the introductory words of paragraph (b) commence "a contract entered into on a stock market of a securities exchange or on an exempt stock market". Accordingly, an index option traded on an over-the-counter market is not a security.
OTHER ISSUES RAISED BY AUSTRALIAN SECURITIES COMMISSION

A number of the issues raised by the ASC in its Discussion Paper have been addressed in the body of our submission and in Attachment A. However, a number of peripheral issues raised in the Discussion Paper have not been dealt with directly and those issues are discussed below.

1. IS IT APPROPRIATE TO DISTINGUISH BETWEEN SECURITIES AND FUTURES CONTRACTS?

The only valid basis for distinguishing between securities and futures contracts is the general inapplicability of the prospectus provisions and the disclosure obligations contained therein (as set out in section 1022) to futures contracts. The fundamental basis behind the prospectus provisions is to ensure full disclosure of the relevant business undertaking in which persons are asked to invest. This concept of business undertaking is not applicable to the futures contract provisions. However, in all other respects the regulation of the securities and futures industry is and should remain very similar.

2. IS IT DESIRABLE FOR OVER-THE-COUNTER TRADING IN DERIVATIVES TO BE LIMITED TO PARTICULAR TYPES OF TRANSACTIONS?

2.1 We believe it is not appropriate to place any such limitation on the types of over-the-counter derivatives permitted to be traded on professional exempt markets. Once the proposition is accepted that appropriate persons should be permitted to enter into derivatives independent of the prohibition on establishing an unauthorised futures market, those parties should be permitted to transact any type of transaction which would fall within the classification of futures contracts. This conclusion is necessary in order to promote the objectives for which over-the-counter markets are established, namely risk management through innovation.

2.2 Given our recommendation that over-the-counter trading be limited to professional parties, we also do not believe that there is any necessary distinction between “hedging” transactions and “speculative” transactions because:
(a) such a restriction would introduce a level of uncertainty into the regulatory structure. It would be very difficult to determine in any particular transaction the reasons why a counterparty is entering into the transaction and the manner in which such a distinction could be incorporated in a practical and logical manner is unclear; and

(b) given that participation is limited to sophisticated investors, the reasons why they are entering into the transaction should be irrelevant.

3. WHAT FEATURES OF THE CORPORATIONS LAW REGIME SHOULD APPLY TO OVER-THE-COUNTER DERIVATIVES MARKETS?

3.1 The only appropriate Corporations Law limitations which should be placed on trading in over-the-counter derivatives should be:

(a) the persons who are permitted to participate in the market; and

(b) existing regulations prohibiting acts such as market rigging, insider trading, fraud etc.

3.2 In particular, we do not believe that the introduction of an SRO is justified. Given the nature of the exemption and the sophistication of the parties who are going to enter into contracts, the introduction of intermediaries is unjustified for cost reasons.

4. SHOULD PRUDENTIAL STANDARDS BE IMPOSED ON PROVIDERS OF OVER-THE-COUNTER FACILITIES?

4.1 Participants in the over-the-counter market will be in a position to assess the credit worthiness of their counterparties. Prudential supervision should not be an issue, therefore, for professional markets except to the extent that such activity may destabilize regulated markets.

4.2 Accordingly, prudential supervisions should be limited to those Australian institutions whose activity in the over-the-counter markets may affect their ability to meet their obligations in regulated futures markets.
Global Derivatives Study Group

Enforceability Survey — Brazil

prepared by Pinheiro Guimarães-Advogados
with the assistance of
Cleary, Gottlieb, Steen & Hamilton

June 13, 1993
I. General contract law issues that may affect how derivative transactions are carried out in Brazil

A. Oral agreements

Under Brazilian law, the evidence required to make an agreement enforceable is governed by Article 123 of the Commercial Code (Law No. 556 of June 25, 1850), Article 141 of the Civil Code (Law No. 3,701 of January 1, 1916) and Articles 401 and 402 of the Code of Civil Procedure (Law No. 5,869 of January 11, 1973).

Article 123 of the Brazilian Commercial Code reads:

Except in the cases expressly provided for in this Code, proof by witnesses is admitted in Commercial Court only with respect to contracts the value of which does not exceed forty centavos of cruzeiros.

For contracts the value of which exceeds such amount, proof by witnesses is only admitted in support of evidence in writing.

Furthermore, Article 141 of the Civil Code and its sole paragraph provide that:

Except in the cases expressly provided for by law, evidence presented exclusively by witnesses is admitted only with respect to

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1The author wishes to acknowledge the assistance of Anthony C. Gooch, Esq., of Cleary, Gottlieb, Steen & Hamilton in the preparation of this memorandum.
contracts the value of which does not exceed Cr$ 10.000,00 (Ten Thousand Cruzeiros).

Sole Paragraph: Whatever the value of the contract, proof by witnesses is admitted to support or supplement written proof.

Finally, as a matter of procedural law, the Brazilian Code of Civil Procedure establishes the following (Articles 401 and 402):

Article 401 - Proof produced exclusively by witnesses is only admitted in relation to contracts the value of which does not exceed ten times the minimum wage in force in the country at the time of execution of such contracts.\(^2\)

Article 402 - Whatever the value of the contract, proof by witnesses is admitted whenever:

I - There is a prima facie written evidence, with documents issued by the party against whom the document is sought to be used as evidence being considered as such;

II - The creditor cannot or could not, for moral or practical reasons, obtain the documentary evidence of the obligation, as in cases of family relationships, necessary custody or hotel lodging.

Therefore, it is not possible under Brazilian law to enforce oral agreements involving amounts of more than approximately US$ 900.

B. Signatures of witnesses and other formalities required to make derivatives contracts enforceable in Brazil or to make summary proceedings available

Written agreements may be enforced through ordinary proceedings even though they are not witnessed. In order to make summary proceedings available, it is necessary that there be a written contract signed by the debtor and by two witnesses (Brazilian Code of Civil Procedure, Article 585 II).

\(^2\)Now Cr$ 3.303.300,00 (approximately US$ 900).
II. Other enforceability issues affecting domestic and cross-border derivative products in Brazil

A. Prohibitions against gambling contracts

Articles 1,477 to 1,479 of Brazil's Civil Code render wagering contracts unenforceable. Article 1,479 of the Code provides that certain sorts of derivative transactions—contracts on exchange-quoted securities, commodities or securities in general—will be treated as wagering contracts if they are settled in accordance with the difference between an agreed price and their quoted price at the expiration of the transaction.

The preceding articles, 1,477 and 1,478, provide that wagering or gambling debts are not binding and that there is no action for repayment of loans made to finance bets or wagers.

The commentators are unanimous in the view that differential contracts; that is, contracts of sale in which the parties have no real intention of delivering the merchandise, the instrument or the security, but only to settle for the difference between a stipulated price and the quoted value of the item that was sold on the settlement date, are considered wagering contracts.

There is as yet no authority in Brazil on the question whether payments made in connection with derivative transactions are to be considered wagering contracts for this purpose. In interest rate and currency swaps, there is no sale of merchandise, instruments or securities, so that there is a persuasive argument that Article 1,477 through 1,479 of the Civil Code do not apply to such transactions. As noted below, the Central Bank of Brazil has expressly permitted certain kinds of international hedging activities by Brazilian private sector companies.

B. Prohibitions on usurious transactions

In general terms, it is unlawful to charge interest in excess of 12% per annum (Decree No. 22,626 of April 7, 1933, Art. 1), and only 1% per annum may be added as default interest. Charging interest above the legal rates constitutes an economic crime (crime contra a economia popular) under Law No. 1,521 of December 26, 1951, Art. 4(a).

Financial institutions are not subject to the limits provided in Decree No. 22,626 as the Federal Supreme Court, in Precedent No. 596, ruled that "the provisions of Decree No. 22,626 do not apply to interest and other fees charged in transactions carried out by financial institutions that are part of the Brazilian financial system."
Moreover, in light of Brazil’s chronic inflation the general view is that simple indexing to take account of the effects of inflation does not constitute interest and, as a consequence, that it is permissible to charge indexation plus interest (the real rate) of up to 12% per annum.

Article 192(3) of Brazil’s Constitution of 1988 provides for a ceiling of 12% per annum on real rates of interest on bank loans. Brazil’s Federal Supreme Court has held that Article 192(3) will not be given effect until implemented by legislation. Such legislation has been under consideration in the Brazilian Congress since 1988.

There is no authority in Brazil as to whether payments made in connection with interest rate swaps or other derivative transactions are to be considered interest for purposes of Brazil’s usury legislation (or, for that manner, other purposes). In my view, it is unlikely that swap payments themselves (other than interest due on late swap payments) will be analyzed as interest, inasmuch as there is no underlying principal debt.

C. "Gold-clause" legislation

Decree-Law 857 of September 11, 1969, provides that:

Art. 1. Contracts, instruments or other documents, or obligations to be performed in Brazil, that provide for payment in gold, in foreign currency or that in any way have the effect of restricting or impinging on the role of the cruzeiro as legal tender are automatically void.

The provisions of the preceding article do not apply to:

I - contracts and instruments relating to imports or exports of merchandise;

II - financing or guaranty agreements relating to the export of goods produced in Brazil and sold abroad on credit;

III - contracts for the purchase and sale or foreign exchange;

IV - loans and other obligations in which the debtor or creditor is a person resident or domiciled abroad, except for rental contracts relating to real property situated in Brazilian territory; and
V - contracts relating to the sale, transfer, delegation, assumption or amendment of obligations referred to in the preceding clause, even if both the parties are persons resident or domiciled in Brazil.

D. Territorial considerations relating to the provisions referred to in points II.A to II.C

Wagering—The Central Bank of Brazil, in Resolution 1,921, expressly authorized private sector entities to enter into rate swaps, caps, floors and collars to hedge against the risks of rate changes in the international markets, with respect to amounts scheduled to be paid or received in the future.

Thus, transactions of this kind, in international markets, are outside the reach of Articles 1,477 through 1,479 of the Civil Code.

Usury—There is no authority on the question whether a foreign financial institution would be treated as if it were a Brazilian financial institution for purposes of the exemption from the usury laws, though it is widely believed by legal practitioners that the exemption from the usury laws would be extended to foreign institutions.

Gold Clause—Brazil's gold-clause legislation does not apply to contracts in foreign currency if one of the parties is resident or domiciled abroad.

E. Provisions of Brazilian law and regulation that may reserve derivative transactions or certain kinds of derivative transactions to particular kinds of institutions

Brazil's capital markets law and regulations (including regulations relating to stock and commodities exchanges), financial institutions law and regulations, insurance law and regulations and commodities regulation do not contain provisions reserving derivative transactions to particular kinds of regulated institutions.

III. Specific issues affecting cross-border transactions

A. Exchange controls—Under Central Bank Resolution No. 1,921 of April 30, 1992 and related provisions, cross-border interest rate or currency swaps relating to international financing transactions and swaps related to registered foreign equity investments in Brazil require approval of the Central Bank. There are no regulations in force in Brazil relating to other types of cross-border derivative transactions, and they would require Central Bank approval on a case-by-case basis.
B. Securities regulation—The legality of derivative transactions that are linked to equity in Brazilian open capital companies must be examined in each case to ensure that they do not involve any infringement of regulations relating to the control of such companies or "relevant participation" in their capital.

C. Applicability of the prohibitions on cross-border netting (compensação privada de cambio) to derivative transactions—Brazilian law prohibits private foreign exchange netting transactions. The prohibited transaction is one that involves payments, debits or credits between a Brazilian company or resident, on one hand, and a non-Brazilian party, on the other, which have the effect of effecting a transfer in foreign currency without the intermediation of a bank in Brazil that is authorized to deal in foreign exchange.

The examples of prohibited transactions that are most frequently cited are as follows:

Four-party transaction: Party A and Party B are both Brazilian residents. Party A has a credit against Party C, a non-resident, and Party B has an obligation to Party D, also a non-resident. The Brazilian exchange control regulations require that Party A collect its credit through a bank transfer and surrender the hard currency proceeds, which can be used only in accordance with the relevant rules. Party B can make a payment in hard currency to its creditor only through an authorized bank, and only if the transaction is one that entitles it to purchase hard currency with Brazilian currency, under those regulations. A prohibited transaction would take place if Party C (a non-resident), instead of paying Party A in Brazil, made its payment to Party D outside Brazil, in satisfaction of Party B's obligation, and Party B made the corresponding payment in local currency to Party A.

Three-party transaction: Party A, a Brazilian, has a payable to Party B, a non-resident, and a claim on Party C, also a non-resident. If Party A instructs Party C to make a payment to Party B on A's behalf, this would constitute an exchange control violation, because the transaction was not closed through a bank authorized to deal in foreign exchange in Brazil. Similarly, if Party A, a Brazilian, has a claim on Party C, a non-Brazilian, and another Brazilian, Party B, owes something to Party C, it is an exchange-control violation for Party A to instruct Party C to apply A's credit against what B owes.

It does not appear that the netting provisions in a stand-alone derivative transaction between a Brazilian party and a non-Brazilian party would infringe the rules described above; in this connection, it is important to note that, under present regulations, each such transaction would be undertaken within a generally-applicable authorization from the Central Bank of Brazil or would require special authorization. If a Brazilian party wishes to enter into a master agreement with
a foreign counterparty that calls for netting of amounts due in connection with one transaction against amounts due in connection with another, this provision would require special approval from the Central Bank of Brazil. Triangular netting provisions that permit netting of amounts due to one party against amounts due from another (an affiliate, for example) should be handled with special care, and it appears unlikely that the Central Bank would approve such provisions.

IV. Authorization issues

A. For Brazilian corporations generally—the examination of this question should begin with the charter (estatutos) of the Brazilian party. The charter might require shareholder approval for a transaction of the kind in question, or might give the Board of Director (conselho de administração) or the executive officers (diretoria executiva) power to enter into the transaction. In order for a delegation to the board or the officers to be effective, the charter provision should be reasonably specific; a mere reference to "credit transactions" or "borrowings" would not appear to confer authority to enter into related derivative transactions.

B. Special internal or governmental formalities for Brazilian public-sector entities to enter into derivative transactions—External financings of the Federal Government, the States, the Federal District, and Brazilian territories and municipalities must be authorized by the Federal Senate, as provided in Article 52V of the Federal Constitution. Central Bank approval is also required for such transactions. The constitutional provision does not by its terms require Senate approval for derivative transactions; however, if the purpose of the transaction is to manage indebtedness, for example, by "converting" a floating rate borrowing to a fixed rate, or a bond issue in one currency to another currency, prudence would appear to dictate obtaining Senate approval for the derivative transaction.

It is not clear whether a public-sector entity could lawfully enter into a derivative transaction not related to a financing without Federal Senate approval. Such a transaction would, in any event, require Central Bank approval, and, depending on the facts, that approval alone might be deemed sufficient.

Cross-border derivatives transactions of public-sector entities, like those of private-sector companies, require Central Bank approval. Transactions of mixed-capital companies (such as Petrobrás and Companhia Vale do Rio Doce) and public companies (such as Embratel) may also require approval of the Department of the National Treasury.

Whether competitive bidding requirements apply to a particular derivative transaction with a public-sector entity must be examined in the light of all the facts of the transaction. Certain types of exchange transactions are exempted from those requirements by Decree-Law 2,300 of November 21, 1986.
V. Credit support (guaranties, collateralization agreements, letters of credit, surety bonds)

A. General contract law issues

1. Private-Sector Entities. Under Brazilian corporate law, a special charter provision is required to permit the issuance of guaranties of obligations of third parties.

2. Public-Sector Entities. Ministry of Finance approval is necessary for guaranties by public sector entities.

3. Summary proceedings—Credit support agreements are enforceable in Brazil through summary proceedings provided the instrument that establishes them provides for payment of a sum certain and provided it is signed by two witnesses.

B. Exchange controls—The approval of the Central Bank of Brazil is not required to render a credit support document in favor of a foreign counterparty enforceable; however, the remittance outside of Brazil of funds paid in satisfaction of credit support obligations would require such approval. If the transaction is registered with the Central Bank, and if the registration properly discloses the existence of the credit support obligation, the remittance would be authorized. Otherwise, approval of the Central Bank may be sought on a case-by-case basis.

C. Securities regulation—No approvals of the Securities Commission are required to render credit support documents enforceable.

D. Authorization issues—for Brazilian corporations generally, the authorization issues are the same as those discussed above for derivative transactions.

E. Special governmental formalities necessary for Brazilian private-sector companies in regulated industries to extend credit support for derivative transactions—Brazilian financial institutions are subject to quantitative limits on issuance of guaranties.

VI. Insolvency and bankruptcy issues

A. Enforceability of early termination provisions in insolvency and bankruptcy situations

The following discussion applies equally to Brazilian corporations that are subject to the Bankruptcy Law and to financial institutions, which are the subject of special intervention or liquidation procedures carried out under the jurisdiction of the Central Bank of Brazil. It is important to note, however, that mixed-capital companies, such as Petrobrás and Companhia Vale do Rio Doce, are not eligible to be debtors under the Bankruptcy Law. In the case of insolvency of
such companies, the controlling shareholder (Brazil’s Federal Government, in the case of federal mixed-capital companies) has subsidiary responsibility for the insolvent’s obligations.

In considering the enforceability of early termination proceedings in Brazil, it is important to distinguish three situations: (i) insolvency events short of actual proceedings, (ii) reorganization proceedings (concordata) and (iii) bankruptcy proceedings (falência).

Contractual provisions that give one party the right to terminate the agreement because of the occurrence of events short of the commencement of reorganization or bankruptcy proceedings, or that provide for automatic termination upon the occurrence of such events, would be enforceable in Brazil.

Such contractual provisions would not, however, be given effect insofar as they relate to the commencement of reorganization or bankruptcy proceedings. In such cases, the solvent counterparty may require the trustee to assume or reject executory contracts within a five-day period. If the trustee rejects the contract or does not reply within that period, the contract is terminated and the counterparty has a claim for damages against the bankrupt estate. Similar rules apply in the case of extra-judicial intervention in or liquidation of financial institutions.

B. Enforceability of netting provisions in insolvency and bankruptcy situations

Generally speaking, counterparties are entitled to net obligations owing by them to entities that are the subject of reorganization or bankruptcy proceedings against obligations owed to them by the insolvent party, both under the Bankruptcy Law and in the case of extra-judicial proceedings involving financial institutions. While there is no authority directly in point, it appears quite likely that master agreements for derivative products that treat all transactions between the parties to the agreement as being part of a single agreement for assumption and rejection purposes would be respected in Brazil.
Global Derivatives Study Group

Enforceability Survey — Canada

prepared by Stikeman, Elliott

June 7, 1993
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THE GROUP OF THIRTY: GLOBAL DERIVATIVES STUDY

CANADA: Survey for the Enforceability Subcommittee

I. INTRODUCTION

This report summarizes various enforceability issues which exist in
Canada in the derivatives market. The enforceability concerns identified in this report
involve capacity and proper authorization issues with respect to certain kinds of
Canadian counterparties, statute of frauds and similar issues, restrictions on the ability
of certain kinds of Canadian counterparties to pledge collateral and continuing
uncertainties surrounding early termination in the bankruptcy and insolvency context.
As is indicated throughout this report, some of the enforceability issues addressed
loom larger than others, but perhaps all issues identified can benefit from legislative
clarification.

Canada is a federation of ten provinces and (presently) two territories.
Consequently, there are potentially thirteen relevant jurisdictions in the consideration
of derivatives transactions. The federal government has jurisdiction over federally
regulated entities, such as banks, federal trust and loan companies, federal insurance
companies, federal Crown corporations and agents and federal pension plans, and
over matters of bankruptcy and insolvency with respect to any person. The federal
government also has jurisdiction over the territories, although the territories pass their
own legislation with respect to local matters. The provincial governments have
jurisdiction over matters that involve property and civil rights in the provinces (which
includes many contract law issues, insurance issues, pension issues etc.),
municipalities and other provincial corporate entities. We have limited our analysis of
the issues addressed in this report to the federal jurisdiction and the provinces of
Alberta, British Columbia, Ontario and Quebec. These are the four largest provinces
(economically speaking) in Canada. It should be noted, however, that other provincial
governments and counterparties incorporated in other provinces do participate in the
derivatives market and that similar or other issues might arise in those jurisdictions.

We have used the term "Transaction" or "Transactions" throughout this
report to refer to any transaction which is a rate swap transaction, basis swap,
forward rate transaction, commodity swap, commodity option, equity or equity index
swap, equity or equity index option, bond option, interest rate option, foreign
exchange transaction, cap transaction, floor transaction, collar transaction, currency
swap transaction, cross-currency rate swap transaction, currency option or any other
similar transaction (including any option with respect to any of these transactions),
any combination of any of these transactions and, where appropriate, any master agreement with respect to such transactions. We have used the term "Master Agreement" to refer to any master agreement that would govern Transactions with a particular counterparty and have assumed, where relevant, that it takes the form of the 1992 (Multicurrency - Cross Border) ISDA Master Agreement.

We have attempted to make recommendations, where appropriate, throughout this report. Our general approach to legislative reform has been that uniformity of legislation between Canadian jurisdictions is a desirable goal and that legislation could maintain appropriate flexibility if lists of authorized Transactions can be expanded by regulation rather than by requiring legislative amendment. In addition, while we have recognized that it might be appropriate to restrict the authority of certain kinds of counterparties to entering into Transactions for particular purposes only (e.g., investment, hedging, debt management), we have adopted the view that, absent knowledge of a lack of authority by the other party, Transaction obligations should be enforceable against a party if the other party in good faith relied upon representations as to the party's authority to enter into the Transaction. With respect to uniformity of legislation, we recognize that different jurisdictions in Canada have different legislative drafting practices. The model legislative provisions contained in our report should be considered with this limitation in mind.

Enforceability issues which we have not addressed in this report include the effect of gaming and wagering laws on Transactions, as well as the potential application of provincial securities and commodity futures legislation to Transactions. Although there exists some uncertainty as to whether certain kinds of Transactions offend (in a technical sense) gaming and wagering laws, we have not addressed this issue in this report given that it has been widely considered elsewhere. We feel that it is sufficient to state that it would be prudent for legislators to amend gaming and wagering legislation in Canada in order to eliminate any residual uncertainty with respect to the application of such legislation to legitimate financial contracts. Similarly, we have not addressed the question whether particular derivative products constitute securities or off-exchange commodity futures contracts for purposes of provincial securities or commodity futures legislation. This issue is not susceptible to simple recommendations, especially where physical delivery is contemplated. Canadian provincial securities regulators continue to study this issue and the question of whether the imposition of regulatory requirements on any aspect of the over-the-counter derivatives market is appropriate. We would anticipate that legislative or regulatory clarification will be forthcoming only after considerable study.

This report does not purport to be and should not be considered or relied upon as an exhaustive discussion of enforceability issues or considerations with
respect to derivative transactions. Participants in the derivatives markets should therefore consult with their own legal advisers and any other adviser they deem appropriate with respect to particular Transactions or contractual relationships. Consequently, Stikeman, Elliott does not accept any responsibility for loss suffered by any person arising from any use of, or any error or omission in, this report. Finally, this report attempts to explain certain enforceability issues which we have identified and, where appropriate, make recommendations for clarification of these issues. Consequently, we have not included extensive footnotes or citations in this report. Parts II through VII of this report highlight capacity and authorization issues with respect to various kinds of Canadian counterparties. The kinds of Canadian counterparties addressed are sovereigns, special act and non-business corporations and public authorities, municipalities, insurance companies, trust companies and loan corporations and pension funds. Part VIII of this report addresses issues relating to pledges of collateral and other security interests by certain Canadian counterparties. Part IX of this report addresses issues relating to statute of frauds' writing requirements. Part X of this report briefly addresses the current situation with respect to early termination and bilateral close-out netting in the bankruptcy and insolvency context.

II. FEDERAL AND PROVINCIAL SOVEREIGNS

A. Issues

1. Capacity

(a) General. In Canada, both the federal government and the provincial governments are referred to as the "Crown". However, each is a separate legal entity. A party entering into a contract with the federal government is contracting with the "Crown in right of Canada", while a party entering into a contract with the Province of Ontario, for example, is contracting with the "Crown in right of the Province of Ontario". By contrast, a municipal government is not an embodiment of the Crown. Certain consequences flow from recognizing that each Crown is a separate legal entity. First, no government may detract from the powers exercisable by another government, such as the power to enter into particular types of contracts. Secondly, no government is responsible for the contractual obligations of another government.

As an embodiment of the reigning monarch, each Crown has the attributes of a natural person, such as the ability to enter into contracts without express statutory authority to do so. Each Crown acts through its agents. The principal representative of each provincial Crown is the Lieutenant Governor of the
province. The Lieutenant Governor typically acts in conjunction with, or as is often said "on the advice and concurrence of", the executive council or cabinet of the government. The Lieutenant Governor when acting in such manner is acting as the "Lieutenant Governor in Council". An order issued by the "Lieutenant Governor in Council" is referred to as an "Order-in-Council" which may constitute the assent of the Crown to a particular contract or, alternatively, the delegation to another entity or person, such as a Crown corporation, of the power to enter into a contract. Specific terminology may vary in certain provinces.

A statute may also confer authority to enter into particular contracts on an entity, such as a Crown corporation, or a person, such as a particular Minister of the Crown. In the absence of any restriction to the contrary, Ministers also have the authority to bind the Crown with respect to matters within the scope of their respective portfolios and may be expressly granted the power to delegate their authority to other persons or entities.

(b) **Legislative Restrictions on Capacity.** The wide common law power of the Crown to enter into contracts can be restricted only by statute. The federal Crown and the provincial Crowns of Alberta, British Columbia, Ontario and Quebec are authorized by their respective Financial Administration Acts to enter into certain types of Transactions, subject to certain conditions. Arguably, failure to comply with those conditions would raise a capacity issue. Also, if the statute deals only with certain types of Transactions this could be read as an implied prohibition on other types of Transactions. In this part we consider only those capacity issues that arise where the Crown is engaging in Transactions for the purposes of overall management of federal or provincial financial affairs, such as may be conducted by the relevant Treasurer or Minister of Finance. In our experience, it is typically the Treasurer or Minister of Finance who enters into Transactions on behalf of the Crown. We have not considered the authority of other Ministries to engage in Transactions.

It is not clear whether a counterparty could enforce a Transaction obligation against the Crown where the Transaction falls outside of the legislative authorizations. Although some authorities suggest that, while the Crown may not have the power to enter into such contracts, unless public policy concerns dictate otherwise, such provisions would be considered as "directory" only (meaning that they could support an injunction or similar remedy prior to the execution of the contract, but would not render invalid an executed Transaction), legislative clarification would be highly desirable.

(i) **Canada.** The Financial Administration Act (Canada) allows the Governor in Council to authorize the Minister of Finance to enter into interest rate and
currency exchange agreements on such terms as the Minister of Finance or the Minister’s delegate considers necessary (section 45.1). Because no other types of Transactions are provided for, it can be argued that this is an implied legislative restriction on the types of Transactions which the Governor in Council has the capacity to authorize. The provision does not, however, limit the purpose for which such agreements can be entered into.

(ii) **Alberta.** Under the Financial Administration Act (Alberta) the Alberta Treasurer is permitted to engage in any type of Transaction for a relatively wide range of purposes, namely (a) direct investment for the General Revenue Fund (section 50(1)(i.2)), (b) in connection with permitted investments under Part 5 (section 50(5.1)), or (c) in connection with raising money for the purposes of depositing money in the Alberta Loan Fund or Capital Fund, or making any other disbursements under the Financial Administration Act (Alberta), the Small Business Term Assistance Act (Alberta) or the Farm Credit Stability Fund Act (Alberta), or any combination of those purposes (section 61(3)).

For the purpose of direct investment for the General Revenue Fund (section 50(1)(i.2)), the Treasurer may invest in instruments respecting interest, dividends, rates, currencies, indices, mediums of exchange, income or cash. The Lieutenant Governor in Council can also approve other types of instruments for direct investment. Without limiting the generality of this list, the provision provides that such instruments include exchange agreements, futures agreements, option agreements or rate agreements. Clearly this authorizes a wide range of Transactions for investment purposes.

For the purpose of managing investments (section 50(5.1)), the Treasurer can enter into agreements or engage in other activities of a financial nature. Without limiting the types of agreements of a financial nature the Treasurer can enter into in this regard, the provision provides for agreements such as exchange agreements, futures agreements, option agreements, rate agreements, any other financial agreements or any combination of these agreements and activities. Again, this list is very general and probably includes Transactions that are not specifically mentioned. The Treasurer is authorized to enter into these same types of agreements for the purpose of managing certain funds and obligations (section 61(3)). As a pre-condition to the Treasurer’s authority in this latter respect, an Order-in-Council must have authorized or be anticipated to authorize the Treasurer to raise money for the Loan Fund, the Capital Fund, other disbursements under the Act, the Small Business Term Assistance Fund Act (Alberta) and the Farm Credit Stability Fund Act (Alberta) or any combination of these purposes.
These provisions give the Treasurer very wide powers to engage in Transactions of all types, albeit for certain purposes, and, in the case of Transactions entered into under section 61(3), subject to the requisite Order-in-Council. Given how wide those purposes are, practically, there would seem to be no capacity issue with respect to the Alberta Crown or Treasurer.

(iii) **British Columbia.** The Financial Administration Act (British Columbia) expressly permits the Minister of Finance to enter into (i) currency exchange agreements, (ii) spot and future currency agreements, (iii) interest rate exchange agreements, and (iv) future interest rate agreements. The purpose of such agreements must be to reduce risks or maximize benefits in relation to the borrowing, lending or investment of public money. Also, the Lieutenant Governor in Council may by regulation confer power on the Minister of Finance to enter into a prescribed "class of financial agreements" for these same purposes or for the "efficient management of public money" (section 59.1). B.C. Regulation 370/90 (as amended by B.C. Regulation 321/91) provides that (a) options to enter into any of the agreements listed above, (b) forward security purchase or sale agreements, and (c) options to enter into forward security purchase or sale agreements, are within the permitted classes of financial agreements. The Minister may also enter into any of such Transactions in a manner which binds the Crown for the purpose of reducing risks or maximizing benefits in relation to the borrowings, lendings or investments of "government bodies". This is discussed below in Part III.

The Lieutenant Governor in Council may by regulation impose restrictions on the Minister's authority. Currently, there are no such regulations.

This provision is expressly stated not to limit any authority given elsewhere in the Act (eg. section 59.2 which applies to governmental bodies) or in any other Act. However, notwithstanding that section 59.1 is not an implied limitation on other statutory powers, it might nevertheless be read as an implied limitation on the common law capacity of the federal Crown to enter into Transactions that do not fall within the specified list. However, the specified purposes (especially, the maximization of benefits in relation to the investment of public money) are quite broad and so would not appear, practically, to raise any capacity concern.

(iv) **Ontario.** Under the Financial Administration Act (Ontario), when the Ontario Treasurer considers it advisable for the sound and efficient management of public money, the public debt, the Consolidated Revenue Fund or any other fund for which the Treasurer is responsible, the Treasurer may enter into, among other agreements:
- foreign currency exchange agreements, spot foreign currency agreements and forward foreign currency agreements;

- interest rate and currency exchange agreements and forward rate agreements;

- bond futures agreements, bankers' acceptance futures agreements, foreign currency exchange futures agreements and other similar financial futures agreements;

- agreements to sell or purchase the right to exercise an option, put or call or any combination of them;

- short selling agreements with respect to a security, financial instrument or agreement in which the Treasurer is authorized to invest; and

- other "financial agreements" authorized by or belonging to a class authorized by the Lieutenant Governor in Council.

Other types of Transactions not specifically mentioned would come within the meaning of "financial agreements" and could be authorized by Order-in-Council. To date there is no such Order-in-Council. The capacity of the Ontario Crown to enter into Transactions is arguably limited to those entered into for financial management purposes, as opposed to investment or speculation.

(v) Quebec. Under the Financial Administration Act (Quebec), the Minister of Finance may, where it is considered appropriate for the proper management of the consolidated revenue fund, the public debt or any sinking fund obligation, invest in or conclude currency exchange agreements, interest rate exchange agreements, options and futures contracts and any other contract of a financial nature as determined by the government of Quebec as prescribed by Order-in-Council (section 36.1). Order-in-Council 1698-91, passed in December 1991, prescribes forward rate agreements, and cap, floor and collar contracts or instruments related to interest rates or currency exchanges as authorized contracts of a financial nature.

We would also note section 10 of the Act which provides that, on the authority of an Order-in-Council, the Minister may enter into "any agreement" with "any ... body" consistent with the interests and rights of Quebec to facilitate the carrying out of this Act.
2. **Authorizations Required**

   (a) **General.** Two issues must be considered in determining whether a Transaction with a Crown is properly authorized. First, is the Crown representative that executed the Transaction properly authorized to do so? Second, is it a precondition to a valid Transaction that an appropriation from the applicable revenue fund be authorized at the time of the entering into the Transaction?

   (b) **Authorization of Agent.** Although the Crown, acting through the Governor in Council or Lieutenant Governor in Council, has the capacity of a natural person (subject to the discussion in section 1 above), other agents that act for the Crown may have statutory limitations placed on their authority to bind the Crown. In section 1 above, we have already noted that the authority of the Treasurer or Minister of Finance might be limited by the applicable *Financial Administration Act* to engaging in only certain types of Transactions or Transactions for a specific purpose unless there is an Order-in-Council authorizing the particular Transaction or type of Transaction. Delegates of the Minister or Treasurer might also have limited authority. Generally, if there is a statutory limitation on the agent’s power, then a counterparty cannot rely on the fact that a particular agent appears to have such authority or on representations as to the agent’s authority. For example, in theory a counterparty might not be able to rely on a representation by the Minister of Finance that he or she is engaging in a particular currency exchange agreement for the purpose of managing the province’s foreign currency loan obligations. In recent jurisprudence, Canadian courts have required clear statutory language in order to displace the normal rules of agency that would otherwise apply to the Crown. In such cases, the courts have either interpreted purported limitations to be language which merely empowers such servants or have interpreted them to be rules of indoor management. However, this position is not certain to succeed and so care must be taken to ensure that the agent is properly authorized.

   (i) **Canada.** As noted above, the Minister of Finance’s authority to enter into Transactions is subject to a prior authorization by Order-in-Council. The *Financial Administration Act* (Canada) allows the Minister to delegate to an officer in the Finance Ministry the decision as to the appropriate terms and conditions for the interest rate or currency exchange agreement, but not the authority to enter into such agreements.

   (ii) **Alberta.** The Alberta Treasurer is permitted to authorize in writing employees of the Treasury Department or other government departments, agencies or boards to do any act or thing required or permitted to be done by the Treasurer under the *Financial Administration Act* (Alberta) or its regulations (section 13(1)) other
than to make regulations or authorizations under section 13(1). This authorization can either be general or apply to a particular case (section 13(2)). Delegates may also be empowered by the Treasurer to further delegate (section 13(6)). Execution by an employee is *prima facie* proof that the employee was authorized to execute or sign the document (section 13(5)). Being *prima facie* proof only, the presumption of due authorization can be rebutted. Therefore, it is necessary for a counterparty to review the written authorization if an employee other than the Treasurer is executing the Transaction.

It should be noted that any Transaction entered into by the Treasurer in connection with the raising of money under section 61(1) must be entered into either "in anticipation" of the Order-in-Council authorizing the raising of money being made under section 61(1) or "after" the order is made. Presumably, if the Transaction is entered into "in anticipation" of the order being made but the order is in fact never made, the Provincial Treasurer entered into the Transaction without authority. Section 67(1) of the Act supports this conclusion as it states that "The Provincial Treasurer ... whether in anticipation of an order being made under section 61(1) or after an order is made under section 61(1) or both, may approve, sign or execute, on behalf of the Crown, contracts, agreements ... and any other documents or instruments of any nature that the Provincial Treasurer considers necessary or desirable in connection with the raising of money under this Part, but the Provincial Treasurer is not authorized by this section to raise money under this Part without an order being made under section 61(1)." The issuance of an Order-in-Council is not required with respect to Transactions referred to in section 50(1) or section 50(5.1) (see section 1(b)(ii) above). However, to the extent that the Treasurer is, for investment purposes, entering into a Transaction of a type not listed in section 50(1)(i.2), an Order-in-Council approving the type of Transaction is required.

Although the Act specifies the various purposes for which the Treasurer can enter into Transactions, these purposes are sufficiently wide that there is no real concern that an argument would be raised as to the Treasurer’s authority to enter into a Transaction because it fell outside the authorized purposes.

In summary, it is necessary for a counterparty to review the written authorization for delegates that execute Transactions and certain Orders-in-Council in order to be satisfied as to due authorization. In our view, this level of due diligence is not inappropriate.

(iii) **British Columbia.** In British Columbia, the Minister of Finance is authorized to enter into certain Transactions (see section 1(b)(iii) above). It will be necessary for the counterparty to review the regulations under the Financial
Administration Act (British Columbia) to determine that there are no restrictions imposed on the Minister's authority. The Minister can enter into the specified Transactions only for specific purposes, but, as noted above, these purposes are very wide. There is no provision for the delegation of authority by the Minister, although under the Interpretation Act (British Columbia) (section 23), Deputy Ministers are deemed to have the authority of the Minister.

(iv) Ontario. In Ontario, the general rule that a counterparty is not able to rely on the fact that a particular agent appears to have authority to bind the Crown, if there is a statutory limitation on the agent's power, has been given specific legislative expression in the Executive Council Act (Ontario) (section 6). Consequently, a party to a Transaction with the Ontario Treasurer could not rely simply on a representation by the Treasurer that he or she had authority to enter into the Transaction (eg., that the Transaction is being entered into for hedging purposes). The statute also provides that no contract in respect of matters under the control of a government Minister shall bind the provincial Crown or be deemed to be the act of such Minister unless it is signed by the Minister or approved by the Lieutenant Governor in Council.

Delegation by the Treasurer is provided for by section 6 of the Ministry of Treasury and Economics Act (Ontario). Any duty or power conferred on the Treasurer by the Financial Administration Act (Ontario) may be delegated, in writing, to the Deputy Treasurer or an officer of the Ministry of Treasury and Economics. When acting in place of the Treasurer, such delegates are "presumed conclusively" to act in accordance with the delegation. Notwithstanding section 6 of the Executive Council Act (Ontario), any agreement made by such a delegate empowered by such a written delegation has the same effect as if made and signed by the Treasurer. Therefore, so long as a counterparty reviews the written delegation and is satisfied that it delegates the power of the Treasurer to enter into Transactions, then the counterparty can be satisfied as to the authority of the agent. As stated above, the Treasurer has authority to enter into several types of Transactions. An Order-in-Council authorizing the Treasurer to do so will be required for any type of Transaction not listed. In our view, this degree of due diligence for a counterparty dealing with a Crown is not inappropriate.

(v) Quebec. As in Ontario, an Order in Council with respect to "contracts of a financial nature" may be required to confer authority on the Minister of Finance to enter into some types of Transactions.

The Financial Administration Act (Quebec), section 36.1, provides that any document relating to a Transaction (see section 1(b)(v) above) may be signed in
the name of the Minister by any person designated by the government. Order-in-Council 1248-91 designates a number of specified persons to execute the authorized transactions in the name of the Minister of Finance, namely, (a) the Deputy Minister of Finance, (b) the Associate Deputy Minister - Policy and Financial Operations, (c) the Assistant Deputy Minister Financing, (d) the Director General - Cash and Public Debt Management, (e) the Director - Capital Markets, (f) the Director - Treasury Operations, (g) the Director - Loan Contracting, (h) the Director - Public Debt Management, and (i) the Assistant Director - Capital Operations. Where any of these persons authorize the terms and conditions of the Agreement, certain specified representatives of Quebec in Brussels, Dusseldorf, London, New York, Paris, Tokyo and Toronto can execute the Agreements. Although this section of the Act addresses the issue of a signature on the agreement (i.e., due execution), it does not address the issue of actual authorization to enter into the agreement (although the Order-in-Council suggests that this is the intention). As to authorization, the Deputy Minister has the same authority as the Minister (section 5). Section 36.2 provides that every transaction which the Minister of Finance can enter into under section 36.1 (see section 1(b)(v) above) "is valid and its validity cannot be contested if the documents relating to it bear the signature of the Minister or of a person designated by the Government in accordance with section 36.1, except where the cause of invalidity is established by the terms of the transaction." Payments made under such contracts are also valid. Consequently, a counterparty will have to determine that an Order-in-Council authorizes the particular delegate and, if the Transaction is not within the list specified in the Act, that an Order-in-Council prescribes the particular type of Transaction in order to be satisfied as to the Transaction's enforceability. In our view, this degree of due diligence is not inappropriate.

(c) **Appropriation as a Pre-condition to Validity.** Because of some rather vague wording in a number of the Financial Administration Acts, it is arguable that certain transactions that might involve payment by the Crown within the current fiscal year at the time of the Transaction (a fiscal year for each of the jurisdictions considered being April 1 to March 31) would not constitute valid contracts unless an appropriation was available to satisfy the Transaction at the date it was entered into.

The Financial Administration Act (Canada) (section 32) provides that no contract shall be entered into with respect to any program for which there is an appropriation by Parliament, or an item included in estimates then before the House of Commons to which the payment will be charged, unless there is a sufficient unencumbered balance available out of the appropriation or item to discharge any debt that, under the contract, will be incurred during the fiscal year in which the contract is entered into. This requirement does not appear to apply to contracts which are not considered part of a pre-existing appropriation. It is quite difficult for a counterparty
with the federal Crown to determine whether there is such a pre-existing appropriation.

The Financial Administration Act (British Columbia) (section 25(1)) provides that no agreement or undertaking of any kind providing for the payment of money by the government shall be entered into that would result in an expenditure in the then current fiscal year in excess of an appropriation for that fiscal year. Again, this is difficult for the counterparty to assess.

The Financial Administration Act (Quebec) (section 47) provides that no contract obliging the Quebec Crown to pay a sum of money shall be made or be valid unless the Comptroller certifies that there is available, in an appropriation, a balance sufficient to carry out the commitments resulting from such contract and maturing in the fiscal year in which it is made. However, as is noted below, there is a permanent appropriation for Transactions properly entered into by the Minister of Finance or the Minister's delegate. Therefore, the Comptroller should always be in a position to certify the availability of an appropriation; the certificate is, nevertheless, technically required to ensure the validity of the Transaction.


3. Appropriations

(a) General. Where an appropriation is not a precondition to the existence of an obligation, it may still be necessary that there be an appropriation in order to enforce the obligation against the Crown. Since the property of the Crown is exempt from seizure (as discussed below), the only effective remedy for a party to a Transaction with a Crown is an order to cause the Treasurer to make a payment out of the consolidated revenue fund, and in some cases such an order cannot be obtained in the absence of an appropriation. Where there has been a specific appropriation of funds for a contract in the year at the time the Transaction was entered into, the existence of an appropriation at the time of payment will not be an issue, provided that a balance exists in the appropriation. However, where there is no prior or sufficient appropriation, the existence of an appropriation at the time when payment is due is a relevant consideration.
(b) Specific Jurisdictions

(i) Canada. All contracts providing for the payment of money by the federal Crown are deemed by section 40 of the Financial Administration Act (Canada) to contain a term to the effect that payment under the contract is conditional on the existence of an appropriation for the payment. An appropriation is, therefore, arguably made a true condition precedent to performance and, consequently, the payment obligation cannot be enforced until the condition is met. The condition will be met if there is a "permanent appropriation". An argument can be made that the Financial Administration Act (Canada) provides a permanent appropriation for some obligations under authorized Transactions on the basis that it states that all "costs" and "expenses" incurred in the "servicing, payment and management" of any loan shall be paid out of the consolidated revenue fund. However, the Minister of Finance could be authorized to enter into interest or currency exchange agreements unrelated to the government’s loan portfolio, and arguably this provision would not apply to those types of Transactions. Even with respect to those Transactions entered into to hedge specific loan obligations, there is significant doubt that the obligation would constitute a loan management cost or expense.

(ii) Alberta. There is no specific provision in the Financial Administration Act (Alberta) which deems a contract to contain a term to the effect that the existence of an appropriation is a condition of payment by the Crown. In any event, the Act provides a permanent appropriation for obligations under Transactions entered into in connection with the raising of money under section 61 (section 69(2)). However, there is no permanent appropriation with respect to Transactions entered into for the purpose of direct investment for the General Revenue Fund or for the purpose of managing investments. However, the Act allows for the payment of "disbursements" (which might include Transaction obligations incurred for investment) without evidence of an appropriation (section 37(2)). Therefore, in Alberta the issue of appropriations does not appear to raise an enforceability concern.

(iii) British Columbia. All contracts providing for the payment of money by the British Columbia Crown are deemed by section 25(1) of the Financial Administration Act (British Columbia) to contain a term to the effect that payment is subject to an appropriation being available in the fiscal year when payment becomes due. There does not appear to be a permanent appropriation for obligations under Transactions. In British Columbia the relevant statute states that the Minister of Finance "may" pay out of the consolidated revenue fund amounts required to be paid by the government pursuant to such agreements (section 59.1(2)). Such discretion likely means that a permanent appropriation of funds for Transactions has not been created. However, the statute also provides that all "costs" and "expenses" incurred
in the "servicing" and "management" of loans by the government "shall" be paid out of the consolidated revenue fund. As with the similar provision in the federal Act, whether this creates a permanent appropriation for those Transactions entered into to hedge loan obligations is not clear. Therefore, in British Columbia, the issue of appropriations does raise an enforceability concern.

(iv) **Ontario.** The Financial Administration Act (Ontario) provides that money required in respect of the performance of the Transactions which the Treasurer has properly entered into is a "charge upon" and "payable out of" the consolidated revenue fund (section 3(3)). This language, in our view, constitutes a permanent appropriation, and can be contrasted with other sections of the statute which merely provide that certain monies "may" be paid out of the revenue fund. Therefore, in Ontario, the issue of appropriations does not raise an enforceability concern.

(v) **Quebec.** Section 48 of the Financial Administration Act (Quebec) deems it to be a condition of every contract obliging the Crown to pay money that payment be subject to the availability of an uncommitted appropriation for the fiscal year in which it falls due. There is, however, a permanent appropriation for Transaction obligations properly incurred by the Minister of Finance. Section 36.1 provides that charges and expenses incurred under the section of the statute which expressly permits the Minister of Finance to enter into Transactions are "permanently charged" against the revenue fund of the province. Further, the statute confirms in section 39 that no annual vote by the Quebec legislature is required for such permanent appropriations.

4. **Crown Immunities**

Certain immunities or prerogatives unique to governmental bodies may also affect the ability of a private counterparty to enforce a Transaction against the Crown. In addition, a government can theoretically at any time pass legislation which expressly abrogates existing and future contractual obligations of the Crown. This is an enforceability risk inherent in the nature of government and one that cannot be protected against through legislation. A counterparty must take its assurance from the fact that the government's credit would be seriously compromised by failing to pay such obligations.

The area of Crown immunities and prerogatives is complex. As such, all such rights which may be available to the Crown in the context of the enforcement of a Transaction are not considered in this report. However, it should be noted that such rights include the immunity of the Crown from any set-off that may be asserted against the Crown during proceedings brought by the Crown, the general immunity
of the Crown from the application of limitation periods and the immunity of the Crown
from execution against its assets.

The immunities and prerogatives of the Crown have been interpreted
strictly so as to respect as much as possible the ordinary law of contracts. The
Supreme Court of Canada has held that "subject possibly to a limited number of
exceptions... the rights and prerogatives of the Crown cannot be invoked to limit or
alter the terms of the contract, which comprises not only what is expressly provided
in it, but also everything that normally results from it according to usage of the law."¹
While we believe that one should be cautious in discounting the continuing relevance
of these immunities, certain commentators have concluded that the prerogatives and
immunities of the Crown are destined only to have a limited practical importance in
the preparation and application of administrative contracts.

B. Recommendations

As the above discussion demonstrates, there is little uniformity between
jurisdictions on the subject of the Crown’s capacity and authority to enter into
Transactions. However, many of the capacity and authorization concerns have been
dealt with in the various jurisdictions, albeit somewhat differently in each. There
remain several areas of uncertainty for counterparties. We would recommend that the
areas of uncertainty be dealt with by amendments to the Financial Administration Acts
of each jurisdiction, to the extent required to deal with the particular deficiencies in
that jurisdiction.

With respect to the federal jurisdiction the following uncertainties should,
in our view, be dealt with:

1. The Financial Administration Act (Canada) presently suggests that
the Crown’s capacity is limited to interest rate and currency exchange agreements.
We would recommend that the Act be amended so as to confer on the Minister of
Finance the authority to enter into a broader range of Transactions without prior
authorization by Order-in-Council. Flexibility can be obtained by providing for
expansion of the list by regulation (as is the approach in Ontario and Quebec and also,
to some extent, in British Columbia and Alberta). If the government desires any
restriction on the Minister’s authority, such restrictions could be included in the
regulations.

2. The question of delegation to Ministry of Finance officials and employees should be clarified, as should the question of reliance on representations by such officials as to their authority.

3. It should be specified that there is a permanent appropriation for amounts which may be owing by the government under a Transaction.

We have set out suggested Model Legislation in Appendix "A" to this report.

With respect to Alberta, we would not at this time recommend any legislative reform respecting issues of capacity, delegation or appropriations. It would be an improvement to the current regime, however, if it was made clear that a party dealing with the Crown or its employees could rely on representations made as to authority. We would recommend language similar to that in section 4 of the Model Legislation in Appendix "A".

With respect to British Columbia, we would not at this time recommend any legislative reform with respect to issues of capacity. However, the British Columbia statute requires clarification with respect to the power of the Minister to delegate to officials and should be amended to provide a permanent appropriation for Transactions. We would recommend language similar to that in sections 2 and 3 of the Model Legislation in Appendix "A".

With respect to Ontario, we would not at this time recommend legislative reform with respect to capacity, authorization, delegation or appropriations. It would be helpful, however, to have a provision similar to that in section 4 of the Model Legislation in Appendix "A" to clarify that persons can rely on representations as to authority in absence of knowledge of a lack of authority.

With respect to Quebec, we would not at this time recommend any legislative reform.

III. SPECIAL ACT AND NON-BUSINESS CORPORATIONS AND PUBLIC AUTHORITIES

A. Issues

Most business corporations in Canada are incorporated under a general business corporations statute and for the most part are invested with natural person
powers. However, there are a large number of other types of corporations which are incorporated in any one of a number of other ways, such as by the issuance of letters patent under a general corporations statute or by a special Act of the legislature of the federal or a provincial government. These entities do not necessarily have natural person powers and, consequently, the ultra vires doctrine has potential application. Very often entities that serve a governmental or regulatory function are incorporated by special Act. However, special Act corporations need not be public bodies or authorities. The capacity issues with respect to special Act corporations which are not public authorities are the same as with respect to those that are, with the possible exception of public sector bodies in Quebec and British Columbia. Section 1 of this Part explores those capacity issues. Section 2 of this Part explores the issues unique to special Act corporations which are public bodies, namely the extent to which they can bind the Crown or act independently.

1. Capacity

(a) Corporations Act Corporations. As discussed above, a number of corporations are incorporated under a general corporate statute that applies to non-business corporations, namely:

- federally, the Canada Corporations Act (Canada);
- in Alberta, the Companies Act (Alberta) and the Societies Act (Alberta);
- in British Columbia, the Company Act (British Columbia) and the Societies Act (British Columbia);
- in Ontario, the Corporations Act (Ontario); and
- in Quebec, the Companies Act (Quebec).

(i) Canada. Non-share capital corporations and certain other types of special corporations may be incorporated under the Canada Corporations Act (Canada) by means of letters patent. The common law rule is that the ultra vires doctrine does not apply to letters patent corporations and, therefore, capacity is not an issue with respect to such entities. Limitations in the letters patent can affect corporate authority only. The Act also grants broad powers (with certain exceptions) to a corporation to conduct its operations (which can be restricted by the letters patent), including the power to do anything incidental to the attainment of its objects. However, persons dealing with such a corporation could rely on representations by the corporation as to whether or not the Transaction was designed to further the objects of the corporation. The Act expressly states that any contract accepted or endorsed by any agent, officer or servant of the company within the apparent scope of their authority is binding upon the company. Other restrictions which apply more
particularly to Transactions might, however, affect the corporation’s authority to enter into Transactions.

(iii) **Alberta.** Not for profit corporations incorporated under the **Societies Act** (Alberta) or the **Companies Act** (Alberta) have limited powers, and so may not be empowered to engage in Transactions.

(iii) **British Columbia.** Not for profit corporations are incorporated under the **Societies Act** (British Columbia) which confers all the powers of a natural person as may be required to pursue its purposes. Other types of corporations are formed under the **Company Act** (British Columbia) and, consequently, enjoy natural person powers.

(iv) **Ontario.** Non-share capital corporations, corporations with objects in whole or in part of a social nature, insurance companies and certain pension fund society corporations are incorporated under the **Corporations Act** (Ontario) by means of the issuance of letters patent. The Act provides that such a corporation has the capacity of a natural person, unless otherwise provided in the Act or in the letters patent. This language suggests that capacity may be restricted by terms in the letters patent or the Act. As noted above, the common law rule is that the ultra vires doctrine does not apply to letters patent corporations. This conflict raises an ambiguity as to whether restrictions in the Act and letters patent affect capacity or only corporate authority. Although the **Corporations Act** (Ontario) contains no restriction on the power of corporations to enter into Transactions, it is necessary to review the letters patent of the particular entity to determine whether they contain any such restrictions. Letters patent will generally contain a list of objects that the corporation is restricted to, but such an objects clause affects corporate authority, not capacity. Consequently, persons dealing with such a corporation could, in good faith, rely on representations by the corporation as to whether or not the Transaction was designed to further the objects of the corporation. The Act also grants broad powers to conduct its business (which can be restricted by the letters patent), including the power to do anything incidental to the attainment of its objects. Other more precise restrictions in the letters patent might, however, affect the corporation’s capacity to enter into Transactions.

(v) **Quebec.** Non-share capital corporations are generally incorporated under the **Companies Act** (Quebec). Various statutes creating special corporations refer explicitly or implicitly to Part II of the **Companies Act** (Quebec), which provides the framework for corporate law matters for the corporations created by those statutes, including capacity issues. Relevant legislation also requires insurance companies, trust companies and loan companies to be incorporated under Part I of the
Companies Act (Quebec). Both Parts I and II of the Companies Act (Quebec) provide for the incorporation of companies which are generally considered not to have the capacity of a natural person. Neither part provides in any way for the capacity of such companies to enter into Transactions. Their capacity to do so is therefore unclear, unless provisions giving capacity are contained in specific enabling provisions in the statutes by which they are created.

(b) **Special Act Corporations.** Corporations can also be created by special Act of the legislature of a province or the federal Parliament. Special Act corporations do not have the powers of a natural person unless the special Act or another applicable Act grants such powers. Consequently, the *ultra vires* doctrine may apply to such corporations with the result that any act outside the scope of the objects and powers expressly or impliedly conferred will be void. Each special Act (and other applicable legislation) must be examined to make this determination. Many special Act corporations are created to undertake specific activities so it is not uncommon for the legislation to endow them with less than natural person powers. It should be noted, however, that in some jurisdictions there is general legislation applicable to certain special Act corporations which may confer on such entities the capacity of a natural person or certain express powers. For example, in Ontario the *Corporations Act* (Ontario) provision discussed above applies to special Act corporations (unless the special Act states otherwise) and, as noted above, it endows such corporations with the powers of a natural person subject to any restriction in the special Act. In contrast, in British Columbia, the provision of the Companies Act (British Columbia) that confers natural person powers on companies is expressly stated not to apply to special Act companies. As noted above, special Act companies in Quebec and Alberta do not, as a rule, enjoy the capacity of a natural person.

(c) **Corporations and Other Entities which are Public Bodies.**

(i) **General.** Corporations which perform public or regulatory functions are often incorporated by special Act and so would be subject to the same capacity restrictions as are discussed above. However, if such corporations are acting as agents of the Crown in entering into a particular transaction or agreement, they will have whatever power the Crown has. The status of such entities as Crown agents is discussed in the next section. In Alberta, for example, the Treasurer is expressly empowered to delegate to Crown agencies and boards. Further, in Quebec and British Columbia, such corporations may be expressly empowered to enter into certain types of Transactions on their own behalf. Aside from these two jurisdictions, there is no law generally applicable to public bodies that would empower them to enter into Transactions.
(iii) **British Columbia.** The *Financial Administration Act* (British Columbia) (section 59.2(1)) provides that "government bodies" may enter into the same types of Transactions that British Columbia’s Minister of Finance may enter into (as discussed in Part II, section 1(b)(3) above) for the purpose of reducing risks or maximizing benefits in relation to their borrowings, lendings or investments. They may enter into these transactions only with the Minister of Finance or through the agency of the Minister of Finance. Government bodies are defined as government corporations, hospital district boards or boards of school trustees, designated education institutions under the *Educational Institution Capital Finance Act* (British Columbia) and any other local or provincial public authority designated by regulation. To date only the Greater Vancouver Sewerage and Drainage District and the Greater Vancouver Water District have been designated (B.C. Regs. 230/80). A government corporation is a corporation that is pursuant to its governing Act an agent of the Crown, or of which the government owns over 50% of the voting shares or that is controlled by the government (i.e., where the majority of the board of directors or management consists of either or both of persons appointed by the Lieutenant Governor in Council, a Minister of the Crown or an Act of the legislature or public officers in their capacity as such).

This authorization is subject to any express restriction or limit on the government bodies’ authority (such as in their governing legislation or charter documents). The Minister of Finance can enter into the agreements on behalf of the government body (and, indeed, must where the agreement is with third parties). As noted in Part II above (section A.2(b)(iii)), the Minister of Finance can also enter into such agreements with respect to the government body in its capacity as agent of the Crown. The Lieutenant Governor in Council can impose restrictions on the authority of government bodies or the Minister of Finance acting in relation to them, but it has not to date done so.

This provision certainly alleviates some uncertainty where the government body is a limited capacity corporation. In the absence of an express restriction, capacity can be presumed. It is still not clear, however, that a counterparty could rely on representations by or on behalf of the government body as to its purpose in carrying out the Transaction.

(iii) **Quebec.** Recent legislative steps have been taken in Quebec to address the capacity question for public bodies. In May 1992, amendments to the *Financial Administration Act* (Quebec) were introduced to permit "public sector bodies" to enter into interest rate or currency exchange agreements if such public sector bodies have the power to borrow and if the authorizations and approvals normally required for them to exercise their borrowing powers are obtained with
respect to the transaction. Such power to enter into Transactions does not apply to public sector bodies to the extent that the power is expressly provided by law or by their governing act. In addition, such public sector bodies may enter into transactions in respect of "instruments or contracts of a financial nature" which the government of Quebec prescribes for particular public bodies or for particular categories of public bodies. The term "instruments or contracts of a financial nature" is defined very broadly as "any financial instrument or contract whose object is the management of financial risks, in particular currency exchange agreements, interest rate exchange agreements, options and futures contracts". The term "public sector body" is also defined broadly, primarily by reference to definitions contained in other Quebec legislation.

If one of the intentions of the Quebec legislation was to alleviate some of the time and effort formerly spent in researching capacity and authorization issues surrounding public bodies in Quebec, the legislation has fallen short. As noted above, the definition of "public sector body" contained in the legislation references definitions contained in other Quebec legislation, which definitions in turn reference other legislation. Accordingly, determining whether a particular public body is a "public sector body" within the meaning of the Quebec legislation is not always an easy task. Further, in order to determine what authorizations are required for Transactions, one must usually first determine what authorizations are required for the public sector body to exercise its borrowing power. This again would force one back to the governing legislation of a particular public body.

On a more positive note, the legislation pursuant to which the amendments were enacted (an Act to amend the Financial Administration Act and the Act respecting municipal debts and loans (Quebec)) contains a potentially helpful provision regarding validity of Transactions entered into prior to the effective date of the amendments. In effect, such provision provides that instruments or contracts of a financial nature in respect of which a transaction has been carried out by a public sector body before the effective date of the amendments are valid from the date of the transaction, and their validity may not be contested if they have been signed by duly qualified representatives, except where the cause of the invalidity is established by the terms of the Transaction. A higher degree of comfort may now be taken by parties who entered into Transactions with Quebec public sector bodies prior to the effective date of the amendments.

Given that public bodies are often entrusted with public moneys or perform essential public services, as a policy matter legislative restrictions on the power of such bodies to put those funds or its operations at risk by engaging in Transactions, particularly speculative ones, are inevitable. However, it would be
preferable for counterparties if these restrictions did not affect the validity of Transactions, at least where the relevant authorities have represented that the Transactions are within their powers.

2. **Crown Agency Status and Liability of the Crown**

Certain public bodies are agents of the Crown and, therefore, may have the authority to enter into Transactions which bind the Crown. In fact, they may have authority to act *only* as agents of the Crown, in which case any attempt to contract as principal would raise a concern as to the enforceability of the contract. Other public bodies are not agents of the Crown and their attempts to contract as such could also raise enforceability concerns.

There are several areas of uncertainty for a counterparty attempting to determine whether the public body counterparty has the power or authority to contract either as agent or as principal, as the case may be. First, in the absence of an express designation in the governing legislation, it is not always clear whether a particular public body is an agent of the Crown. Secondly, even if the public body is clearly a Crown agent, it is often not clear whether the public body also has the capacity to act as principal. Some statutes are internally inconsistent on this matter as they provide, for example, that the Crown agent has the capacity to contract only as agent of the Crown, but then go on to provide that certain of its obligations can be guaranteed by the Crown.

3. **Appropriations**

If the public body is contracting as agent for the Crown, then the issue of the need for an appropriation to enforce the payment obligation arises. The permanent appropriation provisions noted above with respect to Crown transactions do not apply to Transactions entered into through the agency of public bodies. The *Financial Administration Act* (British Columbia) provides that the Minister of Finance "may" pay such obligations out of the Consolidated Revenue Fund, but this would not create a permanent appropriation. The Quebec legislation with respect to public bodies does not provide for appropriation, but many of such bodies may contract as principal and not as an agent of the Crown.
B. **Recommendations**

In order to alleviate much of the uncertainty surrounding the capacity of public bodies to engage in Transactions, it would be advantageous for the federal and provincial governments to amend their respective *Financial Administration Acts* to include similar provisions to those presently in use in either British Columbia or Quebec providing specific authority for certain specified public bodies to enter into Transactions. Legislation could remove the necessity of examining the governing legislation of each particular counterparty in addressing the issue of capacity. We have set out suggested Model Legislation for public bodies in Appendix "B" to this report.

As to the capacity issues with respect to special Act corporations that are not public bodies, it is less helpful to design an appropriate model given the diversity among special Act corporations. However, there is generally a corporate statute in each jurisdiction that applies to special Act corporations, at least in part (see Part III A.1(a) above). This legislation could be revised to provide that special Act corporations have the power to engage in Transactions, unless the special Act or charter specifically provides otherwise. Such legislation would have to be tailored to the specific jurisdiction.

IV. **Municipalities**

A. **Issues**

1. **Capacity**

   (a) **General.** The issue of whether or not municipal authorities have the legal capacity to enter into Transactions and the consequences of entering into Transactions in the absence of such capacity, which was specifically considered by the English House of Lords in *Hazell v. Hammersmith & Fulham London Borough Council*, has not been judicially considered in Canada. The precise effect that Hammersmith will have on Transactions entered into by Canadian municipal authorities depends largely on the provincial statutes and the charter document, if any, that govern the particular municipality.

   For the most part, each Canadian province has enacted a *Municipal Act* which prescribes and regulates the business and affairs of the various municipalities throughout the province. In addition, some provinces (eg. Alberta and British Columbia) have enacted legislation which creates a Municipal Finance Authority for
the express purpose of providing certain financing and investment services to the municipalities in that province. Where the governing statutes of the individual municipalities or the Municipal Finance Authority do not specifically authorize them to participate in Transactions, any Transactions to which they are a party may be held to be beyond their capacity. Notwithstanding the absence of specific authority, however, the statute of incorporation (often referred to as the charter) of particular municipalities may contain incidental power provisions that are sufficiently broad to be construed as enabling the municipality to engage in Transactions. Furthermore, a municipality’s statute of incorporation may state that it has all the powers of a natural person, and such a municipality would, therefore, have the capacity to enter into Transactions. In certain provinces, the provincial governments have attempted to deal with these legal uncertainties and have recently made statutory amendments to permit designated municipalities to enter into certain types of Transactions.

(b) **Specific Jurisdictions**

(i) **Alberta.** Neither the Municipal Government Act (Alberta) nor the Alberta Municipal Financing Corporation Act (Alberta) expressly permits municipalities or the Municipal Financing Corporation, as the case may be, to engage in Transactions. Moreover, there are no incidental power provisions of sufficient breadth to be construed, with any degree of certainty, to grant such entities the capacity to enter into Transactions. Similarly, neither the charters of the City of Calgary nor the City of Edmonton bestow powers analogous to those of a natural person.

Section 10 of the Municipal Government Act (Alberta) confers on the Lieutenant Governor in Council broad powers, on the application by a municipality, to "make regulations providing for any matter not provided for or insufficiently provided for in this Act...". It is, therefore, conceivable that the Lieutenant Governor in Council could by regulation grant to a municipality the capacity to participate in Transactions. As a result, municipalities in Alberta presently do not have the express legal capacity to engage in Transactions and any implied authority in that regard has been put into question by Hammersmith.

The Municipal Government Act (Alberta) may be significantly revised in the future. In this regard, Bill 51 (the proposed new Municipal Government Act

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It should be noted that any regulations which may in the future be made pursuant to section 10 of the Municipal Government Act granting to a municipality the capacity to participate in Transactions would, in any event, only be a temporary solution to a municipality interested in engaging in a Transaction, and would likely have to be applied for on a transaction by transaction basis, since section 10 expressly provides that "any regulation so made ceases to have effect after the last day of the next ensuing session of the Legislature".
(Alberta)) was tabled in the Alberta Legislature in July 1992. Section 4(1)(a) of Bill 51 provides that a municipality, "except to the extent provided by this or any other enactment, has the capacity of a natural person and the rights, powers and privileges of a natural person". The municipalities to which the new Act would apply, which would include the cities of Calgary and Edmonton, would be granted the capacity to enter into Transactions subject only to express statutory limitations. Although Bill 51 was tabled before the Alberta Legislature in July 1992, it died on the order paper without being considered by the Legislature prior to adjournment. The Bill has been sent back to committee for review and revision and no firm timetable has been established for when it will again be brought forth for the Legislature's consideration.

(ii) **British Columbia.** The *Municipal Act* (British Columbia) provides that every municipality incorporated thereunder has "all the rights and liabilities of a corporation" and has (subject to any express limitation in the Act) "the full power to engage in any commercial, industrial or business undertaking". Although this provision of the *Municipal Act* (British Columbia) does not extend to the City of Vancouver, the charter of the City of Vancouver similarly states that it has (again, subject to any express limitation) full power to engage in "any commercial, industrial or business undertaking". Persuasive arguments can be advanced to support the characterization of Transactions as commercial or business undertakings. Thus, despite the absence of any judicial comment on the subject, it would appear that the relevant legislation in *Hammersmith* can be distinguished from the legislation applicable to the City of Vancouver and other municipalities in British Columbia. Although not absolutely clear, the City of Vancouver and other municipalities in British Columbia are generally thought to have the requisite capacity to enter into Transactions. As this capacity is implicit to the relevant legislation, no express authorizations or consents are required before British Columbia municipalities may engage in Transactions. Moreover, there are no express restrictions in respect of who may be counterparties to Transactions with British Columbia municipalities or in respect of the types and purposes of such Transactions. In fact, given that British Columbia municipalities (excluding the City of Vancouver) have the status of a corporation and that both British Columbia municipalities and the City of Vancouver have the power to engage in any commercial or business undertaking, it is arguable that they have the capacity to enter into any type of Transaction with any counterparty, including those that are of a speculative nature. However, the matter is not entirely clear and, consequently, there remains some risk that Transactions are beyond the capacity of British Columbia municipalities and the City of Vancouver.

In contrast to the *Municipal Act* (British Columbia) and the charter of the City of Vancouver, the *Municipal Finance Authority Act* (British Columbia) does not
confer expansive rights and powers on the Municipal Finance Authority. Furthermore, it is not at all clear that the power to engage in Transactions can be implied as incidental or conducive to the exercise of the borrowing and other financial powers of the Municipal Finance Authority. Given that the Municipal Finance Authority is a public authority dealing with public moneys and is not intended to generate a profit, the reasoning in Hammersmith may be applicable. As a result, pending a clear judicial determination, we cannot confidently conclude that the Municipal Finance Authority has the capacity to enter into Transactions.

(iii) **Ontario.** Until recently, neither the Municipal Act (Ontario) nor the Regional Municipalities Act (Ontario) addressed whether Ontario municipalities and regional municipalities have the capacity to enter into Transactions. However, in June 1992, amendments were enacted that specifically permit prescribed municipalities or classes of municipalities to enter into certain types of Transactions. In fact, the amendments provide that regulations may be introduced that actually require a municipality or class of municipalities that has invested in securities issued in a foreign currency to enter into Transactions to minimize costs or counteract the risk associated with currency fluctuations. The permitted types of Transactions include foreign currency agreements and interest rate agreements. These agreements may only be entered into for the purpose of minimizing costs or counteracting interest rate or currency rate fluctuations. Furthermore, these types of authorized agreements are limited to the currencies in respect of which the particular municipality is authorized to issue debentures. Unless otherwise authorized by regulation, such foreign currencies include only British pounds and U.S. dollars. It should be noted, however, that additional types of financial agreements may be authorized by regulation. At present, no such financial agreements have been authorized. In addition, if the agreement will require payment beyond the term of the municipal council in power at the date of entering into the Transaction, then certain financial obligation limits prescribed in the regulations will apply.

Admittedly, a municipality is entrusted with public funds and such funds should not be put at risk through speculative transactions. As a result, the motivation supporting the limitations on the types, currencies and purposes of permitted Transactions is understandable. In this respect, it will be interesting to observe the types of other financial agreements, if any, that may ultimately be authorized by regulation and the limitations that may be imposed.

As noted above, before an Ontario municipality is legally authorized to enter into a Transaction, it must be designated as a prescribed municipality. At present, no regulations have been passed that designate any such municipalities nor has there been any public comment as to which municipalities are likely to be
designated. It is anticipated that the aforementioned regulations will also establish the conditions pursuant to which, and the persons with whom, Ontario municipalities may enter into Transactions. In this respect, it is hoped that the regulations are not unnecessarily restrictive and afford the prescribed municipalities sufficient latitude in determining when and with whom to engage in Transactions.

(iv) **Quebec.** As in Ontario, legislative amendments have recently been introduced which expressly enable municipalities in the Province of Quebec to enter into certain types of Transactions. More specifically, the Act respecting municipal debts and loans (Quebec) was amended in May 1992 to permit Quebec municipalities to conclude currency exchange agreements or interest rate exchange agreements, and enter into transactions in respect of other instruments or contracts of a financial nature which the Government of Quebec may prescribe. "Instruments or contracts of a financial nature" are defined in relatively broad terms as "any financial instrument or contract whose object is the management of financial risks, in particular currency exchange agreements, interest rate exchange agreements, options and futures contracts."

Prior to entering into any such Transactions, a municipality must obtain from the Minister of Municipal Affairs the same authorization which is required for the exercise of its borrowing powers; municipalities are required in many cases to receive an authorization from the Minister before borrowing and may also require other authorizations, such as from the Commission of Municipal Affairs. Where Transactions are carried out within the framework of a program established by a municipality and the program has been approved by the Government, individual Transactions will not require authorization, provided that the program establishes the principal compulsory characteristics of the Transactions and limits the commitments which may result from them. The Government of Quebec also has the discretion to exempt one or more municipalities or categories of municipalities from the requirement to obtain such authorization. At present, it is unclear as to when and under what conditions this discretion will be exercised.

The Quebec regime is, nevertheless, quite flexible. Despite the requirement to obtain governmental authorization, the Quebec legislation specifically acknowledges that municipalities may wish to, and indeed need to, enter into a potentially diverse range of financial instruments or contracts. At the same time, by limiting such instruments or contracts to those in respect of which the object is the management of risk, it also recognizes that public funds entrusted to municipalities should not be subjected to undue risk of loss by virtue of speculative transactions. As discussed above, municipalities may establish a specific swap program and once it is duly established Transactions carried out by the municipality within the
framework of the program are not subject to authorization by the Minister of Municipal Affairs. This unique provision of the Quebec legislation appears to strike a desirable balance between the need for provincial authorities to maintain a degree of control and regulation over the scope of permitted transactions, and the need to afford municipalities the flexibility and autonomy necessary to govern their financial affairs. It remains to be seen, however, to what extent and under what conditions the Government of Quebec will approve these specific programs. If the Government of Quebec imposes restrictive conditions on such programs or if it is inexpedient to obtain its approval, the benefits of this provision may be illusory.

B. Recommendations

It is encouraging to note that jurisdictions such as Ontario and Quebec have recognized the uncertainty surrounding the capacity of municipalities to enter into Transactions and have promulgated specific legislation to address this uncertainty. However, as discussed above, uncertainties remain with this legislation. Furthermore, there does not appear to be a great deal of uniformity or consistency between the existing legislation or the legislation that is proposed in other provinces. Although they would clarify the capacity of municipalities to enter into certain Transactions, the proposed amendments to the Alberta legislation bear little resemblance to those in other provinces. As a result of this lack of uniformity, it is anticipated that potential counterparties will face considerable confusion and ambiguity when dealing with municipalities throughout Canada.

For the foregoing reasons, there would appear to be significant merit in each Canadian province enacting comprehensive and uniform legislation authorizing municipal authorities (or specified Municipal Finance Authorities) to engage in Transactions. We have set out suggested Model Legislation in Appendix "C" to this report.

V. INSURANCE COMPANIES

A. Issues

1. Federal Insurance Companies and Fraternal Benefit Societies

   (a) Capacity. With the enactment of the Insurance Companies Act (Canada) (effective June 1, 1992) the issue of ultra vires action by a federally incorporated insurance company or fraternal benefit society (defined as a body
incorporated for the sole purpose of insuring the members thereof) has no further general application as the Act grants these entities the capacity of a natural person and (subject to the Act) the rights, powers and privileges of a natural person. Given that federal insurance companies and fraternal benefit societies now have the powers of a natural person, they clearly have the legal capacity to enter into and perform Transactions.

(b) **Limitation on Powers.** Notwithstanding that they have the capacity of a natural person, the corporate authority of insurance companies may be limited by the Act or the charter documents. The Act prohibits a federally incorporated insurance company from exercising any power in a manner contrary to the Act (section 15). Generally, lack of authority could also affect the enforceability of contracts where such lack of authority was known or ought reasonably to have been known to the contracting party. The **Insurance Companies Act** (Canada) provides that, subject to other provisions of the Act, an insurance company shall not engage in or carry on any business other than such business as appertains to the business of providing financial services (section 440). While the "business of providing financial services" is not defined in the Act, it is our view that it would be broadly interpreted to include Transactions. To the extent that there is any ambiguity, a counterparty could rely on the saving provision in section 708 which states that no contract is unenforceable simply because it was entered into in contravention of the Act or regulations.

Sections 492 and 551 of the **Insurance Companies Act** (Canada) impose a prudent person standard with respect to investment and lending policies of insurance companies and fraternal benefit societies, respectively. Although many Transactions are probably not properly characterized, as a legal matter, as "investments" or "loans", it is likely that the Office of the Superintendent of Financial Institutions ("OSFI") (the federal regulatory agency for federal financial institutions) would expect a similar standard to be adhered to with respect to Transactions. OSFI has previously published a notice (September 1, 1987) with respect to the use of futures and options contracts (which it states are not investments) by regulated entities within their purview, including federal insurance companies, trust companies, loan companies and pension funds. The notice makes it clear that OSFI expects financial institutions to be able to demonstrate that such transactions were entered into for hedging purposes. While the then applicable insurance companies legislation was substantially different from the new **Insurance Companies Act** (Canada), it is not unreasonable to expect that OSFI will expect a similar standard be met under the new legislation. This prudence standard is an internal matter for the directors of an insurance company and should not directly affect the enforceability of the Transaction unless the counterparty had notice of a breach of the standard.
2. **Alberta Insurance Companies**

In Alberta, insurance companies are not incorporated under the *Insurance Act* (Alberta), but rather by special Act of the Legislature (section 136(1)). In the result, the legislative and other charter documents of an Alberta insurance company must be reviewed to ascertain whether (i) there exists an *ultra vires* concern, and (ii) there exists any other restrictions which would preclude the entering into of Transactions by that company. Special Acts incorporating Alberta insurance companies generally do not confer the capacity of a natural person, but rather restrict such companies to exercising the powers ancillary to their insurance business. In our view, the entering into of Transactions, at least for debt or investment management purposes, would be ancillary to an insurance business, but the matter is not entirely free from doubt and there is no saving provision such as exists in the federal legislation.

The *Insurance Act* (Alberta) is primarily a licensing statute and, as such, would not appear to enlarge upon the power or capacity of an insurance company as provided by its charter documents (section 29). The *Insurance Act* (Alberta) is silent with respect to the ability of an insurance company governed by that Act to enter into Transactions. Section 94 contains a traditional "legal list" of investments in which an insurance company incorporated under Alberta law is permitted to invest its funds, with a typical "basket clause" in section 94(5). But, as noted, many Transactions are probably not investments, and therefore an insurance company would not by the provisions of section 94 be expressly permitted to enter into, or impliedly prohibited from entering into, such Transactions. To the extent that Transactions are investments, breach of the prudence standard should not affect the enforceability of the Transactions, at least against counterparties without notice of the breach.

There is, therefore, uncertainty as to whether an Alberta insurance company can enter into Transactions that are not investments.

3. **British Columbia Insurance Companies**

(a) **Capacity.** Although British Columbia does have an *Insurance Act* (British Columbia), the previously relevant provisions regarding powers that may be exercised by an insurance company licensed under that Act have been repealed and replaced by the *Financial Institutions Act* (British Columbia). Unlike the other provincial statutes discussed above, the *Financial Institutions Act* (British Columbia) provides that insurance companies in British Columbia are to be incorporated under or converted to an insurance company under its terms. Section 19 of the *Financial*
Institutions Act (British Columbia) confers the capacity and powers of a natural person.

(b) Limitation on Powers. The Financial Institutions Act (British Columbia) limits the authority of an insurance company to undertake business outside of the business authorization granted to it under the Act. However, section 65(1)(b) specifically authorizes an insurance company to undertake "business....ancillary to the business authorized under its business authorization..."). As noted above, it is our view that Transactions can be ancillary to an insurance business. To the extent that any uncertainty remains, however, the Act contains a saving clause which states that contravention of section 65 does not affect or invalidate a transaction entered into by an insurance company. There are no specific provisions in the Financial Institutions Act (British Columbia) which might restrict the corporate authority of an insurance company in British Columbia to enter into or perform its obligations under a Transaction.

The prudent person investment standard found in the general investment and loan provisions of the Financial Institutions Act (British Columbia) may be relevant to Transactions undertaken by an insurance company, notwithstanding that a Transaction may not be an investment or a loan, because such standard references "other financial obligations". These provisions require an insurance company as part of its investment and lending policy to establish prudence standards with respect to "other financial obligations" as well as, specifically, establishing a monetary cap on the amount a financial institution may commit under "all guarantees or other financial obligations" to one person and its associates. Section 133 requires the directors of a financial institution and its subsidiaries to appoint an investment and loan committee. The investment and lending policy established by the committee and the directors pursuant to sections 134(3) and (4) must be filed with the Superintendent of Financial Institutions who may review the policy and may order the directors of a financial institution to immediately review the policy if it is not comprehensive or in compliance with section 134(5). Non-compliance with these provisions should not affect the enforceability of the Transaction by a counterparty without notice of the non-compliance.

4. Ontario Insurance Companies

(a) Capacity. As discussed in Part III of this report, Ontario insurance corporations are incorporated under the Corporations Act (Ontario), and so have the powers of a natural person subject to restrictions in the Act or the letters patent. There are no restrictions in the Act which would adversely affect the authority of an insurer to enter into Transactions. However, the letters patent of the corporation will
have to be reviewed to determine whether there are any restrictions on capacity. Although the Act is not clear, this may raise a corporate authority issue but should not raise a capacity issue.

(b) Limitation on Powers. Part XVII of the Insurance Act (Ontario) deals with "Investments" by an insurer and sets out a traditional legal list of permitted investments and loans. There is no incidental powers provision specific to this section. As noted above, many Transactions are probably not investments and, therefore, the investment restrictions would not be relevant to such Transactions. To the extent that a Transaction may be an investment and the provisions are therefore applicable, breach of the provisions should not affect the enforceability of the Transaction by a counterparty without notice of the breach. There does not appear to be any other provision in the Insurance Act (Ontario) which would restrict a corporation governed by the Act from entering into and performing a Transaction.

5. Quebec Insurance Companies

(a) Capacity. In Quebec, the applicable legislation is the Act respecting Insurance (Quebec). As in Ontario, most insurance companies are not incorporated pursuant to the terms of this Act but take their basic corporate power from the statute under which they are incorporated. Subject to a few exceptions in the case of mutual insurance companies and similar institutions, insurance companies incorporated in Quebec after October 20, 1976 must be incorporated under Part I of the Companies Act (Quebec). Insurance companies incorporated in Quebec before that date were usually created through the adoption of a special statute or under the provisions of Part I or its equivalent in the past. As discussed above, companies incorporated under Part I of the Companies Act (Quebec) do not enjoy the capacity of a natural person and, therefore, the doctrine of ultra vires would apply. The special statute under which a company is incorporated, its letters patent or the relevant provisions of the Act respecting Insurance (Quebec), as the case may be, must therefore be examined on a case-by-case basis to determine whether the company may enter into Transactions.

The Act respecting Insurance (Quebec) does provide expressly that every insurance company incorporated under the laws of Quebec may carry on certain activities, and that the Inspector General of Financial Institutions can authorize an insurance company to carry out other activities. The activities specifically listed in the statute do not clearly establish that an insurance company may enter into Transactions; the further activities authorized by the Inspector General of Financial Institutions for some insurance companies also do not specifically address Transactions.
(b) **Limitation of Powers.** The Act respecting Insurance (Quebec) requires insurers to invest or lend their funds as would a prudent and reasonable person in similar circumstances. Insurers must act with honesty and loyalty in the best interest of their policyholders and shareholders. Whether entering into a Transaction in a given situation would pass these tests is a matter of fact. The Act also sets ceilings on investments in various areas. For instance, no insurer may invest more than 4% of its assets in the common shares of a given corporation or may control corporations, except in specific circumstances. None of these restrictions, however, appears to affect an insurer’s capacity or authority to enter into Transactions.

B. **Recommendations**

There is no capacity or corporate authority enforceability issue for federal or British Columbia insurance companies. There is some ambiguity in Ontario as to whether a restriction in the letters patent would affect capacity or corporate authority only. This is an issue for all letters patent corporations, not just insurance corporations, and, consequently, our recommendations are the same as in Part III. B. In Alberta, there is uncertainty as to whether the entry into Transactions would be a power ancillary to the insurance business and therefore within the corporation’s authority and capacity. In Quebec, as discussed, there is no clear provision of law giving insurance companies the capacity to enter into Transactions. We recommend that provisions clarifying such capacity be adopted in both Alberta and Quebec.

VI. **TRUST COMPANIES AND LOAN CORPORATIONS**

A. **Issues**

1. **Federal Trust Companies and Loan Companies**

(a) **Capacity.** With the enactment of the Trust and Loan Companies Act (Canada) (effective June 1, 1992) the issue of ultra vires action by a federally incorporated trust or loan company has no further general application as the Act grants these entities the capacity of a natural person, and (subject to the Act) the rights, powers and privileges of a natural person (section 14(1)). Given that federal trust and loan companies now have the capacity of a natural person, they clearly have the legal capacity to enter into and perform Transactions.

(b) **Limitation on Powers.** Corporate authority may, however, be limited by the Act or by a company’s charter documents (section 14(2)). Section 409(1) of the Trust and Loan Companies Act (Canada) provides that, subject to other
provisions of the Act, a trust or loan company shall not engage in or carry on any business other than such business as appertains to the business of providing financial services. As discussed in relation to insurance companies, it is our view that this phrase would be broadly interpreted to include Transactions. It is important to note that the Trust and Loan Companies Act (Canada) also contains a general "saving" provision (section 536) in the same terms as that in section 706 of the Insurance Companies Act (Canada).

Section 450 of the Trust and Loan Companies Act (Canada) imposes a prudent person standard with respect to investment and lending policies in identical terms to those found in section 492 of the Insurance Companies Act (Canada), discussed above. In addition, the OSFI notice mentioned above with respect to the use of futures and options by federal financial institutions also applies to trust and loan companies. This notice indicates that OSFI expects that such transactions will be entered into solely for the purpose of hedging, this intent having to be demonstrable by the institution in question. We understand that OFSI may take a similar position with respect to other Transactions, but again this requirement should not directly affect the enforceability of Transactions by the counterparty.

2. Alberta Loan and Trust Corporations

(a) Capacity. The Loan and Trust Corporations Act (Alberta) provides "provincial corporations" with the capacity and the rights, powers and privileges of an individual subject to any restriction in the Act, regulations, by-laws or its registration (section 14(1)). A "provincial corporation" is defined in that Act as being a loan or trust corporation "incorporated or continued under this Act".3 Since full capacity is subject to any restrictions in the Act or charter documents, these documents must be reviewed to determine whether the doctrine of ultra vires applies.

(b) Limitation on Powers. As provided by section 14(2) of the Loan and Trust Corporations Act (Alberta), a loan or trust corporation cannot act in a manner contrary to the Act or the regulations thereunder. A number of provisions are relevant with regard to whether the Act or regulations impose any such restrictions. A corporation cannot engage in any business other than that which generally

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3 Although the Trust Companies Act (Alberta), which is a predecessor to the Loan and Trust Corporations Act (Alberta), has not been repealed, all provincial trust companies under the former Act are required to be continued under the Loan and Trust Corporations Act (Alberta) within one year of the coming into force of the Loan and Trust Corporations Act (Alberta). See section 327 of the Loan and Trust Corporations Act (Alberta). This Act was proclaimed in force January 16, 1992.
appertains to the business of providing financial services (section 181(1)). "Financial services" is not defined in the Act, but in our view the entering into of Transactions would appertain to such business.

Section 325 of the Act authorizes the making of regulations imposing terms and conditions subject to which a provincial corporation may make investments, give guarantees or enter into other transactions. In this regard, section 27 of the regulations to the Act sets forth certain terms and conditions on which loan and trust corporations are entitled to enter into Transactions. That section provides as follows:

(1) A provincial corporation may

(a) enter into a swap or forward contract,

(b) purchase financial futures or options, and

(c) engage in short selling

only where the purpose of the transaction is to hedge against interest rates, exchange rates or similar risks associated with specific assets or liabilities or groups of assets or liabilities of the provincial corporation.

(2) Where a provincial corporation enters into a swap with another party (referred to as the counterparty), the counterparty must be an issuer of and have issued debt securities that are outstanding and have a rating in accordance with the table in the Schedule.

"Swap" is defined in section 1(t) of the regulations as "an agreement between the two parties whereby one party offers to pay specified obligations of another party and in exchange the other party agrees to pay specified obligations of the first party". Clearly, this definition of swap is inaccurate. Definitions are also provided in the regulations for "forward contract", "financial futures", "options" and "short selling", which are ambiguous in their terms. As such, it is unclear whether they cover all types of Transactions.

The Schedule referred to in section 27(2) sets out investment grade ratings for bonds, debentures and commercial paper by CBRS Inc., Dominion Bond Rating Service Limited, Moody’s Investor Service, Inc. and Standard & Poor’s Corp.

Based on the foregoing, a loan or trust corporation governed by the Loan and Trust Corporations Act (Alberta) would only be permitted to enter into Transactions that fit within the requirements prescribed by section 27 of the
regulations to that Act.4 There is no indication in the legislation as to whether a counterparty could rely on representations by the corporation as to its purpose in entering into the Transaction. Given the inaccurate definition of swap and the ambiguity of the other relevant definitions, the capacity of an Alberta loan and trust corporation to engage in Transactions is unclear.

3. British Columbia Trust Companies

Trust companies in British Columbia are subject to the provisions of the Financial Institutions Act (British Columbia). As such, the discussion in Part V as to the capacity of British Columbia insurers to enter into and perform Transactions is equally applicable to trust companies.

4. Ontario Loan and Trust Corporations

(a) Capacity. The relevant legislation in Ontario is the Loan and Trust Corporations Act (Ontario). A body incorporated pursuant to general corporate law may apply for registration as either a loan or a trust corporation. In addition, the Act provides for the incorporation of a loan corporation by letters patent. The Loan and Trust Corporations Act (Ontario) grants the entities so registered or incorporated the rights, powers and privileges of a natural person subject to any restrictions in the Act or its charter documents (section 13(a)). As such, loan and trust corporations have the capacity to enter into and perform Transactions unless their power to do so is otherwise limited by the Loan and Trust Corporations Act (Ontario), their registration or their charter documents.

(b) Limitation on Powers. The Loan and Trust Corporations Act (Ontario) imposes a prudent person standard on loan and trust companies in the making and managing of their investments. As noted previously, it is unlikely that many Transactions would be considered investments as a strictly legal matter. In any event, breach of the prudent person standard should not affect the enforceability of a Transaction against a counterparty without notice of the breach. There are no other provisions in the Act which limit the general ability of loan and trust corporations to enter into and perform Transactions.

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4 See also section 12(3) of the Loan and Trust Corporations Regulation which permits a provincial corporation, subject to section 27(2) of the Regulations, to enter into a swap or similar agreement with a securities dealer that is a restricted party if the securities dealer is acting as agent, not as principal, and the transaction is at fair market rate. Note also section 52(3)(i) of the Regulations, which requires the investment committee to provide for the setting of specific positioning limits and control arrangements with respect to the use of hedging instruments such as futures and options in its investment policy.
5. **Quebec Trust Companies and Savings Companies**

The relevant legislation in Quebec is the *Act respecting Trust Companies and Savings Companies* (Quebec). As is the case with insurance companies, trust companies and savings companies are usually incorporated under Part I of the *Companies Act* (Quebec) and, as discussed above, are therefore subject to the *ultra vires* doctrine. Examination of the special Act under which a trust or savings company has been incorporated on a case-by-case basis and of the relevant provisions of the *Act respecting Trust Companies and Savings Companies* (Quebec) is, therefore, necessary to determine whether a Quebec incorporated trust or savings company has the capacity to enter into Transactions.

The provisions of the *Act respecting Trust Companies and Savings Companies* (Quebec) establishing the powers of such companies do not specifically mention Transactions. Those provisions allow trust companies to carry on any activity related or accessory to their activities as trustees or financial intermediaries, but there is some uncertainty as to whether Transactions can be included in such related or accessory activities. There is no general saving provision for contracts entered into in breach of the Act such as exists in the federal legislation.

**B. Recommendations**

Although legislation governing loan and trust corporations does not expressly address the issue of Transactions, generally the governing statutes confer the capacity and powers of a natural person. Therefore, in our view, there is no need for reform federally or in Ontario or British Columbia. The capacity of a loan and trust corporation remains uncertain in Alberta and Quebec, however. We would recommend that Alberta and Quebec bring their legislation in line with that in the other jurisdictions. To the extent that these provinces elect to maintain restrictions, certain other amendments to the legislation could be suggested. Given that all types of Transactions can legitimately be entered into for hedging purposes, we would suggest that a more all-encompassing list of authorized transactions be developed. In this regard, the present definitions in the Alberta legislation are particularly problematic.
VII. **PENSION FUNDS**

A. **Issues**

1. **Capacity, Authorization and Legislative Restrictions**

   (a) **General.** Canadian pension funds are typically specialized forms of trusts. However, some Canadian pension funds are constituted as bodies corporate pursuant to special Acts or general acts applying to the creation of pension fund societies. A trustee acting in respect of a pension fund in Canada will have the legal capacity granted to it by the governing trust agreement, in the case of a trusteeed pension plan, and by the particular special Act or letters patent etc. in the case of a pension plan constituted as a corporation. As with all corporations created by special Act or pursuant to a general corporations act, the governing legislation itself and, if applicable, letters patent etc. must be examined to determine the capacity and powers of the particular entity (see Part III. A.1.(a) above). In the case of trusteeed pension plans, it must be noted that the pension fund is not a legal person and, therefore, cannot itself be sued or contract with third parties. The trustee of the fund may, however, be sued or enter into contracts with third parties in a representative capacity. Subject to express restrictions contained in the relevant trust documents on the trustee’s ability to deal with the pension fund assets, as a matter of general trust law, the trustee would have full powers to deal with and to incur liabilities in respect of trust assets.

   The activities of a Canadian pension fund are also governed by applicable federal and provincial pension fund legislation. The application of such legislation depends upon a nexus between the pension fund and the relevant jurisdiction. Where the particular pension fund relates to an employer involved in a federally regulated industry (such as banking, railways, airlines etc.), federal pension fund legislation will be applicable. In addition, where the pension fund has beneficiaries in one or more provinces, the relevant provincial pension fund legislation may also be applicable. Each of the Provinces of Alberta, British Columbia, Ontario and Quebec has enacted pension fund legislation. The Province of British Columbia has draft regulations to its Act which have not yet been enacted. Canadian pension fund legislation is not uniform and pension regulatory authorities in Canada have reciprocal arrangements for enforcement of pension legislation where beneficiaries reside in more than one province and different rules apply in those provinces. Conceivably, however, a pension fund could be required to be registered and to comply with different regulatory requirements in different provinces.
Historically, Canadian pension fund legislation prescribed a legal list of investments which pension funds were permitted to make. Amendments to pension fund legislation in certain provinces in recent years have replaced the legal list concept with a prudent person investment standard. It should be noted that Revenue Canada requires, as a pre-condition for registration of pension plans under the Income Tax Act (Canada), that certain minimum conditions with respect to investment standards be included in a pension plan.

(b) **Specific Jurisdictions**

(i) **Canada.** As discussed above, pension funds can be established as bodies corporate pursuant to pension fund societies legislation. The applicable federal statute in this regard is the *Pension Fund Societies Act* (Canada). This Act provides that after its incorporation pursuant to the Act, a pension fund society has the power to form a fund and may invest, hold and administer the funds (section 10). In addition, section 11(1) provides that every incorporated pension fund society has all powers necessary for the purposes of the Act. Section 11(2) permits a pension fund society to make by-laws relating to a number of matters including the management of the pension fund and section 12 further provides that all powers, authority and rights of the pension fund society shall be such as are defined and limited by the by-laws of the society and may be exercised and enforced in the manner prescribed by those by-laws.

The relevant federal legislation of general application is the *Pension Benefits Standards Act, 1985* (Canada) and the Regulations thereunder. There are no provisions in that Act which expressly authorize a trustee to enter into, or prevent a trustee from entering into, a Transaction on behalf a the pension fund. Schedule III to the Regulations under the Act set out a legal list investment regime for federal pension funds. However, as it is unlikely that many Transactions are investments, these provisions should not have any application, and to the extent that they do, they should not affect the enforceability of the Transaction unless the counterparty has knowledge of the breach of duty. Draft amendments to Schedule III have recently been promulgated which move federal pension funds from a legal list investment regime to a prudent person investment regime. As noted above, OSFI has previously published a notice stating that the use of futures and options contracts by certain federally regulated entities, including pension funds, should be for clearly demonstrable hedging purposes only and it is not unreasonable to expect a similar approach to be taken to other types of Transactions.

(ii) **Alberta.** Private sector pension plans are regulated in Alberta under the *Employment Pension Plans Act* (Alberta). The *Employment Pension Plans*
Act (Alberta) does not apply to certain large public sector pension plans and, although it does not expressly permit a pension plan to enter into Transactions, it does not expressly preclude such activity. As a general matter, Schedule 2 of the regulations under the Employment Pension Plans Act (Alberta) provides that, subject to the Schedule, Schedule III of the Pension Benefits Standards Regulations, 1985 (Canada) applies to all investments under the Alberta Act. The Schedule expands on investment activities by pension plans by authorizing pension plans to sell or write covered call options and put options as part of a defensive strategy for acquiring an investment subject to certain conditions, including that the underlying security is a permitted investment. In addition, short-selling and purchasing futures contracts are permitted, also on conditions, including that such instruments are related to securities held or permitted to be held by the pension fund. In our view, this is not an implied prohibition on entering into other types of Transactions or Transactions for other purposes.

Neither Schedule 2 to the Employment Pension Plans Regulation (Alberta) nor, as stated above, Schedule III to the Pension Benefits Standards Regulations, 1985 (Canada) expressly permit or preclude a pension plan from entering into Transactions to manage its investment risk.

In the result, pension plans regulated by the Employment Pension Plans Act (Alberta) are not statutorily precluded from entering into Transactions. However, the documentation under which the pension plan is established should be reviewed to ascertain what additional powers and/or restrictions are placed on the administrator of the pension plan in that regard.

(iii) British Columbia. A pension fund society may be established as a body corporate pursuant to the Pension Society Act (British Columbia). The provisions of this Act are substantially identical to those of the Pension Fund Societies Act (Canada). The pension legislation of general application is the Pension Benefits Standards Act (British Columbia) which provides in section 44 that assets of a pension plan must be invested in accordance with the regulations. At this time, such regulations are in draft form only. As presently drafted, the regulations cross-reference Schedule III to the Pension Benefit Standards Regulations, 1985 (Canada), which currently incorporates the legal list of permitted investments referred to above. It is expected that British Columbia’s own regulations will be enacted in mid-1993; it is not known whether these regulations will continue to cross-reference Schedule III of the federal Act.
(iv) **Ontario.** Ontario pension fund corporations, including pension fund societies, will likely be subject to the *Corporations Act* (Ontario) and will, therefore, have the powers of a natural person subject to restrictions in the special Act or other charter documents (i.e., letters patent). Sections 83 to 195 of the *Corporations Act* (Ontario) provide for the incorporation of pension fund societies in substantially the same terms as the federal *Pension Fund Societies Act*.

The *Pension Benefits Act* (Ontario) regulates the activities of the trustees and administrators of pension funds. Section 63 of the Act provides, in effect, that every trustee and administrator of a pension plan shall ensure that investments are selected in accordance with the criteria set out in the Act and prescribed by the regulations made under the Act. The regulations impose limits on certain kinds of investments. Neither the Act nor the regulations specifically address Transactions.

The regulations under the Act requires the administrator of a pension plan to establish and adopt a written statement of investment policies and goals for the pension plan. In the establishment and application of the written statement of investment policies and goals, the selecting of investments must be made "with consideration given to the overall context of the investment portfolio without undue risk of loss or impairment and with a reasonable expectation of fair return or appreciation given the nature of the investment". The statement of investment policies and goals must be filed with the pension regulatory authorities. The legal community (including, it appears, the pension regulatory authorities) in Ontario has accepted the proposition that a pension fund is empowered to undertake Transactions if such activities are not prohibited by its trust agreement and are described in the pension fund’s statement of investment policies and goals, and pension funds in Ontario are entering into Transactions on this basis.

In the event that the trust agreement (and, perhaps, the statement of investment policies and goals) of a particular pension fund authorize Transactions in appropriately prescribed circumstances, an issue potentially remains with respect to each particular Transaction as to whether it was made with consideration given to the overall context of the investment portfolio without undue risk of loss or impairment and with a reasonable expectation of fair return or appreciation given the nature of the investment. The Act does not address the consequences for the enforceability of a Transaction of the failure by a trustee or administrator to meet this standard in entering into the Transaction. Where a pension fund enters into a Transaction without such due consideration, it is our view that the trustee or administrator may be in breach of its fiduciary duties, but that the party contracting with the pension fund should not be prejudiced in its ability to enforce its rights against the pension fund.
absent actual or constructive knowledge of the breach of duty on the part of such party.

(v) **Quebec.** The *Supplemental Pension Plans Act* (Quebec) regulates pension plans in Quebec. Section 169 of the Act requires the pension committee of every pension plan to establish and adopt a written investment policy. The policy need not be filed with the authorities.

Section 170 of the Act sets out certain requirements in regard to investment policies. In particular, it provides that "unless they are already set out in the plan, the policy must also include ... rules applicable to the use of future contracts, options, share purchase warrants or share rights or other financial instruments." There are no other references in the Act or the regulations thereunder to Transactions or similar arrangements. Consequently, it appears that pension plans governed by the *Supplemental Pension Plans Act* (Quebec) may enter into Transactions, subject to any restrictive provisions contained in the charter documents of the plan, the terms of the plan and the written investment policy.

B. **Recommendations**

In our view, there is no need for, or benefit to be obtained by, reform in this area. We would note, however, that because of the legal structure of pension funds an appropriate amount of due diligence should be undertaken by a counterparty.

VIII. **PLEDGES OF COLLATERAL AND OTHER SECURITY INTERESTS**

A. **Issues**

1. **Restrictions on Ability**

(a) **Federal Entities**

(i) **Banks, Trust and Loan Companies and Insurance Companies.** Federal banks, trust and loan companies and insurance companies are restricted in their ability to provide security for their obligations, including obligations under Transactions. For example, section 419 of the *Trust and Loan Companies Act* (Canada) provides:
Restriction on security interests

419. (1) Subject to subsection (3), a company shall not create a security interest in any property of the company to secure an obligation of the company, unless

(a) the obligation is to the Bank of Canada or the Canada Deposit Insurance Corporation; or

(b) the Superintendent has approved in writing the creation of the security interest.

Encumbered property

(2) A company shall notify the Superintendent in writing of any beneficial interest in real and personal property acquired by the company, other than by way of realization, that is subject to a security interest.

Exceptions

(3) Subsection (1) does not apply in respect of security interests created on

(a) such classes of personal property as the Superintendent may, by order, designate; or

(b) property having an aggregate value that is less than such amount as the Superintendent may, by order, specify.

Section 419 of the Bank Act (Canada) is identical. Section 470 of the Insurance Companies Act (Canada) is also identical, except for section 470(1)(a) which allows security interests created in relation to the reinsurance by the company of risk insured by another insurer. The Superintendent has not designated any classes of personal property or specified any amount for the purposes of section (3)(a) and (b) respectively. For this purpose, a "security interest" is an interest in or charge on property by way of mortgage, lien, pledge or otherwise taken by a creditor or guarantor to secure the payment or performance of an obligation.

Section 419(1)(b) does not appear to give the Superintendent the power to approve a particular class or classes of Transaction for all banks, trust and loan companies and insurance companies. Arguably, it only applies to a particular Transaction by a specified bank, trust, loan or insurance company. For example, the Superintendent could approve a grant of security for a Transaction entered into pursuant to a Master Agreement by a particular bank with a particular counterparty. Perhaps it could authorize the grant of security by a particular company for Transactions generally, but this is less clear. OSFI appears to be taking the position that the Superintendent can approve the grant of security by a particular entity without reference to a particular Transaction (for example, in the context of securities lending agreements).

(ii) **Pension Funds.** The trustees of federally regulated pension plans are not restricted by applicable legislation from creating security interests in assets
under their control to secure obligations under Transactions which are properly incurred in the course of administering the trust assets. There are limits in Regulation 8503 of the Income Tax Act (Canada) that prohibit registered pension plans from securing their assets for borrowed money, but they are silent on the issue of securing other obligations on the fund’s assets.

The terms of the particular trust deed or plan may, however, restrict or prevent the trustee from exercising such a power or encumbering the trust assets in this manner. The trustee’s general obligation to act prudently in the administration of the trust will also impact on its decision with respect to the grant of security. A typical trust deed will confer on the trustee the power to dispose of the trust assets and, in the absence of any actual or constructive notice of a lack of power, third parties dealing with the trustee can assume that it has the power to dispose of the assets.

Where the pension fund is a special Act corporation, the legislation will have to be reviewed to determine whether it provides any authority to grant security for Transactions.

(b) Alberta Entities

(i) Loan and Trust Corporations. The Loan and Trust Corporations Act (Alberta), section 191(3), prohibits a loan and trust corporation incorporated or continued under that statute from directly or indirectly pledging any part of its total assets to secure its obligations, except as expressly provided for in the Act or its regulations. "Total assets" are the assets of the corporation calculated under the regulations and, in the case of trust corporations, include cash and securities which are earmarked and set aside to meet deposit liabilities (section 1(oo)). By regulation, certain transactions may be exempted from the prohibition in section 191(3) (section 191(2)). Currently there are no regulations which exempt Transactions from the scope of the prohibition.

Pledges of property obtained in breach of this provision are void (section 191(6)).

(ii) Insurance Companies. The Insurance Act (Alberta) does not contain any provisions which would either expressly permit or preclude an insurance company governed by that Act from pledging its property. The charter documents of the insurance company, including the legislation under which the insurance company was incorporated, would, therefore, have to be reviewed to determine whether the insurance company has the capacity to pledge its property, either generally or in connection with a permitted Transaction.
(iii) **Pension Funds.** The *Employment Pension Plans Act* (Alberta) and the regulations thereunder are silent with respect to the capacity of a pension plan to pledge its property. Consequently, the documentation under which the pension plan was created must be reviewed to determine whether the trustee or administrator of the pension plan has the power to pledge its property.

(iv) **Municipalities.** As reviewed above, the matter of the capacity of Alberta municipalities to even engage in Transactions is uncertain and is currently the subject of proposed reform.

(c) **British Columbia Entities**

(i) **Trust Companies.** Trust companies are governed by the *Financial Institutions Act* (British Columbia) and are defined as corporations that carry on a "trust business, deposit business or both". Under section 19, a trust company has the power and capacity of a natural person of full capacity. As a result, a trust company would be permitted to grant security interests in the absence of an express limitation in the statute.

The only relevant limitation in the Act is section 69(1), which requires the prior written consent of the Minister before a financial institution (which expression includes a trust company) may grant to a person the right to appoint a receiver or a receiver manager of the property or business of the financial institution. Inasmuch as the *Personal Property Security Act* (British Columbia) contains an implicit right to appoint a receiver over pledged assets, the granting of a security interest may *per se* offend section 69(1). However, one might argue that the section was intended to apply only to a receiver of all or a material portion of the undertaking of the institution, especially having regard to section (2), which expressly ties the exercise of the Minister's discretion to the ability of the secured party to control or influence the institution.

Subject to the forgoing, the Act constrains the giving of security only incidentally, by virtue of the liquidity and reserve requirements applicable to institutions generally.

(ii) **Insurance Companies.** Insurance companies are also governed by the *Financial Institutions Act* (British Columbia) and, therefore, their ability to grant security is the same as for trust companies.

(iii) **Pension Funds.** Pension funds in British Columbia are governed by the *Pension Benefits Standards Act* (British Columbia). Currently, there are no legislative constraints on the granting of a security interest by a pension fund. We understand that regulations are under consideration which would restrict the granting
of a security interest where the market value of the pledged assets exceeds 110% of the "amount of the borrowing". However, this is not expected to become law until at least the fall of 1993. Because this provision is applicable only to security for short term "borrowing" obligations, it would not apply to Transactions and would raise the issue of whether security for other types of obligations is impliedly prohibited. It is expected that any proposed changes would be subject to further review and may reflect similar federal initiatives. There may, therefore, be an opportunity for The Group of Thirty to influence legislative reform in this respect.

(iv) **Municipalities.** Inasmuch as they have the power of a corporation, municipalities in British Columbia may grant security for Transaction obligations that are otherwise properly incurred.

(d) **Ontario Entities**

(i) **Loan and Trust Corporations.** Loan corporations and trust corporations governed by the Loan and Trust Corporations Act (Ontario) are prohibited from directly or indirectly investing or pledging any part of their "total assets" except as expressly provided for in the Act (section 161(1)). "Total assets" are the assets of the corporation calculated under the regulations and, in the case of trust corporations, include cash and securities which are earmarked and set aside to meet deposit liabilities. Unlike the similar Alberta provision, there is no scope for the enactment of exempting regulations. Pledges of part of the total assets are permitted to secure debt obligations in respect of money borrowed to enable the corporation to meet short-term operational requirements for liquid funds, but this is unlikely to apply to Transactions. Therefore, the Act does not allow the pledging of assets as security for obligations under Transactions.

(ii) **Insurance Companies.** Companies incorporated under the Corporations Act (Ontario) and governed by the Insurance Act (Ontario) are not prohibited from granting security interests with respect to their property, subject to any restrictions in their letters patent.

(iii) **Pension Plans.** The trustees of pension plans regulated by the Pension Benefits Act (Ontario) are prohibited by regulation from directly or indirectly pledging, mortgaging or hypothecating the assets of the pension fund, unless they are expressly permitted to do so by the regulations. Nothing in the regulations permits the granting of security for obligations incurred under Transactions.

The terms of the particular trust deed or plan may also restrict or prevent the trustee from exercising such a power or encumbering the trust assets in this manner. The trustee’s general obligation to act prudently in the administration of the trust will also impact on its decision with respect to the grant of security. A typical
trust deed will confer on the trustee the power to dispose of the trust assets and, in
the absence of any actual or constructive notice of a lack of power, third parties
dealing with the trustee can assume that it has the power to dispose of the assets.

(iv) Municipalities. The Municipal Act (Ontario) is silent as to whether
a municipality is authorized to grant security for its obligations under authorized
Transactions. In the absence of an express authorization there is significant doubt as
to the capacity to grant security.

(e) Quebec Entities

(ii) Loan and Trust Companies. Trust companies and savings
companies can be created in Quebec and are governed by the Act respecting Trust
Companies and Savings Companies (Quebec). Such companies may not pledge,
hypothecate or pawn their property or the property they hold in trust for the payment
of deposits, except for certain purposes, none of which apply to Transactions.

(ii) Insurance Companies. Security for Transactions is not permitted
in Quebec. The Act respecting Insurance (Quebec) provides that no insurer may grant
security on its property, except in order to secure a short-term loan to meet liquidity
needs or security on real estate. No insurer may issue bonds or other evidence of
indebtedness, except in order to secure short-term loans made to meet liquidity needs,
unless they are unsecured and stipulate that they will rank with other unsecured
evidence of indebtedness, but before subordinated shareholder loans. Any such
evidence of indebtedness must also comply with certain other terms and conditions
prescribed by regulations.

(iii) Pension Plans. The Supplemental Pension Plans Act (Quebec) and
the regulations thereunder are silent with respect to the capacity of a pension plan to
pledge its property.

(iv) Municipalities. Quebec civil law recognizes a distinction between
that property of a municipality which is in the "public domain" and that which is in the
"private domain". The former category of municipal property may not be alienated nor
may any privilege or security be granted in respect thereof. Property in the "public
domain" includes, pursuant to article 400 of the Civil Code, roads, public ways
maintained by the state, navigable and floatable rivers and streams and their banks,
the sea shores, lands reclaimed from the sea, ports and harbours and all lakes and
non-navigable and non-floatable rivers and streams and their banks bordering on lands
alienated by the Crown after February 9, 1918. Jurisprudence has at times also
included in the definition of "public domain" property municipal airports, incinerators,
parks, watercourses and aqueducts.
B. **Recommendations**

1. **Federal Entities**

   (a) **Federal Financial Institutions.** We understand that certain federal financial institutions have requested or intend to request that the Superintendent approve the granting of security by such institutions for a broad range of Transactions without reference to a particular Transaction. We would recommend that The Group of Thirty coordinate efforts with the various federal financial institutions through their representative bodies to obtain the Superintendent's approval to secure a wide list of Transactions, but with restrictions on the type or margin of security that can be granted.

   (b) **Federally Regulated Pension Funds.** We would not recommend any legislative amendments with respect to federally regulated pension plans.

2. **Alberta Entities**

   (a) **Loan and Trust Corporations.** We would recommend that Alberta enact regulations to the Loan and Trust Corporations Act (Alberta) to exempt certain Transactions from the prohibition on the grant of security. We would recommend that a wide list of Transactions be provided for, but with restrictions on the type or margin of security that can be granted.

   (b) **Insurance Companies.** We would recommend that Alberta enact amendments to the Insurance Act (Alberta) clarifying the ability of insurance companies to enter into and secure Transactions. We would recommend that a wide list of Transactions be provided for, but with restrictions on the type or margin of security that can be granted.

   (c) **Pension Funds.** We would not recommend any legislative amendments with respect to Alberta pension funds.

   (d) **Municipalities.** We would refer to section 3 of our suggested Model Legislation in Appendix "C" of this report.

3. **British Columbia Entities**

   (a) **Trust Companies; Insurance Companies and Other Financial Institutions.** We would not recommend any reform at this time.

   (b) **Pension Funds.** We would not recommend any legislative amendments with respect to British Columbia pension funds.
(c) **Municipalities.** We would not recommend any reform at this time.

4. **Ontario Entities.**

(a) **Loan and Trust Corporations.** We would recommend that the Loan and Trust Corporations Act (Ontario) be amended to allow for a regulatory exemption for Transactions from the prohibition on the pledging of assets. In the interests of uniformity, we would recommend that the types of Transactions and limitations and restrictions on the type or margin of security be coordinated with similar initiatives in the other jurisdictions.

(b) **Insurance Companies.** We would not recommend any reform at this time.

(c) **Pension Plans.** We recommend that the Ontario regulators be approached to enact a regulation to exempt certain Transactions from the prohibition on the grant of security in the regulations. We would recommend that a wide list of Transactions be provided for, but with restrictions on the type or margin of security that can be granted.

(d) **Municipalities.** We would refer to section 3 of our suggested Model Legislation in Appendix "C" of this report.

5. **Quebec Entities.**

(a) **Loan and Trust Companies.** We would recommend that the Act respecting Trust Companies and Savings Companies (Quebec) be amended to allow for a regulatory exemption for Transactions from the prohibition on the pledging of assets. In the interests of uniformity, we would recommend that the types of Transactions and limitations and restrictions on the type or margin of security be coordinated with similar initiatives in the other jurisdictions.

(b) **Insurance Companies.** We would recommend that the Act respecting Insurance (Quebec) be amended to provide a regulatory exemption for Transactions from the prohibition on the pledging of assets. In the interests of uniformity, we would recommend that the types of Transactions and limitations and restrictions on the type or margin of security be coordinated with similar initiatives in the other jurisdictions.

(c) **Pension Plans.** We would not recommend any reform at this time.

(d) **Municipalities.** We would not recommend any reform at this time.
IX. **WRITING REQUIREMENTS**

A. **Issues**

This part considers the requirements, if any, that the Master Agreement or confirmations of individual Transactions be in a particular written form, with respect to Transactions governed by the laws of Alberta, British Columbia, Ontario and Quebec. Provincial statutes may impose writing requirements for various different types of transactions. In none of the above jurisdictions is there any specific requirements that Transactions be in writing or in any particular written form. However, more general writing requirements exist in a number of jurisdictions that may, in certain circumstances, include Transactions within their scope.

1. **Ontario and Alberta**

Each of Alberta and Ontario is subject to a Statute of Frauds, in virtually identical terms, which imposes writing requirements with respect to certain types of contracts as a condition of enforceability. These provisions have potential application to Transactions in two respects; namely, to the extent that:

(a) the Transaction may not be fully performed within one year of the date of entering into the Transaction; or

(b) the Transaction involves a credit support document in the form of a guarantee.

(a) **Contracts Not Fully Performed Within One Year.** Section 4 of the Statute of Frauds provides, in part, that no action can be brought upon an agreement that is not to be performed within the space of one year from its making unless the agreement upon which the action is brought, or some memorandum or note of it is in writing and signed by the party against whom it is sought to enforce the agreement. If a contract is worded so as to show that the parties contemplated that it would have a duration of greater than one year, then even though it is possible that the agreement will come to an end sooner (e.g. through the application of a termination provision or the completion of all transactions) the statute will still apply. The matter is less clear where the contract is silent or ambiguous as to duration and it could possibly be performed within one year, but there is still a significant risk that such a contract would fall within the statute.

Although it may not be clear from its terms, it is often anticipated that a Master Agreement will govern the parties’ relationship for many years. Because the Master Agreement, although not a contract separate and apart from the Transactions entered into pursuant to it, is more than simply a document containing terms which
are to be incorporated into the individual Transactions, it is necessary, in our view, for any writing requirements to be met with respect to the Master Agreement, including properly authorized signatures.

Also, the date for performance of any specific Transaction may be more than one year from the date of the agreement. In many cases, the specific terms of a Transaction are agreed to orally between the parties. The Master Agreement provides (in section 9(e)) that the parties are legally bound by the terms of each Transaction from the moment they agree to those terms (whether orally or otherwise). Although the Transaction is valid from the time it is entered into, if it is not to be fully performed within one year, then it will not be enforceable until a subsequent written form of Confirmation is executed and delivered. The Master Agreement provides that the Confirmation be entered into as soon as practicable and this provision should be carefully adhered to for Transactions with Ontario and Alberta counterparties.

Not all of the terms must be in writing in order to meet the requirements of the Statute of Frauds. There need only be some note or memorandum, in any written form, of the essential terms of the agreement. What constitute the essential terms depends on the particular Transaction in issue. Essential terms with respect to a Transaction might include the effective date, the termination date, the notional or currency amount, the type and quantity of commodity (if relevant) and the rates or indices (if relevant).

The Master Agreement (section 9(e)(iii)) provides that a Confirmation may be executed and delivered by facsimile transmission or be created by an exchange of telexes or by an exchange of electronic messages on an electronic messaging system. No particular form of agreement, memorandum or note is required by the Statute of Frauds so long as the form is "written". The Interpretation Act (Ontario) provides that unless the context otherwise requires, the words "writing" and "written" includes words printed, painted, engraved, lithographed, photographed, or represented or reproduced by any other mode in a visible form. Similarly, the Interpretation Act (Alberta) provides that the words "writing" and "written" includes words represented or reproduced by any mode of representing or reproducing words in visible form. A telex or facsimile form of Master Agreement or Confirmation would therefore be admissible written evidence of those terms in an Ontario or Alberta court. Not being in a visible form, a tape recording of a conversation would not fall within such definitions, nor might an electronic message or electronic form of data recording. Although the Interpretation Act definitions are inclusive and not exhaustive, there is significant doubt that any non-visible form of recording would be sufficient to meet the writing requirement.

The Master Agreement also provides that the Confirmation can be executed in counterparts. The Statute of Frauds does not require that the
memorandum or note be signed by both parties, but only by the party against whom it is sought to enforce the agreement. Therefore, it is not significant for purposes of the statute that the signatures are executed in counterpart.

The agreement, memorandum or note must also be "signed" by the party against whom it is sought to enforce the agreement. The statute does not import any requirement that a signature take a specific form. It does not have to be an actual subscription of the party’s name; it may be a mark. Also, it probably does not have to be in writing, but may be printed or stamped anywhere on the document. Therefore, a Confirmation on the letterhead or printed form containing the party’s name would likely be "signed" by the party sending the Confirmation. A mechanical or facsimile signature is also likely to be accepted by the court as meeting the Statute of Frauds requirement. However, the most prudent course to adopt is for the written signature of a properly authorized agent of each party to appear on the Confirmation or Confirmations (where executed in counterparts).

(b) **Guarantees.** The same writing requirements apply to any contract of guarantee. Any credit support documents that are in the form of guarantees must meet these requirements.

In addition, it should be noted with respect to Alberta that the Guarantees Acknowledgement Act (Alberta) provides that where a guarantee is given by a person, not being a corporation, that guarantee will not have any effect unless that person appears before a notary public and has the notary public complete a statement in a form prescribed by regulation, which must be signed by that person as well. The Guarantees Acknowledgement Act (Alberta) will not impact on Transactions where the credit support provider is a corporation, which is usually the case.

2. **British Columbia**

British Columbia has repealed its Statute of Frauds and, consequently, there is no writing requirement generally applicable to Transactions. However, section 54(6) and (7) of the Law and Equity Act (British Columbia) provides as follows:

(6) A guarantee or indemnity is not enforceable unless

(a) it is evidenced by writing signed by, or by the agent of, the guarantor or indemnitor, or

(b) the alleged guarantor or indemnitor has done an act indicating that a guarantee or indemnity consistent with that alleged has been made.

(7) A writing can be sufficient for the purpose of this section even though a term is left out or is wrongly stated.
The Interpretation Act (British Columbia) defines "writing" as "... words printed, typewritten, painted, engraved, lithographed, photographed or represented or reproduced by any mode of representing or reproducing words in visible form". As a result, any credit support document for a Master Agreement or Transaction in the form of a guarantee must be evidenced by a writing or must be supported by some consistent act of the alleged guarantor.

3. Quebec

There is no legislative equivalent in Quebec to the Statute of Frauds. There are however provisions in the Civil Code and the Charter of the French Language which deal with the issue of writing and documentation.

Generally, contracts can be made in the Province of Quebec either orally or in writing. Where the contract clearly concerns "commercial matters", proof of the contract in court may be made by testimony. It is arguable that entities which have particular and limited statutory purposes do not engage in "commerce" and that, therefore, testimonial evidence as to the existence and contents of a contract would not be admissible against them. It must be noted, however, that Quebec’s current Civil Code will be replaced by a new Civil Code, which is currently expected to come into force in January 1994. The new Code will replace the concept of "commerce" with that of "enterprise", which is considerably wider. It is, therefore, likely that testimonial evidence of contracts would more easily be admitted under the new Code. A court can, in any case, accept an admission as to the existence of the contract or any other "commencement of proof in writing" in order to admit proof of the existence of a contract, both under the existing Code and the new Code. It is therefore highly preferable, although not essential to the validity of the contract, that each Master Agreement and each Transaction be evidenced in writing as soon as possible following agreement.

In order to ensure that a document constitutes a "writing" or a "commencement of proof in writing", it should generally be signed by all parties to the contract. Where only one party has signed, the writing may in some circumstances nonetheless constitute an acknowledgement of the writing by that party.

Various provisions of the Charter of French Language require that contracts must be drawn in the French language. Contracts pre-determined by one party and contracts containing printed standard clauses and related documents (commonly referred to as "adhesion contracts") must be drawn in French unless the parties expressly require otherwise. Consequently, any adhesion contract, which in our view would likely include a Master Agreement and confirmations of Transactions, executed in a language other than French in Quebec should contain a clause in both
French and such other language expressing the parties’ desire that the contract and all related documents be drawn up in such other language.

Whether or not the contract is an "adhesion contract", every contract executed in Quebec must be in French if one of the contracting parties is the Quebec Government, an organization the employees of which are considered Quebec civil servants, an organization at least half of the equity of which came from the Quebec consolidated revenue fund or a municipal or school organization. The circumstances of each contracting party located in Quebec should, therefore, be examined to determine whether it falls into any of these categories. In these cases, care should be taken to ensure either that the Master Agreement and each Transaction is in French or that they are fully executed outside of Quebec.

Under Quebec’s new Civil Code, provisions of adhesion contracts which are illegible or incomprehensible to a reasonable person will be void, as will exclusion clauses and obligations imposed in documents to which reference is made in a contract, unless the clause is expressly brought to the attention of the contracting party or unless the contracting party otherwise knew of it. It is as yet unclear what scope will be given to these provisions.

B. Recommendations

Occasionally, there are calls in Canada for reform or repeal of the Statute of Frauds. There are, however, no current legislative efforts seeking repeal of the law in either Ontario or Alberta. In our view, recommendations to the provincial authorities that they exempt Transactions from the scope of the statute are unlikely to be given priority. To the extent that the legislatures are inclined to do anything about the Statute of Frauds, they would likely consider its entire repeal. However, some impetus to repeal the Statute of Frauds might be provided by a request originating from The Group of Thirty to exempt Transactions.

X. ENFORCEABILITY OF TERMINATION AND NETTING PROVISIONS

A. Issues

This part considers the enforceability of the insolvency termination provisions (section 5) and the bilateral close-out netting provisions (section 6(e)) of the Master Agreement upon the insolvency of various entities in Canada.
1. **General**

(a) **Insolvency Regimes.** Enforceability of termination provisions depends upon the particular insolvency regime governing the insolvent counterparty. The particular regime applicable will depend upon the type of corporation under consideration and whether the corporation is being liquidated or is in the process of attempting a reorganization with its creditors. The potential liquidation regimes are:

(i) voluntary and involuntary bankruptcy under the **Bankruptcy and Insolvency Act** (Canada) (the "BIA");

(ii) liquidation under the **Winding-Up Act** (Canada) (the "WUA"); and

(iii) the appointment of a receiver by a secured creditor or the court.

The potential reorganization regimes are:

(iv) the filing of a proposal under the BIA;

(v) the filing of a plan of arrangement or proposal for a plan of arrangement under the **Companies’ Creditors Arrangement Act** (Canada) (the "CCAA"); and

(vi) reorganization by the Canada Deposit Insurance Corporation ("CDIC") under the **Canada Deposit Insurance Corporation Act** (Canada) ("CDIC Act").

There is a procedure for creditor sponsored reorganization under the WUA, but it is rarely, if ever, used.

(b) **Types of Entities Subject to Each Regime.** Banks, loan and trust corporations and insurance corporations carrying on operations in Canada are subject to the WUA; they are not subject to the provisions of the BIA. The WUA also applies to other corporations (except those incorporated under the **Canada Business Corporations Act**). Corporations are also subject to the BIA and it is the more popular statute for entities that are not financial institutions. Insolvent municipal corporations technically may be subject to the BIA, but this is unclear as insolvency of a municipality is a rare event in Canada. The CCAA provides a procedure for effecting a compromise or arrangement with creditors and it can be taken advantage of by any corporation (except banks, insurance companies, railways, and loan and trust corporations - although the CCAA appears to apply to provincial loan and trust corporations) with outstanding debt instruments issued under a trust deed. The trust deed requirement tends to be more illusory than real given the judicial sanction given
to trust deeds which are created simply to take advantage of the CCAA - so called "instant trust deeds". If the proposal procedures in the BIA fail to produce a compromise with creditors, then there is an automatic bankruptcy and consequent liquidation. The same is not true of the CCAA, but the admission of insolvency inherent in making a CCAA application will provide grounds for a bankruptcy or winding-up petition. The reorganization mechanism under the CDIC Act is only available at the instance of CDIC with respect to federal member institutions (e.g. banks) and, potentially, provincial member institutions.

Section 5(4)(vii)(4) of the Master Agreement is wide enough in scope to cover petitions, filings or applications under any of the above procedures.

2. **Enforceability of Termination Provisions**

Institution of the above proceedings does not result in an automatic termination of contracts with the insolvent counterparty.

**In Liquidation.** In a liquidation scenario, the insolvency representative (whether a trustee in bankruptcy under the BIA or liquidator under the WUA) generally obtains no higher rights with respect to the contract than the insolvent corporation had. The insolvency representative has no right to cancel the contract (although certain proceedings to enforce the contract are stayed). Although no particular provision of the BIA or the WUA so provides, the law supports that the insolvency representative has no right to keep in existence a contract which is terminated on the happening of the liquidation event. Although both the BIA and the WUA stay "proceedings" upon a petition being filed, these provisions would not likely apply to prevent either the elective or automatic termination of outstanding Transactions by the non-insolvent counterparty. To the extent that the Master Agreement provides that the termination occurs in the moment before the making of the petition, etc., the effectiveness of this timing is uncertain. However, this should not matter to the Canadian liquidation analysis since termination after the filing is likely permitted.

**In Reorganization.** There are provisions in the BIA that prevent the termination of contracts upon the filing of a proposal for creditor reorganization (notwithstanding an automatic termination provision). However, these provisions expressly exclude "eligible financial contracts", which is very widely defined and would include most if not all Transactions. There are similar provisions in the CDIC Act, which Act applies to federal deposit taking institutions and to provincial deposit taking institutions if there is an agreement with the province for the Act to apply. These provisions will be triggered when CDIC is involved in effecting a restructuring of the institution. These provisions of the BIA and the CDIC Act do not, however, entitle parties to eligible financial contracts to exercise rights under security arrangements to realize on collateral outside the statutory stay provisions, nor do they
expressly protect collateral transfers in good faith under an eligible financial contract from the preference provisions of these or other statutes.

The CCAA also arguably permits the court to grant a stay that would prevent the termination of contracts. A stay is typically granted on the application of the debtor without notice of the proceeding being given to creditors, and, consequently, generally has as wide an application as the debtor desires it to have. Unlike the BIA and the CDIC Act, the CCAA contains no express exclusion for "eligible financial contracts". The CCAA is quite skeletal and so allows the parties ultimate flexibility in working out an arrangement. To date there is no established practice for dealing with outstanding Transactions, although there is some precedent for the grant of an order lifting the stay with respect to Transactions and allowing their termination as of the date of the original stay order. The court is also likely to be influenced to lift the stay order by the analogous provisions in the CDIC Act and the BIA. The selection of the Automatic Early Termination option arguably provides the counterparty with an additional argument against the stay since the court only has jurisdiction to stay "proceedings". As Automatic Early Termination involves no action on the part of the counterparty, it is less likely to be viewed as a "proceeding" than an elected termination. Even so, Automatic Early Termination is not certain to protect against a stay order. Being permitted to terminate is particularly important in the CCAA context, not only because of timing concerns, but because otherwise the solvent party may be compromised with respect to outstanding Unpaid Amounts through the majority vote of other creditors in its class and be forced to maintain the existence of the other Transactions going forward.

Termination provisions with respect to Transactions are thought to be enforceable in bankruptcy and insolvency proceedings in Canada, except, perhaps, proceedings under the CCAA, in which instance the selection of Automatic Early Termination may provide an advantage.

3. **Enforceability of Netting Provisions**

In our view, a Master Agreement and the Transactions that relate to it would be treated as a single agreement and, consequently, an insolvency representative would not be entitled to maintain the existence of some Transactions while terminating others. The bilateral netting of amounts owing or owed under Transactions relating to one Master Agreement would be enforced. It is important in this respect that a Master Agreement that contemplates physical delivery of a commodity replace any delivery obligations upon termination with obligations to pay cash amounts in lieu of delivery. The CDIC Act and the BIA proposal provisions (discussed above) both expressly recognize the validity of a netting provision and allow for its operation. The liquidation provisions of the BIA and the WUA do not expressly recognize the validity of netting provisions, but a trustee or liquidator can
obtain no higher rights than the bankrupt and, so, would be subject to the single agreement characterization. They also each provide for the setting off of mutual liquidated debts upon liquidation.

It is also our view that both the Loss and Market Quotations measures of damages calculation in the Master Agreement would be enforceable. The full two-way payments method of calculating damages would also be enforceable. Although it is arguable that the limited two-way payments method could, in certain circumstances, constitute a forfeiture of property, and would consequently not be enforceable in bankruptcy or liquidation, we are of the view that this argument would not prove successful.

B. Recommendations

The only significant enforceability concern with respect to the insolvency termination and bilateral close-out netting provisions of the Master Agreement lies with the CCAA creditor reorganization provisions. As stated above, it is uncertain as to whether termination will be permitted in this case. The new proposal (and eligible financial contract) provisions of the BIA were enacted in November 1992 and, at that time, it was determined that in three years time the federal government would review whether there was a continued need for the CCAA. We understand that the Canadian government is not predisposed to amend the CCAA until that time for review arrives. However, The Group of Thirty should advise the Canadian government of the need for an amendment, to allow termination of Transactions, as soon as possible.
Appendix "A"
Federal and Provincial Sovereigns

A. Canada: Model Amendment to Financial Administration Act (Canada)

Authorized Transactions

1. (1) Without limiting an authority given in this Act, any other Act or otherwise, but subject to any restriction, limitation or condition prescribed under section (2), the Minister may enter into the following agreements on behalf of the government:

   (a) a currency or interest rate swap agreement;
   (b) a basis swap agreement;
   (c) a spot, future, forward or other foreign exchange agreement;
   (d) a cap, collar or floor transaction;
   (e) a commodity swap;
   (f) a forward rate agreement;
   (g) a repurchase or reverse repurchase agreement;
   (h) a spot, future, forward or other commodity contract;
   (i) an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities;
   (j) any derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in paragraphs (a) to (i);
   (k) any master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j);
(l) a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (k); or

(m) any other financial agreements as may be prescribed by regulation.

(2) The Governor in Council may make regulations,

(a) establishing any conditions under which the Minister may exercise the powers described in section (1);

(b) prescribing the persons with whom the Minister may enter into agreements under section (1); and

(c) prescribing the currencies in which the Minister may enter into agreements under section (1).

Delegation of Minister’s Authority

2. (1) The Minister may authorize in writing an employee of the Department of Finance, or of any other department named in Schedule 1, to do any act or thing that the Minister is required or permitted to do under section 1 or any regulation under section 1 and the power to make an authorization under this section.

(2) An authorization given under section (1) may be general or applicable to a particular case and may specify an employee by the employee’s personal name or by the name of the employee’s office.

(3) An act or thing done or document or instrument executed or signed pursuant to an authorization given under section (1) has the same effect as if the act or thing were done or the document or instrument were executed or signed by the Minister.

(4) The Minister may authorize in writing an employee of the department of finance, or of any other department named in Schedule 1, to exercise the Minister’s powers under section (1) subject to any conditions prescribed by the Minister, and in that case sections (2) to (4) apply to an authorization given by the employee pursuant to section (1) to the same extent as though that authorization had been given by the Minister.
Consolidated Reserve Fund

3. The consolidated revenue fund shall be permanently charged with all amounts required to be paid by the government in respect of an agreement under section 1.

Validity of Transaction

4. (1) Notwithstanding the failure by the Minister or a person authorized under section 2 to comply with the provisions of this Act or the regulations, every agreement to which section 1 applies is valid, and its validity may not be contested by the Crown if the documents relating to it bear the signature of the Minister or a person authorized under section 2.

(2) A person that enters into an agreement to which section 1 applies may rely on a representation by the Minister or a person authorized under section 2 that he or she is authorized to enter into, execute or sign such agreement on behalf of the Crown.

(3) Sections (1) and (2) do not apply if

(a) the person entering into the agreement has actual knowledge of non-compliance with the Act or regulations, that the agreement is not valid or that the Minister or a person authorized under section 2 does not have the authority to enter into, execute or sign such agreement on behalf of the Crown; or

(b) the cause of the invalidity can be established by the terms of the transaction.

(4) Any agreement to which section 1(1) applies, but entered into before the date on which this section comes into force, is valid from the date of the agreement, and its validity may not be contested by the Crown if it could not be contested if entered into on or after such date.
Appendix "B"
Public Sector Bodies

Model Provisions

1. For the purposes of this Part, "public sector body" means a body prescribed by regulation under section 2(2) of this Act.

2. (1) Without limiting an authority given in this Act, any other Act or otherwise, but subject to any restriction, limitation or condition prescribed under sections (2) or (3), a public sector body may enter into the following agreements:

(a) a currency or interest rate swap agreement;
(b) a basis swap agreement;
(c) a spot, future, forward or other foreign exchange agreement;
(d) a cap, collar or floor transaction;
(e) a commodity swap;
(f) a forward rate agreement;
(g) a repurchase or reverse repurchase agreement;
(h) a spot, future, forward or other commodity contract;
(i) an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities;
(j) any derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in paragraphs (a) to (i);
(k) any master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j);
(l) a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (k); or
(m) any other financial agreements as may be prescribed by regulation.
(2) The Governor in Council may make regulations,

(a) prescribing public sector bodies which may exercise the powers described in section (1);

(b) establishing any conditions under which the public sector body or bodies may exercise the powers described in section (1);

(c) prescribing the persons with whom the public sector body or bodies may enter into agreements under section (1);

(d) prescribing the currencies in which the public sector body or bodies may enter into agreements under section (1);

(e) requiring a public sector body that has invested in securities issued in a foreign currency to minimize costs or counteract the risk associated with currency fluctuations in the manner prescribed; and

(f) exempting one or more public sector bodies from any of the restrictions, limitations or conditions prescribed.

(3) No public sector body shall enter into any agreement pursuant to section (1) other than for the purpose of managing an interest rate, currency, commodity price, investment or other similar risk that arises in connection with, or incidental to, the activities of the public sector body.

(4) Transactions carried out within the framework of a program established by a public sector body and approved by the Governor in Council are not subject to any restriction, limit or condition prescribed under section (2), except to the extent set out in the program, where the program establishes the principal compulsory characteristics of the transactions and limits the financial commitments which may result from them.

3. In connection with entering into any agreement under section 2(1), but subject to any limitations prescribed under section 2(2), a public sector body may enter into credit enhancement or liquidity agreements with such payment, security, default, remedy, and other terms and conditions as the public sector body determines necessary or desirable in connection with, or incidental to, the conduct of its activities.
4. (1) Notwithstanding the failure of the public sector body or any of its employees or other agents to comply with the provisions of this Act or the regulations, every agreement to which section 2(1) applies is valid, and its validity may not be contested by the public sector body if the documents relating to it bear the signature of a qualified representative of the public sector body.

   (2) A person that enters into an agreement to which section 2(1) applies may rely on a representation by or on behalf of the public sector body that it is authorized to enter into, execute or sign such agreement either on its own behalf or as agent of the Crown, as the case may be.

   (3) Sections (1) and (2) do not apply if

      (a) the person entering into the agreement has actual knowledge of non-compliance with the Act or regulations, that the agreement is not valid, or that the person entering into, executing or signing such agreement is not properly authorized to enter into, execute or sign the agreement on behalf of the public sector body; or

      (b) the cause of the invalidity can be established by the terms of the transaction.

   (4) Any agreement to which section 2(1) applies, but entered into before the date on which this section comes into force, is valid from the date of the agreement, and its validity may not be contested by the public sector body, if its validity could not be contested if entered into on or after such date.

5. The consolidated revenue fund shall be permanently charged with all amounts required to be paid by the government in respect of an agreement entered into by a public sector body as agent of the Crown under section 2(1).
Appendix "C"
Municipalities

Model Provisions

1. For the purposes of this Part, "prescribed municipality" means the municipalities prescribed by regulation under section 2(2)(a) of this Act.

2. (1) Subject to any restriction, limitation or condition prescribed under section (2), a prescribed municipality may enter into the following agreements:

   (a) a currency or interest rate swap agreement;

   (b) a basis swap agreement;

   (c) a spot, future, forward or other foreign exchange agreement;

   (d) a cap, collar or floor transaction;

   (e) a commodity swap;

   (f) a forward rate agreement;

   (g) a repurchase or reverse repurchase agreement;

   (h) a spot, future, forward or other commodity contract;

   (i) an agreement to buy, sell, borrow or lend securities, to clear or settle securities transactions or to act as a depository for securities;

   (j) any derivative, combination or option in respect of, or agreement similar to, an agreement or contract referred to in paragraphs (a) to (i);

   (k) any master agreement in respect of any agreement or contract referred to in paragraphs (a) to (j);

   (l) a guarantee of the liabilities under an agreement or contract referred to in paragraphs (a) to (k); or
(k) any other financial agreement as may be prescribed by regulation.

(2) The Governor in Council may make regulations,

(a) prescribing municipalities, including regional, metropolitan and district municipalities, or classes of municipalities which may exercise the powers described in section (1);

(b) establishing any conditions under which prescribed municipalities may exercise the powers described in section (1);

(c) prescribing the persons with whom prescribed municipalities may enter into agreements or transactions under section (1);

(d) prescribing the currencies in which prescribed municipalities may enter into agreements or transactions under section (1);

(e) requiring a prescribed municipality that has invested in securities issued in a foreign currency to minimize costs or counteract the risk associated with currency fluctuations in the manner prescribed; and

(f) exempting one or several prescribed municipalities, or a class of prescribed municipalities from any of the restrictions, limitations or conditions prescribed.

(3) No prescribed municipality shall enter into any agreement pursuant to section (1) other than for the purpose of managing an interest rate, currency, commodity price, investment or other similar risk that arises in connection with, or incidental to, the activities of the prescribed municipality.

(4) Transactions carried out within the framework of a program established by a prescribed municipality and approved by the Minister of Municipal Affairs are not subject to any restriction, limit or condition prescribed under section (2), except to the extent set out in the program, where the program establishes the principal compulsory characteristics of the transactions and limits the financial commitments which may result from them.

3. In connection with any agreement authorized by section 2(1), but subject to any limitations prescribed under section 2(2), a prescribed municipality may enter into credit enhancement or liquidity agreements with such payment, security, default,
remedy, and other terms and conditions as the prescribed municipality determines necessary or desirable in connection with, or incidental, to the conduct of its activities.

4. (1) Notwithstanding the failure of a prescribed municipality or any of its employees or other agents to comply with the provisions of the Act or the regulations, every agreement to which section 2(1) applies is valid and its validity may not be contested by the prescribed municipality if the documents bear the signature of a qualified representative of the prescribed municipality.

(2) A person that enters into an agreement to which section 2(1) applies may rely on a representation by or on behalf of the prescribed municipality that it is authorized to enter into, execute or sign such agreement.

(3) Sections (1) and (2) do not apply if

(a) the person entering into the agreement has actual knowledge of non-compliance with the Act or regulations, that the agreement is not valid, or that the person entering into, executing or signing such agreement is not properly authorized to enter into, execute or sign the agreement on behalf of the municipality; or

(b) the cause of the invalidity can be established by the terms of the transaction.

(4) Any agreement to which section 2(1) applies, but entered into on or before the date on which this section comes into force, is valid from the date of the agreement, and its validity may not be contested by the prescribed municipality, if its validity could not be contested if entered into on or after such date.
Global Derivatives Study Group

Enforceability Survey — England

prepared by Linklaters & Paines

May 12, 1993
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1. INTRODUCTION

The Enforceability Subcommittee established by The Group of Thirty Study Group in relation to its Global Derivatives Study has, in its Working Paper, identified a number of enforceability risks that can occur in relation to over-the-counter derivatives transactions. This Memorandum, which relates to the position under English law, (a) deals primarily with the issue of the capacity of certain types of entity to enter into such transactions, as well as considering (more briefly) (b) the enforceability of "close-out netting", (c) whether there are any requirements that certain formalities be complied with for the creation of an enforceable contract, (d) whether over-the-counter derivatives transactions constitute unenforceable gaming or wagering contracts and (e) certain areas of uncertainty that may be encountered in relation to arrangements for the giving of security for a party's obligations in relation to over-the-counter derivatives transactions.

2. CAPACITY TO ENTER INTO DERIVATIVES TRANSACTIONS

2.1 Introduction

The range of entities using derivatives transactions for financial risk management purposes has widened considerably in recent years. However, varying degrees of uncertainty surround the basic question of the capacity of some of those entities to enter into derivatives transactions. The problem stems in large part from the fact that legislation and/or constitutional documents relating to the business objects and other powers of such entities have very often lagged behind the rapid development of the derivatives market. This uncertainty was highlighted in England by the House of Lords judgment in January 1991 in the London Borough of Hammersmith and Fulham case to the effect that the local authority in question, the London Borough of Hammersmith and Fulham, lacked the necessary vires or capacity to enter into swap and other derivatives transactions and that the transactions it had entered into were therefore void and unenforceable. (The counterparties can claim restitutionary remedies, but these are uncertain in their scope). This case has also focussed attention on similar concerns which exist in many other legal jurisdictions.

There are a number of consequences which flow from any uncertainty relating to capacity. Some of the consequences affect only the type of entity whose capacity to enter into derivatives transactions is called into question. For instance, such entities (or even entities which are legally quite distinct but which are nonetheless popularly identified as being similar to such entities) may encounter great difficulty in finding counterparties prepared to enter into such transactions with them or may find that the cost – or in extreme circumstances, the possibility – of doing so is distorted by concerns relating to the capacity issue. They may therefore be denied access (or granted only restricted access) to the use of such transactions for the prudent management of financial risk. Other consequences flowing from any uncertainty relating to capacity affect the market more generally – the distortion of competition in the market, the creation of uncertainty in the market generally as to whether
transactions entered into in good faith will be upheld etc. It is against this background, that it is important to establish certainty in relation to the capacity of entities established under English law to enter into derivatives transactions.

Set out below is a discussion of the position relating to certain entities established under English law, namely companies, building societies, insurance companies, unit trusts and pension funds. The discussion focuses on the capacity issue (and, in certain cases, the related question of the authority of individual representatives to bind the entity in question). It is important nonetheless to appreciate that there are other statutory or regulatory matters affecting these entities which regulate the conduct of their business (such as prudent/efficient management guidelines laid down by regulatory bodies, requirements to maintain certain margins of solvency etc) but which are not discussed in this Memorandum.

2.2 **Companies Incorporated Under the Companies Acts**

2.2.1 **Memorandum of Association**: A company's objects and powers depend upon its Memorandum of Association. Usually these are drafted in very wide terms and would permit the company to effect derivatives transactions for purposes associated with its main objects or powers. Accordingly, derivatives transactions could be entered into for hedging against risks inherent in the company's business, e.g. interest rate and currency fluctuations, and for efficient management of surplus funds temporarily held. On the other hand, a derivatives trading programme for purely speculative purposes, unconnected with other business objectives of the company, is likely to be outside the terms of its Memorandum and hence ultra vires.

2.2.2 **Section 35 Companies Act 1985**: However, as far as third parties dealing with companies incorporated under the Companies Acts are concerned, this limitation is generally speaking no longer relevant since, as a result of Section 35 of the Companies Act 1985, the validity of an act done by a company may not be called into question on the grounds of lack of capacity by reason of anything in the company's Memorandum of Association. Accordingly, a derivatives transaction with a company incorporated under one of the Companies Acts will not be void on the grounds of ultra vires.

2.2.3 **Authority of individual representatives**: The protection afforded by the Companies Act, however, goes even further than protection against problems arising purely out of a transaction being ultra vires a company. There are other grounds upon which a transaction may fail to bind a company even though the transaction itself is intra vires the company, namely if the representative who purports to enter into it on behalf of the company does not have the necessary authority (actual or ostensible) to do so. A considerable degree of protection is provided by Section 35A of the Companies Act 1985 against problems relating to the authority of individuals to bind a company. Section 35A provides that, in favour of a person dealing with a company in good faith, the power of the board of directors to bind the company, or to authorise others to do so, is deemed to be free of any limitation under the company's Memorandum and Articles of Association. The effect is similar to the protection
given in Section 35 against ultra vires acts, although there are two limitations:

(a) It only applies if the third party is dealing in "good faith". At present, the exact meaning of this term is not clear, although it is clear that mere failure to check the company's Memorandum and Articles (whether deliberately or not) is not bad faith. Nor is it bad faith for a third party to enter into a transaction with a company knowing that the directors have exceeded their powers under the Memorandum and Articles. The legislation also provides that a person shall be presumed to have acted in good faith unless the contrary is proved.

(b) The provision relates only to the power of the board of directors to bind the company or authorise others to do so. If the third party is dealing with an individual director, or an employee who has been authorised to enter into the transaction by such a director, no protection would be given. Accordingly, before entering into a transaction with a company a counterparty will therefore often require production of a certified copy of the board resolution authorising the transaction to be entered into (or authorising an individual to determine whether or not to enter into it).

The protection afforded by Sections 35 and 35A is supplemented further by Section 35B which provides that a party dealing with a company is not bound to enquire as to whether it is permitted by the company's Memorandum or as to any limitation on the powers of the board of directors to bind the company or authorise others to do so.

2.2.4 Safe Harbour: The effect of these Sections is to abolish the ultra vires doctrine as regards third parties so that transactions entered into by such persons with companies incorporated under the Companies Acts are within a safe harbour and are no longer put at risk of unenforceability by reason of concerns relating to ultra vires. These Sections also restrict, for the benefit of third parties dealing with a company in good faith, problems regarding the authority of individuals to bind companies. Although one or two minor uncertainties remain, these are unlikely to cause major problems and, as a general principle, difficulties are unlikely to arise in practice. As will be discussed later in this Memorandum, the Companies Act model is one which could be recommended in relation to other entities.

2.3 Building Societies

2.3.1 Section 23 Building Societies Act 1986: Building societies are statutory corporations whose powers derive entirely from the Building Societies Act 1986. Section 23 of this Act states that:

"A building society may effect contracts of a prescribed description for the purpose of reducing the risk of loss arising from changes in interest rates, currency rates or other factors of a prescribed description which affect its business".

The powers conferred by Section 23 are only available to building
societies which have expressly adopted them. In addition, in order to exercise these powers, building societies must in certain cases, at the time of entering into a relevant transaction, meet a "qualifying asset holding" test (currently, total commercial assets, as shown in its annual accounts for the previous financial year, of not less than £100,000,000). Broadly speaking, this test does not apply in the case of interest rate swaps, as long as the rates in question are "interest rates" in the narrow sense (i.e. excluding rates linked to indices or the value of property of any kind).

2.3.2 "Prescribed Contracts": The types of hedging transactions into which building societies may enter are set out in subordinate legislation (currently The Building Societies (Prescribed Contracts) Order 1993) and, at present, include most types of currency and/or interest rate swaps, equity-, commodity- and index-linked (cash difference) transactions, swap option contracts (if a society has the right to enter into the underlying swap - but not if it can be required to accept cash settlement in lieu) and interest rate and currency forward and futures contracts. The subordinate legislation is fairly widely worded and generally it is not difficult to establish whether a particular type of transaction falls within the scope of transactions permitted by the subordinate legislation, although there may on occasions be transactions in relation to which questions arise.

2.3.3 "Purpose Test": Whilst the detailed wording of the subordinate legislation may cause some minor difficulties, the major difficulty in relation to building societies is that Section 23 contains a "purpose test" (see paragraph 2.3.1). The test is probably a subjective one - i.e. it depends upon the actual intentions of its personnel and it is neither sufficient that a transaction in fact has, nor necessarily fatal that it has not, the effect of reducing a risk of loss arising from the factors mentioned in Section 23. The effect of a building society having an improper purpose would be that the transaction would be ultra vires and void.

In some cases, it will be fairly obvious that a particular transaction is unlikely to reduce the risk of loss for a building society and that therefore the subjective test is unlikely to be satisfied. For instance, it is unlikely in most circumstances that a building society could be said to have the purpose of reducing the risk of loss by selling a cap or floor since, by their nature, such transactions tend (by themselves) to create a risk of loss to the seller of the transaction. In many other cases, however, it should be possible to reduce the ultra vires risk to an acceptable level by ensuring that the transaction in question falls within the Prescribed Contracts Order referred to above and obtaining comfort from the building society's relevant personnel as to its purpose in entering into the transaction. The level of comfort which is required will be a matter of commercial judgment in the relevant circumstances. Often a counterparty will seek to obtain additional representations from the building society which are designed to ascertain the relevant purpose of the building society in entering into the transaction. Such representations may well help to focus attention on, and mitigate, the vires problem and could, in certain circumstances, establish an independent right of action if the building society did not have the requisite purpose. However, ultimately, the difficulty remains
that if such "representations" turn out to be false – because the building society had the "wrong" purpose – the transaction will be void and unenforceable.

Accordingly, whatever the degree of comfort on a practical level which a counterparty may obtain from a building society, the risk of the hedging "purpose test" not being satisfied is a risk which is allocated by the Building Societies Act to the counterparty and is therefore a risk which cannot be completely eliminated. A counterparty acting in good faith cannot enforce a swap transaction with a building society in respect of which the "purpose test" is not satisfied.

2.4 Insurance Companies

2.4.1 Constitution of insurance companies: Although some of the older established insurance companies (e.g. mutual life assurance companies) may have been created by special Act of Parliament, most insurance companies are incorporated under the Companies Act 1985 and its predecessors. Accordingly, third parties dealing with them enjoy the safe harbour protection afforded by Section 35 of the Companies Act 1985 in relation to the ultra vires doctrine as well as the benefit of Section 35A as regards the restriction of problems regarding the ability of individual representatives to bind their companies (see paragraph 2.2).

Certain insurance companies are, however, incorporated under a private Act of Parliament and their capacity to enter into derivatives or other transactions must be verified by reference to that private Act of Parliament (as must the possibility of any safe harbour protection for third parties against the full rigours of the ultra vires doctrine). The constitutional documents should also be checked to determine what procedures are necessary to ensure that the transaction has been properly authorised and confirmation should be obtained that these have been followed.

2.4.2 Insurance Companies Act 1982: In addition to considerations generally applicable to companies, additional considerations are relevant in relation to insurance companies. The Insurance Companies Act 1982 ("ICA") provides for authorisation for those wishing to carry on insurance business and regulates their activities. The ICA imposes certain restrictions upon insurance companies which may have an impact in relation to derivatives transactions.

From the standpoint of capacity to enter into derivatives transactions, Section 16 of the ICA is relevant. This section provides that an insurance company shall not carry on any activities otherwise than in connection with or for the purposes of its insurance business. However, the ICA makes no provision for the civil consequences of a breach of Section 16. Whilst it would seem unlikely that breach of the section would result in the relevant contract being void, there is no authority on this point and uncertainty therefore exists. It would therefore be prudent for any counterparty to ensure that an insurance company with which it intended to contract is acting for the purposes of its insurance business. But, it is not entirely clear what this entails. It is clearly the case that the purposes of an insurance business include
accepting insurance premiums and investing them in a variety of assets and it follows that to invest in derivatives products generally would therefore be permitted. But, on a more detailed level, it is arguable that the writing of, for instance, an option does not amount to investing but constitutes a separate business as it is essentially the taking on of a non-insurance obligation in return for payment. It is therefore not possible always to be certain that the relevant purpose test is satisfied.

2.5 **Unit Trusts and other Investment Vehicles**

2.5.1 **General:** English unit trusts are formed either as authorised unit trusts (which are regulated by the Securities and Investments Board ("SIB") pursuant to the Financial Services Act 1986) or unauthorised unit trusts (which are largely unregulated and therefore not fully marketable on a retail basis), but the same legal principles apply to both authorised and unauthorised unit trusts when determining their capacity to enter into derivatives transactions.

Most other English investment vehicles are formed as companies (for example, investment trust companies), and the basic considerations in determining their capacity to enter into derivatives transactions is no different from the considerations applicable to any company (see paragraph 2.2). The only other form of investment vehicle likely to be established in England would be an investment vehicle in the form of a limited partnership.

2.5.2 **Unit Trusts:**

(a) A unit trust is not a distinct legal entity in itself and is therefore not able as an entity to enter into contractual arrangements such as derivatives contracts. All contractual arrangements must be entered into by the trustee of the unit trust (either directly or through the agency of a third party such as an investment manager). The trustee is commonly a corporate trustee incorporated under the Companies Act. All such contractual positions and other investments would be held on trust by the trustee for investors in the unit trust.

The power of the trustee to enter into derivatives transactions will derive from the terms of the trust. In the case of an unauthorised unit trust, these terms will generally be contained in the trust deed constituting the unit trust. In the case of an authorised unit trust, the power of the trustee to engage in derivatives transactions again derives from the trust deed, but also derives from those parts of the SIB's Regulated Schemes Regulations that deal with the powers of unit trusts. These Regulations enable trustees to enter into derivatives transactions for the account of a unit trust in the following circumstances:-

(i) Most types of authorised unit trust may use derivatives instruments for the purposes of "Efficient Portfolio Management". In brief, this enables the use of derivatives instruments for the purposes of reducing or eliminating risk, reducing cost or enhancing performance (through arbitrage,
covered option writing or stocklending), but their use will generally be ancillary to the main investment objective of the trust. In particular, the relevant unit trust manager must reasonably regard the particular transaction as economically appropriate to reduce risk or cost arising by reason of asset or sectoral price fluctuations or interest or exchange fluctuations, or by reason of an intended exposure switch or in relation to short term cashflow. Alternatively, the manager must reasonably believe that the transaction is certain to result in arbitrage profits or option premium receipts. Within these criteria, the Regulations lay down the particular types of derivatives that may be employed. All transactions effected for efficient management purposes must be fully covered by other property in the unit trust fund (and in certain limited circumstances one derivatives transaction can be treated as providing cover for another).

(ii) Unit trusts which are authorised as Futures and Options Funds ("FOFs") are allowed to use derivatives instruments (mainly exchange-traded options, futures and contracts for differences, but also certain off-exchange options) as an inherent part of their investment policy but their use is restricted. Derivatives positions will generally need to be covered.

(iii) Finally, there are Geared Futures and Options Funds ("GFOFs") which may take certain uncovered positions, subject to a maximum of 20% of the Fund being paid out as margin or premium.

(b) The position as regards capacity, power and authority for unit trusts to enter into derivatives transactions is an extremely complicated area of the law and the discussion which follows is only a brief summary of certain of the issues that arise.

From the perspective of a counterparty dealing (indirectly) with a unit trust, the concerns relating to capacity are not quite the same as those encountered when dealing with, say, a building society. The counterparty will, as a basic requirement, wish to be satisfied when entering into a derivatives transaction with the trustee that the trustee has the capacity to act as a trustee of trusts and, indeed, to enter into the relevant derivatives transaction. In the case of a corporate trustee, the trustee will either have such capacity or the counterparty will be able to claim the protection of Section 35 Companies Act 1985 (see paragraph 2.2). In this sense, there is unlikely to be any issue of corporate capacity which causes a problem.

However, there is an analogous problem - that of the authority of the trustee under the terms of the relevant trust to enter into derivatives transactions for the account of the relevant unit trust. If the trustee enters into a derivatives transaction, the trustee will be personally liable as principal to meet the obligations as counterparty, even if the trustee is acting outside the terms of the relevant trust deed or the SIB Regulations.
However — and this is the critical factor — if the trustee is acting outside the scope of its powers contained in the trust deed or the Regulations or if the trustee is exercising its powers in an improper way having regard to its fiduciary duties as a trustee, then the trustee will not be entitled to use the trust's assets (by way of a right of indemnity) to meet the personal liabilities it has incurred to the counterparty (which the trustee would otherwise be entitled to do if it had been acting within its powers etc). (There may also be other factors, relating more to the trustee than to the nature of the transaction as a derivatives transaction, which limit the ability of the trustee to claim such an indemnity). Likewise, any counterparty cannot be subrogated to the trustee's rights against the assets of the trust if the trustee is acting outside its powers or within them but in an improper way. Accordingly, although the relevant transaction will be within the capacity of the trustee (as an entity distinct from the unit trust) and its validity will not be affected, the problem which arises if the trustee is either acting beyond its powers under the trust deed or the SIB Regulations or within them but in an improper way is that the assets available to meet any liabilities of the trustee may well be very different from those envisaged by the counterparty, thereby fundamentally altering the credit risk involved.

In practice, while it may be possible to discover whether or not as a general matter the trustee has power to enter into the transaction (by perusing the trust deed), it is likely to be extremely difficult for a counterparty to be able to satisfy itself that the trustee is properly exercising its powers (and can therefore claim an indemnity out of the trust's assets). This is because the question of whether or not it is appropriate for a trustee to enter into any particular derivatives transaction may depend upon the size of the trust and the nature of the other investments held which will, of course, vary on a daily basis. In particular, in many instances, a derivatives instrument may be acquired but only if it is covered or matched by an off-setting position. Unless a counterparty has access to the details of the trust's portfolio, it will not be possible for it to check that any particular transaction is a proper exercise of the power of the trustee. There is no equivalent to the concept of "ostensible" or apparent authority that a director has when dealing for his company.

It may be that a counterparty may be satisfied with a trustee's credit risk and may not be concerned as to whether or not it would have access to the assets of the trust. Indeed, the trustees of many English unit trusts are the big clearing banks, whose credit risk may be such that a counterparty would not concern itself with whether or not it would have direct access to the assets of the trust. Nonetheless, the legal position is clearly unsatisfactory.

(c) An alternative method of entering into contractual arrangements is for the trustee to enter into such arrangements through the agency (disclosed or undisclosed) of a third party investment manager. The investment manager will be the entity dealing, on a day to day basis, with counterparties. In practice, many counterparties may prefer to deal with the investment manager as
principal since they will be familiar with that party (and the credit and settlement risks involved). It is therefore not uncommon for an investment manager to trade as principal (or undisclosed agent), in which case the counterparty risk will be with the investment manager. In such cases, the counterparty need not concern itself with the capacity or power of the trustee (that will be a concern only for the investment manager as regards its own position vis-a-vis the trustee). The counterparty need only be concerned that the investment manager itself has the capacity to enter into the relevant transaction and, on the likely assumption that the investment manager is a company incorporated under the Companies Act, this is unlikely to be a problem (see paragraph 2.2).

On other occasions, the investment manager will enter into transactions in the capacity as disclosed agent for the trustee. In such case, the counterparty will need to be satisfied about the corporate capacity and the trustee powers of the trustee if it is not to find itself merely taking a credit risk solely on the trustee rather than also on the assets of the unit trust. As already discussed, although it may be possible to ascertain the corporate capacity and trustee powers of the trustee, it is very difficult in practice to ascertain if the trustee is properly exercising its powers. In addition, the counterparty will need to ensure that the investment manager has the necessary authority to enter into transactions on behalf of the trustee and in this context there is no equivalent of Sections 35A and 35B of the Companies Act 1985 to provide any protection in this regard.

(d) In summary, the position in relation to unit trusts is unsatisfactory and whilst, in practice, there may be fewer practical difficulties than theoretical difficulties, there is undoubtedly a need for greater certainty and simplification in this area of the law.

(e) It is however worth mentioning that the United Kingdom is currently reviewing a proposal to allow the creation of open-ended investment companies alongside certain types of unit trust. It may be some time before these proposals come to fruition but, if and when they do, the use of a corporate vehicle will remove many of the problems for counterparties that dealing with unit trusts currently poses.

2.5.3 Limited Partnerships: The only other form of investment vehicle likely to be established in England would be in the form of a limited partnership. As with unit trusts, a partnership is not a legal entity in itself and any contractual arrangement with a counterparty is deemed to be a contract with each individual partn, under which each such partner is jointly and severally liable. At a practical level, the general partner, either directly or through an agent such as an investment manager, will be the party contracting with a counterparty. The counterparty will need to be satisfied, through inspection of the relevant partnership deed, that the general partner has the necessary power and authority to enter into derivatives transactions on behalf of the partnership. The same types of consideration therefore apply in
relation to the capacity of limited partnerships to enter into derivatives transactions as apply to unit trusts.

2.6 **Pension Funds**

A pension fund is not generally a separate legal entity. Under the most common arrangements, the assets of the funds are vested in one or more trustees and managed on behalf of the trustees by a separate investment manager. The investment manager will enter into derivatives transactions as agent for the fund. In broad terms, the general principles (but not the detailed SIB Regulations) which apply in relation to determining the capacity of unit trusts to enter into derivatives transactions also apply with respect to pension funds. See paragraph 2.5

2.7 **Conclusion**

2.7.1 The foregoing summary highlights the sorts of concerns which currently exist in relation to the capacity of certain types of entities to enter into derivatives transactions. On the assumption that efficient risk management is to be permitted — and indeed encouraged — it is important that uncertainties relating to the question of capacity be removed. There are alternative methods of removing these uncertainties. One method is by abolishing altogether the doctrine of ultra vires — which is a doctrine which exists only in relation to incorporated entities and not to natural persons. This Memorandum is not the appropriate place to discuss the relative overall advantages and disadvantages of the ultra vires doctrine, and it may be that the desirability or practicality of abolishing the ultra vires doctrine may differ according to the precise nature of the entity concerned. For current purposes, it is sufficient to note that the abolition of the doctrine is a method of removing uncertainty and that this course has been recommended on many occasions in recent years. Indeed, abolition has been accepted in practice for certain entities since the practical effect of Section 35 of the Companies Act 1985 is to abolish, at least for third parties, the doctrine of ultra vires for companies incorporated under the Companies Acts (see paragraph 2.2). (The result of not abolishing altogether the ultra vires doctrine for such companies is, for instance, to retain a right for the shareholders of the company to bring proceedings to restrain the company from entering into the relevant transaction at any time until the agreement is entered into — something which gives a shareholder certain protection but does not adversely affect the (legitimate) expectation of a third party to have the transaction, once entered into, enforced). Whilst the detailed drafting of Section 35 is perhaps capable of improvement, it would nonetheless be a basis for any future legislation along similar lines.

If, for any entity, it is not appropriate to abolish the ultra vires doctrine, uncertainty relating to its capacity to enter into derivatives transactions can be achieved by clear enabling powers. The critical factor is that capacity must be clearly and unambiguously given — subjective tests or tests depending upon purpose do nothing to create certainty; their effect is quite the reverse. This is demonstrated by the position of building societies (see paragraph 2.3). If, however, in the case of certain entities, it is considered necessary or appropriate to restrict the ability of such entities to enter into derivatives
transactions by reference to some form of purpose test or other test, it
should be provided that third parties dealing in good faith should not be
affected by such restrictions. Such a safe harbour provision would
clearly assist, for instance, in relation to building societies.

In addition, if the ultra vires doctrine is not to be abolished for any
entity, another risk to be avoided is the risk of the enabling authority
not keeping up with market developments and innovations — and therefore
of people seeking to rely upon enabling authority which is not
necessarily appropriate or sufficient. The necessary flexibility can be
achieved in the case of enabling legislation by, for instance, empowering
some person or body to add to or amend the list of "permitted"
transactions. In this respect, building societies are a good example.
For building societies, the Building Societies Commission has the power
to designate permitted ("prescribed") transactions for building societies
by statutory instrument (a form of subordinate legislation) and this
power has been used on a number of occasions over the years (most
recently in May 1993) in order to keep up with market developments and
building society practices and requirements.

Other uncertainties to eradicate are statutory provisions, such as
Section 16 of the Insurance Companies Act 1982, whose effect upon the
validity or enforceability of derivatives transactions is doubtful.
Furthermore, uncertainties arising in relation to unit trusts and
pension funds clearly require to be resolved.

2.7.2 Whatever the technical method ultimately chosen to resolve the
uncertainties summarised in this Memorandum in relation to any entity —
whether it be abolition of the ultra vires doctrine or the passing of
clear enabling legislation — it is critical that progress be made to
resolve such uncertainties. There is a clear need for a general, but
cov-ordinated, review of these problems and by means of a formal process.
This task is ideally suited to the Financial Law Panel, a formal body
recently established under the aegis of the Bank of England with the
following objects:

- "to be the central forum, working closely, where appropriate,
  with existing associations and regulatory bodies for consideration
  and practical resolution of legal uncertainties and anomalies as
  they affect wholesale financial markets and services in the U.K.

- to give guidance on particular areas of legal uncertainty

- to review and comment on proposals for legislation and
  regulation — both U.K. and EC — which could affect financial markets
  and services

- to make proposals for law reform to secure the more efficient
  functioning of financial markets and services".

The members of the Financial Law Panel have now been appointed and the
recruitment of a secretariat is in hand. It is recommended that the
detailed findings of the Legal Risk Review Committee (which was
established by the Bank of England in 1991 and whose Final Report in
October 1992 led to the establishment of the Financial Law Panel) and of
other bodies who have considered the ultra vires doctrine be put to, and
considered by, the Financial Law Review Panel.

Issues such as the ultra vires doctrine clearly require statutory
resolution but it is also clear that there is no universal statutory
approach which can be taken in relation to the various different types of
incorporated entity. Each particular type of entity is the subject of
detailed statutory regulation and the precise of wording of any statutory
changes requires careful consideration in the context of that framework.

3. **CLOSE-OUT NETTING**

3.1 **Introduction**

There is no reported judicial authority or statutory authority which
deals directly with the enforceability of close-out netting in the
context of over-the-counter derivatives transactions. (In very general
terms, close-out netting is the procedure whereby the "normal" payment or
delivery obligations of the parties under a master agreement no longer
apply following the occurrence of a particular event or circumstance and
the values of the transactions covered by the master agreement are netted
out, giving rise to an obligation on one of the parties to pay the other
a net close-out amount). Despite the lack of direct authority, there is
a very strong body of opinion, on the basis of general principles of
English law, to the effect that close-out netting under a master
agreement in relation to derivatives transactions between two corporate
entities incorporated in England under the Companies Act is, as a general
principle, enforceable (in the sense of a single net sum being payable by
one of the parties rather than gross sums being payable by both parties),
including in the context of a liquidation of one of the parties.

3.2 **Legal Analysis**

It is not intended to set out a detailed analysis of close-out netting in
this Memorandum given the strong weight of opinion supporting the
enforceability, as a general principle, of close-out netting. Rather it
is intended to point to some of the factors which have to be borne in
mind in the analysis of any close-out netting arrangements.

For current purposes, it is assumed that the approach of "full two way
payments" is adopted (namely the approach that either party could,
depending upon the result of the calculations made, be required to pay
the close-out amount and not just the "defaulting" party). As regards
the other terms of any close-out netting arrangements - and the precise
terms will clearly affect the enforceability of the arrangements - the
following points are important to bear in mind:

3.2.1 The wording of the master agreement should ideally make it clear
that the obligations of both parties to make on-going payments or
deliveries in the ordinary course of events is conditional upon there
having been no triggering event, such as a breach of the agreement by one
of the parties or the commencement of its liquidation. This is
particularly important in the context of a liquidation of one of the
parties (to avoid any argument to the effect that the party in
liquidation is being deprived of rights and assets by reason of its liquidation).

3.2.2 The amount of any net close-out payment which is expressed to arise on the occurrence of such triggering event must result from a fair and reasonable valuation, as of an appropriate date and time, of any outstanding obligations under the agreement and of any obligations which would have arisen under the agreement had the triggering event not have occurred.

Depending upon the manner in which the close-out netting arrangements are drafted, it may also be important that certain general principles be complied with in relation to the determination of the amount of the net close-out payment, namely that:

(a) the amount in question payable by the party in breach under the master agreement must be a genuine and reasonable pre-estimate of the loss suffered by the party to which such amount is expressed to be payable and must not include any penal element;

(b) the party not in breach is under a duty to mitigate or reduce any loss it suffers as a result of the breach of contract, for instance by entering into alternative arrangements shortly after the breach occurs, and this duty must be taken into account in assessing the amount of the net close-out payment.

3.2.3 If the master agreement extends to the derivatives transactions pursuant to which any of the "normal obligations" require to be discharged by the physical delivery of a commodity rather than by the payment of a cash amount, additional considerations will apply. It will be important that, pursuant to the master agreement, the physical delivery obligations no longer exist as physical delivery obligations at the commencement of the liquidation of one of the parties but that the obligations exist as obligations which must be discharged by the payment of a cash amount.

4. **FORMAL REQUIREMENTS FOR THE CREATION OF A CONTRACT**

The Group of Thirty Enforceability Subcommittee identified the requirement in certain jurisdictions that, in order to create an enforceable contract, the parties to the contract should satisfy certain formal requirements for the creation of a contract, such as a requirement that the contract be in writing or be evidenced in writing. Under English law, the basic principle, subject to certain statutory exceptions, is that a contract need not take any particular form (provided that the other basic requirements under English law for the formation of a valid and binding contract are satisfied - namely that each party has the necessary capacity to enter into and perform the transaction, that each party intends to create a legally binding contract, that the terms are sufficiently certain and that there is agreement on all material points and that consideration is given (i.e. something of value is given or some detriment is suffered) by each party). The statutory exceptions to this basic principle are not applicable to interest rate or currency swap transactions or to other
types of derivatives transactions which are currently commonly entered into. Hence, the potential enforceability risk identified by the Enforceability Subcommittee is not a risk which is relevant in the English law context.

However, for the sake of completeness, it is perhaps worth noting that there are two statutory exceptions to the basic principle which might apply to a credit support document. In particular, these two exceptions may apply to a guarantee or to a security document. First, the Statute of Frauds 1677 requires that certain contracts be supported by written evidence. That statute remains applicable to guarantees. Accordingly, if a guarantee is not supported by evidence in writing, it is unenforceable (but not void). Secondly, by virtue of the Law of Property (Miscellaneous Provisions) Act 1989, if security were provided for a derivatives transaction and that security related to land (real estate), then the contract for that security arrangement must be in writing and the contract must incorporate all the terms that the parties have expressly agreed.

5. **GAMING ACT CONSIDERATIONS**

Another enforceability risk identified by The Group of Thirty Enforceability Subcommittee is the risk of the "legality" of derivatives transactions. In particular, the risk was identified of derivatives transactions being unenforceable for the reason that they constitute gaming or wagering contracts.

In England, the Gaming Act 1845 renders all contracts "by way of gaming or wagering" void. However, Section 63 of the Financial Services Act 1986 specifically provides that the various Gaming Acts do not apply to any dealings in "investments" (as set out in Part 1 of Schedule 1 to the Financial Services Act 1986). The list of investments in Schedule 1 is extensive and includes a wide range of warrants, options, futures and "contracts for differences". Most derivatives transactions are likely to fall within Schedule 1. There may be certain transactions which, as a consequence of the detailed drafting of the Act, do not fall within the various paragraphs of Schedule 1. Nevertheless, provided the transaction is entered into by way of a bona fide business transaction, it is very unlikely that, as a matter of general law, a derivatives transaction would be regarded as a gaming contract.

6. **CREATION OF SECURITY**

6.1 **Introduction**

As in most legal jurisdictions, the taking of the formal security interest under English law requires careful compliance with a detailed body of law. Whilst English law recognises that security may be given in a number of different ways (including by way of a pledge, mortgage or charge) and that almost any type of asset may be the subject of some form of security interest, there are certain areas of English law which give rise to uncertainty in the context of security given for the obligations of parties to derivatives transactions. These are briefly described below.
6.2 **Assets which may be charged**

Almost any type of asset may be the subject of a charge. This would include cash, bonds and shares and probably any other kind of assets which would be likely to be charged under security agreements entered into in connection with master derivatives agreements. One exception to this general rule arises from the Charge Card Services Limited case decided in 1986. In that case, the court said that it was "conceptually impossible" for a creditor in respect of a debt to grant security over that debt to the person who is the debtor in respect of that debt (a charge-back type of arrangement). Although the remark probably does not represent the basis of the actual decision of the court and was therefore "obiter" (since the actual decision did not depend upon this point), the remark has caused considerable difficulties in practice. On the basis of the court's remark, the commercial practice of a bank making a loan to a customer and securing that loan on a deposit made by the customer with the bank is effectively stopped. Likewise, the court's remarks invalidate the taking of a charge by one party to a derivatives transaction over cash deposited with it by the other party as security for that other party's obligations in respect of the transaction.

The Charge Card case has been the subject of considerable legal commentary and, despite the fact that the remark in question probably did not represent the basis of the actual decision of the court and despite the fact that there may be practical alternatives to the charge-back situation (for instance, by arranging for the deposit to be made with an affiliated entity of one of the parties or by relying instead upon an alternative which does not amount to the granting of a formal security interest - see paragraph 6.4 below), the current state of the law is unsatisfactory. This is the more so because the remarks ran counter to most people's previous understanding of the position and because there are good commercial and legal reasons why it should be possible for a creditor to charge his debt back to the debtor. Clarification on this point would eliminate the expense and complexity involved in parties seeking to structure security arrangements in a manner which does not run counter to the remarks of the court in the Charge Card case.

6.3 **Registration of charges**

6.3.1 **Requirement for registration:** Under the Companies Act, certain (although not all) charges need to be registered if created by a company incorporated in England and Wales or by a company incorporated outside Great Britain (even if that overseas company only later acquires property in England and Wales within the scope of the charge) where that overseas company has an established place of business in England. The categories of charge that require registration are set out in Section 396 of the Act. They do not specifically include charges on cash, shares or securities as such, but they do include charges on "book debts" of the company and floating charges on the company's undertaking and assets.

6.3.2 **Book debts:** The term "book debts" is not defined in the Companies Act. It has been judicially defined to mean debts arising in a business in which it is the proper and usual course to keep books and which ought to be entered in the books, whether or not in fact so entered. This is not a particularly helpful definition.
Arguably, a charge over a bond or share is a charge over an investment and not over a book debt. However, a charge which extends to an entitlement to interest, dividends or cash bonus entitlements paid or payable on securities and a charge over rights to payment due from a depositary, custodian or a clearing system in respect of securities may be a charge on book debts. There is some authority to suggest that cash at the bank is not a book debt as accounting practice is to show cash at bank as a separate item in a balance sheet. But the position remains unclear.

Despite discussion of the term in the cases and in legal commentaries, there remains no satisfactory resolution of the precise scope of the term and hence there remain doubts as to what do and do not constitute "book debts".

6.3.3 Floating charges: Broadly speaking, the term "floating charge" means a charge which is not to be put into immediate operation but which is to "float" so that the chargor may deal in the ordinary course of business with the assets over which the floating charge has been created. A floating charge cristallises or becomes fixed in relation to the assets over which it was created upon the appointment of a receiver, the liquidation of the chargor or the happening of any other event (subject to certain restrictions) which may be set out in the document creating the floating charge.

One particular problem which arises in the context of floating charges is that a charge which has been expressed as a fixed charge will nonetheless be treated as a floating charge if it appears that the chargor will be entitled to dispose of the charged assets in the course of its business without the consent of the chargee. For instance, a charge given in respect of a portfolio of securities which is permitted to be changed over time, perhaps within certain constraints, may (but need not necessarily) constitute a floating charge even if the charge was expressed as a fixed charge. There is no certainty as to the degree of control which must be exercised by the chargee in order to prevent what is expressed to be a fixed charge taking effect as a floating charge.

6.3.4 Consequence of failure to register: Even though the better view of a situation may be that a particular charge does not constitute a charge over book debts or a floating charge, in view of the uncertainty that exists it is quite a common practice to seek to register the charge since the consequences of not presenting the charge for registration are draconian - the charge would, in the absence of registration, be void against the liquidator and any creditor of the charging company. Registration, however, is not always commercially acceptable. Clarification in this area would therefore be helpful.

6.4 Alternatives

Although not amounting to the grant of a formal security interest, there is an alternative approach which seeks, by way of contract, effectively to "secure" the obligations of one party to another. That approach is the "flawed asset" approach. For instance, cash "collateral" would be given by one party to the other in circumstances where the cash amount
need not be repaid unless and until some event has occurred, such as the performance of the first party's obligations under the relevant master agreement. If, however, there is a default, then the relevant contract would provide that the cash collateral could be set off against the obligations which should have been performed or the loss resulting from the default. Likewise, bonds or shares may be transferred from one party to the other in circumstances where there is a corresponding obligation to "re-deliver" equivalent (but not the same) securities in the same manner as described above for cash "collateral". Properly structured, this is not security as such but gives parties protection for the consequences of non-performance.

As is the case in relation to the enforceability of close-out netting, there is a strong body of opinion to the effect that, properly structured, such contractual provisions relating to the provision and repayment of the "collateral" should be enforceable in the context of a liquidation of one of the parties. Again, however, in the absence of clear authority to this effect, clarification would be desirable.
Global Derivatives Study Group

Enforceability Survey — France

prepared by Linklaters & Paines

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1. **INTRODUCTION**

This memorandum deals with four of the enforceability issues identified in the Working Paper of the Enforceability Subcommittee in relation to over-the-counter derivatives transactions, namely (a) capacity of French entities to enter into such transactions, (b) enforceability in France of "close-out netting" in the context of insolvency, (c) documentation issues, particularly as regards the use of "product-by-product" documentation v. "all-in" master agreements and (d) collateral arrangements.

One important issue mentioned in the Working Paper of the Enforceability Subcommittee, namely legality of derivatives transactions, is excluded from the scope of this memorandum as it has been largely resolved by legislation. In view of the concerns that existed in France that derivatives transactions could constitute gambling contracts under French law, which contracts are unenforceable pursuant to article 1965 of the French Civil Code, article 1 of a law of 28 March 1885 (which already contained certain exceptions to the principle of unenforceability of gambling contracts) was amended on two occasions (most recently by law no. 91-716 of 26 July 1991) specifically to exclude derivatives transactions from the scope of article 1965 of the Civil Code. The current version of this article provides that "all transactions [marchés] on interest rates, indices and currencies are legal" and "no one can rely on article 1965 of the Civil Code to avoid the obligations arising thereunder, even if they are settled by the payment of a simple difference". It is thought that this wording would cover most types of transactions currently used in the derivatives sector.

2. **CAPACITY TO ENTER INTO DERIVATIVES TRANSACTIONS**

2.1 **General**

In France, as in other jurisdictions across the world, the decision of the House of Lords in the Hammersmith & Fulham case has sent a warning to market participants by highlighting the risks associated with lack of capacity to enter into derivatives transactions and has emphasised the need to achieve certainty in this area. Nevertheless, issues of capacity and due authorisation do not raise major concerns in France in the vast majority of cases. Transactions between financial institutions or involving large corporations as end users do not create specific issues of capacity in the derivatives industry. Although the ability of non-financial institutions to enter into purely speculative transactions is not entirely beyond doubt, this issue does not take on particular importance in France as the Companies Law of 1966 contains provisions protecting third parties acting in good faith against the risks of derivatives transactions not being within the corporate objects of the company as well as against the risk of lack of authority on the part of the company's representatives.

Two types of counterparty, namely local authorities and collective investment schemes, do require more careful consideration and are examined below. Insurance companies, although operating in a highly
regulated environment, do not face capacity problems as such, but their ability to use risk management techniques is limited by regulatory constraints.

2.2 Local Authorities

French local authorities were given a greater degree of autonomy, in particular as regards their ability to borrow on an arm's length basis, by a law no. 82-213 of 2 March 1982 on the rights and freedoms of municipalities, departments and regions. Against this new legal background, and especially since 1986 following certain reforms of the financial markets in France and the abolition of subsidised loans to local authorities, the latter have increasingly had recourse to a variety of financing sources requiring the use of risk management techniques. Although the capacity of French local authorities to enter into derivatives transactions for hedging purposes was never questioned, uncertainties remained as regards the types of instruments capable of being used, limitations on such use, method of authorisation and application of public accounting rules. The need to achieve certainty in this area was emphasised by the various decisions rendered in England in the Hammersmith & Fulham case, even though it was recognised that the position in France did not give rise to the same concerns as in England. After a long consultation process, a ministerial circular was released by the Ministries of Finance and Budget and the Secretary of State for Local Authorities (Ministry of the Interior) in September 1992. The joint paper, entitled "Interest Rate Hedge Contracts Offered to Local Authorities and Local Public Utilities" goes some way towards clarifying the legal régime applicable to the use of swaps and other derivatives instruments by French local authorities and their public utilities.

(a) Types of derivatives transactions that may be entered into:

As a general rule, the circular confirms that French local authorities and their public utilities may validly enter into all forms of derivatives transactions, subject to the restrictions summarised below. In particular, the circular indicates that the general rule contained in article 1 of the law of 28 March 1885 (referred to in section 1 above), applies to local authorities, absent any specific legislation to the contrary.

(b) Circumstances under which derivatives transactions may be entered into:

Local authorities may not enter into swaps or other derivatives transactions for trading (speculative) purposes. Such transactions would be ultra vires as outside the functions of local authorities and not in the general interest.

Hedge instruments, on the other hand, may be validly used by local authorities. To qualify as a hedge, the instrument must satisfy the following criteria laid down by the National Accounting Council (Conseil National de la Comptabilité) in its recommendation dated 10 July 1987:-
* the transaction must have the effect of reducing the risk of a fluctuation in value affecting the item being hedged (the financial costs of a given borrowing) or a series of homogeneous items (the financial costs of a group of borrowings having the same characteristics);

* the risk must be identified taking into account all of the financial assets and liabilities of the local authority;

* there must be a correlation between the price movements of the hedge instrument and the value of the items being hedged, the purpose being to neutralise partially or totally losses incurred on the hedged item out of gains realised on the hedge instrument;

* instruments qualified as a hedge must be identified as such at the start and will remain so qualified until their maturity unless the item being hedged disappears prior to such maturity or the correlation referred to above can no longer be established;

* hedging can only be applied to assets, liabilities and commitments that are homogeneous and for which the correlation referred to above can be established.

Each hedge instrument must therefore be related and pro-rated at all times to one or more identified debt instruments. In addition, the total amount of reference debt used as the basis for calculating the interest rates being swapped or being protected by hedging instruments may not at any time exceed the total existing debt of the local authority, including the debt budgetted for in the current budget.

Local authorities may not enter into any transaction which would violate the following rules of French administrative law:

* all funds of local authorities must, pending their allocation, be deposited with the French Treasury (article 15 of Ordinance no. 59-2 of 2 January 1959);

* such deposits are non-interest bearing (articles 3 and 8 of law of 14 September 1941);

* local authorities may not make financial investments (save in the very limited circumstances provided by a circular of the Ministry of Finance and the Ministry of the Interior dated 5 March 1926);

* local authorities may not open / maintain bank accounts: all transfers of funds are effected by the debit or the credit of the account maintained with the French Treasury (article 11 of decree no. 62-1587 of 29 December 1962).
Based on the foregoing, the circular lists, by way of illustration, a number of transactions that would be regarded as illegal if entered into or authorised by a French local authority, namely:-

* MATIF futures contracts: A local authority may not purchase financial futures traded on the MATIF as such purchase would constitute an unauthorised financial investment. Further, participants on the MATIF are required to maintain margin deposits with the MATIF Clearing House and to open a bank account before entering into any transaction, which would be contrary to the rules identified above. It follows that, for the same reason, a local authority would not be authorised to enter into any derivatives transaction requiring the posting of collateral in favour of the counterparty.

* Any transaction which contractually provides for a remuneration by the counterparty of the premium or fee paid by the local authority upon entering into the transaction would be illegal. In particular, in the event of early termination of the transaction by the local authority, the premium or fee, if returned by the counterparty, may not be so returned with interest or any other form of remuneration. Similarly, any transaction requiring the local authority to make an up-front payment to its counterparty to compensate for the difference of value of the swapped items, would constitute an unauthorised financial investment. For example, a single currency fixed-to-fixed swap whereby the local authority pays a low coupon and receives a high coupon in consideration for an up-front payment made by the local authority would be regarded as a form of investment amortised during the term of the transaction, and not as a genuine interest rate swap.

* Forward/forward transactions are authorised provided that the term of the transaction does not exceed the term of the financial year of the local authority.

(c) Procedures to be followed in entering into derivatives transactions:

The circular sets out in some detail the method in which the entry into derivatives transactions must be authorised by the local authority. The ability to delegate in part this power is considerably limited and any such delegation must be construed narrowly.

In addition, the circular includes derivatives contracts in the category of contracts which, by virtue of article 2 of the law of 2 March 1982, must be notified, together with the corresponding resolutions, to the local governor (préfet) in order for the same to become enforceable. This notification opens a two-month period during which the préfet may, if he considers the transaction to be illegal or ultra vires the local authority, refer the transaction to the Administrative Tribunal. In practice, it is possible for the local authority to request from the préfet delivery of a no-action letter which, although not legally binding, gives some comfort to the parties to the transaction.
(d) Allocation of risk if requirements for entering into the transaction are not met:

A decision of the Administrative Court declaring the transaction to be illegal or ultra vires will render the contract void against the local authority's counterparty. It is unclear whether the supervening illegality of the transaction on the ground that it has ceased to be a hedge (e.g. following early repayment of the underlying debt) would have the same effect. In the absence of authority, it may be prudent for counterparties to authorise early unwinding of the transaction in such a case. In any event, under general law, the counterparty may have an action in restitution against the local authority or an action in damages.

(v) Types of counterparties with whom derivatives transactions may be entered into:

To reduce counterparty risk, local authorities are required to enter into such transactions exclusively with credit institutions (établissements de crédit) as defined in the French Banking Law of 1984. It is unclear whether or not this requirement should be interpreted as restricting eligible counterparties to French institutions licensed as établissements de crédit under the Banking Law. The circular is silent on this point and clarification should be required. The Ministry of Finance adopts unofficially the restrictive view that only French credit institutions are eligible counterparties. Yet, at least credit institutions established within the European Community should be eligible counterparties. Foreign (i.e. non-EC) credit institutions could also be authorised under certain conditions, e.g. if they are subject to international prudential ratios such as those defined by the Basle Committee.

2.3 Collective Investment Schemes

Under this heading, this memorandum examines capacity issues affecting the following entities or vehicles: (a) Sociétés d'Investissement à Capital Variable ("SICAVs"), a form of open-ended investment company incorporated with limited liability as a société anonyme, by far the most commonly used type of investment vehicle in France, (b) Fonds Communs de Placement ("FCPs"), the other type of investment vehicle in France, which is defined by law as a co-ownership of securities with no separate legal personality and (c) Fonds Communs de Créances ("FCCs"), a new type of fund established in 1988 with a view to facilitating the securitisation of debts originated by credit institutions and insurance companies. All three vehicles are subject to law no. 88-1201 of 23 December 1988, as amended, and to various implementing regulations.

(a) Types of derivatives transactions that may be entered into:

SICAVs and FCPs are allowed to deal in traded options and futures provided that the contracts are negotiable on a 'regulated market', as defined by the regulations. However, a decree no. 89-624 of 6 September 1989, amended in November 1992, authorises SICAVs and FCPs to enter into 'swaps of interest rates, currencies, dividends and index variations'
subject to the satisfaction of certain conditions listed in (b) below. The term "swap" is not further defined by the decree. Although this gives some margin as to the interpretation of the regulations, it also raises uncertainties as to the proper characterisation of certain derivatives transactions which, although identified as swap transactions by the parties, present the characteristics of over-the-counter options which in principle are not an eligible investment (although it has been accepted in the past that OTC options could be acquired by SICAVs and FCPs if it could be demonstrated that a similar instrument was not available on a regulated market). Nevertheless, the Commission des Opérations de Bourse ("COB"), the authority in charge of the supervision of SICAVs and FCPs, seems prepared to show some flexibility. In addition, the COB has also released a policy statement in its July 1992 Bulletin permitting SICAVs and FCPs to enter into caps, floors and collars in the same manner as swaps on the basis that cap and floor transactions constitute "virtual" swap transactions.

FCCs have only recently become authorised to enter into interest rate swaps by virtue of a decree no. 93-589 of 27 March 1993 and only in limited circumstances.

(b) Circumstances under which derivatives transactions may be entered into:

SICAVs and FCPs are authorised to enter into interest rate and currency swap transactions provided that the following conditions are met:

* the constitutive documents must specifically envisage such a possibility;

* the swap counterparty must be an institution authorised to act as the depositary (dépositaire) of a mutual fund in France;

* the swap must be capable of being terminated at any time by the SICAV or FCP; the COB requires the counterparty to provide bid-offer quotations to the SICAV or FCP for that purpose on a periodical basis;

* in the case of cap and floor transactions, the COB required in its policy statement of July 1992 that the documentation should follow the General Terms published by the Association des Banques Françaises ("AFB") in 1989 for this category of derivatives instruments; a similar requirement is in practice applied to swap transactions, which must be documented by reference to the AFB General Terms of October 1988.

In addition, the aggregate of the commitments of the SICAV or FCP in respect of futures, options and swaps must not represent more than 100 per cent. of the total assets of the fund (save where the fund is approved as a Fonds Commun d'Intervention sur les Marchés à Terme, a special type of vehicle designed to invest in financial and commodity futures and options traded on certain regulated markets). Commitments in respect of swaps are determined on a net basis by calculating the net present value of future payments or receipts during the term of the
swap. This prudential ratio must be maintained at all times during the life of the fund. Caps and floors are also included in the 10 per cent. of total assets limitation applicable to certain types of investments of SICAVs and FCPs.

These prudential limits are regarded as sufficient to protect investors. In particular, the French legislation does not attempt to distinguish between speculative and hedging instruments (although the COB requires that, in the case of FCPs used as the vehicle for employees' savings schemes - Fonds Communs de Placement d'Entreprise -, derivatives must be used exclusively to protect the value of the portfolio and not to boost the performance of the portfolio, let alone for speculative purposes). Similarly, the French regulations do not implement the general requirement contained in the European Community Directive that use of derivatives instruments by SICAVs and FCPs should be 'for efficient management purposes'. In this respect, France is clearly more liberal than some of the other European Community jurisdiction, in particular the United Kingdom.

FCCs, on the other hand, have only recently become entitled to enter into interest rate swap transactions by virtue of a decree no. 93-589 of 27 March 1993. The swap must be entered into "for the sole purpose of matching the cash flows that the FCC receives with the cash flows that it is committed to pay", which confines the use of this technique to hedging purposes only. Other over-the-counter instruments are not available to FCCs. It is perhaps unfortunate that the new decree did not include caps and floors in the type of derivatives instruments which FCCs are entitled to use.

(c) Procedures to be followed in entering into derivatives transactions:

Issues of authorisation do not raise specific concerns, although it is obviously important to ascertain that the constitutive documents of the vehicle contain an express authority to use derivatives.

(d) Allocation of risk if requirements for entering into the transaction are not met:

This is an area of much uncertainty as the regulations do not specifically cater for the consequences of failure to comply with the requirements. It seems likely that if the COB was to have knowledge of such failure, it would require the collective investment scheme to unwind the relevant derivatives transaction and could possibly withdraw the authorisation granted to the collective investment scheme. The breach of the requirements should not affect the enforceability of the transactions except perhaps where it is demonstrated that the counterparty was not acting in good faith at the time it entered into the transaction and should therefore have known that the manager did not have the requisite authority to commit the scheme.

(e) Types of counterparties with whom derivatives transactions may be entered into:

By restricting eligible counterparties to institutions authorised to act as 'depositaries' of French collective investment schemes, the
regulations applicable to SICAVs and FCPs have excluded all foreign financial institutions, including those established within the European Community. This is because pursuant to article 3 (in the case of SICAVs) and 13 (in the case of FCPs) of the law of 23 December 1988, the "depositary" - i.e. the institution with which the assets of the collective investment scheme must be maintained - must have its registered office in France. The compatibility of these provisions with European law is not beyond doubt.

Similarly, the regulations applicable to FCCs restrict eligible counterparties to credit institutions and companies regulated under the French Insurance Code. These regulations are largely interpreted as excluding non-French banks and financial institutions, at least where these do not belong to the European Community.

2.4 Insurance Companies

As a general rule, insurance companies regulated under the French Insurance Code have the capacity to enter into any type of derivatives in the same manner as any corporation. The French Treasury's insurance service considers that the entry into derivatives transactions for speculative purposes is not within the spirit of the regulations, but there is no explicit prohibition in the Insurance Code and insurance companies are therefore free to enter into such transactions provided only that the volume of activity conducted for trading purposes is not such that it could jeopardise maintenance of their solvency margin. If this was the case, the Commission de Contrôle des Assurances (the authority in charge of supervision of the insurance sector) could issue an injunction against the company requiring it to strengthen its financial position and possibly to disengage itself from the relevant derivatives transactions. Similarly, insurance companies should only enter into derivatives transactions as "end users", i.e. for their own management and not as professional intermediaries, lest their involvement in this capacity should amount to the conduct of a non-insurance activity. Although the Insurance Code has recently been amended to permit insurance companies to undertake certain non-insurance activities, provided that these remain "of limited importance in comparison with the overall activity", no implementing regulation has yet been adopted and existing regulations still require insurance companies to confine their activity to insurance.

The ability of French insurance companies to make use of derivatives instruments as part of their risk management technique is in practice limited. This is because they are subject to strict prudential regulations, including in particular (a) coverage of technical reserves by certain eligible assets, (b) matching currency requirements, (c) constitution of compulsory anti-depreciation reserves and (d) limitation on the maximum return which they can guarantee to policyholders. It is likely that the Third Life and Non-Life European Community Directives will result in a greater use of derivatives by insurance companies, since the Directives authorise the use of derivatives instruments as a means of reducing investment risk and for efficient management purposes, but this will only be the case if the prudential regulations of the French
Insurance Code are amended to give greater flexibility as to the methods available to cover technical reserves and as to the management of portfolio and liability risks.

2.5 Conclusion

The French regulators have already established a legal framework for determining capacity issues where those create specific concerns in the derivatives industry. Although some questions may require clarification or further liberalisation (e.g. the ability of European Community credit institutions and, possibly, of non-EC institutions, to be eligible counterparties for derivatives transactions with local authorities and collective investment schemes; allocation of risk questions), it is felt that at this stage there is no fundamental requirement for legislative action in France.

3. Close Out Netting and French Insolvency Law

3.1 General Outline of French Insolvency Procedures

3.1.1 The Insolvency Law 1985

The Law no. 85-98 of 25 January 1985 (the "Insolvency Law 1985") provides the legal framework for the institution of insolvency proceedings against French commercial undertakings. This legislation is applicable to most French counterparties, with the exception of public utilities, local and regional authorities and other public bodies. Insurance companies are also subject to special procedures that are aimed at protecting the interests of policyholders and beneficiaries of insurance contracts.

3.1.2 Redressement Judiciaire

French insolvency proceedings are initiated with a decision of the competent court ordering the judicial reorganisation (redressement judiciaire or "RJ") of the company. There is only one test that determines the making of an RJ order, namely the company ceasing to be able to meet its current liabilities out of its current assets. The purposes of redressement judiciaire are (a) to permit the survival of the company as a going-concern, (b) to preserve employment, and (c) to discharge the liabilities of the company.

3.1.3 Observation Period

To achieve these three purposes, the Insolvency Law 1985 requires that the RJ order be followed by an observation period, during which an assessment can be made as to the economic and employment situation of the company with a view to determining whether the company should be reorganised, sold or liquidated. In principle, the observation period lasts no more than 6 months, but can be extended for a further 6-month period and, in "exceptional circumstances", brought up to 18 months.

3.1.4 Administrator and Liquidator

At the commencement of the proceedings, the court must appoint an administrator and a liquidator, which are both court officers.
The administrator's main role is to prepare a report on the basis of which the court will decide the fate of the company at the end of the observation period. The administrator normally only supervises the management of the company. However, the court can extend his powers either to assist the directors for all or part of the management decisions or indeed to take over management and control of the company.

The liquidator's role is two-fold:

(a) so long as the company is not liquidated, he must represent and defend creditors (in this capacity, he is referred to by the Insolvency Law 1985 as the "creditors' representative") and all creditors must file their proofs of claims with him;

(b) upon the making of a liquidation order, he is in charge of the winding up of the company.

3.1.5 Freeze on pre-RJ debts

All creditors whose debt arose before the commencement of the RJ procedure are barred from initiating legal proceedings or taking action against the company. In addition, as from the RJ order, the payment of debts which arose prior to the order is frozen.

3.1.6 Creditors obliged to continue performance

The administrator is entitled to demand the continuation of outstanding contracts, subject only to compliance by the company of its own obligations under the contracts. In principle, the decision of the administrator to continue outstanding contracts is not required to be taken within a specified time. However, the counterparty can serve a notice on the administrator demanding continuation of the contract, and failing a response by the administrator within one month of the notice, the administrator is deemed to have renounced continuation. Where the contract is, or deemed to be, disclaimed, the other party may be entitled to claim damages for non-performance and to file its claim accordingly. If continuation is demanded, the other party must perform its obligations, notwithstanding any failure by the company to have performed its obligations prior to the RJ order. In particular, it is not entitled to rely on contractual clauses providing for the termination of the contract or for the acceleration of unmatured debts of the insolvent company on the ground that it has gone into redressement judiciaire. Termination is only permitted in the event of non-performance of obligations arising after the commencement of the proceedings. On the other hand, claims of the counterparty that arise out of the continuation of the contract benefit from the general lien instituted by article 40 of the Insolvency Law 1985 in favour of new creditors. This is a "super priority" lien securing the payment of all debts validly incurred by the insolvent company after the making of the RJ order (e.g. new money made available during the observation period) and ranks ahead of all other liens and security, with the exception of one general lien instituted in favour of employees. Creditors benefiting from such "super priority" do not, however, rank equally between themselves. In particular, claims against the company arising out of the continuation of outstanding
contracts would rank fifth after the payment of certain preferred debts, including employees' wages payable during the RJ procedure, costs and expenses of the procedure and new advances granted by credit institutions to the company.

3.1.7 Outcome of observation period

At the end of the observation period, and on the basis of the report prepared by the administrator, the court may choose one of the following options:

(a) Continuation of the business: This route is followed only where there exists a possibility of recovery and discharge of the liabilities. The continuation of the business is made in accordance with a plan (plan de continuation) adopted by the court. Creditors are barred from accelerating their claims or instituting legal proceedings against the company until the expiry of the plan, when the court determines that the reorganisation period has come to an end and that the company is no longer the subject matter of an RJ procedure.

(b) Sale of the business: The court may decide that all or part of the business of the company is to be sold to purchasers having made unconditional bids. Where the court orders a sale of the whole of the business, the effect of the decision is similar to that of a liquidation: creditors are paid out of the proceeds of the sale in accordance with their rank. Where the sale concerns only part of the business, the remaining part is continued and the position of the creditors is the same as under a continuation plan.

(c) Liquidation: If neither of the above options is available, the court must decide to liquidate the company, whereupon all unmatured debts become due and payable.

3.2 Impact on OTC derivatives transactions

3.2.1 Absence of Authority

There are no judicial precedents on the application of the Insolvency Law 1985 to swaps or similar derivatives transactions. Many of the provisions of the law are inappropriate to deal with the particular nature of derivatives transactions and there remains some uncertainty as to the manner in which those provisions will affect the performance of derivatives transactions entered into with French counterparties. The main areas of difficulty concern the right of termination on a supervening insolvency and the efficacy of the close out netting provisions.

3.2.2 Termination

(a) Prior to the RJ order

Assuming that the transaction or, if any, the master agreement has been terminated prior to the making of the RJ order, such termination will be
effective notwithstanding the subsequent commencement of insolvency proceedings. The non-defaulting party will need to file a proof of claim in respect of the termination amount calculated in accordance with the contractual provisions agreed upon between the parties, except however that, where the termination amount is denominated in a foreign currency, it will be required to be converted into French francs on the basis of the exchange rate prevailing on the date of the RJ order. The termination amount will clearly constitute a pre-RJ debt, the payment of which will be frozen during the observation period and may be subject to deferral if a plan de continuation is adopted at the outcome of the observation period.

(b) Subsequent to the making of an RJ order

(i) By the Non-Defaulting Party: No termination will be allowed following the making of an RJ order. Contractual provisions to the contrary, such as Section 5(a)(vii) of the ISDA Master Agreement or article 8.1.1.7 of the AFB Standard Terms for Swaps, will not be effective. Certain commentators also take the view that the designation of an early termination date on the ground of an event of default other than insolvency may be frozen by the subsequent making of an RJ order if it appears that this was impending at the time of the designation. Similarly, in a recent decision (Cass. Com. 2 March 1993), the Cour de Cassation ruled that a contractual provision authorising early termination of the contract if the counterparty ceases to pay its debts generally would equally be ineffective on the ground that this situation determines the institution of redressement judiciaire proceedings.

If the administrator decides to continue the agreement, the other party is bound by such decision and will be required to perform its own obligations, notwithstanding any default of the insolvent counterparty prior to the commencement of the redressement judiciaire (which default may only entitle the non-defaulting party to prove for its loss against the insolvent counterparty). All unpaid amounts as at the date of the RJ order will constitute pre-RJ debts, the payment of which will be frozen during the observation period and may be subject to deferral if a plan de continuation is adopted at the outcome of the observation period. On the other hand, payments falling due by the insolvent counterparty after the making of the RJ order will not be frozen and will benefit from the "super priority" lien instituted by article 40 of the Insolvency Law 1985. Some commentators consider, however, that this will only apply to obligations to be performed by the insolvent counterparty following an actual or deemed decision by the administrator to continue the relevant contract. Therefore, obligations falling to be performed after the making of the RJ order but prior to the decision of the administrator would, according to these commentators, be treated in the same manner as pre-RJ debts. In view of this doubt, it is thought important for creditors to serve a notice on the administrator as soon as practicable at the beginning of the procedure to force the administrator to take a decision on the continuation of outstanding contracts.

(ii) By the administrator: The decision as to whether or not to continue performance of outstanding contracts lies within the sole discretion of the administrator. If the administrator chooses not to continue the
contract or if, following the giving of a notice by the solvent counterparty, the administrator is deemed to have renounced continuation of the contract, then the contract may be terminated and the solvent counterparty will be entitled to prove for its damages with the creditors' representative. This claim would, in most commentators' view, constitute a pre-RJ debt even though it arises after the commencement of the redressement judiciaire. The right to terminate the contract will also arise if, following continuation by the administrator, the insolvent counterparty fails to perform its own obligations under the contract. In this case, the claim in damages could be regarded as a post-RJ debt benefiting from the "super priority" lien instituted by article 40.

Where continuation is demanded by the administrator, the insolvent counterparty must perform all of its obligations arising out of the continued contract, and it is not possible for it to "cherry-pick" between the various obligations assumed under a single contract. The difficulty with respect to master agreements such as the ISDA Master Agreement or the one contemplated by the AFB Standard Terms is whether the "single agreement" language contained therein will be effective, i.e. whether the administrator can exercise his power to continue or discontinue performance only in respect of the entire master agreement (and hence in respect of all transactions entered into pursuant thereto) or whether the administrator could pick and choose among the various component transactions. As in other jurisdictions, this question has given rise to much academic debate in France ever since the coming into force of the Insolvency Law 1985. The main cause of uncertainty lies in the terms of article 37 of the Insolvency Law 1985, pursuant to which no unseverability (indivisibilité) may result by reason only of the commencement of a redressement judiciaire procedure, notwithstanding any provision to the contrary. The prevailing view among practitioners is that the "single agreement" language contained in the AFB or ISDA Master Agreements should be effective to prevent cherry-picking as it is not intended to operate solely upon the commencement of a redressement judiciaire procedure. This question has however never been tested in the courts and a number of commentators of the Insolvency Law 1985 favour the opposite view.

3.2.3 Netting

(a) Prior to the making of an RJ order

Article 107-4 of the Insolvency Law 1985 provides that all payments made during the so-called "suspect period" (the duration of which is fixed by the court and may extend as far as 18 months prior to the date of the RJ order) may be set aside as fraudulent preferences if they have been effected "otherwise than in cash, negotiable instruments, transfers (...) or any other mode of payment commonly admitted in business relationships". This raises the question of whether set-off of reciprocal payment obligations during the suspect period would be regarded as an unauthorised mode of payment. In principle, the provisions of the Insolvency Law 1985 on fraudulent preferences will not affect statutory set-off, which pursuant to articles 1290 and 1291 of the French Civil Code operates automatically with respect to monetary debts which are mutually owed between the parties provided the debts are
fungible, have matured and are liquidated. These requirements would clearly apply to the netting of amounts payable on the same date and in the same currency even if they relate to several derivatives transactions (a decision of the Paris Court of Appeal rendered in 1941 excluded statutory set off where the debts are denominated in different currencies on the basis that the requirement of fungibility was not met; in fact, this decision has been widely criticised and it is likely that a different solution would prevail nowadays, as long as no restrictions affect the transferability or convertibility of the currencies in question).

Any other form of the netting is at risk of being regarded as a form of contractual set-off which could amount to an unauthorised mode of payment for the purpose of article 107-4° of the Insolvency Law 1985. Indeed, there is authority to challenge "contractual set off arrangements" if made during the suspect period. This could affect netting under a master agreement if relating to amounts payable on different dates. It could also affect the close out provisions contained in the AFB Standard Terms or the ISDA Master Agreement, since these contemplate effectively off-setting the various payment obligations arising on termination of the master agreement. However, a number of legal commentators consider that set off in the derivatives industry could be regarded as a "mode of payment commonly admitted in business relationships", especially in view of the growing internationalisation of this market and the fact that netting is both commonly used and accepted in other major jurisdictions. The consultative proposals issued in April 1993 by the Basle Committee authorising the use of bilateral netting by internationally active banks should lend additional authority to this view. Some decisions from the lower courts have also upheld contractual set off made during the suspect period on the ground that the debts in question were "closely connected", but this position does not appear to have been upheld so far by the Cour de Cassation, France's Supreme Court in civil and commercial matters, which only applies the "close connection" test to permit set off between pre-RJ and post-RJ debts (as more fully described below).

(b) Subsequent to the making of an RJ order

(i) **Netting between post-RJ debts**: Where the derivatives contract is continued by the administrator after the making of an RJ order, netting between reciprocal obligations arising out of the continuation should in principle be available, either under statutory set-off or in accordance with the contractual provisions agreed between the parties. This is because payment obligations arising out of the continuation of a contract outstanding on the date of the RJ order are not frozen in the same manner as pre-RJ debts.

(ii) **Netting between pre-RJ and post-RJ debts**: In principle, all payments of pre-RJ debts are frozen during the observation period (and may further be deferred where a plan de continuation is adopted). This would normally prevent the operation of set-off as between pre-RJ and post-RJ debts. However, French courts have traditionally accepted that set-off could be allowed as between pre-RJ and post-RJ debts where the debts in question were "closely connected" (connexes). This traditional approach
has been confirmed by a recent case of the Cour de Cassation (Cass. Com. 19 March 1991 – Bulletin Civil IV, n°105, p.73). The determination of what constitutes a "close connection" (lien de connexité) lies within the discretion of the court but, at least prior to the passing of the Insolvency Law 1985, the trend was to interpret the expression very broadly (decisions of the Cour de Cassation, particularly in 1982 and 1987, extended the concept to cover a series of transactions that could be regarded as part of a "global economic transaction as defined by the common intention of the parties" and entered into pursuant to an agreement that "defined for the parties a framework for the development of their business relationship") and the decision rendered by the Cour de Cassation on 19 March 1991 would seem to confirm this trend. In the case of derivatives transactions, the prevailing view is that such a close connection would probably be found as between several derivatives transactions entered into pursuant to a single master agreement provided that the parties' intention was clearly expressed in the master agreement and that the connection was not artificially created. A study prepared by the Commission Bancaire and the legal department of the Banque de France in 1989 also favours the view that the "close connection" test should be met in the context of master agreements such as the one contemplated by the AFB Standard Terms and the ISDA Master Agreement. Whilst most commentators are relatively optimistic as long as the master agreement covers transactions of a similar nature, doubts have been voiced in the case where the master agreement is used to cover instruments of a different nature (e.g. swaps and "physically" settled options) which is the case of the 1992 ISDA Master (see also section 4.2 below).

3.3 Conclusion

There is undoubtedly a general trend among legal commentators and French banking regulators towards supporting the enforceability of "close out netting" provisions vis-à-vis French counterparties. However, some uncertainty remains in the absence of specific statutory or judicial authority. In addition, provisions such as the automatic stay on termination rights following the making of an RJ order clearly affect the operation of these provisions. It is suggested that only legislative changes can fully overcome some of the difficulties, actual or perceived, identified above. The Survey of Industry Practice, which has placed France in the unenviable (and to some extent unfair) position of being the jurisdiction (among major jurisdictions) that raises most serious concerns among derivatives dealers, only serves to emphasize the need for legislative action. Proposals addressing the uncertainties identified above are currently being discussed between the AFB and the French Treasury and it is anticipated that they may be put to Parliament shortly.

4. DOCUMENTATION ISSUES

4.1 General

The enforceability risks identified by the Enforceability Subcommittee in relation to certain jurisdictions as regards contract formation do not
arise as such in France. Under French law, a contract may be made by oral agreement or in writing and therefore, provided that the basic requirements for the formation of a contract are satisfied, a valid and binding agreement would be concluded at the moment the traders reach agreement on the telephone. The parties may of course decide that the conclusion of a contract will be subject to a written confirmation, in which case the contract will only come into being upon exchange of such confirmation. Whether the parties intended the written confirmation to be a condition to the conclusion of the contract or simply to confirm the terms of an oral agreement already reached between them is a matter that is left to the discretion of the court. In determining this question, the court will have regard to the intention of the parties, which may be discovered through all factual circumstances, including, if relevant, any commercial or local usage against the background of which the parties may have negotiated.

In exceptional circumstances, French law demands a written document as a substantive requirement of contract (e.g. a mortgage over real property can only be created by notarial deed) but no such requirement exists for contracts such as a derivatives transaction. On the other hand, the existence of a written instrument may be a requirement of French law as a matter of evidence as to the existence and contents of the contract. A distinction is drawn under French law as between civil and commercial contracts and as between traders (commercants) and non-traders. A transaction is commercial either if it falls within a specified category of transactions or activities which the French Code of Commerce defines as commercial in nature (e.g. banking transactions) or if it is entered into by a trader in the course and furtherance of his professional activities. Although there is no specific authority on the question, there is little doubt that derivatives will normally be characterised as commercial contracts either by nature (e.g. if they are susceptible to characterisation as "banking transactions") or because they are entered into by traders in the course and furtherance of their activity (this is clearly the case for banking institutions but also for corporate counterparties, for which the conclusion of a derivatives transaction will normally be incidental to their principal activity).

The importance of this distinction is that, as a matter of evidence (not substance), whilst a written proof is required in order to give evidence as to the existence and contents of a contract against a non-trader where the contract relates to more than FF5,000, all modes of proof are admissible to prove the existence and contents of a commercial contract against a trader (e.g. parol evidence, account books, commercial documents such as invoices, receipts, bank statements, factual or legal presumptions etc.). In particular, a telex or facsimile communication constitutes admissible evidence before the French courts. This does not mean, however, that it constitutes conclusive evidence, and the court has discretion to reject a particular mode of proof if it considers that it is insufficient in the particular circumstances of the case. As regards more particularly telex communications, they appear to be treated more often than not as presumptions of fact, which are therefore rebuttable by evidence to the contrary. It is worth pointing out, however, that in commercial matters and between traders, even a written instrument (such as a letter-form confirmation) does not constitute
conclusive evidence, and as a result, other modes of proof can be admitted to add to, vary or contradict a written instrument. The weight to be given to a particular item of evidence is a matter of fact which is decided by the judge in his sole discretion, in the light of the circumstances and largely on the basis of common sense (so that, as a matter of practice, a written instrument is for obvious reasons likely to carry more weight than other modes of proof).

4.2 Master Agreements

The uncertainties identified in section 3 above with regard to close out netting have given rise to concerns as to the enforceability of "cross-product netting" pursuant to a single master agreement such as the 1992 Master Agreement produced by the International Swap Dealers Association, Inc. Although there has been little legal commentary on this question, it would appear that the efficacy of "close out netting" provisions contained in a master agreement should not be adversely affected by the inclusion of different types of transactions. The requirement that debts should be "closely connected" to allow set off in an insolvency context does not necessarily imply that the debts should arise out of transactions of a similar nature (although at least one decision of the Cour de Cassation - Cass. Com. 17 May 1989; Bull. Civ. IV, no 153, p. 102 - does refer to the fact that the various transactions were of a similar nature to determine the existence of a close connection). The question of whether documenting "physically-settled transactions" and "cash-settled transactions" under a single master agreement could prejudice the chances of the various transactions being viewed as "closely connected" or otherwise could prejudice the effectiveness of the "close out netting" provisions is more debatable, although in principle, the solution should not be different in this case. Clearly, the more the transactions vary in nature and purpose, the more the risk that the "close connection" could be regarded as having been artificially created.

Unlike ISDA, the Association Française des Banques has produced different sets of Standard Terms for each type of OTC derivatives transactions (including swaps, options and FRAs). However, this approach was not so much motivated by specific concerns concerning the enforceability of "cross-product netting", as by historical reasons pertaining to the manner in which the AFB's legal committee undertook its task. As a matter of fact, a number of market participants already propose the conclusion of "master master" agreements which purport to bridge the various master agreements entered into in connection with each type of derivatives transaction. However, this approach somewhat weakens the argument that the various transactions are intended to form part of a "single agreement" or "global economic transaction" and that the parties intend them to be "closely connected". It would therefore be desirable to conduct an analysis as to the desirability of introducing an "all-in" type of master agreement for use in connection with derivatives transactions governed by French law and it is hoped that French regulators will encourage this exercise. Indeed, this would also avoid certain market practices, such as the use of ISDA Master Agreements under French law, despite the fact that this pro-forma documentation was exclusively drafted in contemplation of New York law and English law.
5. **COLLATERAL ARRANGEMENTS**

5.1 **General**

Attempts have been made in France as elsewhere at introducing collateral arrangements aimed to reduce exposure through the posting of collateral on a unilateral or reciprocal basis. These arrangements typically envisage the making of an initial deposit, in the form of cash or securities, and often contemplate subsequent margin calls that take into account fluctuations in current exposure. In this respect, these arrangements purport to mirror by contract the procedures established in major regulated or centralised traded futures and options markets around the world.

Nevertheless, the use of collateral arrangements in France remains marginal. A number of reasons can be identified as responsible for this relative lack of success. From a practical point of view, the posting of collateral, especially in the form of cash, can have a negative impact on the economics of derivatives OTC transactions. Furthermore, French counterparties often feel that they lack the necessary technical means for monitoring exposure on a periodical basis and the corresponding margin calls. Legal reasons, however, must also be blamed for the limited use of collateral arrangements in France. First and foremost, the uncertainties remaining as regards the effectiveness of "close out netting" against French counterparties reflect upon the adequacy of collateral arrangements as a means of reducing net exposure under master agreements. But there are also a number of uncertainties as regards methods of collateralisation where the collateral is to be held in France and, perhaps more importantly, effectiveness of such methods in an insolvency context.

5.2 **Methods of collateralisation in France**

5.2.1 **Securities**

Most types of securities in France must be held in book-entry-form and accordingly exist only by virtue of entries made in securities accounts. This method of holding has been provided by a law no. 81-1160 of 30 December, 1981 (for shares and bonds) and by a law no. 91-716 of 26 July, 1991 (for commercial paper, certificates of deposit and medium term notes). The method of creating security over this type of collateral is provided by article 29 of law no. 83-1 of 23 January, 1983 (for shares and bonds) and article 19-II of law no. 91-716 of 26 July, 1991 (for other instruments). In both cases, the security is created by means of "Declaration of Pledge" (Déclaration de Gage). This document is a short form instrument signed by the pledgor and delivered to the pledgee setting out (a) the name and address of the pledgor, (b) the name and address of the entity with which the securities are held in book-entry-form, (c) details of the securities being pledged and (d) the amount of the secured liabilities. The Declaration of Pledge is sent to the entity maintaining the securities account, which may be either the issuer of the underlying securities (in the case of registered securities) or a bank or other authorised financial intermediary in France. This entity is required by law to return to the pledgee a
"Pledge Certificate" (Attestation de Gage), certifying that the relevant securities have been transferred to a specific sub-account of the pledgor's securities account, earmarked to show that they are subject to a pledge in favour of the pledgee. From a legal point of view, the pledge is deemed to be perfected as from the date of signature and delivery of the Declaration of Pledge, but in practice it is desirable to ensure that a Pledge Certificate is returned to the pledgee as soon as possible.

Although admittedly, the formalities required for the creation of a pledge over securities are relatively simple, the need to repeat them on each margin call under the collateral agreement eventually renders the whole process cumbersome and unattractive. Also, the requirement that the Declaration of Pledge should specify the amount of the secured liabilities is difficult to satisfy in this context.

Furthermore, although this form of security is characterised as a pledge, it is thought that it does not have all the effects of a true pledge with delivery of possession, since the pledged securities, being represented by book entries only, do not constitute a tangible asset capable of physical possession and remain registered in the name of the pledgor. In particular, it is thought that the pledgee does not benefit from the right of retention which would otherwise attach to a true pledge. This has serious drawbacks for the pledgee, in particular in an insolvency context (as to which see paragraph 5.3 below).

On the other hand, being a pledge, this form of security is subject to the restrictions as to enforcement provided for by article 93 of the French Code of Commerce. This provision requires the pledgee to serve a formal notice on the pledgor demanding payment of the secured liabilities and authorises the pledgee, failing payment within eight days of such demand, to cause the pledged securities to be sold at public sale through a stockbroker licenced as such in France or through a public officer authorised to do so or any other public officer appointed by the president of the competent commercial court. As an alternative method of enforcement, article 2078 of the Civil Code provides that the pledgee can apply to the competent court to have all or part of the pledged assets judicially allocated to it up to the value of its claim, on the basis of a valuation of the assets made by an expert appointed by the court. Any provision of the pledge agreement authorising the creditor to forfeit the securities or to sell the securities in any manner other than that provided by article 93 of the Code of Commerce or by article 2078 of the Civil Code is void (although this would not apply to an arrangement between the parties made after the date on which the pledge was granted).

The above requirements, which are of a mandatory nature, are generally perceived by market participants as reducing considerably the benefits anticipated from the posting of collateral in the form of securities.

5.2.2 Cash

Neither the French Civil Code, nor the Code of Commerce, provide for a specific regime as to the granting of a security interest over cash. However, a practice has developed, as in other jurisdictions, of making
cash payments by way of collateral, which practice is recognised and upheld by the courts. This form of collateral is often described as a gage-espèces (pledge of cash), although this characterisation is not entirely satisfactory given the fungible nature of cash and the fact that the payee becomes the beneficial owner of the collateral. In certain cases, particularly where the beneficiary of the collateral is a bank, the cash collateral is paid into a special account, often referred to as compte impersonnel (literally, "Impersonal account", i.e. a non client account), in an attempt to individualise the monies paid by way of collateral. Some commentators argue that this method of individualisation permits a characterisation of the security as a form of true pledge, but this is not free from doubt. More recently, a practice has developed of making cash collateral arrangements without any specific reference to the creation of a security interest. This practice effectively relies on the "flawed asset" approach, which simply provides for the making of deposits repayable only upon the occurrence of certain events, typically the performance in full of the depositor's obligations under the main contract. Although there does not appear to be any compelling reason of French law that would make such approach illegal or ineffective, the technique is criticised by a number of opponents who hesitate about its proper characterisation under French law.

Again, the above-mentioned hesitations about the proper method of creating security over cash do not seem so far to have caused serious difficulties in the courts. Most court decisions accept that, where a sum of money is paid by way of collateral, the pledgee is entitled, in the event of a failure by the pledgee to pay the secured liabilities when due, to apply those monies in or towards reduction of the secured liabilities. The legal nature of such an application is explained in different manners (not necessarily dependent upon the characterisation adopted by the parties). Some decisions/commentators consider that the application is made by way of enforcement of a pledge, but that the restrictions contained in the Code of Commerce and the Civil Code do not apply to this type of security since the rationale of those restrictions is to ensure that the pledgee will not enforce the pledge at an undervalue (a concern which does not arise in relation to cash). Other decisions/commentators argue that the application of the collateral is made pursuant to the exercise of a right of set off, as between the secured liabilities and the debt in restitution of the collateral monies due by the pledgee to the pledgor. Where the "flawed asset" approach is used, the rights of the holder of the collateral merely constitute rights arising under a contract. The holder of the collateral is entitled to keep the collateral up to the value of its claim simply because its obligation to return the collateral arises only upon full satisfaction of the secured liabilities.

One legal risk associated with the posting of collateral in the form of cash concerns the possible application of banking or other restrictions affecting the ability to make or take deposits. Under the French Banking Law of 1984, deposit-taking is defined as a banking activity which only certain licenced institutions are entitled to undertake on a regular basis. It is at least arguable that this legislation affects the ability of non-bank entities to engage in collateral arrangements, although this position is by no means free from doubt. Similarly, certain French
counterparties are subject to specific limitations that may affect (e.g. in the case of collective investment schemes) or altogether exclude (e.g. in the case of local authorities) their capacity to make cash collateral deposits.

5.3 **Effectiveness in a French insolvency**

5.3.1 Avoidance provisions

(a) Pre-insolvency

There are a number of provisions of the French Insolvency Law 1985 that could affect the validity of the posting of collateral by a French counterparty if made during the suspect period preceding the commencement of the insolvency proceedings otherwise than in substitution for collateral previously posted by the counterparty:-

* Article 107-3° of the Insolvency Law 1985 declares void all payments made during the suspect period in satisfaction of unmatured debts of the insolvent company. Some commentators argue that the posting of cash collateral could be regarded as constituting an anticipated payment of the termination sums, or part thereof, that would be due in the event of early termination of the main contract. Although this view is not supported by any actual judicial authority under the Insolvency Law 1985, some hesitation prevails on the question.

* Article 107-6° of the Insolvency Law 1985 declares void any pledging of property of the insolvent company in relation to previously incurred debts (i.e. any pledge which is not contemporaneous with the incurring of the debt). There is a risk that the posting of additional collateral pursuant to margin calls could be regarded as a pledge in respect of a "previously incurred debt" to the extent that such collateral relates to outstanding derivatives transactions. The application of Article 107-6° will depend on the meaning and interpretation of the expression "previously incurred debt".

* Article 108 of the Insolvency Law contains a sweep-up provision which enables the court, at its discretion, to avoid all payments of debts and all onerous contracts made by the insolvent company during the suspect period if the other party had knowledge that the company had already ceased to pay its outstanding debts. The rationale of the provision is that a creditor who is aware that his debtor has ceased its payments generally should not seek to be preferred to other creditors.

(b) Post-insolvency

Assuming that the administrator demands the continued performance of the main agreement after the institution of the insolvency proceedings, there is a clear risk that the administrator could do so disregarding the requirement for posting of collateral on the basis of Article 33 of the Insolvency Law of 1985, which requires court authorisation for "any
disposal outside the ordinary business of the company, the granting of any mortgage or the giving of any pledge" after the institution of insolvency proceedings and on the basis that compliance with the undertakings assumed under the collateral agreement would be in breach of the general principle of equal treatment of the company's creditors.

5.3.2 Enforceability

The making of a redressement judiciaire (RJ) order against the French counterparty normally freezes the right of the pledgee to seek enforcement of the collateral, whether by way of a sale or of a judicial allocation. This freezing effect will last for at least the duration of the observation period. During this period, a pledgee in possession may however keep the collateral pursuant to its right of retention and may only be forced to part with possession if (a) the court authorises the administrator to pay the secured liabilities or (b) the court orders the substitution of "equivalent security" in lieu of the collateral – although certain commentators of the law argue that this right of substitution is not applicable to a pledge where the pledgee has a right of retention. At the outcome of the observation period, the rights of the pledgee depend on the solution adopted by the court:

* If a plan de continuation is adopted, the pledgee will only be entitled to enforce the pledge upon the counterparty failing to pay the secured liabilities, as rescheduled by the plan, and provided a proof of claim has been duly filed in respect of such liabilities. However, if the pledgee decides to enforce the pledge by way of a sale, the right of retention will be lost, and the pledgee is at risk of being outranked in respect of the proceeds of the sale by preferred creditors. The main creditors likely to be preferred to the pledgee would include employees, in respect of certain wages, the court in respect of the costs of the proceedings, the Treasury, in respect of certain taxes, as well as all creditors whose claims arose after the commencement of the redressement judiciaire, who benefit from the "super priority" instituted by article 40 of the Insolvency Law 1985 in respect of such claims.

* In the event that the court decides to sell all or part of the business of the company, a portion of the proceeds of the sale is allocated to each of the assets the subject of a security and is distributed to the creditors secured over such assets in accordance with general rules of priorities. Here again, the pledgee is likely to be preferred by other creditors. However, it is thought that a pledgee having possession of the pledged property is entitled to oppose his right of retention in such a case and therefore to keep possession of the pledged property until full discharge of his claim.

* Lastly, if the court orders the liquidation of the company, the pledgee may enforce the pledge both by way of a sale or of a judicial allocation. However, the judicial allocation route is preferable in this context, since in the event of a sale by the pledgee, his right of retention is lost and he may be preferred
by other creditors. If the pledgee does not take any action, then the liquidator is entitled, subject to court authorisation, either (a) to pay the secured liabilities, whereupon the pledgee must return the collateral, or (b) to sell the collateral, whereupon the right of retention of the pledgee is deemed to apply to the proceeds of the sale, thereby conferring the pledgee a first priority over such proceeds.

As will be seen, and except in the context of a liquidation, the main protection of the pledgee in the event of insolvency is the right of retention, which the pledgee can oppose for so long as the secured liabilities have not been discharged.

Yet as indicated above, it is doubtful whether any right of retention exists by virtue of a pledge over book-entry-form securities in France, since traditionally such right can only apply to tangible assets. Although there is no clear authority on this question, most commentators consider that the right of retention does not benefit a pledge over this type of collateral. There follows that the administrator could, subject to court authorisation, dispose of the pledged securities, whereupon the proceeds of the sale would be deposited with a statutory custodian (the Caisse des Dépôts et Consignations) and would only be available for distribution to the pledgee upon the adoption of a plan de continuation, failing payment of the secured liabilities, or upon liquidation of the company, and in all cases subject the rights of preferred creditors.

Given the peculiar nature of cash collateral, it is unclear whether enforcement of this type of security is subject to any of the above restrictions. Most commentators take the view that the security is enforced by the pledgee exercising a right of set off. Such a set off is considered to be permissible, since the two debts (namely, the secured liabilities and the debt in restitution of the collateral) are necessarily "closely connected". Other commentators (and certain court decisions) take the view that the cash collateral should be treated as a true pledge where the pledgee benefits from a right of retention. The position of the pledgee would then be as stated above except that the power of sale is unlikely to be available as a remedy given the nature of the collateral.

5.4. Conclusion

In 1991, as part of a move to promote stock lending transactions in France, specific legislation was adopted to facilitate the making of collateral arrangements supporting such transactions. Article 18.I.1° of Law no. 91-716 of 26 July 1991, which authorises the making of cash deposits or the transfer of securities by way of security for stock lending transactions, answers most of the concerns and uncertainty identified above with respect to collateral agreements. In particular, it provides for a simple method of creating a security interest in cash and securities without the need to restore to the characterisations of the French Civil Code. Similarly, it provides for an effective means of enforcement by allowing the non-defaulting party to forfeit the cash or the securities in the event of a default "notwithstanding any provision to the contrary" (this phrase being intended to supersede not only the
restrictions of the Code of Commerce and of the Civil Code, but also 
also amends the Banking Law 1984 to exclude cash collateralisation from 
the definition of what constitutes a banking activity.

Similar legislation should be sought for with respect to over-the-counter 
derivatives transactions, all the more so as Law no. 91-716 has 
indirectly confirmed the concerns and uncertainties identified above with 
respect to the use of collateral arrangements in connection with 
transactions that do not fall within its scope.

In addition, in view of the wide variety of collateralisation techniques 
used across the world and the need in each case to take into account 
local requirements of security laws, it is suggested that some 
harmonisation should be achieved to facilitate the setting up of 
collateral arrangements for cross-border transactions. An analysis could 
also be conducted as to the desirability of establishing a centralised 
system for collateralisation of derivatives transactions meeting certain 
standard requirements. Given the growing internationalisation of the 
derivatives industry, it is suggested that such an analysis can only be 
made at an international level.

LINKLATERS & PAINES
12 May 1993
Global Derivatives Study Group

Enforceability Survey — Germany

prepared by Hengeler Mueller Weitzel Wirtz

June 16, 1993
THE GROUP OF THIRTY
GLOBAL DERIVATIVES STUDY

Germany

Survey of Enforceability Subcommittee

This memorandum addresses certain enforceability issues under German law in connection with derivative transactions. These issues include (i) contract formation, (ii) capacity, (iii) close-out netting and (iv) legality. Where appropriate, desirable or prospective legislative changes will be identified.

I. CONTRACT FORMATION

As a general rule, there are no statutory requirements that contracts made under German law must be in writing or must comply with any other requirement as to form. In particular, derivative transactions entered into by oral agreement or electronic transmission are generally binding, regardless of the duration or value of the transaction.

The above rule is, however, subject to certain exceptions. Requirements as to the form of a derivative transaction may apply (i) where the counterparty is a German public law entity, (ii) where the counterparty is not a registered merchant or professional (iii) in respect of certain types of collateral and (iv) where the parties stipulate such requirement. While the overall practical impact of these exceptions for the derivatives market appears marginal, it is nevertheless important to identify the situations in which they may apply.

(i) Commitments by public law entities (as defined in II. below) are in certain cases required to be in writing and to satisfy other formal requirements and/or are subject to approval by superior administrative bodies. Non-compliance with such requirements may render the relevant transaction ineffectiv. for lack of the requisite form or authority. Therefore, in addition to the vires issues discussed below, the existence of formal requirements should be carefully examined before entering into derivative transactions with public law entities.
(ii) Derivative transactions with certain private counterparties may be unenforceable under German governing regulations, unless the counterparty, prior to entering into the transaction, received certain specified information in writing regarding the risks involved.\footnote{1}

(iii) Certain types of collateral (such as mortgages or certain guarantees by private individuals) must be in written form and satisfy other formal requirements. The importance of these types of collateral in the derivatives market is, however, negligible.

(iv) Under Sections 125, 127 German Civil Code, parties may agree that a future transaction between them shall only be valid if is in writing or meets other requirements as to form. Courts, however, have often upheld subsequent agreements lacking the stipulated form on the grounds that the parties implicitly waived their previous agreement establishing the formal requirement.

II. CAPACITY

While legal entities organized under German private law enjoy unlimited capacity, German public law entities have been held generally to be subject to the ultra vires doctrine.\footnote{2} Therefore, public law entities, as a rule, cannot validly enter into any transaction beyond their respective powers as set forth in their charter or as provided for by applicable law.

The following is a survey on vires and related issues with respect to various German public law entities which are, or which are expected to become, active in the derivatives market. These entities include sovereign bodies (i.e. Federal Republic and States) (see 1.1.), certain federal entities (Railways, Mail, Treuhandanstalt) (see 1.2.), public law banks (Landesbanken, savings banks) (see 1.3.) and public law insurance institutions (see 1.4.). Following this survey, the allocation of risk in connection with the ultra vires doctrine and appropriate legislative measures regarding the capacity of public law entities will be addressed (see 2. below).

\footnote{1} Section 53(2) Exchange Act, see Appendix 1. For details see IV. below

\footnote{2} German Federal Supreme Court (1956), BGHZ 20, 119.
1. Vires Issues and Related Issues Regarding Various Public Law Entities

1.1. Sovereign Bodies (Federal Republic and States)

We have concluded that the Federal Republic and its 16 constituent States (Länder) are not subject to the ultra vires doctrine. The main argument supporting this view is that the ultra vires doctrine as stated by the German Federal Supreme Court refers to public law entities to which only a limited scope of objects is assigned. The Federal Republic and each State, however, are sovereign and (through their legislative bodies) have the power independently to determine and amend their "objects" as defined in their respective constitutions. It appears, therefore, that the Federal Republic and the States are not subject to the ultra vires doctrine. In addition, even if the powers of the Federal Republic and the States were limited under the ultra vires doctrine by the scope of objects set forth in their respective constitutions, the constitutional objects of the Federal Republic and the States are so widely drawn that commercial transactions beyond the scope of such objects are virtually inconceivable.

The Federal Republic and each State, thus, have the requisite capacity to enter into derivative transactions. Under the constitutions of the Federal Republic and of each State, the authority for entering into financial transactions, such as derivatives, lies with the relevant Minister of Finance. However, as derivative transactions may result in expenditure, they are subject to budgetary authorization by the relevant parliament. While this requirement should not limit the authority of a Minister of Finance to bind the relevant sovereign body, financial institutions should nevertheless take care not to enter into transactions which do not have the necessary budgetary authorization.

The current Finance Acts of a majority of the German States provide for express budgetary authorization of certain derivative transactions within the context of

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3 These conclusions are included in a memorandum prepared on behalf of various German banks and published in essential parts as special supplement to the German law review "Wertpapiermitteilungen" (WM Sonderbeilage Nr. 2/1992). It is intended to publish an English summary of that memorandum.
borrowings. The scope of these budgetary authorizations varies from state to state ranging from "agreements for the purpose of limiting interest rate fluctuation risks"\(^4\) to "supplementary agreements for the purpose of managing liquidity and interest rate fluctuation risks and obtaining more favourable terms and for similar purposes in respect of new borrowings and existing debt"\(^5\).

In the case of the Federal Republic and some States no express budgetary authorization for derivative transactions presently exists. We believe, however, that the budgetary authorization required for entering into derivative transactions should be considered as being implied by the budgetary authorization of borrowings where a derivative transaction is so closely related to an authorized borrowing that, in a commercial sense, it forms part of the terms of such borrowing.\(^6\)

1.2. German Railways, German Mail, Treuhandanstalt

The Treuhandanstalt ("THA") is a federal public law entity charged with the privatization of East Germany's state-owned enterprises. As a separate legal entity organized under public law it is subject to the ultra vires doctrine. The position of the German Railways and the German Mail\(^7\) is more complex. They are both public law special funds of the Federal Republic so that, technically, all rights and obligations attributable to the German Railways and the German Mail, respectively, are exclusively rights and obligations of the Federal Republic (which is not subject to the ultra vires doctrine). However, both entities are legally separate from the Federal Republic in almost all material respects: They may enter into contracts, sue and be sued in their own names, they are organized and operated separately and all liabilities resulting from their operations are limited to their respective assets which, in turn, are not subject of other liabilities incurred by the Fed-

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\(^5\) Niedersachsen, § 3(4) Finance Act 1993.

\(^6\) The requirements for such "close relation" are similar to those set out under 1.2, below in connection with the implied power to enter into derivative transactions.

\(^7\) The German Mail consists of three divisions (Postal Services, Postal Bank and Telekom), each of which forms a partial special fund.
eral Republic. In the light of the above, it is likely that a German court would apply the ultra vires doctrine to the Federal Railways and the Federal Mail as if they were separate legal entities.

Neither the THA nor the Federal Railways or the Federal Mail are expressly authorized to enter into derivative transactions by virtue of the respective applicable law and, in the case of THA, their charter documents. We have concluded\(^8\), however, that the power of the THA and the German Railways to borrow money implies the power to enter into certain derivative transactions that are directly related to an individual borrowing. This conclusion is equally applicable in respect of the German Mail which also has the power to take borrowings.\(^9\) The main argument for such implied power is that where certain terms of borrowing can be validly achieved by structuring and/or amending the underlying loan agreement, then the relevant entity should also have the power to achieve the same commercial terms by using a combination of a derivative transaction and a loan agreement (instead of a single structured loan agreement), especially where this procedure tends to reduce the overall financing costs. The same should apply where a derivative transaction is used in combination with the issue of debt securities.

The scope of derivative transactions that should be covered by such implied power may be determined by the underlying concept of the derivative transaction forming part of the commercial terms of the borrowing. For instance, a fixed versus floating interest rate swap entered into in connection with a floating rate borrowing should meet the following conditions: (i) the duration and the notional amount of the swap transaction may not exceed the duration and the principal of the loan transaction; (ii) the amounts payable under the loan transaction and receivable under the swap transaction by such entity must be based on the same reference rate and in the same currency; and (iii) the swap transaction must be entered into by such entity for the purpose of managing the interest rate fluctuation risk resulting from the loan transaction.

\(^8\) See Note 3 above.

\(^9\) Section 40 German Mail Constitution Act (Postverfassungsgesetz).
1.3 Landesbanken, Saving Banks, Other Public Law Credit Institutions

The 12 German Landesbanken are both regional state banks organized under public law and universal commercial banks. The Landesbanken, within their respective region also serve as central banks for more than 700 municipal saving banks together with which they form the German savings bank system representing roughly one third of Germany's domestic banking assets.

As public law entities, the Landesbanken are subject to the ultra vires doctrine. Typically, the charters of the Landesbanken provide that the relevant Landesbank may enter into all "transactions ordinarily carried out by banks" (bankmäßige Geschäfte) or all "business transactions serving the purpose and interest of the bank". In these cases the relevant Landesbank should have the power to enter into any type of derivative transaction. Where a different language is used to describe the activities of a Landesbank, the relevant charter must be carefully examined to see whether the Landesbank has the power to enter into derivatives.

Savings banks, typically, do not have the power to enter into all types of derivative transactions. The power of savings banks to enter into derivative transactions varies significantly from State to State and is typically defined more narrowly than in the case of the Landesbanken. The relevant State Regulations may also provide for the possibility of a savings bank being authorized by the competent supervisory authority on a case-to-case basis to enter into transactions which are normally beyond its powers.

Apart from the Landesbanken and savings banks, there are other public law banks in Germany (such as KfW, DSL-Bank, DG Bank and public law mortgage banks). These banks are all subject to the ultra vires doctrine. Their capacity to enter into derivative transactions varies depending on their respective charter documents and applicable statutory provisions.

1.4 Insurance Institutions

Under Sec. 7(2) Sentence 1 German Insurance Supervision Act (Versicherungsaufsichtsgesetz - VAG) both private and public law insurance institutions may only enter into insurance contracts and transactions
which are "directly related" thereto. Sec. 7(2) Sentence 2 VAG provides that

"In respect of futures transactions and transactions involving options and comparable financial instruments, such relation is deemed to exist, if such transactions are designed to hedge currency or interest rate fluctuation risks in respect of existing assets or future acquisitions of securities or if additional yield from existing securities is to be generated, unless the performance of any delivery obligation would result in any shortfall of the committed assets."

Non-compliance with the above statutory restrictions by private insurance companies should not invalidate the relevant transaction, the effect of such non-compliance being limited to possible administrative measures by the insurance industry's supervisory authority. However, in respect of public insurance institutions, Sec. 7(2) VAG, subject to any additional restrictions in the charter of each such institution, at the same time provides the power to enter into derivative transactions and determines the scope of such power. Accordingly, derivative transactions by public law insurance institutions beyond the limits set forth in Sec. 7(2) VAG are void.

2. Allocation of Risks and Legislative Recommendations

Derivative Transactions beyond the powers of a public law entity that is subject to the ultra vires doctrine are void, regardless of a counterparty's good faith or any representations to the contrary. Generally, there is no potential for a successful claim for damages against the relevant public law entity. However, any payments made in respect of such transaction are subject to restitution.

As the power of public law entities in respect of derivative transactions is frequently unclear and, in addition, often depends on the purposes pursued by the relevant public law entity, the ultra vires doctrine involves a significant degree of uncertainty. Given the considerable commercial activity of the public law entities in respect of which vires issues in connection with derivative transactions arise, it seems unfair that the burden of risk related to proper authorization and purposes on the part of the
public law entity be shifted to the counterparty which is usually not in a position to reliably control or even assess this risk. Of the possible legislative approaches to reduce the legal uncertainty resulting from the ultra vires doctrine, both the most efficient and equitable would be to abolish such doctrine altogether. However, we are not aware of any legislative initiative in this context.

III. CLOSE-OUT NETTING

1. Current Legal Position

There is no statutory provision or reported judicial authority which specifically addresses the question of the enforceability of close-out netting in respect of derivative transactions and related master agreements in Germany. However, it is a widely held view amongst leading legal commentators that agreements providing for close-out prior to the institution of insolvency proceedings are enforceable. This includes close-out triggered by bankruptcy-related events such as the insolvency of a party, the inability of a party generally to pay its debts or the filing for bankruptcy proceedings. The related netting provisions generally do not raise any enforceability problems as netting is widely permitted under German bankruptcy law.

The enforceability of close-out netting in respect of derivative transactions is indirectly supported by judicial authority providing that, although bankruptcy law is generally mandatory, the receiver must accept the terms of a contract and the condition of a contractual relationship as they exist at the time of the opening of bankruptcy proceedings. Even more specifically, courts have upheld termination clauses providing for a party's right to terminate a contract upon the institution of bankruptcy proceedings in respect of the other party.

The remaining uncertainty as to the enforceability of close-out netting in the context of derivative transactions (which stems from the lack of specific authority and from the views of some legal commentators that close-out provisions which effectively undercut mandatory rights of the receiver should be unenforceable) may be reduced by drafting the relevant agreement accordingly. This involves two major aspects:
First, although close-out upon the institution of bankruptcy proceedings should be enforceable under present law, it is advisable to ensure that close-out be completed prior to the institution of bankruptcy proceedings. This is even more important because under a proposed new Insolvency Code which may be adopted in the near future, the termination of certain derivative transactions upon the opening of insolvency proceedings will be invalid. This proposed legislation may also have an impact on the present legal situation since, at times, courts view proposed legislation as a source of inspiration. Accordingly, the relevant agreement should provide for automatic termination occurring no later than upon the filing for bankruptcy where grounds for bankruptcy actually exist or the petition for bankruptcy is filed by or on behalf of the defaulting party.

Second, the less the results of a close-out netting provision deviate from the situation which would exist without such provision, the more likely it is to be upheld. For that reason, the stipulation of full two-way-payment, a fair valuation of the mutual rights and obligations, a single agreement approach, cash settlement and the choice of DM as close-out currency should increase the likelihood of a close-out netting clause being enforceable against a German counterparty.

2. Proposed Insolvency Code

Currently, a bill for a new Insolvency Code is being discussed in Parliament. The proposed legislation does not expressly address contractual close-out netting provisions in respect of derivative transactions. However, it provides additional comfort in that the scope of derivative transactions terminated ipso facto upon the opening of insolvency proceedings under statutory law (i.e. without contractual termination) is significantly extended with the resulting claim for damages against the bankrupt estate generally being subject to set-off. On the other hand, the bill in its present form expressly provides that certain executory contracts (i.e. swap transaction) cannot be validly terminated upon the institution of insolvency proceedings. The bill may be passed by the end of this year, although, as yet, there is no specific timetable.
IV. LEGALITY

"Futures transactions" (Börsentermingeschäfte) within the meaning of Section 50 of the German Exchange Act may be unenforceable under Section 52 et seq. Exchange Act if certain requirements specified in Section 53 Exchange Act are not met. The term "futures transactions" is very widely interpreted and is deemed to comprise virtually any derivative transaction including futures, options, forward rate agreements, swaps and swaptions (whether for hedging or speculative purposes).

Under Section 53(1) Exchange Act a derivative transaction is binding if each party (i) is a merchant who is either registered or not subject to registration because he is a foreign resident or a public law entity or (ii) a professional as defined in Section 53(1) sentence 2 Exchange Act.

If only one party qualifies under the foregoing, a derivative transaction is unenforceable unless such party is subject to statutory banking or exchange supervision (whether in Germany or abroad) and informs the other party in writing of certain risks set out in Section 53(2) Exchange Act (see Appendix 1).

The foregoing restrictions also apply to derivative transactions governed by foreign law if the person invoking the unenforceability of the transaction under Section 53 Exchange Act was a German resident at the time of the transaction and was present in Germany when entering into the transaction.
The German Exchange Act
with
Amendment of August 1, 1989

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Note: In this translation several German terms have been retained in their original in parenthesis for explanatory purposes. The terms „Kursmakler“ and „Makler“ have not been translated. Laws and rules have been cited as is common in the German language; e. g. „§ 1(2)” means „Paragraph 1 Absatz 2” or „paragraph 1 subparagraph 2”.
§ 52 Effectiveness of Futures Transactions

A futures transaction which does not violate a prohibition pursuant to this Act or a prohibition imposed pursuant to § 63 shall be valid only in accordance with §§ 53 – 56.

§ 53 Enforceability of Futures Transactions

(1) A futures transaction shall be binding if the parties to the transaction on both sides are merchants who

1. are registered in the commercial register or the register of cooperatives or

2. pursuant to § 36 Commercial Code or, in the case of a public cooperation, according to the regulation applicable to it, do not need to be registered or

3. are not registered because they have their domicile or principal place of business outside of the area of applicability of this Act.

Persons, who at the time of the transaction or prior thereto, traded in futures commercially or professionally or were permanently admitted to engage in exchange trading shall also be deemed merchants within the meaning of this provision.

(2) If only one of the two parties to the transaction is a merchant within the meaning of subparagraph (1), the transaction shall be binding if the merchant is subject to statutory banking or exchange supervision and, prior to the transaction, informs the other party in writing that

- rights acquired through futures transactions which are limited in time can expire or diminish in value;
- the risk of loss can be indeterminable and can exceed the value of securities which might have been granted;
- transactions intended to exclude or limit the risks resulting from open futures transactions may not be effected or may be effected only at a price which will result in a loss;
– the risk of loss is increased if
credit is used to fulfil obligations resulting from futures transac-
tions or
the obligation resulting from futures transactions or the considera-
tion claimable thereunder is denominated in a foreign currency or a
unit of account.
The risk disclosure statement may contain only information about
futures transactions and the risks associated therewith and must be
signed by the other party. The date of the risk disclosure may not go
back for more than three years; however, subsequent to the first risk
disclosure, the risk disclosure has to be repeated after the expiry of
one year. In the event of any dispute as to whether or not or when the
merchant informed the other party, the burden of proof shall rest
upon the merchant.

(3) Subparagraph (2) shall not apply to futures transactions in com-
modities other than precious metals.

§ 54 (Repealed)

§ 55 Imperfect Obligation
What has been given to perform the transaction may not be reclaimed
on the ground that no obligation existed for the performing party pur-
suant to §§ 52 and 53.

§ 56 Set off
Set off against claims resulting from futures transactions with claims
resulting from other futures transactions shall be permissible even if
these transactions do not create a claim of the party setting off pur-
suant to §§ 52 and 53.

§ 57 Enforceability in Case of Readiness to Perform and Per-
formance
A futures transaction which is not prohibited shall be deemed valid
and enforceable from the beginning if the one party agrees with the
other party, when the performance becomes due or thereafter, to
accept the performance as contracted and the other party has per-
formed in fulfilment of that obligation.

§ 58 Defences
The plea pursuant to §§ 762 and 764 of the Civil Code may not be
raised against claims resulting from futures transactions by a person
for whom the transaction is valid and enforceable according to §§ 53
and 57. To the extent such plea against claims of this kind continues
to be admissible, § 56 shall apply mutatis mutandis.
§ 59 Recognition of Debt

The provisions of §§ 52 to 58 shall also apply to an agreement by which the one party incurs an obligation to the other party for the purpose of settling a debt arising from a futures transaction which is not prohibited, in particular a recognition of debt.

§ 60 Giving and Acceptance of Orders, Associations for Futures Transactions

The provisions of §§ 52 to 59 shall also apply to the giving and accepting of orders as well as to associations for the purpose of concluding futures transactions which are not prohibited.

§ 61 Foreign Transactions

Regardless of the law applicable to a futures transaction, the claims which may be asserted by reason thereof against a person

1. upon whom the transaction is not enforceable pursuant to § 53;
2. whose habitual abode was in Germany at the time of the transaction and
3. who made the declaration of intent necessary for the conclusion of the transaction in Germany may not be more extensive than those granted by German law.

§ 62 Default with Respect to Commodity Futures

(1) In a commodity futures transaction the seller who delivers goods not in conformity with the contract shall, upon termination thereof, be deemed in default, even if the time for delivery has not yet expired.

(2) Any agreement to the contrary shall be null and void.

§ 63 Restriction of Futures Transactions

The Federal Minister of Finance may, with the approval of the Federal Council, prohibit or restrict futures transactions or subject their admissibility to conditions, if this is required for the protection of the public.

§ 64 Invalidity of Prohibited Futures Transactions

(1) A futures transaction which is prohibited pursuant to § 63 does not create any obligation. The invalidity also extends to the granting of a security.

(2) What has been given to perform the transaction may not be reclaimed on the ground that no obligation existed pursuant to subparagraph (1) sentence 1.
Global Derivatives Study Group

Enforceability Survey — Japan

prepared by Mitsui, Yasuda, Wani & Maeda

April 12, 1993
I. Introduction

The securities, banking, insurance and related financial industries are heavily regulated in Japan. However, many of the regulations are through administrative guidances by certain bureau of the Ministry of Finance (hereinafter the "MOF") or the Ministry of International Trade and Industry (hereinafter the "MITI") to specific financial institutions. Therefore, it is almost impossible to state definitively what the current regulatory position of the government is with respect to specific business areas such as swap transactions. At present, there is no move by any governmental agency to set forth any clear-cut guidance in order to permit or regulate swap transactions.

Hence, this memorandum is based on our understanding and interpretation of the discussions which we have had with the institutions and government officials regarding swap transactions as well as our observation of the practices occurring in this country which presently is prevailing over legal interpretations.

II. Relevant Laws

There are no laws, ordinances or even administrative guidances which specifically regulate swap transactions. However, the Foreign Exchange and Foreign Trade Control Law governs a very technical matter that may be applied to swap transactions, and the Penal Code, the Securities Exchange Law and the Commodity Exchange Law are relevant to certain aspects
of swap transactions.

The Foreign Exchange and Foreign Trade Control Law states in relevant part that:

(3) a transaction involving a claimable right, creation, etc. under a sales and purchase contract between a resident and a non-resident of a foreign means of payment or a claimable right; (4) a transaction involving a claimable right creation, etc., payable in a foreign currency, under a deposit contract, trust contract, money lending and borrowing contract, guarantee contract for an obligation, or sales and purchase contract of a foreign means of payment, claimable right, and others, between a resident and another resident; ... require license from the MOF. (The Foreign Exchange and Foreign Trade Control Law, Article 20 item 3 and 4)

The official interpretation by the MOF is that the term "purchase" as used in these provisions may include the exchange of claimable rights. Thus, these provisions may be applied to swap transactions. In order to receive such permission the financial institution desiring to enter into foreign exchange transactions must disclose information regarding the transaction to the MOF. It is rather difficult to obtain the necessary approval from the MOF even after extensive disclosure has been made. However, authorized foreign exchange banks are granted blanket exemption under the law.

Article 185 of the Japanese Penal Code provides that a fine of up to 500,000 Yen or penal detention of up to 30 days shall be imposed on every person who has gambled or bet for property to be gained or lost by chance. This Article is generally construed to mean that if parties agree to win or lose property on the basis of the outcome of a future event which is not ascertained by the parties at the time when the agreement is made, then that conduct will come within the Article. However, Article 35 of the Japanese Penal Code provides that a person
whose conduct could fall within the category of a criminal act under the provisions of the Penal Code or other laws shall not be punished if such conduct is taken pursuant to the provisions of a law or pursuant to justifiable business reasons.

The Securities Exchange Law and the Commodity Exchange Law also have anti-gambling provisions. Under Article 201 of the Securities Exchange Law and Article 145 of the Commodity Exchange Law, speculation on the securities or commodities index, respectively, off the market is prohibited. Thus, if equity or commodity swap transactions are considered to be index speculation, then they would be in violation of the relevant provision.

It is very difficult, in reality, to distinguish between hedging and/or investment from speculation. The review of the appropriateness of application activities will become necessary. Currently, we can argue that swap transactions entered by the financial institutions are outside of the application of the anti-gambling provisions because they are entered into with legitimate business reasons.

According to Article 87, paragraph 2 of the Securities Exchange Law, no establishment of facility similar to an exchange market is permissible. The Commodity Exchange Law, Article 8, has substantially the same provision in it. There has been some debate on whether persons involved in either equity or commodity swap transactions are in fact in violation of these laws. It appears that the Securities Bureau of the MOF has no intention of applying Article 87, paragraph 2 to swap transactions. And the MITI which supervises the application of
the Commodity Exchange Law appears to think that commodity swap transactions are not the type of transactions intended to be covered by Article 8 when legislators enacted the provision.

III. Banks

The Banking Law of Japan and the Banking Bureau of the MOF set forth regulations and guidelines which must be followed by Japanese banks. According to Article 4, paragraph 5 of the Banking Law, three standards for banks exist in Japan. They are (i) long-term credit banks under the Long-term Credit Bank Law, (ii) foreign exchange banks under the Foreign Exchange Bank Law and (iii) commercial banks (hereinafter, collectively, the "Banks"). A number of these Banks are authorized foreign exchange banks pursuant to the Long-term Credit Bank Law, the Foreign Exchange Bank Law and the Foreign Exchange and Foreign Trade Control Law.

According to the Long-term Credit Bank Law, a long-term credit bank is permitted by the MOF to participate in foreign exchange transactions. Hence, long-term credit banks are authorized foreign exchange banks. The Foreign Exchange Bank Law has a provision making it necessary for a bank to obtain a license from the MOF if it intends to engage in foreign exchange transactions. The Bank of Tokyo, Ltd. is the only bank which has obtained such a license subject to this law.

The Foreign Exchange and Foreign Trade Control Law also has a provision regulating banks. According to Article 10, paragraph 1 of this law, "[a]ny bank which intends to deal in
foreign exchange business shall determine its offices which deals therein ..., and scope of such business, and shall obtain an authorization therefor from the Ministry of Finance." (The Foreign Exchange and Foreign Trade Control Law, Article 10, paragraph 1) Pursuant to this Article, a number of commercial banks have obtained a license from the MOF and become authorized foreign exchange banks.

Article 10 of the Banking Law sets forth what types of transactions the Banks may participate in. Article 10.1 provides in relevant part that:

a Bank may (1) receive deposits or instalment savings; (2) loan funds or discount bills or notes; and (3) become involved in exchange transactions. (Banking Law, Article 10, paragraph 1)

Article 10, paragraph 2 lists additional business which Banks may perform and also states that other business similar or ancillary to such additional business may be performed by the Banks. Hence, the Banking Law is rather vague as to what types of transactions the Banks are restricted from doing.

Although the most recent amendment to the Banking Law was enacted in 1992, there are no provisions specifically for the Banks contemplating or becoming involved in swap transactions. Therefore, the Banks have broadly interpreted the vagueness of the Banking Law and have been involved in interest rate and/or currency swap transactions since the mid 1980s. The MOF has not commented on such transactions; hence, it appears that the MOF has tacitly approved or at least has no intention at present of prohibiting the Banks’ participation in swaps.

The Banks have participated in interest rate and/or currency, equity and commodity swap transactions based on the
interpretation that Article 10, paragraph 2 of the Banking Law permits such transactions as ancillary to banking business. The Banks claim that they are participating in these swap transactions in order to hedge and protect themselves and their customers to the best of their abilities and not for speculation purposes as that would be in violation of the anti-gambling provisions of the Securities Exchange Law and Commodity Exchange Law as well as the Penal Code.

As to equity swap transactions, although the Banks' involvement in the securities business is heavily regulated by the Securities Exchange Law, the Banks have originally been allowed to handle securities as their ancillary business. Also, the Banks' involvement in the equity swap transactions can be categorized as credit enhancement business with the Banks acting as financial intermediaries. Therefore, the Banks can deal with equity swap transactions as a type of financial products as long as the terms and conditions of such transactions do not violate Article 185 of the Penal Code.

The argument permitting commodity swap transactions is that the Banks are playing the role of intermediaries to give credit enhancement and matching up customers who want to swap their commodities for fixed or floating interest rates with other customers who want commodities in lieu of their fixed or floating interest rates. Although the MITI seems to argue that commodity swap transactions are commodity transactions which are subject to their jurisdiction, the Banking Bureau of the MOF seems to analyze such transactions as financial derivative transactions.
Whether the Banks are authorized foreign exchange banks or not have resulted in the Banks' participation in solely domestic swap transactions or international swap transactions. Long-term credit banks and commercial banks that are also authorized foreign exchange banks are able to participate in swaps which involve foreign currency and non-resident counterparties because they do not need the MOF approval. Although most of the commercial banks are authorized foreign exchange banks, commercial banks which are not authorized foreign exchange banks must receive the MOF approval for each transaction according to Article 20, item 3 of the Foreign Exchange and Foreign Trade Control Law. Therefore, these commercial banks only participate in swap transactions that involve yen and residents of Japan, which do not need the MOF approval.

In addition to the Banks, there are several financial institutions similar to Savings and Loan Associations such as the Shinkin Banks. Yet, at present it is not common for them to be involved in cross border swap transactions. If, however, such financial institutions were to be involved in swap transactions, the same arguments as used for the Banks' participation in swap transactions would apply.

IV. Special Banks and Cooperatives Set Up by the Government

In Japan there are a number of special banks and cooperatives that cater to certain organizations or working groups and which have been set up by the government. The
special banks are (i) Bank of Japan, (ii) Export-Import Bank of Japan, and (iii) Japan Development Bank (hereinafter, collectively, the "Special Banks"). The cooperatives are those including (i) Central Bank for Commercial and Industrial Cooperatives, (ii) Credit Associations, (ii) Central Cooperative Bank for Agriculture and Forestry, and (iv) Labor Credit Cooperative (hereinafter, collectively, the "Cooperatives").

The Special Banks and the Cooperatives have laws set forth specifically to govern each Special Bank and each Cooperative. As the central bank of Japan, Bank of Japan was established by the Bank of Japan Law to regulate currency, to control and facilitate credit and finance of the country, and to foster the general economic activities of the nation. It is our opinion that although in general Bank of Japan does not participated in swap transactions it may consider a swap transaction pursuant to the Bank of Japan Law which states in relevant part that:

Bank of Japan may, whenever deemed necessary for international financial transactions, and with the permission of the competent Minister, make contribution of capital or advances to any foreign financial institutions or undertake exchange clearing transactions with such foreign institution. (Bank of Japan Law, Article 24)

Since the laws governing Export-Import Bank of Japan, Japan Development Bank and the Cooperatives are specific to their purposes, they differ significantly. However, they all contain a provision permitting incidental business as was provided for the Banks in the Banking Law. They have interpreted the relevant provisions and intent of the laws in the same manner as the Banks. In addition, these two Special Banks, both which are qualified as authorized foreign exchange banks, and the Cooperatives which are authorized foreign
exchange banks have been allowed to participate in a wide range of swap transactions involving residents as well as nonresidents of Japan and domestic and foreign exchange transactions. Thus, they have participated in interest rate and/or currency swap transactions for hedging purposes unless they have a credit analysis problem or other business reasons whereby they choose not to enter into swap transactions.

V. Securities Houses

The most important law regulating the securities business and market in Japan is the Securities Exchange Law. Japanese securities houses and foreign securities houses, indirectly pursuant to the Foreign Securities Companies Law, are regulated by the Securities Exchange law.

Article 2, paragraph 8, item 1 through 6 of the Securities Exchange Law and Article 2, paragraph 1, item 4 of the Foreign Securities Companies Law set forth limitations on the business in which securities companies may be engaged in by defining what "securities business" shall consist of. As with the Banking Law, the laws governing Special Banks and those governing Cooperatives, swap transactions are not explicitly covered in the relevant laws. Yet, applying the concept of ancillary business, these financial institutions are thought to have authority to enter into swap transactions.

However, Article 43 of the Securities Exchange Law and Article 17 of the Foreign Securities Companies Law provide that even if a business is not defined as "securities business" if
an approval by the MOF has been obtained for that business, then securities houses may participate in such business. There has been no formal approval granted allowing securities houses to enter into swap transactions. Still, the securities houses have received oral administrative guidance from the MOF and entered into interest rate swap transactions with other residents of Japan. They have not directly been involved in swap transactions based on foreign currencies or with non-residents of Japan unless the counterparty is an authorized foreign exchange bank because they are not authorized foreign exchange banks and will have to receive the MOF approval pursuant to Article 20, item 3 and 4 of the Foreign Exchange and Foreign Trade Control Law.

As to equity swap transactions involving securities houses, the position of the MOF, Securities Bureau, is quite unclear but several securities houses have entered into such transaction. The MOF's concern is the violation of the anti-gambling provisions of the Securities Exchange Law and the Penal Code. However, such concern does not seem to be reasonable and our argument stated in the previous section regarding equity swap transactions by the Banks would also apply. If the MOF adopts a position that securities houses cannot enter into equity swap transactions, the result would be quite strange because the most appropriate financial institutions to handle equity swap transactions would be prohibited from entering into such transactions and only the Banks, which are under the jurisdiction of the Banking Bureau of the MOF would be entering into such transactions. Thus, securities houses will most
likely continue to increase the volume of their equity swap transactions by assuming such "regulatory risks".

As to commodity swaps, Japanese Securities houses do not seem to have been visibly involved in such transactions because of the nature of underlying products.

VI. Insurance Companies

The Insurance Business Law regulates what types of business an insurance company may enter into.¹ According to Article 5 of the Insurance Business Law, in general insurance companies are prohibited from carrying on any business other than insurance business. Hence, swap transactions are entered by them only in connection with their own asset management. Their asset management is heavily controlled by a Ministerial Ordinance called "Guideline Book on Asset Management". It is generally said that insurance companies cannot make any investment other than those provided in this Guideline Book. The swap transactions are not covered by such Ministerial Ordinance as is usual with new financial products.

The investment activities by insurance companies outside of such guidelines will cause problems under the Insurance Business Law, but it is highly unlikely that Japanese courts will hold swap transactions entered into by insurance companies void because of such overreaching. It is probable that an

¹ Japanese insurance regulations segregate life insurance companies from casualty companies such as fire and marine insurance companies but the discussion in this section will apply to both types of insurance companies.
argument that swap transactions are not investment but only a
method of hedging would apply. In fact, insurance companies
have entered into yen based swap transactions with residents of
Japan or in interest rate and/or currency swap transactions with
authorized foreign exchange banks as part of their asset
management. We are not aware whether they have entered into
equity swap transactions, but legally speaking they may enter
into equity swap transactions for hedging purposes.

In addition, insurance companies most likely may
participate in commodity options or precious metal options if
they have their own position of bonds linked to such
commodities. The position of the MOF, Banking Bureau, Insurance
Department, is also unclear. However the MOF has not prohibited
such transactions for hedging purposes although it is aware that
insurance companies are participating in swap transactions.
There was a movement by life insurance companies to set up self
regulatory rules, but such plan was abandoned. It appears that
at present insurance companies may participate in swap
transactions in order to diversify their portfolio and the
volume of swap transactions entered into by insurance companies
will continue to increase because of their huge portfolio which
needs hedging.

VII. Pensions

Currently, we are not aware of any pension fund having
entered into swap transactions although pension funds may need
hedging mechanism. In practice, the moneys of pension funds are
deposited with trust banks and managed by such trust banks or asset management company. Therefore, legally speaking, as such funds do not have any independent legal personality, swap transactions should be entered into by trust banks on behalf of the pension funds. However, trust banks may demand that their liabilities under such transactions be limited to the value of such deposited assets or even decline to assume such liabilities. We think some legal structure can be introduced to manage such situation, but it would take some more time before such structure will be accepted in the Japanese market. It is clear that there is a big demand for swap transactions in this market.

VIII. Municipalities

Municipalities are regulated by the Local Autonomy Law and the Local Finance Law. According to the Local Finance Law Article 8, municipalities are required to manage their properties efficiently and safely. The Local Autonomy Law gives the district assembly the power to decide the budget of its municipality. The assembly, subject to the Local Finance Law, is to resolve how many bonds and in which currency the bonds should be issued in order to best manage the assets. The assembly will then request the Ministry of Home Affairs, which is the supervising body of bond issuance by municipalities, to review the resolution of the assembly and to permit the assembly to issue such bonds. In reviewing the resolution, it has been the practice of the Ministry of Home Affairs to determine
whether it is better for the bonds to be a domestic issue or an Euro-issue. If the Ministry of Home Affairs determines that an issuance of Eurobonds is preferable, then a swap transactions with Japanese authorized foreign exchange banks will become permissible. Therefore, swap transactions are entered into by municipalities for hedging purposes. Hence, in this manner, municipalities have participated in swap transactions with approval from the Ministry of Home Affairs. We think that it is unlikely that such municipalities will negate swap transactions based on the argument of ultra vires.

IX. Conclusion

Although there are no regulations or guidelines specifically permitting swap transactions in Japan by any of the financial institutions set forth above, in practice they are participating in swap transactions. None of the relevant governmental agencies have prohibited such transactions. Hence, we are of the opinion that as long as swap transactions are entered into with legitimate business reasons, such transaction will not be held to be in violation of the Penal Code, the Securities Exchange Law or the Commodity Exchange Law. Since swap transactions will be considered valid, then under the Japanese Civil Code such transactions will be held not to be in violation of public policy and enforceable.²

² We have attached a memorandum by Professor Koji Shindo (Professor Emeritus) of University of Tokyo regarding Bankruptcy and Attachment Law Issues Concerning the ISDA Master Agreement which states that provisions concerning early termination is enforceable.
BANKRUPTCY AND ATTACHMENT
LAW ISSUES CONCERNING THE
ISDA MASTER AGREEMENT

January 27, 1993

Koji Shindo

Professor Emeritus, University of Tokyo
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1.Validity of Close-out Provision  271

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Section 1. Introduction

I. Identification of Issues and Method of Analysis

This memorandum discusses the Interest Rate and Currency Exchange Agreement (the "Master Agreement") created by the International Swap Dealers Association ("ISDA") in 1987, in the context of Japanese bankruptcy and attachment laws.¹

Because there are no reported court decisions which consider the issues discussed in this memorandum, this memorandum presents the author's view of the possible judgment that a Japanese court would reach. For this memorandum, it is assumed that the Master Agreement is governed by Japanese law and that a Japanese court would have jurisdiction to adjudicate the issues discussed.

1. Main Provisions of the Master Agreement

The following is an outline of swap transactions conducted pursuant to the Master Agreement.

1) Two parties enter into the Master Agreement.

2) In addition to the Master Agreement, individual swap transactions (each an "Individual Swap Transaction") are entered into by exchanging confirmations (each, a "Confirmation") (see the introductory paragraph of the Master Agreement).

¹ Translator's Note: In this memorandum, the general phrase "Japanese bankruptcy laws" in this context refers to Japanese laws governing both bankruptcy and corporate reorganization.
Concerning the relationship between the Master Agreement and the Confirmations, it is possible to consider the Master Agreement and the Confirmations to constitute a single agreement between the two parties. However, it can be concluded that Individual Swap Transactions are entered into each time a Confirmation is exchanged, and that the Master Agreement supplements the contents of such Individual Swap Transactions.

3 "Netting" is effected among claims that would otherwise be payable on the same payment date, if they are in the same currency and in respect of the same swap transaction (see the first sentence of Section 2(c) of the Master Agreement).

4 If "Net Payments--Corresponding Payment Dates" is specified in a Confirmation, netting is effected among all claims based on Individual Swap Transactions that would otherwise be payable on the same payment date and in the same currency (see the second sentence of Section 2(c)). If netting is effected in this way, one remaining claim is produced for all Individual Swap Transactions payable on the same payment date and in the same currency.

5 Payment is made in the place of the account specified in the Confirmation, in the manner customary for payments in the required currency (see Section 2(a)(ii)).

6 Each obligation of each party to pay any amount due is subject to (i) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing and (ii) each other applicable condition precedent specified in the Master Agreement (see Section 2(a)(iii)).

7 Close-out Provision

"Close-out" means the production of a single remaining claim ("Last Remaining Claim (Ω)") as a result of the netting
calculation provided pursuant to Section 6(e) of the Master Agreement in case of the occurrence of any Event of Default defined in Section 5(a).

According to Section 5(a) of the Master Agreement, Events of Default consist of Failure to Pay, Breach of Agreement, Credit Support Default, Misrepresentation, Default under Specified Swaps, Cross Default, Bankruptcy, and Merger Without Assumption (see Section 5(a)(i) through (viii)).

For example, if a party files a bankruptcy petition, or if a bankruptcy petition is filed against a party and such petition results in a judgment of bankruptcy or is not dismissed within 30 days, there is an Event of Default under Section 5(a)(vii)(4). The result is that all outstanding Individual Swap Transactions based on the Master Agreement are automatically terminated early. This "Early Termination Date" is deemed to have occurred immediately preceding the commencement of the bankruptcy proceeding or the presentation of the petition. (See the second sentence of Section 6(a), Section 5(a)(vii); such date shall hereinafter be referred to as the "Close-out Point".)

Pursuant to Section 6(e) of the Master Agreement, the defaulting party shall pay to the other party at the Close-out Point the excess, if a positive number, of (A) the sum of (i) the cost to the other party of executing economically equivalent swap transactions with third parties in the market (the "Settlement Amount") (see Section 14, "Market Quotation") and (ii) the total unpaid amounts owing to the other party, over (B) the total unpaid amounts owing to the defaulting party. Performed as above, close-out produces the Last Remaining Claim ($\Omega$) through netting.

2. Identification of Issues

A petition under Japanese law for bankruptcy or corporate reorganization meeting the elements set forth in Section
5(a)(vii)(4) of the Master Agreement constitutes an Event of Default. Accordingly, assuming that A Bank and B Bank have entered into swap transactions (see Figure No. 1, page 7 below), if B Bank files a petition for bankruptcy or corporate reorganization, or if a petition for bankruptcy or corporate reorganization is filed against B Bank and such petition results in a judgment of bankruptcy or commencement of reorganization or is not dismissed within 30 days, all outstanding Individual Swap Transactions are automatically terminated as the result of close-out and a close-out is effected (see Section 6(a) and (e)). If a close-out is effected, A Bank's claims against B Bank will be paid prior to those of other creditors to the extent A Bank's claims against B Bank and B Bank's claims against A Bank are netted in the process of producing Last Remaining Claim ($\Omega$). Therefore, the questions are whether the result of such a close-out can be given effect against creditors who have attached B Bank's right to receive payments from A Bank under swap transactions ("attaching creditors"), or against B Bank's trustee in a bankruptcy or reorganization (a "trustee").

This memorandum will discuss these questions.

3. **Method of Analysis**

This memorandum will show the validity of the close-out provision under Japanese law by demonstrating that the same result achieved through close-out would be obtained under Japanese law even if there were no close-out provision. That is, in Section 2 below, this memorandum will show that the result achieved through close-out would also be achieved under Japanese law by "set-off" (sosai) of all swap transaction claims.

II. **Status of All Claims at Close-out Point**

The claims A Bank and B Bank have against each other pursuant to Individual Swap Transactions serve as
consideration for each other and originally constitute bilateral contractual relationships. On the other hand, when, through netting pursuant to Section 2(c), remaining claims payable on the same date and in the same currency are created for each party, this bilateral relationship is lost among such remaining claims. The netting pursuant to Section 2(c) is interpreted as an "obligation netting" since that Section uses the term "replaced". Furthermore, this obligation netting replaces claims not at the time the opposing claims arise but at the payment date, since Section 2(c) only refers to the effect at the payment date.

Thus, in respect of Individual Swap Transactions, the parties' claims remain as unperformed claims in bilateral contractual relationships until the payment date; they are replaced by a single remaining claim and lose their bilateral relationship at the payment date by netting pursuant to Section 2(c). Accordingly, if close-out occurs before the payment date, each claim pursuant to an Individual Swap Transaction is interpreted to remain in a bilateral relationship with an unperformed opposing claim.

In this memorandum, the above interpretation is assumed to apply.

Note: In addition to the above interpretation, the following interpretation is possible.

Translator's Note: A "claim" (saiken) means a right to demand performance from an opposite party according to the terms of an agreement with that party. In the swap context discussed in this memorandum, mutual claims based on a swap transaction arise at the time the parties exchange a Confirmation. The right to demand actual payment, however, does not accrue until the payment date specified in the Confirmation, absent grounds for acceleration of the payment obligation.
The netting provision can be interpreted to include an agreement of "current account" (kōgo keisan, Article 529 of the Commercial Code) as to all claims payable on the same date and in the same currency pursuant to Individual Swap Transactions (see page 33 below). Since the netting provision constitutes an agreement of current account for all claims payable on the same date and in the same currency, all opposing claims pursuant to Individual Swap Transactions can be regarded as being categorized into groups by payment date and currency at the time such claims arise. According to this logic, the defense of simultaneous performance (a defense available where claims are in a bilateral contractual relationship) is lost at the time Individual Swap Transactions are executed. Thus, the netting provision can be interpreted to include an implicit agreement that the defense of simultaneous performance is mutually waived in advance, both because the Master Agreement has a netting provision at the payment date, and because this could logically be the intent of the parties. Further, according to this interpretation, we can also demonstrate that the result achieved through close-out would occur by netting calculation pursuant to the application of Article 66 of the Bankruptcy Law and Article 107 of the Corporate Reorganization Law (the "Reorganization Law"), which Articles define and prescribe the application of current account in the context of such Laws.
Section 2. Propriety of Close-out by Set-off (Sosai)

I. Achievement of Close-out by Set-off

1. Analysis of Question

Claims existing between A Bank and B Bank at the Close-out Point and the process of close-out of those claims are shown in Figure No. 1.

<Figure No. 1> Process for Producing Last Remaining Claim (Ω) by Close-out
The result of the application of Section 6(e) is to terminate all outstanding swap transactions and to produce a single claim by netting calculation. The calculation in Figure No. 1 is described as follows.

\[(\text{Last Remaining Claim (Ω)})\]
\[= (\text{Unpaid Amount}) + (\text{Settlement Amount})\]
\[= (X-Y+Z) + [(MQ \text{ of } a) + (MQ \text{ of } b) + \ldots + (MQ \text{ of } w)]\]
\[(\text{Note: MQ means Market Quotation})\]
\[= (X-Y+Z) + [(a_1-a_2) + (b_1-b_2) + \ldots + (w_1-w_2)]\]
\[= (X-Y+Z) + (A+B+\ldots+\hat{w})\]

If we analyze the above calculation, the function of close-out is to set off all due but unpaid remaining claims \((X, Y, Z)\), and all claims not yet due \((a_1, a_2, b_1, b_2, \ldots, w_1, w_2)\) (hereafter "\(a_1 \ldots w_2\)") based on Individual Swap Transactions \((a, b, \ldots, w)\). That is:

1. All claims in respect of claims \(X, Y, Z\) are set off. (This is the \((X-Y+Z)\) portion of the above calculation.)

2. In respect of claims \(a_1 \ldots w_2\), the values of all Individual Swap Transactions which are not yet due are determined by Market Quotation and totaled. (This is the \([(MQ \text{ of } a) + (MQ \text{ of } b) + \ldots + (MQ \text{ of } w)]\) portion of the above calculation.)

That is, because a Market Quotation means an amount payable or receivable, due on the Close-out Point, that has an economic effect similar to the parties' obligations at the original payment date (see Section 14, "Market Quotation"), Market Quotation is used to set off the parties' opposing claims pursuant to Individual Swap Transactions (claims \(a_1\) and \(a_2\), or claims \(b_1\) and \(b_2\)) by applying the estimated value of such claims at the Close-out Point. Accordingly, the close-out amount of claims not yet due (the Settlement Amount) is the result of the set-off of opposing claims based on Individual Swap Transactions whose values have been estimated.
at the Close-out Point, and the further set-off of all claims (A, B, ... W) as the result of this set-off. (This is the [(a₁-a₂) + (b₁-b₂) + ... (w₁-w₂)] portion of the above calculation.)

3 The amount of Last Remaining Claim (Ω) produced as the result of close-out can be considered to be the amount remaining after further set-off of the Unpaid Amount, 1 above, and the Settlement Amount, 2 above.

This Section analyzes whether the above set-offs are valid in the context of Japanese law.

<Figure No. 2> Process for Producing Last Remaining Claim (Ω) by Set-off
2. **Method of Analysis**

In this Section, it will be assumed that there is no close-out provision; based on this assumption, there will be presented a discussion of the questions whether the "set-off" (sosai) of claims based on swap transactions is permissible under Japanese bankruptcy and reorganization procedures, and, if so, whether such set-off is given effect against attaching creditors or a trustee.³

To answer whether the various set-offs mentioned in 1 above are permissible, the following five questions need to be analyzed.

1. In respect of due but unpaid remaining claims (X, Y, Z) and claims not yet due (a₁ ... w₂), is set-off between claims in different currencies permissible in view of the requirement of Article 505 of the Civil Code that "opposing claims must have the same kind of character"?

2. In respect of opposing claims, such as a₁ and a₂, b₁ and b₂, ..., w₁ and w₂, is a set-off between such claims permissible even if they are in a relationship of simultaneous performance, in view of the requirement of Article 505 of the Civil Code that claims to be set off must "not be of a nature that is impermissible for set-off"?

3. In respect of claims a₁ ... w₂, because the floating interest rate portions of such claims are not fixed, at the filing of the petition for bankruptcy, can a set-off be effected by using a "special agreement" (tokuyaku) to provide a valuation method?

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³ Translator's Note: This memorandum focuses on the type of set-off established in and governed by the Japanese Civil Code (hotei sosai). At p. 30 below, this memorandum also mentions the type of set-off (yakujo sosai) established by agreement between parties.
4. To set off claims $a_1 \ldots w_2$, a "special agreement" (tokuyaku) of acceleration is necessary to make the claims suitable for set-off. Is such a special agreement given effect against attaching creditors or a trustee?

5. In respect of a set-off concerning claims $X, Y, Z$ and claims $a_1 \ldots w_2$, is there any situation where set-off is not permissible because of the special provisions of Article 104 of the Bankruptcy Law and Article 163 of the Reorganization Law?

Below each of these issues will be discussed in turn.

3. Set-off Between Claims of Different Currencies

(1) Identification of Question

According to Section 1 of Article 505 of the Civil Code, in order to set off opposing claims, such claims "must have the same kind of character." In Figure No. 2 (page 9 above), claims $X, a_1, b_2$ and $w_1$ are Yen claims, claims $Y$ and $w_2$ are Dollar claims, claims $Z$ and $a_2$ are Mark claims, and claim $b_1$ is a Franc claim. Thus, it is possible that set-off of these claims might not be permissible if, under the Civil Code, claims of different currencies are seen as not having the same kind of character.

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Translator's Note: The Japanese law concept of a "special agreement" (tokuyaku) appears in various places in this memorandum. A "special agreement" generally means a special understanding between parties governing a particular point.
(2) Yen Option

Under the interpretation of Article 403 of the Civil Code discussed below, A Bank has the right to choose Yen as the currency of payment (the "Yen option") for its foreign currency liabilities (such as Dollar liabilities Y and \( w_2 \), and Mark liability \( a_2 \)) and for its foreign currency claims (such as Franc claim \( b_1 \), and Mark claim \( Z \)). As a result, all claims become claims of the "same kind of character," and set-off between claims that were of different currencies becomes permissible.

First, in respect of A Bank's foreign currency liabilities (Dollar liabilities Y and \( w_2 \), Mark claim \( a_2 \)), A Bank has the Yen option under Article 403 of the Civil Code.

Next, let us consider A Bank's foreign currency claims (Franc claim \( b_1 \), Mark claim \( Z \)). Because it specifically covers only the Yen option of a debtor, Article 403 of the Civil Code does not apply directly to A Bank's foreign currency claims as a creditor. However, a precedent of the Supreme Court permits creditors the Yen option in respect of foreign currency claims (Decision of the Supreme Court of July 15, 1975, Minshu 29-6, p. 1029). Accordingly, A Bank can choose Yen as the currency for payment in respect of Franc claim \( b_1 \) and Mark claim \( Z \). In opposition to the Supreme Court precedent, there is a contrary opinion that creditors do not have the Yen option because Article 403 of the Civil Code is only intended to ensure a convenient method of payment for a debtor, and because a debtor may suffer a disadvantage as a result of fluctuation in exchange rates. However, in reality, if a creditor demands performance in a foreign currency and obtains a judgment ordering performance in that currency, such creditor must be paid in Yen at the time of execution on the judgment if the debtor does not have the foreign currency. In view of this fact, most foreign currency claims are converted to claims in Yen (Toji Tao, 1975 Supreme Court, Hanrei Kaisetsu, 1979, Hosokai, p. 325).
Considering the realities of how these matters are treated at the time of judgment and at execution, the contrary opinion described above misses the point, because to allow creditors the Yen option would not disadvantage a debtor under such actual practice. The above decision of the Supreme Court can be considered reasonable.

Precedents decided since the above Supreme Court decision have come to the same conclusion. A creditor's right to the Yen option is thought to be established in the case law.

Accordingly, A Bank can choose Yen as the currency for payment in respect of both its foreign currency liabilities (Dollar claims \( y \) and \( w_2 \), Mark claim \( a_2 \)) and its foreign currency claims (Franc claim \( b_1 \), Mark claim \( z \)).


(3) *Special Agreement Excluding Application of Article 403 of the Civil Code in Swap Transactions*

It can be said that, although in principle the Yen option in respect of foreign currency claims and liabilities is available to both creditors and debtors, in swap transactions
payment is ordinarily intended to be made in the foreign currency specified -- in other words, in swap transactions the parties should be considered to have implicitly agreed to a "special agreement" (tokuyaku) that excludes the application of Article 403 of the Civil Code in the ordinary situation. This view is grounded on the notion that a swap transaction is intended, in the ordinary situation, to be performed actually at the agreed amount and in the agreed currency, since the purpose of a swap transaction is to avoid exchange risk.

However, if an Early Termination Event occurs, such as the bankruptcy or reorganization of B Bank, it is A Bank's expectation that it may receive substituted economic value because actual performance in the agreed manner by B Bank is no longer expected (see Note). Thus, a special agreement excluding application of Article 403 of the Civil Code is not thought to apply in the case of an Early Termination Event, and A Bank can set off by converting all foreign currency claims to Yen claims in such cases.

Note: In "Kokusai Kinyu Torihiki ni kakaru Hoteki Shomondai" (Legal Problems Concerning International Financial Transactions) authored by the Group for Study of Legal Problems Concerning International Financial transactions, Kinyu Homujijo 1334, 1992, p. 14, it is stated that, "In respect of exchange transactions or currency swap transactions, currency is the object of such transactions, and, as stated above, the parties would not anticipate the set-off of their respective claims and obligations in the ordinary situation. In addition to that, it should be said that the parties have agreed to a "special agreement" that set-off pursuant to the Civil Code shall not be effected, even if such set-off is possible. However, if one of the parties goes bankrupt, the other party normally expects close-out of the relevant transactions. In such sense, that party commonly expects set-off." This memorandum's
interpretation concerning the above special agreement can be said to be supported by the above statement.

(4) The Validity of the Yen Option Against Attaching Creditors, etc.

The Yen option is not only a right provided by law to creditors and debtors, it also has no effect on the economic value of claims whose currency has been converted. Accordingly, the Yen option is not harmful to attaching creditors or a trustee, and, needless to say, it is given effect against them.

(5) Special Agreement Relating to Conversion Method

All claims may be converted into Yen by A Bank's exercise of the Yen option. A special agreement is needed to govern the method of conversion to Yen from foreign currencies. This raises questions about the validity of such special agreement and the validity of set-off by such special agreement.

To the extent such special agreement's conversion method is fair, there is no reason to judge it invalid as between the parties. Further, such an agreement is given effect against attaching creditors and a trustee because it does not unfairly alter economic value, as discussed in (4) above.

According to Article 22 of the Bankruptcy Law, a bankruptcy claim in a foreign currency must be converted to Yen by using the market exchange rate at the time of the adjudication of bankruptcy. However, this provision is thought to fix the conversion method only for the purpose of distributing the assets in the bankrupt estate where there is no special agreement intended by the parties to govern the conversion method, and it cannot be considered to prohibit such a special agreement to convert foreign currency into Yen. Article 117 of the Reorganization Law provides that a
claim in a foreign currency is to be converted to Yen by using the market exchange rate at the time of the commencement of the reorganization procedure. This provision is thought to apply to currency conversion for the purpose of calculating creditors' voting rights in the reorganization, but only where there is no special agreement; it cannot be thought to override such a special agreement governing conversion to Yen.

4. **Set-off and the Defense of Simultaneous Performance**

(1) **Identification of Issue**

According to the proviso of Section 1 of Article 505 of the Civil Code, in order to set off claims it is necessary that the claims "not be of a nature that is impermissible for set-off." Thus, there arises a question whether claims subject to the defense of simultaneous performance can be set off. In Figure No. 2 (page 9), there would be no question as to claims X, Y and Z because such claims have no bilateral contractual relationship. As to claims a₁ and a₂, and b₁ and b₂, which are in bilateral contractual relationships, we should examine whether opposing claims may be set off to the extent they are of the same kind.

The Civil Code establishes set-off and the defense of simultaneous performance as the means to maintain fairness in securing the simultaneous performance of each party where two parties have opposing claims. We can say that set-off applies to claims of the same kind, and the defense of simultaneous performance applies to claims arising from the same contract. As discussed in 2 above, all claims of A Bank and B Bank can be converted into Yen. Accordingly, we can consider claims a₁ and a₂, or claims b₁ and b₂, to be, for example, claims for 1 million Yen and 800 thousand Yen, or claims for 5 million Yen and 10 million Yen. Then the question is, which of the two systems applies where opposing
claims in the same currency arise, such as 1 million Yen and 800 thousand Yen pursuant to one contract?

(2) **Set-off and the Defense of Simultaneous Performance**

One precedent found that a claim which was subject to the defense of simultaneous performance could not be set off against another claim (Decision of Taishin-in of March 1, 1938, Minshu jyo 17, p. 318). However, the two claims as to which set-off was sought were not in a simultaneous performance relationship -- one was a payable that was a landlord's rent claim, and the other was a receivable that was a tenant's claim for payment for improvements made.\(^5\) Rather, the tenant's claim was in a simultaneous performance relationship with the landlord's right to receive the improvements. If set-off had been permitted between the tenant's claim and the landlord's rent claim, the landlord could not have asserted its right to receive the improvements in exchange for payment of the tenant's receivable, one of two claims deemed to be securing mutual performance (the tenant's receivable) would have been extinguished, and one party's (the landlord's) expected security interest would have been lost. Thus, this precedent is quite reasonable.

However, where both claims pursuant to one bilateral contract (such as claims for 1 million Yen and 800 thousand Yen) are money claims, it would seem to be the reasonable expectation of the parties that 200 thousand Yen would be paid after set-off, rather than face deadlock by allowing each party to insist on its defense of simultaneous performance. If the defense of simultaneous performance is permitted, the creditor that is entitled to 1 million Yen will obtain a judgment ordering that payment in exchange for the 800 thousand Yen payment. And it would be pointless to

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5 Translator's Note: In this context, a "receivable" (jidosaiken) means the amount being claimed by a party seeking set-off; a "payable" (judosaiken) means the amount owed by that party on an opposing claim.
insist that the 1 million Yen claim could only be enforced by depositing the 800 thousand Yen. Accordingly, only set-off, and not the defense of simultaneous performance, must apply to opposing money claims arising under one bilateral contract. A recent Supreme Court precedent states that, as to a claim for payment for construction work performed and an opposing claim for damages for defective work, both claims having occurred under the same bilateral construction contract, such money claims can be set off. The Court's reason is that set-off makes the legal relationship more simple, convenient and fair for both parties than does actual performance, where there is no substantial interest for both parties actually to perform, notwithstanding that both claims are in a relationship of simultaneous performance. (Decision of Supreme Court, September 21, 1978, Hanreijiho 907, p. 54.)

The above 1978 decision treated the case where the amount receivable is greater than the amount payable. In contrast, where the payable of the party seeking set-off is greater than the amount receivable, it is possible to think that set-off should not be permitted; this is because, if set-off were allowed, the opposite party would be required to accept a claim for the difference between the payable and the receivable after set-off without actually receiving payment of the claim at that time; this would be less advantageous than exercising the defense of simultaneous performance, which would enable the opposite party to receive actual payment in exchange for making its payment. However, the opposite party does benefit in a set-off because the 200 thousand Yen balance after set-off becomes due immediately, rather than later. The rationale behind the defense of simultaneous performance would not prohibit set-off, up to equal value, of money claims (which are by their nature divisible and performable in part) because this does not harm the fairness to the parties. A precedent also approves set-off where the amount payable is greater than the amount receivable (Decision of Supreme Court, March 4, 1976, Hanreijiho 849, p. 77).
Accordingly, where opposing Yen claims arise under one bilateral contract, it can be concluded that both claims can be set off, in equal amounts, regardless of the existence of the defense of simultaneous performance.

5. **Validity of Special Agreement Fixing Amount of Claim**

Some of claims $a_1 \ldots w_2$ (claims not yet due) pursuant to Individual Swap Transactions may include claims with floating interest rates which are not yet fixed at the filing of the petition for bankruptcy. Because claims of unfixed amounts cannot be set off, a special agreement is needed to fix such claims in a certain manner. Then the question becomes whether set-off by such special agreement is permissible (the proviso of Section 1 of Article 505 of the Civil Code). Further, there is the question whether such special agreement is given effect against attaching creditors or a trustee.

Such a special agreement is thought to be valid, both because there is no reason to consider it void as between the parties, and because the same reasons stated in 3(5) above (in respect of the special agreement for conversion from foreign currency to Yen) apply with regard to the validity against attaching creditors or a trustee.

6. **Validity of Special Agreement of Acceleration**

(1) **Identification of Issue**

According to Section 1 of Article 505 of the Civil Code, in order to set off opposing claims "both claims must be due." Therefore, claims $a_1 \ldots w_2$, which are not yet due, must be accelerated by a special agreement in order to be appropriate for set-off. Questions then arise as to the validity of such special agreement and whether a set-off pursuant to such agreement is given effect against attaching creditors or a trustee.
(2) Validity of Special agreement of Acceleration Against Attaching Creditors

In a decision of the Grand Bench of the Supreme Court of June 24, 1970, the Court gave effect to a special agreement of acceleration against attaching creditors (Minshu 24-6, p. 587 the "1970 Decision"). Precedents afterwards have followed the 1970 Decision.

Note: These precedents are set out below --

Decision of Supreme Court of August 20, 1970, Hanreijiho 606, p. 29
Decision of Supreme Court of November 6, 1970, Hanreijiho 610, p. 43
Decision of Supreme Court of December 18, 1970, Kinyu-homujijyo 603, p. 17
Decision of Supreme Court of November 19, 1971, Kinyu-homujijyo 637, p. 29
Decision of Supreme Court of November 25, 1976, Minshu 30-10, p. 939

As to precedents before the 1970 Decision: ① the decision of the Supreme Court of July 19, 1957 (Minshu 11, p. 1297) held that a set-off could be given effect against attaching creditors if the receivable was due at the time of the attachment, even though the payable was not due, and ② the decision of the Supreme Court of December 23, 1964 (Minshu 18-10, p. 2217) held that set-off could be given effect against attaching creditors as long as the receivable is going to be due before the payable becomes due, even though the receivable is not due at the time of the attachment. To the contrary, ③ the 1970 Decision held that the set-off could be given effect against attaching creditors without regard to the due dates of the receivable and opposing payable. Although there was a special agreement of acceleration in each of the above ①, ② and ③, the decision
in ① assumed that the special agreement of acceleration could not be given effect against attaching creditors, the decision in ② held so explicitly, and the decision in ③ held that the special agreement could be given effect and overruled the decisions in ① and ②.

At the foundation of the Court's reasoning in the 1970 Decision is the idea that, if two parties have a relationship of continuing transactions with and claims against each other, they anticipate that such claims will be satisfied by set-off regardless of the due date of the claim, expecting that set-off will have a security interest-type function (meaning that, through a party's receiving a release of its obligations, it has its claims against the other party satisfied). The Court concluded that such expectation is the basis for ordinary transactions and should be protected. In this sense, the special agreement of acceleration is nothing other than the means to give effect to this expectation, since application of the special agreement allows setting off all opposing claims (see the opinion of Justice Kenichiro Osumi in the 1970 Decision and the opposing opinion of Justice Jiro Matsuda in the above 1964 decision).

This idea can also be applied to swap transactions. The aim of banks entering into swap transactions is to profit from margins and to manage interest rate and exchange rate risk, by monitoring their overall interest rate and exchange rate position and continuously entering into swap transactions pursuant to the Master Agreement to create opposing claims. Parties to continuous transactions expect, as a security measure, that claims against each other can be set off if one of them becomes insolvent, regardless of the due date. It can be concluded that this expectation should be protected as reasonable.

Also, attachment can only operate to prohibit disposition of claims, and cannot operate to change the contents of
existing claims. Thus the special agreement of acceleration can be given effect against attaching creditors.

There is a view that the existence of such a special agreement must be public knowledge in order to be effective against attaching creditors, for the reason that such an agreement should not cause unexpected harm to a third party who is unaware of it. Even if this view is accepted, the special agreement of acceleration is public knowledge in the Japanese financial community, and cannot be said to cause unexpected harm to third parties.

Note: Scholarly theories as to the validity against attaching creditors of the special agreement of acceleration can be categorized as follows:

Hogakukyokaizasshi 89-1, 1972, p. 126 etc. [Supporting limited validity], (Based on the theory stated by Justice Osumi, if a reasonable expectation exists, such as the special agreement’s being public knowledge or the event of acceleration being clear) Ryohei Hayashi "Sosai no kinou to koryoku (The Function and Effectiveness of Set-off)" (Tanpoho Taikei Gokan), 1984, Kinyuzaiseijiiyo-kenkyukai p. 532, Yoshio Nakai "Chusyaku Minpo Junikan", 1970, Yuhikaku, p. 476 etc. [Against validity] Ryohei Hayashi, Kikuo Ishida, Takio Takagi "Saiken Soron (General Theory of Claims)", 1978, Seirinshoin, p. 318 etc.
(3) **Validity of Special Agreement of Acceleration Against a Trustee**

When bankruptcy procedures are commenced it is at a time when the credit of a party is in an even worse state than in the ordinary attachment situation. This means it is more necessary than in the attachment situation to fulfill and protect, through set-off, the parties' security interest-type expectation. As mentioned above, court precedents have held that a party's expectation that it will be able to set off claims regardless of the due date should be duly protected by giving effect to the special agreement of acceleration against attaching creditors. Following the reasoning of these precedents, it is obvious that the special agreement of acceleration should be considered valid in order to protect the parties' expectations in the case of bankruptcy and reorganization.

The effect of the commencement of bankruptcy procedures is to prohibit disposition of the assets of the bankrupt, and accordingly results in attachment of the bankrupt's estate. Accordingly, absent some explicit provision to the contrary in the law, the commencement of bankruptcy procedures does not alter rights and obligations and cannot be thought to extinguish a creditor's reasonable expectation of set off. In particular, Article 99 of the Bankruptcy Law provides that claims with specific due dates for performance can be set off without any special agreement of acceleration, so the above special agreement of acceleration, which has the same effect as Article 99 of the Bankruptcy Law, should be interpreted to be valid.

In addition, in the case of reorganization, the right to effect set-off outside the reorganization procedure is recognized in the Reorganization Law (Section 1 of Article 162). Since the expectation of set-off is protected in this provision, a special agreement of acceleration which fulfills this due expectation cannot be denied. Accordingly, the
special agreement of acceleration should be interpreted to be effective against a trustee in reorganization; further, in actual reorganization practice, the special agreement is given effect pursuant to the 1970 Decision mentioned above (see Hachiro Yamanouchi, "Jitsumu Kaisha Koseiho, third edition", 1977, Ichiryusha, p. 196.)


(4) Arguments in Opposition to Opinions that Special Agreement of Acceleration is Invalid

Two opinions have been advanced that are contrary to the view that the special agreement of acceleration is valid in reorganization.

(i) The first opinion is grounded in a precedent of the Supreme Court of March 30, 1982 (Minshu 36-3, p. 484). This case involved a special agreement providing that the occurrence of an event which could form the basis for the commencement of reorganization procedures would be a termination event. In a sale of machinery where the seller had retained title, the seller terminated the purchase agreement based on the special agreement and demanded that the buyer's trustee in reorganization return the machinery. In this decision, the agreement purporting to allow termination was held invalid because it undermined the purpose and effect of reorganization procedure, namely, to maintain and reorganize the business of a corporation in financial straits by coordinating the interests of creditors, shareholders and other concerned parties. This first contrary opinion considers the intent underlying the Supreme
Court precedent to be that the right of the seller retaining title should be treated as a secured claim in the reorganization and should not be converted into a title recovery right by the special agreement of acceleration. This opinion asserts that, based on the above intent, the special agreement of acceleration for set-off should be invalid, because such an agreement would give a creditor in a reorganization an even stronger right than a title recovery right, since set-off would allow the creditor actually to realize its claim. (Morio Takeshita, Hanrei Times 505, 1983, p. 280.)

However, the above precedent does not apply to the special agreement of acceleration for set-off, for the following reasons.

① As the above 1982 precedent was a decision of the Third Petit Bench of the Supreme Court, while the 1970 Decision which held valid the special agreement of acceleration for set-off was a decision of the Grand Bench, the 1982 decision cannot be considered to have changed the 1970 Decision. The 1982 decision must be interpreted as limited to the question of recovery of property, where title has been retained, by termination pursuant to the special agreement of termination, and not to cover the special agreement of acceleration. (For opinions stating that the 1982 decision does not apply, see Jiro Yamada, Kinyu Homu Jijo 1009, 1982, p. 18, Jin Horiuchi, Tegata Kenkyu 331, 1982, p. 48).

② The title retention device examined by the 1982 decision is considered to be a security interest that, under the Reorganization Law, cannot be foreclosed upon outside the reorganization process. The special agreement purporting to give the creditor a termination right was denied in the 1982 decision because to validate such an agreement would permit the same result that would be achieved by exercising a security right or title recovery right outside the
reorganization, and thus a result more favorable than that available under the Reorganization Law. In contrast, the right of set-off can be exercised outside reorganization, under Article 162 of the Reorganization Law, and thus it is different from other security rights. Accordingly, set-off pursuant to the special agreement of acceleration outside the reorganization process yields the result considered appropriate under the Reorganization Law. Considering the difference in result between the above two special agreements, it is an incorrect jump in reasoning to say that the special agreement of acceleration for set-off is invalid based on the 1982 decision, which held a special agreement of termination ineffective to allow foreclosure outside the reorganization.

(ii) The second contrary opinion states that claims should be set off only when their original due dates permit such set-off, because the scope of set-off must be limited in the context of a corporate reorganization. Section 1 of Article 162 of the Reorganization Law provides that set-off of claims requires that such claims be suitable for set-off before the deadline for proof of claims in the reorganization. This opinion reasons that this requirement of Section 1 of Article 162 would be meaningless if set-off by the special agreement of acceleration were permitted. It also maintains that set-off by such special agreement may not be given effect against the trustee in reorganization. According to this opinion, claims dependent on the special agreement of acceleration are nothing more than secured claims and must be treated the same as other secured claims in reorganization. (Makoto Ito "Kaisha Kosei Tetsuzuki ni Okeru Sosai Kensha no Chii (The Position of Creditor with the Right of Set-off in Reorganization Procedures)" Minshoho Zasshi 86-4, 1983, p. 570, Yukihiro Miyawaki and others "Chukai Kaisha Kosei ho" 1986, Seirin Shoin, p. 597, Jiro Matsuda "Kaisha Koseiho, Shinban", 1976, Yuhikaku, p. 206.)
The bases for this opinion are, first, that the purpose of Section 1 of Article 162 of the Reorganization Law is to limit the right of set-off in reorganization, as opposed to bankruptcy, because a broad set-off right would make corporate reorganization difficult, and second, that a set-off, which serves both a "self-help" function, thereby giving priority in payment, as well as a security function, can be given effect only when it satisfies the requirements set forth in the Reorganization Law.

1 However, the common purpose of both bankruptcy and reorganization procedures is to treat creditors fairly; of course, the reorganization procedure has certain differences that derive from its other purpose, which is to facilitate reorganization, but that procedure should only be considered to differ in its protection of creditors when differences are clearly established in the law. Set-off is permitted outside both bankruptcy and reorganization procedures, and there is no reason to distinguish the two. If the two procedures are interpreted to treat creditors in two different ways, it will be contrary to the expectation of the parties and impair normal transactional relationships. For example, when trading companies provide financing, they manage the credit risk assuming an ability to effect a set-off, and both parties transact business on the basis of net claims and liabilities after set-off. In such a situation, neither party expects a different result as between bankruptcy and reorganization. Accordingly, Article 162, Section 1 of the Reorganization Law must be interpreted to positively permit set-off, just as the Bankruptcy Law does. (Hajime Kaneko and Akira Mikazuki "Jyokai Kaishakoseiho", 1953, Kobundo, p. 335, Takeo Suzuki and Satoru Sakabe "Kaishaseiri-Kosei", 1955, Seirin Shoin, p. 112.) That provision must be interpreted as limiting the period for exercise of the right of set-off in order to facilitate establishment of a plan of reorganization, but not as preventing claims from being made suitable for set-off by the special agreement of acceleration.
Further, the second opinion seems to assume that, if the special agreement of acceleration is interpreted to be effective, then banks will in practice be permitted to set off without limitation, thus making reorganization difficult. However, in actual reorganization practice, at the time banks effect such a set-off by the special agreement of acceleration, the amount of the reorganizing company's deposit against which the set-off is effected is typically less than the amount of the loan. Thus, it is rarely thought that the special agreement makes reorganization more difficult.

No court has decided the validity of the special agreement of acceleration for set-off in the context of corporate reorganization. However, this simply means that in corporate reorganization practice the special agreement of acceleration is considered valid without any argument, under the 1970 Decision discussed earlier. Thus, the 1970 Decision's application to the special agreement of acceleration is considered appropriate in the actual practice of reorganization.

Furthermore, the second opinion states that creditors who are prohibited, under Article 162 of the Reorganization Law, from setting off are to be treated as secured creditors in the reorganization. However, this is a doubtful interpretation of the Article. Under the Bankruptcy Law, a secured creditor is treated as a creditor with special rights (betsujokensha) entitled to exercise its rights outside the bankruptcy, while under the Reorganization Law a secured creditor may not exercise rights outside the reorganization process. Nevertheless, under the Reorganization Law, the right of set-off is permitted to be exercised outside reorganization, and thus, it can be concluded that under the Reorganization law creditors with rights of set-off have a higher expectation of recovery than ordinary secured creditors in the reorganization. Such treatment under the
Reorganization Law cannot be considered to affirmatively prohibit claims from being made suitable for set-off by the special agreement of acceleration. If set-off by that special agreement is prohibited, and a creditor that would otherwise have the right to set off by special agreement of acceleration is treated as simply a secured creditor in the reorganization, then the funds owed by the creditor under its obligation to the estate must be deposited into an account and the creditor will have a security interest in that deposit. It is difficult to conclude that the law should be interpreted to require such a technical treatment without a specific provision saying so; even more to the point, this kind of treatment is of doubtful utility in the reorganization of corporations.

3 The second opinion states that Article 163 of the Reorganization Law applies where there is no justifiable expectation of a security interest, and that the self-help type remedy permitted under Article 162 cannot be automatically applied to all cases outside Article 163. However, as already noted, such a limited interpretation of Article 162 seems inappropriate; restriction on set-off must be limited to that in Article 163.

Note: Another opinion states that the special agreement of acceleration is effective only where the due date of a receivable is prior to that of a payable, following the reasoning of the decision of the Supreme Court of December 23, 1964 (Minshu 18-10, p. 2217). However, it has already been explained above that the 1964 Decision was not appropriate, and this opinion has no basis. (Akira Mikazuki "Syokai Kaishakoseiho, Cyukan" 1973, Kobundo, p. 884)

In light of the above, the special agreement of acceleration for set-off in swap transactions is valid and given effect against attaching creditors and a trustee in bankruptcy or reorganization.
7. Relationship with Provision Prohibiting Set-off

Article 104 of the Bankruptcy Law and Article 163 of the Reorganization Law prohibit certain set-offs. However, a set-off between claims in connection with swap transactions entered into before the "preference" period defined in Items 2 and 4 of Article 104 of the Bankruptcy Law and Items 2 and 4 of Article 163 of the Reorganization Law is not prohibited. Claims in connection with transactions entered into within such period may not be set off; however, for purposes of this memorandum, such claims can be ignored, because the close-out provision which is the subject of this memorandum comes into effect at the filing of the bankruptcy petition and does not contemplate further transactions.

8. Conclusion

As described above, claims pursuant to swap transactions will become a single claim of one party against the other by set-off, and such set-off is given effect against attaching creditors and a trustee in bankruptcy or reorganization.

II. Set-off and the Trustee's Election

1. Identification of Issue

As was discussed in I above, at the time of filing of the petition for bankruptcy or corporate reorganization, all claims pursuant to swap transactions can be set off and reduced to a single remaining claim (Last Remaining Claim ($\Omega$)); the trustee's usual right, under Article 59 of the Bankruptcy Law and Article 103 of the Reorganization Law, to elect whether to perform or terminate claims pursuant to bilateral contracts does not seem to apply.

In considering the status of claims before a set-off, as shown in Figure No. 2 (page 9), claims X, Y and Z are not in
bilateral contractual relationships, and set-off of those claims can certainly be effected. However, claims $a_1$ and $a_2$, $b_1$ and $b_2$, ..., $w_1$ and $w_2$ are in bilateral contractual relationships, so there may be doubt as to whether those claims can be set off, if set-off is seen as an evasion of Article 59 of the Bankruptcy Law and Article 103 of the Reorganization Law. We now examine this question.

Note: Concerning the relationship between set-off and Article 59 of the Bankruptcy Law, in "Kokusai Kinya Torihiki ni kakaru Hoteki Shomondai (Legal Problems regarding International Financial Transactions)" (the article quoted above at p. 14), it is stated that, "in respect of set-off established by law (hotei sosai), Article 98 of the Bankruptcy Law takes priority over Article 59," but that, in respect of set-off pursuant to the parties' agreement (vakuijo sosai), the answer is not clear. Other than the above, no writings that discuss this problem have been found. Below will be discussed the question of whether set-off should take priority over the bilateral contractual character (especially the defense of simultaneous performance) of a swap transaction, given that opposing claims pursuant to swap transactions in bilateral contractual relationships can become Yen claims by the application of Article 403 of the Civil Code.

2. Analysis of two opposing Scholars' Opinions Concerning Legislative Intent of Article 59 of the Bankruptcy Law and Article 103 of the Reorganization Law

There are two opposing opinions concerning the legislative intent of Article 59 of the Bankruptcy Law. One opinion gives primacy to the smooth conclusion of bankruptcy proceedings and fair protection for both parties to a bilateral contract where one party is in bankruptcy; the other gives primacy to increasing the assets of the bankrupt
entity's estate by permitting the trustee the right of election in the above case.


The first opinion asserts that the intent of Article 59 is both to avoid the unfairness that would result if, as the result of the bankruptcy, all of a creditor's claims simply became claims (of doubtful value) in bankruptcy, while all of the creditor's obligations to the bankrupt's estate were enforced, and also to provide a right to terminate bilateral contractual relationships early to avoid the situation where a trustee would have to perform all obligations of the estate in order to terminate such relationships (which would be the case if the Article were seen only as providing for simultaneous performance).

The second opinion asserts that the intent of the Article is to alter contractual relationships for the benefit of the trustee, to increase the assets of the bankrupt's estate and, if the trustee chooses to perform, to confirm the defense of simultaneous performance defined in the Civil Code.

Precedents have not discussed these opposing opinions.

The above views can in the same manner be thought to apply to the interpretation of the intent of Article 103 of the Reorganization Law.
3. **Set-off and the Trustee's Election**

The defense of simultaneous performance is fundamental to preserve fairness for parties to a bilateral contract. However, as argued in I.3 above, the right of set-off is superior to such right, as in the case of the bilateral contract with opposing claims of 1 million Yen and 800 thousand Yen. It is convenient and fair for the parties to set off these claims and reduce them to a remaining claim for 200 thousand Yen. Early settlement by set-off also serves the purpose of promoting on early conclusion to the bankruptcy proceedings. On the other hand, the Bankruptcy Law and the Reorganization Law give effect to the expectation of a security interest by permitting broad exercise of the right of set-off except in unreasonable cases (Article 98 of the Bankruptcy Law and Article 102 of the Reorganization Law). To summarize the above, to the extent that the legislative intent of Article 59 of the Bankruptcy Law and Article 103 of the Reorganization Law is as stated in the first opinion, it can be interpreted as consistent with the structure of the Bankruptcy Law and the Reorganization Law that unperformed opposing Yen claims in bilateral contractual relationships may be set off.

But if, as asserted in the second opinion, the legislative intent of those Articles is to increase the assets of the bankrupt's estate, set-off would deprive the trustee of the election and be substantially inconsistent with such intent.

However, ① scholars advancing the second opinion would permit the creditor to terminate the contract even after adjudication of bankruptcy, based on a default occurring before adjudication, notwithstanding that it deprives the trustee of the opportunity to elect to perform (See Makoto Ito "Hasanho", p. 188, Yasuhei Taniguchi "Tosan shori ho", p. 182). To keep balance with such treatment, set-off must be permitted where the expectation of a right of set-off arises
before the start of the "preference" period, even if it deprives the trustee of the opportunity to terminate or perform.

2 Further, because the trustee cannot speculate as to whether to perform or terminate "market" transactions (that is, transactions for which there is an open market), Article 61 of the Bankruptcy Law, as an exception to Article 59, provides for automatic termination and settlement by netting calculation based on market standards in respect of such transactions, which are meaningless without performance at a specified future time (Tomonori Miyagawa and others "Kihonho Kommentaru Hasanho", 1989, Nihonhyoronsha, p. 85). Swap transactions are speculative transactions which are meaningless if not performed at a specified future time, and they also depend on valuations based on credible market quotations, although they have no official market. Thus, we can apply Article 61 to swap transactions by analogy, and the trustee's election provided in Article 59 of the Bankruptcy Law and Article 103 of the Reorganization Law cannot be permitted.

3 The netting provision of Section 2(c) of the Master Agreement is an agreement to produce a new remaining claim by netting calculation at the payment date among claims payable on the same date and in the same currency pursuant to Individual Swap Transactions. This provision can be regarded as an agreement of "current account" (kogo keisan, Article 529 of the Commercial Code) among claims payable on the same date and in the same currency, which produces one claim by netting calculation on a certain date among claims pursuant to certain transactions. At the adjudication of bankruptcy or the commencement of reorganization, Article 66 of the Bankruptcy Law or Article 107 of the Reorganization Law (these are the two Articles that govern current account) is applied, and the current account is automatically terminated, the final calculation is performed, and the remaining amount becomes due. These Articles are interpreted, as exceptions
to Article 59 of the Bankruptcy Law and Article 103 of the Reorganization Law, to terminate unperformed relationships between opposing claims by the settlement effected through netting calculation at the adjudication of bankruptcy or the commencement of reorganization if the opposing claims are the types of claims included in the current account. (Concerning the Bankruptcy Law, see "Kihonho Konmentaru Hasanho", p. 85 above; concerning the Reorganization Law, see "Jokai Kaishakoseiho Chu", p. 348, above.) Under the above treatment established by the Bankruptcy Law and the Reorganization Law, Article 66 of the Bankruptcy Law and Article 107 of the Reorganization Law apply to claims pursuant to swap transactions, where such claims are payable on the same date and in the same currency and the parties have agreed to include the claims in a current account. The trustee's election under Article 59 of the Bankruptcy Law and Article 103 of the Reorganization Law should not apply.

As described above, whether we adopt the view of the first opinion or the second, set-off between Yen claims (claims a₁ and a₂, claims b₁ and b₂ ... claims w₁ and w₂) in bilateral contractual relationships is not prohibited by these Articles.
III. Summary

As discussed in I and II above, in the context of bankruptcy and corporate reorganization, claims arising out of swap transactions can be reduced to a single Yen claim held by A Bank against B Bank, by set-off through application of several special agreements. That is, for all claims due but unpaid (claims X, Y and Z), and all claims not yet due (claims a₁ ... w₂) pursuant to Individual Swap Transactions, we can choose Yen as the currency, set off by several special agreements and produce a single Yen claim (see Figure No. 2, page 9). This single Yen claim is Last Remaining Claim (Ω), which results from the netting calculations done pursuant to the close-out provision (see Figure No. 1, page 7). Because such set-off is given effect against attaching creditors and a trustee, and is not prohibited by the provisions of the Bankruptcy Law or the Reorganization Law, the close-out provision, which is intended to achieve the same result as such set-off, cannot be considered invalid under Japanese bankruptcy and attachment laws.
Section 3. Conclusion -- Validity of Close-out Provision

1. Validity of Close-out Provision

The aim of the close-out provision in the Master Agreement is to produce Last Remaining Claim ($\Omega$) after netting calculation performed on all claims pursuant to swap transactions. Questions may arise as to whether settlement by this provision deprives a trustee of the election to terminate or perform under Article 59 of the Bankruptcy Law and Article 103 of the Reorganization Law, and whether such settlement must be deemed invalid in view of the rationale of the 1982 decision discussed above. It is the ultimate task of this memorandum to discuss the validity of the close-out provision by clarifying these questions.

As shown in the analysis in Section 2 above, it is recognized as possible under Japanese law to achieve, by set-off, the same result achieved by the close-out provision, and that such result is given effect against attaching creditors and a trustee in bankruptcy or reorganization. Thus, the close-out provision is deemed valid under Japanese bankruptcy and attachment laws, even if the close-out provision is interpreted to be in the nature of a termination (kaijo), or to have some other legal nature.

2. Calculation Method for Last Remaining Claim ($\Omega$)

Needless to say, for the close-out provision to be valid, the method for calculating Last Remaining Claim ($\Omega$) must be fair.

The close-out provision provides that the present value of claims not yet due pursuant to Individual Swap Transactions is to be calculated by reference to market quotations at the Close-out Point. Thus, whether the result of settlement is fair depends on whether reference to these market quotations constitutes a fair valuation method.
The valuation of Individual Swap Transactions by reference to market quotations entails an appraisal of the transactions by third parties that are not parties to the transaction; further, there is no other valuation method existing at present. In addition, market quotation would likely be used in valuing the amount of a claim in bankruptcy or calculating the creditor's voting rights in a reorganization, pursuant to Article 22 of the Bankruptcy Law or Article 117 of the Reorganization Law. According to Section 14 of the Master Agreement (definition of "Market Quotation"), at calculation of Last Remaining Claim ($\Omega$) under the close-out provision, quotations must be obtained from at least three leading dealers in the relevant swap market. In order to secure a fair valuation, if more than three quotations are provided, the Market Quotation is to be determined by the average of the quotations, excluding the quotations having the highest and lowest values; if exactly three quotations are provided, the Market Quotation is to be the quotation remaining after disregarding the quotations having the highest and lowest values. Accordingly, the close-out provision cannot be considered invalid under bankruptcy and attachment laws for using Market Quotation as the method for calculating the settlement.
Global Derivatives Study Group

Enforceability Survey — Singapore

prepared by Allen & Gledhill

June 15, 1993
1. Introduction

This memorandum addresses the issue of the enforceability of swap transactions in Singapore. Specifically, this memorandum will be directed towards ascertaining the types of entities that may legally enter into swap transactions, the procedures which have to be followed by an entity in entering into these transactions as well as the allocation of risks in the event that an entity has acted outside its powers in entering into swap transactions. This memorandum also examines certain related issues arising from the nature of swap transactions (namely that such transactions may be oral and that swaps may be used for speculative purposes) in the light of applicable legislation such as the Statute of Frauds 1677, the Civil Law Act (Chapter 43) and the Futures Trading Act (Chapter 113). Lastly, the issue of whether netting agreements entered into pursuant to swap transactions providing for netting out on insolvency are legally enforceable is examined.
2. Government Entities

2.1 Types of government entities that may enter into swap transactions

In Singapore, government entities include government departments and all statutory bodies which are bodies constituted by their respective constituting legislation. Some of these entities are the Monetary Authority of Singapore ("MAS"), the Public Utilities Board ("PUB"), the Jurong Town Corporation ("JTC") and the Central Provident Fund Board ("CPF").

In order to determine whether a government entity may enter into swap transactions, the constitutive statute of that entity has to be examined in order to determine whether the entry into of swap transactions by that entity is consistent with or furthers the objects for which that entity was set up and whether it is within the powers of that entity to enter into swap transactions.

The respective statutes constituting these entities set out in detail the objects for which these entities were set up as well as the powers conferred on them. From an examination of these statutes, the only government entity in Singapore which appears to have power to enter into swap transactions is MAS, which is the de facto central bank of Singapore with its principal object being to act as the banker to, and financial adviser of, the Government of Singapore. Being officially charged under the Monetary Authority of Singapore Act (Chapter 186)("MAS Act") with promoting monetary stability and credit and exchange conditions conducive to the growth of the economy of Singapore, it has also been given wide powers to do generally all such things as may be commonly done by bankers which are not inconsistent with the discharge of its duties. No other government entity in Singapore has been given such express power to enable them to enter into swap transactions.
Apart from a government entity's express power to enter into swap transactions, an issue which has to be considered in this regard is whether one may imply a power to enter into swap transactions from a government entity's powers to borrow which is usually present in the constituting statutes of most government entities. There is authority that a government entity does not have such implied powers to enter into swap transactions as a consequence of its express power to borrow. This is the result of the English House of Lords decision in Hazell v. Hammersmith and Fulham London Borough Council [1991] 2 WLR 373 (which is of persuasive authority in Singapore) which decided that a particular local authority in England may not engage in interest rate transactions as such transactions could not be said to be calculated to facilitate, or were conducive or incidental to the discharge of, that local authority's express powers of borrowing.

Accordingly, although a government entity may have been given the power to borrow as well as the power to carry on all activities, the carrying on of which appears to that entity to be necessary, advantageous or convenient for or in connection with the discharge of the specific functions with which it has been charged, that government entity does not have the power to enter into swap transactions. Based on the principle in the case of Hazell, such government entity must, like MAS, have express powers in its constituting statute permitting it to enter into swap transactions before it may do so.

2.2 Types of swap transactions that government entities may enter into

So long as a government entity has the necessary power to enter into swap transactions, there should be no limitation on the types of swap transactions that it may enter into. Swap transactions can be grouped into five main categories and they are as follows:
(i) interest rate swaps;
(ii) cross-currency fixed-to-fixed swaps;
(iii) cross-currency fixed-to-floating swaps;
(iv) same currency floating-to-floating swaps; and
(v) cross-currency floating-to-floating swaps.

Accordingly, MAS, which has the power to enter into swap transactions, may enter into any of these swap transactions in its capacity as the central bank of the Government of Singapore.

2.3 Allocating the burden of risk

As stated above, MAS has express authority to enter into swap transactions and so long as these transactions have been entered into by properly authorised officers of MAS, such transactions will not be beyond the capacity of MAS and should be binding on MAS.

2.4 Types of counterparties with whom government entities may enter into swap transactions

Assuming that a government entity has the power to enter into swap transactions, it may enter into swap transactions with any legal entity, local or foreign, which is duly organised and validly existing under the laws of the jurisdiction of its organisation or incorporation which, in its commercial assessment, is a suitable party to the transactions.

3. Corporate Entities

3.1 Types of corporate entities entitled to enter into swap transactions

All companies which are incorporated in Singapore under the Singapore Companies Act (Chapter 50) ("CA") or its predecessor
legislation may enter into swap transactions if authorised to do so by its Memorandum and Articles of Association ("M & A").

Unless the company is a bank or a financial institution, it is unusual for the M & A of a Singapore company to contain an express provision authorising the company to enter into swap transactions. However, the M & A of a company which is incorporated in Singapore with limited liability will typically include a general clause empowering the company to do all such other things as are incidental or conducive to the attainment of the objects and the exercise of the powers of the company. The breadth of such a general clause would probably permit a company to enter into swap transactions which are related to its business. In any event, swap transactions entered into by a company which does not have any express power to enter into swap transactions are still enforceable against the company by the counterparties (see paragraph 3.4 below).

3.2 Types of swap transactions that may be entered into by a corporate entity

If a company is authorised by its M & A to enter into swap transactions, it should be able to enter into both currency as well as interest rate swaps for the purpose of hedging its currency and interest rates trading risks. On the other hand, swap transactions which are speculative in nature and which are not engaged in for a commercial purpose, may not be entered into by a Singapore company.

3.3 Procedures which have to be followed by a corporate entity in entering into swap transactions

If swap transactions may be entered into by a company because it is consistent with or would further the objects or powers of the company as set out in the M & A, the procedure to be followed by
such a company in entering into swap transactions is as set out in the Articles of Association of the company for entering into any other legitimate transaction on behalf of the company. Typically, a swap transaction may be entered into by a Director or any other officer of a company who has been authorised by its Board of Directors to enter into such a transaction. Any agreement in respect of such a transaction may be validly entered into if executed by any officer of the corporation who has been authorised by the Board of Directors through an appropriate and properly passed board resolution.

In the event that a counterparty to a swap transaction discovers after the conclusion of such a transaction that the proper procedure for entering into swap transactions by a company has not been followed, the counterparty may rely on the protection afforded under the rule in Royal British Bank v. Turquand [1856] 5 E & B 327 (which is of persuasive authority in Singapore), known as the "indoor management rule". This rule provides that an "outsider" dealing with a company in relation to a transaction is entitled to assume that all matters of internal management have been complied with unless he has actual or constructive knowledge otherwise.

3.4 Allocating the burden of risks

The general principle is that a company may enter into swap transactions if such transactions are within the capacity and powers of the company and it was not in breach of the fiduciary duties of the directors of the company.

At common law, a company may not enter into an act or transaction that was ultra vires its M & A. The effect of this doctrine is diminished in Singapore as a result of Section 25 of the Companies Act ("CA"), which provides that:-
"No act or purported act of a company and no conveyance or transfer of property, whether real or personal, to or by a company shall be invalid by reason only of the fact that the company was without capacity or power to do such act or to execute or take such conveyance or transfer."

By reason of Section 25(1) of the CA, if the swap transactions are otherwise valid and binding upon the company, the fact that they are ultra vires the company does not invalidate the swap transactions. In effect, because of Section 25 of the CA, the counterparty who deals with a Singapore company need not concern itself with whether the transaction is within the company's capacity.

However, it may still be relevant to determine whether the swap transactions are ultra vires in relation to its members and debenture holders. Pursuant to Section 25(2)(a) of the CA, an ultra vires act of a company may, before it is fully performed by the company, be restrained by a member of the company, a debenture holder secured by a floating charge created by the company or a trustee for such debenture holder. In the event that such a restraining order is applied for, the company may apply for the other party to the contract to be made a party to the action as well. In the proceedings, the court may (if it considers it just and equitable) set aside and restrain the performance by the company of swap transactions which are ultra vires the company, and may allow compensation to any party to the swap transactions for any loss or damage sustained by it because of the avoidance of the swap transactions.

Swap transactions if intra vires the company may still be invalid if such transactions were entered into by the directors of the company for an improper purpose or in breach of their fiduciary duties (for example, if the directors were entering into swap
transactions for speculative purposes unconnected with the company's business). Swap transactions entered into under such circumstances could be set aside by the company if it could be shown that the counterparty is aware (either actually or constructively) of the breach of duty by the directors. This is commonly known as the Rolled Steel doctrine (see the decision of Rolled Steel Products (Holdings) Ltd v. British Steel Corporation [1986] Ch 246) (which is of persuasive authority in Singapore) which provides that "if a third party dealing with the company has actual notice or is put on enquiry as to the directors' real purposes, the transaction will not bind the company". Thus, where a swap transaction is entered into by directors of a company in breach of their duties and the counterparty knew of such breach, the counterparty will not be able to enforce the transaction against the company.

3.5 Types of counterparties with whom corporate entities may enter into swap transactions

A company may enter into swap transactions with any legal entity which its directors deem fit and which is duly organised and validly existing under the laws of the jurisdiction of its organisation or incorporation.

4. Statute of Frauds 1677

The Statute of Frauds 1677 is applicable to swap transactions entered into orally by the parties. This statute, which is applicable in Singapore, states that oral contracts which will not be performed within a year of contracting are not enforceable. Section 4 of the Statute of Frauds 1677 provides :-

"No action shall be brought ... upon any agreement that is not to be performed within the space of one year from the making thereof unless the agreement upon which
such action shall be brought, or some memorandum or
note thereof, shall be in writing and signed by the
party to be charged therewith or some other person
thereinto by him lawfully authorised."

An oral swap agreement may be one which may be performed within a
year, in which case the Statute of Frauds 1677 does not present a
problem, or it may be one whose performance will stretch beyond a
year. In the latter event, if an International Swap Dealers
Association ("ISDA") Swap Agreement has already been entered into
by the parties, the existence of Section 4 in the Statute of
Frauds 1677 does not present a problem. However, the situation
which has to be considered is where a swap transaction is
concluded over the telephone which is then confirmed by a
facsimile or a telex. If such a transaction is not one which is
to be performed within a year, the oral contract has to be
sufficiently evidenced by writing if any action is to be brought
on it by a party. This is in contrast to the situation in
England, where as a result of an amendment to the Statute of
Frauds 1677, oral contracts are enforceable regardless of whether
they are due to be performed within a year or otherwise.

The manner of transacting swap transactions raises the issue of
whether facsimile confirmations and telexes sent pursuant to the
telephone conversation would satisfy the requirements of Section
4 of the Statute of Frauds 1677. The section requires that the
agreement, apart from it having to be in writing, must be signed
by the person whom one wishes to hold to the contract or his
agent in order that it may be enforceable. However, the
requirement of signature under this section does not require the
party against whom the contract is sought to be enforced to
personally inscribe onto the document and there is sufficient
compliance for the purposes of this section where there is a
printed slip with the name of the defendant printed on it. If an
oral swap transaction is confirmed by an exchange of
correspondences, faxes or telexes between the parties, as prescribed by the ISDA, this should be sufficient memorandum for the purpose of compliance with Section 4 of the Statute of Frauds 1677.

5. Whether Swap Transactions Are Gaming Contracts

5.1 Whether swap transactions are gaming or wagering contracts under Section 6(1) of the Civil Law Act

The question of whether swap transactions are a "gaming or wagering" contract under Section 6 of the Civil Law Act ("CLA") next falls to be considered. Sections 6(1) and (2) of the CLA correspond to Section 18 of the English Gaming Act 1845.

Section 6(1) of the CLA provides :-

"All contracts or agreements, whether by parol or in writing, by way of gaming or wagering shall be null and void."

The expressions "gaming" and "wagering" are not defined in the CLA. The general principle derived from common law is that so long as swap transactions are entered into by the respective counterparties for a commercial (and not a speculative) purpose, the provisions of Section 6 of the CLA will not apply. As an example, where swap transactions are entered into by a company for hedging purposes, the presence of a commercial purpose can generally be implied. This is to be contrasted with the situation where swap transactions are entered into for a purely speculative purpose on the part of both parties to the swap transaction without a clear reference to any underlying obligation or asset. In such a situation, the swap transactions will be rendered null and void by virtue of Section 6(1) of the
CLA. The consequence of this is that a party to the swap transactions will not be able to enforce the swap transactions against the other party.

The same principles apply to swap options although it may be thought that the speculative element in swap options is more obvious as the counterparty has the right to decide whether to exercise an option depending on the interest rate or currency fluctuation. Arguably as long as the counterparty has entered into the swap options for a commercial reason (for example, to protect itself against the risk of fluctuating interest rate), the swap options will probably not be gaming or wagering within the meaning of Section 6(1) of the CLA.

5.2 Whether the exception in the Civil Law Act which apply to contracts for future delivery of commodities applies to swap transactions

The general principle contained in Section 6(1) of the CLA rendering gaming or wagering contracts void is subject to an exception contained in Section 6(4) which was introduced in Singapore in 1979. Section 6(4) of the CLA provides:

"For the avoidance of doubt, where any contract for the future delivery of any commodity is entered into in an exchange or market, the fact that the contract is entered into by one or both parties with no intention of actual delivery of the commodity but with the intention of realising a profit arising out of differences in the price of the commodity shall not affect the validity or enforceability of the contract."

Section 6(4), on a plain reading, may be interpreted to apply only to a traditional futures contract in respect of an underlying tangible commodity such as gold and does not appear to
be applicable to commodities in the nature of financial instruments such as interest rates and share indices. According to this interpretation, this section would not apply to swap transactions. This interpretation is consistent with the fact that in 1986, the Singapore Futures Trading Act ("FTA") was enacted and it defined the expression "commodity" to include financial instruments, such as currencies and interest rate instruments. Section 58 of the FTA also clarified the position as to whether a futures contract under the FTA would be, or would not be, a gaming or wagering contract by stating that in respect of futures contracts made at a futures market, such contracts shall not be regarded as a contract of gaming or wagering.

A second reason as to why swap transactions do not fall within the ambit of Section 6(4) of the CLA is that swap transactions, apart from cross-currency swap transactions where the parties contemplate actual delivery of the respective currencies, are not contracts for the future delivery of any commodity which is entered into in an exchange or market as set out in Section 6(4) of the CLA. Thus the exception in the CLA as comprised in Section 6(4) which applies to contracts for future delivery of commodities does not apply to swap transactions.

6. Financial and Commodities Futures

6.1 Whether the standardisation of practice and terms will bring swap transactions within the governance of the statutory and regulatory regime governing futures transactions

The FTA governs the trading of commodities in Singapore. Commodities as defined under the FTA include financial instruments which in turn include currencies, interest rate instruments, share indices and a group or groups of share indices. However, the FTA will only be applicable to swap transactions if they come within the ambit of the definition of futures contract in the FTA. In Singapore, a futures contract means a contract the effect of which is that :-
(i) one party agrees to deliver a specified commodity, or a specified quantity of a specified commodity, to another party at a specified future time and at a specified price payable at that time pursuant to the terms and conditions set forth in the rules or practices of a futures exchange or futures market; or

(ii) the parties will discharge their obligations under the contract by settling the difference between the value of a specified quantity of a specified commodity at the time of the making of the contract and at a specified future time, such difference being determined in accordance with the rules or practices of a futures exchange or a futures market at which the contract was made.

Swap transactions are not likely to be futures contracts within the meaning of the FTA for the following two reasons. First, regardless of whether the swap transactions are interest rate or currency transactions, they are not made pursuant to the rules or conditions or practices of a futures exchange or a futures market. This is because despite the widespread use of the standard ISDA Swap Agreements, it is difficult to argue that there is in existence business rules or practices of a futures market at which the swap transactions are made. Secondly, an interest rate swap transaction is essentially one under which one party undertakes to make to the other party payments calculated by reference to a specified rate on a notional principle sum over a given period and the other party agrees to make a payment by reference to a variable rate on the same notional principle over the same period. This brings an interest rate swap beyond the ambit of futures contract as set out in the FTA as in a swap transaction there is no specified date for the delivery of a specified commodity. In a currency swap, the parties agree to the sale of amounts of currency which are either pre-determined or determined pursuant to an agreed method of calculation and is therefore also not a futures contract within the meaning of the FTA.
7. Netting out on Insolvency

In Singapore, there is no specific legislation which deals with the enforceability of netting agreements. Typically, a netting agreement in respect of swap transactions would provide that upon the occurrence of any event of default (for example, insolvency), any obligations of the parties under that agreement to make any payment immediately accrue.

This memorandum shall not deal with the general enforceability of such netting agreements but shall instead focus on the phenomenon of netting out by counterparties to a swap transaction upon the insolvency of either of the parties. In particular, this memorandum shall focus on whether payments made under a netting agreement prior to the insolvency of a party (the "defaulting party") will violate the rules relating to preferences in Singapore. Regardless of whether the insolvent party is an individual or a company, there is a possibility that any payment by the defaulting party under the netting agreement may be construed to be an undue preference in favour of the non-defaulting party and accordingly, be void or voidable against the Official Assignee, or, as the case may be, the liquidator.

Under the laws of bankruptcy in Singapore, every payment made by a person who is unable to pay his debts as they become due from his own money in favour of any creditor, with a view to giving that creditor a preference over his other creditors (emphasis ours), shall, if the person paying the same is adjudged bankrupt on a bankruptcy petition presented within three months after the date of paying the same, be deemed fraudulent and void as against the Official Assignee.

Singapore courts are unlikely to find that payments pursuant to a netting agreement prior to the presentation of a bankruptcy petition against an insolvent party are made with a view to
giving the non-defaulting party a preference over other creditors because a netting agreement is entered into for the primary purpose of reducing the credit exposure of both parties to the transaction. As such payments by the defaulting party would be payments in the course of ordinary commercial trading and are unlikely to be motivated by any desire to improve the position of the counterparty vis-a-vis other creditors of the defaulting party, they would not be fraudulent preferences under bankruptcy law.

This principle of bankruptcy law which is applicable in the case of a defaulting party who is a natural person applies equally to a defaulting party which is a company by virtue of Section 329 of the CA. Generally, the corresponding events of default in relation to a company which is a party to a netting agreement are either (a) the date of the presentation of the winding-up petition or (b) the date on which a resolution to voluntarily wind up the company is passed. If such events of default are present in the netting agreement and if any payment is made within three months prior to any of the above dates, such payment, for the reasons stated in the above paragraph, is also unlikely to be construed as a preferential payment which would be void as against the liquidator of the company.

8. Summary

In summary, it is likely that the only Singapore government entity which may enter into swap transactions is MAS, which is the de facto central bank of Singapore. Swap transactions may be entered into by companies incorporated under the CA if they are authorised to do so under their respective M & A. If a swap transaction is ultra vires the company, then although the transaction is not rendered void under Singapore law, it may be challenged by a member of the company, a debenture holder or the trustee for such debenture holders although in such a case, the company will be compensated for any loss which it may incur if
the court should prevent the performance of the transaction by the company. The confirmation of swap deals contracted orally by the parties, whether by way of telex or facsimile, should render the transaction enforceable under Singapore law and may form part of the ISDA Swap Agreement if one has already been entered into between the parties. Swap transactions entered into for a commercial, and not a speculative, purpose are not likely to be "gaming or wagering contracts" under Singapore law. As swap transactions are not futures contracts in Singapore, they will not be governed by any applicable legislation in Singapore relating to futures contracts. Finally, netting out on insolvency is unlikely to violate the applicable rules relating to preferences as such netting out is probably not actuated by any motive to prefer the counterparty to a swap transaction to other creditors of the insolvent party.
Global Derivatives Study Group

Enforceability Survey — United States

prepared by Cravath, Swaine & Moore

June 22, 1993
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## Appendices

**APPENDIX I**

State Statutes Authorizing Governmental Entities to Engage in Swap Transactions

**APPENDIX II**

Draft Model Statute Authorizing Governmental Entities to Engage in Swap Transactions
The United States is a jurisdiction where much legal certainty has been provided to the derivatives industry through the efforts of regulators, legislators and market participants. This report, however, analyzes four main areas in which additional legal certainty may be desirable: (i) contract formation (the New York statute of frauds); (ii) capacity (ultra vires); (iii) collateral pledges by U.S. banks and thrift institutions; and (iv) early termination (bankruptcy/insolvency).

I. CONTRACT FORMATION

Recent New York case law and developing technologies have created some legal uncertainties with respect to the formation of an enforceable agreement involving a derivatives transaction.

A. The New York Statute of Frauds

With certain types of contracts, New York requires written evidence of the agreement to make such contracts enforceable. Two New York laws currently impose this requirement: (i) the New York General Obligations Law § 5-701 (the “GOL”); and (ii) the New York Uniform Commercial Code § 2-201 (the “UCC”). The applicability of either provision depends upon the characteristics of the agreement, and the requirements of each provision differ somewhat.

The GOL generally requires a written note or memorandum for every agreement, promise or undertaking that is not performable within one year, and such writing must contain all “essential” terms and be subscribed to at the end. The writing used to satisfy the GOL may be assembled from more than one document. The UCC requires a writing for all agreements involving the sale of goods over US$500, and such writing must contain the quantity term and be subscribed to anywhere on the writing. Consistent with the GOL, multiple writings or documents may satisfy the UCC’s writing requirement.

The UCC offers greater flexibility than the GOL provided both parties are “merchants”, generally defined by the UCC as a person who deals in the goods involved in the contract or holds himself out as having knowledge peculiar to the practices/goods involved. The “merchant exception” to the UCC’s statute of frauds exempts certain oral contracts between merchants if within a reasonable time a written confirmation of the contract (sufficient against the sender) is received, and the party receiving it has reason to know of its contents and does not object to its contents within 10 days after it is received.

B. The General Obligations Law or the Uniform Commercial Code

As indicated, under New York law contracts not performable within one year and sales of goods over US$500 require written evidence. While derivative transactions with a maturity over one year will be subject to the GOL’s more onerous requirements, certain of such transactions (as well as transactions with a maturity of less than one year) may be considered a sale of goods, and thus subject to the UCC’s requirements. It appears that the GOL currently applies to interest rate swaps, since these types of transactions have not yet been classified as a sale of goods; however, other derivative transactions potentially may be classified as sales of goods as a result of certain provisions of the UCC and recent case law holding that foreign exchange (“FX”) transactions are subject to the UCC. Therefore, transactions with similar characteristics to an FX transaction (e.g., currency swaps) also may be subject to the UCC.

Section 2-102 of the UCC states that Article 2 “applies to transactions in goods” and Section 2-105(1) defines “goods” as “all things . . . which are movable at the time of identification to the contract for sale other than money in which the price is to be paid . . ..”. The UCC’s drafters interpreted the term “goods” to include money “. . . when money is being treated as a commodity but not to include it when money is the medium of payment” (UCC § 2-105, Comment 1 (1987)). Therefore, money is a “good” when it is purchased or sold as a commodity.

Two New York courts have dealt with whether the UCC applies to FX transactions. In Intershoe Inc. v. Bankers Trust, 77 N.Y.2d 517, 521 (1991), the Court of Appeals (New York’s highest court) stated that the UCC applied to “foreign currency transactions” in a case involving the exchange of Italian lira for U.S. dollars.
Saboundjian v. Bank of Audi, 556 N.Y.S.2d 258, 261 n.2 (App. Div. 1990), stated that "[t]he [UCC] is applicable to foreign exchange transactions, since the [UCC] excludes money only when it is a medium of payment, not when treated as a commodity". This case involved the failure by a bank to execute a customer's order to sell Deutsche marks when they reached a certain price.

Saboundjian specifically labelled the transaction a "foreign exchange transaction"; however, Intershoe, faced with an FX transaction, termed such transaction both a "foreign currency futures transaction" and a "foreign currency transaction", suggesting that the court either carelessly labelled the transaction or reasoned that the UCC not only applies to FX transactions but to other foreign currency transactions as well. If the latter is the case, then strong precedent exists for holding currency swaps and other similar transactions subject to the UCC, because they would appear to fit the category of "foreign currency transactions". If the former occurred, then precedent, however unintended, exists for the same proposition.

One might ask whether it follows that a currency swap, for example, like an FX transaction, is a purchase or sale of money as a commodity. An FX transaction contemplates the one-time exchange of one currency for another currency. A currency swap, for example, adds multiple settlement dates, the exchange of periodic payments and, in some cases, the exchange of principal. In spite of these differences, we do not see a persuasive reason to conclude that an FX transaction is a purchase or sale of money but that a currency swap (and potentially other derivatives transactions) is not.

C. Enforceability Issues

1. Contents of the Writing. As a result of the uncertainty surrounding which statute of frauds provision will apply to particular derivatives transactions, parties should each sign at the end of a written agreement that sets forth all essential terms. Documentation that includes a master agreement signed by both parties at the end and, together with a confirmation, contains all essential terms would create an enforceable agreement. These procedures also may represent prudent business practice.

An enforceability risk occurs when parties fail to adhere to the stricter requirements of the GOL (or even those of the UCC), and instead document transactions with, for example, a confirmation signed by only one party to the agreement or with only a confirmation that sets forth less than all essential terms. While these two methods, in certain circumstances, would satisfy the UCC (assuming the merchant exception applied in the first example), they would not satisfy the GOL; therefore, there is the risk of an unenforceable agreement.

2. Form of the Writing. The above analyzes what must actually be contained in the writing (i.e., essential terms, subscription). Another issue deals with the actual form of the writing. While the UCC and GOL both require a writing, neither addresses whether a telex, facsimile or other electronic messaging system will satisfy this requirement. Case law has held that a telex is sufficient, yet provides little, if any, guidance as to facsimiles and other means, thereby creating a risk that such forms may not suffice. The volume of derivatives transactions that occurs in the market requires the use of such new technologies without legal uncertainty. Efforts to amend New York's statute of frauds provisions may provide that certainty.


A draft bill to amend the relevant sections of the GOL and the UCC recently has been prepared by a working group in New York and would apply to "qualifying financial contracts" without regard to the amount or length of performance (interest rate swaps... and currency swaps, as well as other derivatives, are included in this definition). The draft bill combines the requirements of the GOL and the UCC (and supplements them), and currently provides that the following methods would satisfy New York's statute of frauds requirements:

(1) an electronic recording of a telephone call which is sufficient to indicate that a contract has been made;
(2) a confirmation in writing sufficient to indicate a contract has been made is received by the other party no later than the fifth business day after such contract is made, and the sender does not receive, on or before the third business day after such receipt, written objection to a material term of the confirmation;

(3) the party against whom enforcement is sought admits in its pleading, testimony or otherwise in court that a contract was made; or

(4) there is a note or memorandum or other writing signed by the party against whom enforcement is sought or by its authorized agent or broker.

In addition, a telex, telefacsimile, computer retrieval or other process by which electronic signals are transmitted by telephone or otherwise would qualify as a "writing".

This draft bill recently was introduced in the New York State Senate. If adopted, it definitely would offer a more certain and predictable answer to the question of what type of documentation (both as to contents and form) is required for legally binding derivatives transactions.

A more complete analysis of statute of frauds issues may be found in the Memorandum by Cravath, Swaine & Moore for the International Swap Dealers Association, Inc. ("ISDA") dated March 6, 1992, entitled "Interest Rate Swaps and Currency Swaps: Required Documentation Under New York Law".

II. CAPACITY

In the absence of specific legislation authorizing governmental entities and insurance companies to enter into swap transactions, there is a risk that such transactions may be held to be ultra vires and thus unenforceable.

A. Governmental Entities

Appendix I lists certain states that have laws authorizing governmental entities to engage in swap transactions or which could be interpreted as doing so. The states have taken a variety of approaches in framing their legislation: from authorizing the entering into of swap transactions only in connection with bond issuances to more general authorizations; and from imposing detailed creditworthiness criteria for permissible counterparties to relying, instead, upon the judgment of the relevant governmental entity.

Sections 1 to 6 below compare the legislative approaches taken by different states and highlight particular issues that swap market participants should address when considering the capacity of a governmental entity to enter into a particular swap transaction. Section 7 refers to a draft model law that has been prepared for ISDA by Cravath, Swaine & Moore authorizing governmental entities to engage in swap transactions, and Section 8 considers an amendment affecting municipalities that should be adopted for the United States Bankruptcy Code (the "U.S. Bankruptcy Code").

1. Which Governmental Entities May Enter into Swap Transactions? Legislatures considering the scope of a statute authorizing swap transactions face two competing concerns. On the one hand, a governmental entity must be sufficiently sophisticated to enter into swap transactions. On the other hand, if a governmental entity borrows large sums of money and manages large investment portfolios, it should be permitted to enter into swap transactions for the purpose of risk-management.

The California Public Financing statute, for example, takes an expansive approach by providing that the "state, any department, agency, board, commission, or authority of the state, or any city, city and county, county, public district, public corporation, authority, agency, board, commission or other public entity" may enter into swap transactions.

By contrast, the Nevada and Illinois statutes incorporate a "sophistication test" by limiting authorization to public corporations having an aggregate principal amount of bonds outstanding exceeding $10,000,000. Where this
form of restriction is used, care needs to be taken to ensure that it does not prevent a sophisticated entity that needs the risk management benefits that swap transactions provide from entering into such transactions because such entity does not satisfy the financial criteria.

2. What Types of Swap Transactions May Governmental Entities Engage in? There is some attraction in limiting the universe of potential swap transactions into which a governmental entity may enter in order to limit governmental entities from engaging in speculative activities. For example, the Colorado statute extends the authorization of government entities only to agreements “for an exchange of interest rates, cash flows, or payments”; however, such an approach substantially reduces the flexibility for those entities in their investment and liability risk management. In addition, given the propensities of the swap market to create new products, flexibility in the range of transactions that may be entered into by governmental entities may be beneficial. For example, the California Public Financing Statute provides that governmental entities may enter into:

“contracts commonly known as interest rate swap agreements, currency swap agreements, forward payment conversion agreements, futures, or contracts providing for payments based on levels of, or changes in, interest rates, currency exchange rates, stock or other indices, or contracts to exchange cash flows or a series of payments, or contracts, including without limitation, interest rate floors or caps, options, puts or calls to hedge payment, currency, rate, spread or similar exposure”.

In addition to authorizing the principal derivative transactions, many of the statutes also expressly authorize governmental entities to enter into security or collateral arrangements. Such provisions are recommended.

3. What Counterparties May a Governmental Entity Enter into Swap Transactions with? The Alabama statute prohibits governmental entities from entering into swap transactions unless the counterparty (a) has a net worth of at least $100,000,000, or its obligations under the swap transaction are guaranteed by a person or entity having a net worth of at least $100,000,000, and (b) has pledged collateral to the governmental entity in the approximate amount payable if the counterparty defaulted under the swap agreement.

The Colorado statute also imposes creditworthiness criteria on eligible counterparties by requiring that (a) the counterparty, or a guarantor, is rated in one of the two highest rating categories by one or more nationally recognized securities rating agencies, or (b) the counterparty’s obligations are collateralized by deposits maintaining a value of not less than the principal amount upon which the swap transaction is based. Minnesota also imposes creditworthiness restrictions on eligible counterparties.

Any approach following the Alabama, Colorado or Minnesota models should expressly indicate that the criteria for valid counterparties will be measured at the time the transaction is entered into, and not throughout the life of the swap. This will avoid the legal risk that a change in circumstances of a counterparty could retroactively taint the transaction as an unenforceable ultra vires agreement. Should a governmental entity desire continued credit assurance throughout the life of the swap agreement, it may elect to include a counterparty credit downgrade as an additional termination event on the municipal schedule to the ISDA Master Agreement—the governmental entity could then terminate such agreement and net out transactions with a counterparty that no longer met the desired level of creditworthiness.

The Arkansas, California and Massachusetts statutes rely upon the judgment of the responsible officials of governmental entities in choosing their counterparties. The terms of each of these statutes are in substantially the same form. As an example, the Arkansas statute directs the government to give “due consideration for the creditworthiness of the counterparties, where applicable, including any rating by a nationally recognized rating service or any other criteria as may be appropriate”.

4. Under What Circumstances May Governmental Entities Engage in Swap Transactions? The Arkansas and Illinois statutes only permit governmental entities to engage in swap transactions in connection with an issuance of bonds. This may not represent a conscious decision by the legislatures to limit the scope of swap transactions. Rather, it is likely that, at the time the statutes were enacted, the relevant legislature focused on maximizing the flexibility of governmental entities in issuing bonds and did not consider alternative applications for swap transactions.
A more expansive approach is adopted by the California and Massachusetts statutes which permit governmental entities to engage in swap transactions in connection with the acquisition or carrying of any investment or program of investment, as well as the carrying of bonds.

5. What Procedures Must a Governmental Entity and its Counterparty Follow and What Restrictions Must They Adhere to? Any statute authorizing governmental entities to enter into swap transactions should expressly prohibit or prevent such entities from doing so for speculative purposes. The California Public Financing Statute attempts to implement this prohibition by specifying that each swap transaction must be entered into with the intent to (a) reduce the amount or duration of payment, currency, rate, spread or similar risk, (b) produce a lower cost of borrowing when used in combination with the issuance of bonds, or (c) enhance the relationship between risk and return with respect to the proposed investment.

By contrast, the Colorado statute directs the public entity to consider the savings and debt management benefits to the citizens of the public entity before entering into a swap transaction. The Alabama statute requires the governmental entity’s governing body to find, determine and to certify to the counterparty that the swap agreement is entered into “for the purpose of hedging against an interest rate, investment, payment, or other similar risk that arises in connection with or incidental to the proper activities of the governmental entity”.

It is important to bear in mind the balance required to be struck between ensuring that adequate checks by governmental entities are maintained when entering into swap transactions and the risks of bureaucratic delays that a cumbersome approval procedure may impose.

6. Which Party Bears the Risk in the Event a Governmental Entity Lacks the Capacity to Enter into Swap Transactions or Fails to Follow Statutory or Regulatory Procedures When Engaging in Swap Transactions? One omission common to the statutes we have seen authorizing governmental entities to engage in swap transactions is their failure to expressly address the issue of which party bears the risk in the event a governmental entity lacks the authority to engage in swap transactions or violates statutory or regulatory procedures when doing so. Most agreements governing swap transactions contain representations by each party that it has the authorization or power to enter into the agreement and to perform the transactions contemplated thereby. The approach that we would recommend would be that a counterparty acting in good faith should, by statute, be entitled to rely on such a representation by the governmental entity.

7. Model Law Authorizing Governmental Entities to Engage in Swap Transactions. A draft of a model law authorizing governmental entities to engage in swap transactions is attached as Appendix II and addresses each of the issues considered in Sections 1 to 6 above. This could provide a useful reference for states wishing to introduce such legislation or amend existing statutes.

8. Amendment to Section 901 of the U.S. Bankruptcy Code. Section 901 of the U.S. Bankruptcy Code lists sections that will apply to the adjustments of debts of a municipality; however, the sections of the U.S. Bankruptcy Code that provide special treatment for “swap agreements” are not listed. While this appears to be an oversight, it does create legal uncertainty for market participants who enter swap transactions with U.S. municipalities. Therefore, Section 901 of the U.S. Bankruptcy Code should be amended to ensure that contractual rights to terminate a “swap agreement” will not be stayed, avoided or otherwise limited as a result of a proceeding in bankruptcy filed by a U.S. municipality.

B. Insurance Companies

Although not expressly provided in many state investment laws and regulations for insurance companies, it is generally understood that U.S. insurance companies currently have authority to engage in swap agreements. The source of this authority is usually the broad right or power to contract rather than state investment laws and regulations; however, in some states the authority to engage in futures and options is covered under investment laws and regulations.

1 See infra Section IV for a discussion of these sections.
Explicit statutory authorization would provide greater legal certainty to insurance companies and their counterparties engaging in derivatives transactions. Toward that end, the National Association of Insurance Commissioners (the "NAIC") Model Investment Law Working Group (of state regulators) is reviewing a June 17, 1993, working draft of the Model Investment Law written by its "industry" Technical Resource Group, which would expressly provide authority for life, health, property and casualty insurers to engage as end-users in exchange-traded and over-the-counter derivatives within a comprehensive framework of limitations. The NAIC Model Investment Law Working Group has announced that it intends to revise the June 17, 1993, Technical Resource Group draft and release on August 1, 1993, the working group's official working draft for broad exposure and comment.

Although the NAIC Model Investment Law Working Group has not yet indicated to what degree it will modify the June 17, 1993, draft, it is expected that the August 1, 1993, draft will provide for limitations on: (1) the extent to which options, caps, floors, collars, swaps, forwards and futures can be used; (2) the credit risk exposure to any one counterparty; (3) the creditworthiness of counterparties with which, and exchanges on which, trading will be permitted; and (4) the permissible uses of derivatives in portfolio management.

After consideration of an insurance industry survey on the impact of the working draft and of comments received or presented at a hearing in mid-September 1993, the NAIC will issue an exposure draft of the Model Investment Law for further comments and industry testing. The NAIC Model Investment Law is expected to be adopted by the NAIC in September 1994, and by individual states at their subsequent legislative sessions. A state's adoption of investment law provisions expressly covering derivatives should produce greater legal certainty for derivatives transactions with U.S. insurers domiciled in that state.

III. COLLATERAL PLEDGES BY U.S. DEPOSITORY INSTITUTIONS

Questions concerning the validity of collateral pledges in certain financial transactions by U.S. banks and thrift institutions have been raised as a result of a recent court decision by the U.S. Court of Appeals for the Eighth Circuit. This decision and the relevant statutory provision raise questions about the enforceability of certain mark-to-market collateral arrangements used in the markets for swaps and other derivatives. While two Federal Deposit Insurance Corporation (the "FDIC") policy statements and an FDIC advisory opinion provide important practical comfort to counterparties receiving collateral pledges from U.S. depository institutions, an amendment to the law should be considered.

A. Relevant Law

The relevant statutory provision upon which the recent court decision is based is Section 13(e) of the Federal Deposit Insurance Act, 12 U.S.C. § 1811 et seq. (the "FDIA"), contained in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"), which provides as follows:

"No agreement which tends to diminish or defeat the interest of the [Federal Deposit Insurance] Corporation in any asset acquired by it . . . either as security for a loan or by purchase or as receiver of any insured depository institution, shall be valid against the Corporation unless such agreement—

(1) is in writing,

(2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution,

(3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and

(4) has been, continuously, from the time of its execution, an official record of the depository institution." 12 U.S.C. § 1823(e) (1992) (emphasis added).
In 1992, the court in *North Arkansas Medical Center v. Barrett*, 962 F.2d 780 (8th Cir. 1992), held that a hospital that had received collateral from a savings and loan association could not assert the alleged collateral agreement and security interest against the FDIC, as receiver of the depository institution, because all the requirements of Section 13(e) of the FDIA were not satisfied. In particular, the court noted that the collateral agreement was not executed by the hospital and the depository institution contemporaneously with the acquisition by the depository institution of the related collateral (the “Contemporaneous Execution and Acquisition Requirement”), and there was not any evidence that the collateral agreement was independently approved by the board of directors or loan committee of the depository institution. *North Arkansas Medical Center* did not mention either of the two FDIC policy statements or the FDIC Advisory Opinion discussed below.

**B. FDIC Policy Statements and Advisory Opinion**

1. **FDIC Policy Statement No. 1.** In 1989, the Board of Directors of the FDIC issued a Statement of Policy on Qualified Financial Contracts (the “FDIC Policy Statement”). The FDIC Policy Statement states that any qualified financial contract (including any ancillary agreement, such as a master agreement or security arrangements) will be deemed to satisfy, in pertinent part, the requirements of Section 13(e) of the FDIA if it meets certain requirements. The FDIC Policy Statement is significant in that it does not itself require execution of the agreement and replaces the Contemporaneous Execution and Acquisition Requirement with the requirement that the writing evidencing the agreement be sent to the other party shortly after the parties’ agreement to enter into the qualified financial contract.

2. **FDIC Policy Statement No. 2.** On March 31, 1993 (after the *North Arkansas Medical Center* decision), the Board of Directors of the FDIC issued a Statement of Policy Regarding Treatment of Security Interests After Appointment of the FDIC as Conservator or Receiver (the “1993 Policy Statement”). The 1993 Policy Statement states that the FDIC will not seek to avoid a security interest solely because the secured obligation or collateral subject to the security interest was not acquired by a federally-insured depository institution contemporaneously with the approval and execution of the security agreement granting the security interest. The remaining three requirements of Section 13(e) of the FDIA, however, must be satisfied. Therefore, the 1993 Policy Statement provides additional comfort to a party secured by collateral received from a federally-insured depository institution even though such party did not satisfy the Contemporaneous Execution and Acquisition Requirement. The 1993 Policy Statement also points out that it should not be interpreted as contradicting or impairing the policies expressed in the FDIC Policy Statement discussed above.

3. **FDIC Advisory Opinion.** In response to an inquiry regarding the application of the “written agreement” and related requirements contained in the FDIA, John L. Douglas, General Counsel for the FDIC, issued an advisory opinion (the “FDIC Advisory Opinion”). The FDIC Advisory Opinion addresses a transaction in which an insured depository institution grants a security interest in assets of the institution to a party to secure an obligation of the institution. The collateral may have been (i) acquired by the institution other than in connection with the above obligation, (ii) acquired by the institution prior to the grant of the security interest therein and/or (iii) pledged to the secured party after the above obligation had been entered into (i.e., pursuant to a “collateral maintenance” provision).

The FDIC Advisory Opinion stemmed from the concern that the Contemporaneous Execution and Acquisition Requirement would permit the FDIC to avoid the above security interest. Mr. Douglas stated that, in his opinion:

"a court would hold that the FDIC . . . could not, pursuant to . . . Section 13(e) . . . of the FDIA, avoid a security interest in the [c]ollateral by the [i]nstitution solely because the grant of the security interest in the [c]ollateral by the [i]nstitution did not occur contemporaneously with the [i]nstitution's acquisition of the [c]ollateral”.

Mr. Douglas, however, states that the agreement evidencing the grant of a security interest in the collateral and the incurrence of the secured obligation must be executed by the institution contemporaneously with the incurrence of the secured obligation and the receipt of the consideration for such obligation.
C. Enforceability Issue

North Arkansas Medical Center illustrates an inherent limitation of both FDIC policy statements and the FDIC Advisory Opinion. Specifically, if there is a conflict between applicable law and a policy statement or an advisory opinion, a court may choose to follow the applicable law. Therefore, notwithstanding the FDIC policy statements and the FDIC Advisory Opinion, if litigation is commenced after a U.S. bank fails and a pledged asset was not acquired “contemporaneously” with the execution of a collateral agreement, a court could invoke Section 13(e) to invalidate that pledge. Interpreted literally, the Contemporaneous Execution and Acquisition Requirement would be difficult to satisfy in the context of the market for swaps and related derivatives because security arrangements often are based on a mark-to-market principle. Other common collateral arrangements also are not likely to comply with a literal reading of the Contemporaneous Execution and Acquisition Requirement because the collateral in many cases will not have been acquired contemporaneously with the execution of the relevant collateral agreement.

Despite this threat, however, swap market participants reasonably may decide that they can still draw a fair degree of practical comfort from the FDIC policy statements and the FDIC Advisory Opinion. As a practical matter, the entity most likely to invoke the provisions of Section 13(e) of the FDIA would be the FDIC. It follows logically that as the “issuer” of the FDIC policy statements and the FDIC Advisory Opinion, the FDIC would hesitate to act in contravention of those statements and opinion. It is, however, also conceivable that an interested third party (e.g., Congress, a depositor, another creditor or an assignee) could pressure the FDIC into challenging the validity of the pledge of collateral in connection with swap transactions by invoking Section 13(e) in a particular situation despite the existence of the FDIC policy statements and the FDIC Advisory Opinion.

In light of the above, a legislative amendment should be considered to Section 13(e) of the FDIA to resolve the uncertainties that exist. A more complete analysis of the issues presented above may be found in two Memoranda by Cravath, Swaine & Moore for ISDA, dated February 18, 1993 and April 14, 1993, entitled “U.S. Bank Pledges of Collateral: FDIC Policy Statement and FDIC Advisory Opinion” and “U.S. Bank Pledges of Collateral: FDIC Statement of Policy Regarding Treatment of Security Interests”, respectively.

IV. EARLY TERMINATION

Early termination also presents enforceability concerns, specifically whether the nondefaulting party to a derivatives master agreement would be able to enforce the provisions entitling that nondefaulting party to terminate the agreement and net out or offset termination values and payment amounts (i.e., close-out netting) upon the bankruptcy/insolvency of its counterparty.

A. Legislation

1. Enactment of FIRREA. In 1989, FIRREA significantly revised the powers of the FDIC as the receiver or conservator for an insolvent financial institution and extended its powers to cover almost all banks and savings institutions in the United States.2

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2 FIRREA would not apply in the case of a bank or savings institution that is neither federally chartered nor federally insured. The FIRREA receivership and conservatorship provisions also would not apply to a proceeding involving the insolvency of a foreign bank’s U.S. branch or agency that did not have federally insured deposits.
FIRREA provides that, in the case of receivership, subject to certain limitations, a party to a “qualified financial contract” will be entitled to:

(i) exercise any contractual right to terminate or liquidate a qualified financial contract as a result of the appointment of the receiver;

(ii) exercise any rights under any security arrangement relating to any qualified financial contract;

and

(iii) exercise any right to “offset or net out any termination value, payment amount or other transfer obligation arising under or in connection with [one] or more [qualified financial contracts]”.

In the case of a conservatorship, the above applies except that a party to a qualified financial contract will be able to exercise any contractual right to terminate other than one based solely on the appointment of the conservator (i.e., a “bankruptcy” default provision).

Another important feature of FIRREA is that it expressly provides that neither payments made nor collateral transferred by a depository institution prior to its insolvency nor any legally enforceable or perfected security interest in any of the assets of the institution may be avoided by the FDIC (subject to certain exceptions), except where the transferee intended to “hinder, delay, or defraud” the creditors or the receiver or conservator of the institution.

As under the U.S. Bankruptcy Code, the definition of “swap agreement” is intended to cover both current and newly developed transactions that, while not specifically enumerated, share fundamental characteristics with those specified.

2. Amendments to the U.S. Bankruptcy Code. Prior to the amendments to the U.S. Bankruptcy Code in 1990, there was significant concern that in a proceeding under the U.S. Bankruptcy Code, termination rights under master swap agreements were subject to an automatic stay, and thus the ability to terminate such master agreements and enforce the close-out netting provisions could be delayed for a long period of time. Moreover, while it was generally believed that a bankruptcy court should give effect to essential elements of a master agreement, such as netting of transaction values upon early termination, there was no guarantee that this would be the result.

Previous amendments to the U.S. Bankruptcy Code had recognized the need for certainty upon early termination for other types of financial contracts, such as securities contracts, repurchase agreements and forward

3 “Qualified financial contract” is defined to include securities contracts, commodity contracts, forward contracts, repurchase agreements and swap agreements. 12 U.S.C. § 1821(e)(8)(A(i). “Swap agreement” is defined to include rate swap agreements, basis swaps, commodity swaps, forward rate agreements, forward foreign exchange agreements, rate cap, floor and collar agreements, currency swap agreements, cross-currency rate swap agreements, any other similar agreements and any options on the foregoing. 12 U.S.C. § 1821(e)(8)(D)(vi).


contracts. In 1990, amendments were adopted to the U.S. Bankruptcy Code that provided such certainty for parties dealing with U.S. corporations through the following provisions applicable to "swap agreements":

(i) an exception to the automatic stay to allow a nonbankrupt party to set off any mutual obligations arising under or in connection with any "swap agreement" following a bankruptcy filing and to use any collateral held to satisfy amounts due from the bankrupt party;

(ii) express recognition that parties will be entitled to exercise contractual rights to terminate a "swap agreement" and net or offset termination values and payment amounts under such agreement; and

(iii) express protection for collateral transfers in good faith under a "swap agreement" against a trustee’s power to avoid payments and other transfers made within 90 days (or in some cases one year) prior to a bankruptcy filing.

The definition of "swap agreement" is intended to cover both current and newly developed transactions that, while not specifically enumerated, share fundamental characteristics with those specified. In particular, the reference to "any other similar agreement" in Section 101(55)(A) of the U.S. Bankruptcy Code, 11 U.S.C. § 101(55)(A), supports this conclusion.

3. Enactment of FDICIA. In 1991, Congress enacted the Federal Deposit Insurance Corporation Improvement Act ("FDICIA"), which recognizes the enforceability of the netting of payment obligations between two "financial institutions" under a "netting contract", "notwithstanding any other provision of law" and notwithstanding any "stay, injunction, avoidance, moratorium or similar proceeding or order, whether issued or granted by a court, administrative agency, or otherwise".

Section 402(9) of FDICIA defines "financial institution" to mean a registered or licensed broker or dealer (and certain affiliates as determined by the Board of Governors of the Federal Reserve System (the "Board of Governors")), a depository institution (i.e., national and state banks, credit unions, thrift institutions, United States

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8 Section 101(55) of the U.S. Bankruptcy Code, 11 U.S.C. § 101(55), defines "swap agreement" as:

"(A) an agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing);

(B) any combination of the foregoing; or

(C) a master agreement for any of the foregoing together with all supplements".

See also Section 101(56) of the U.S. Bankruptcy Code, 11 U.S.C. § 101(56) (setting forth definition of "swap participant").


11 Sections 546(g) and 548(d)(2) of the U.S. Bankruptcy Code, 11 U.S.C. §§ 546(g), 548(d)(2).

12 If the insolvency of a counterparty is governed by FIRREA, such counterparty in all probability would be a "financial institution" for purposes of FDICIA.
branches or agencies of foreign banks or Edge Act corporations), a registered or licensed futures commission merchant or any other institution determined by the Board.\textsuperscript{13} Section 402(14) of FDICIA defines "netting contract" to mean, in pertinent part, a contract between two or more financial institutions that:

"is governed by the laws of the United States, any State or any political subdivision of any State, and . . . provides for netting present or future payment obligations or payment entitlements (including liquidation or close-out values relating to the obligations or entitlements) among the parties to the agreement . . ."\textsuperscript{14}

Also, the contract must be valid under, and not precluded by, the Federal commodities laws to be a "netting contract" for purposes of FDICIA.\textsuperscript{15}

Assuming that each of the parties to a master agreement is a "financial institution" and such master agreement is a "netting contract", then the netting provisions in FDICIA would apply to that contract. After a review of the applicable statutory language and legislative history, we have not found anything to suggest that different types of transactions, such as "swap agreements" (as defined in the U.S. Bankruptcy Code and FIRREA) and other transactions not specifically enumerated in such definition ("Non-Enumerated Transactions"), would fail to qualify under the applicable provisions of FDICIA. In fact, because Congress intended to reduce systemic risk in enacting Sections 401-407 of FDICIA,\textsuperscript{16} it appears that the correct view would be to construe broadly the application of FDICIA so as to include both "swap agreements" and Non-Enumerated Transactions, and thus maximize the reduction of systemic risk.

On May 19, 1993, the Board of Governors published for comment a proposed rule to expand the definition of "financial institution" in Section 402 of FDICIA. The proposed rule is designed to allow certain participants in markets for financial contracts, other than depository institutions, broker-dealers, and futures commission merchants (which are already covered by FDICIA) to receive the benefits of FDICIA's netting provisions. Specifically, the proposal sets forth a two-part test for a market participant to determine if it qualifies as a "financial institution". First, a legal entity (i.e., corporation, unincorporated company, partnership, government unit or instrumentality, natural person or any similar entity or organization) (a "Dealer") must actively participate in a financial market\textsuperscript{17} for its own account and hold itself out as a counterparty that will engage in transactions both as a buyer and a seller. The second part requires certain threshold levels on financial market activities to be met. A Dealer must: (1) have outstanding one or more financial contracts of a total gross dollar value of one billion dollars in notional principal amount on any day during the previous 15-month period, with counterparties that are not its affiliates; and (2) have incurred total gross mark-to-market positions in one or more financial contracts of $100 million on any day during the previous 15-month period with unaffiliated counterparties. The Board of Governors has requested comments on the proposal, specifically the quantitative thresholds, by August 20, 1993. The proposed expansion of the definition of "financial institution" would further FDICIA's goal to increase efficiency and decrease systemic risk in the financial markets, and therefore should be adopted.

The three legislative efforts discussed above provide the certainty for "swap agreements" with U.S. counterparties that the derivatives market has, since its inception, sought on many fundamental issues of netting and early termination.

\textsuperscript{13} 12 U.S.C. § 4402(9).

\textsuperscript{14} 12 U.S.C. § 4402(14).

\textsuperscript{15} \textit{Id}.


\textsuperscript{17} A "financial market" is a market for a financial contract, which, in turn, means a "qualified financial contract" as defined in FDICIA.
B. Enforceability Issues

Where FDICIA applies or where all the transactions documented under a master swap agreement are "swap agreements" as defined in the U.S. Bankruptcy Code or FIRREA, legal certainty exists with respect to a counterparty's ability to enforce the termination and close-out netting provisions found in such agreements. Further legal analysis is required where FDICIA does not apply and some of the transactions documented are Non-Enumerated Transactions, such as equity derivatives and spot FX agreements. One may argue successfully that such Non-Enumerated Transactions deserve "swap agreement" treatment because they fall within "any other similar agreement" as set forth under the definition of "swap agreement" in both the U.S. Bankruptcy Code and FIRREA; however, if this argument fails, legal complexity follows.

1. Non-Enumerated Transactions. Based upon our understanding of market practices, we have concluded that Non-Enumerated Transactions not afforded "swap agreement" treatment would be treated as "forward contracts" or "securities contracts" as defined in both the U.S. Bankruptcy Code and FIRREA. Such types of contracts also are provided with treatment similar to "swap agreements" under the U.S. Bankruptcy Code and FIRREA.


a. Automatic Stay. Under the U.S. Bankruptcy Code, assuming a derivatives dealer cannot persuade a court that all the various transactions under a master agreement are "swap agreements", then that derivatives dealer should at a minimum be able to reach three net amounts either owed to or by it under such master agreement in a situation where swap agreements, forward contracts and securities contracts have been documented thereunder. Sections 362(a)(7) and 553 of the U.S. Bankruptcy Code, however, could delay the ability of a party to net across product types once these final net amounts owed by or to a counterparty are reached for the swap agreements, forward contracts and securities contracts documented under a master agreement since those Sections stay the set-off of mutual debts after the commencement of a bankruptcy case, and there is no applicable exception to the automatic stay that would allow the set-off against each other of amounts owed under these three types of transactions. Strong policy arguments, however, exist for the automatic stay to be removed at an early stage of the bankruptcy proceeding because the transaction types individually are exempt from the automatic stay under Section 362 of the U.S. Bankruptcy Code.

If a derivatives dealer reaches the point where it has determined that three net amounts are owed by or to a counterparty and that the operation of the automatic stay is delaying further set-off, then uncertainty exists whether a master agreement under which swap agreements, forward contracts and securities contracts are documented should be treated as one agreement so that a court would give effect to the close-out termination provisions of such master agreement to reach one net number either owed to or by the nonbankrupt party. While a bankruptcy court should find that such master agreement constitutes a single executory contract that the trustee must assume or reject as a

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18 For a more complete analysis of the issues described in Section IV of this report, please see the Memorandum by Cravath, Swaine & Moore for ISDA, dated June 22, 1993, entitled "Over-the-Counter Derivatives Transactions: Netting Under the U.S. Bankruptcy Code, FIRREA and FDICIA".


21 See supra note 18.


23 See id.

whole because of existing case law and the parties' intent that the master agreement be treated as one agreement, market participants should seek additional legal certainty.

b. Selective Repudiation. Under FIRREA, the risk that a derivatives dealer may face if it does not persuade a receiver or conservator that all transactions under a master agreement are "swap agreements" is selective repudiation among separate qualified financial contracts (e.g., "swap agreements", "forward contracts", and "securities contracts"). A derivatives dealer, however, has a strong argument that would remove this risk of selective repudiation among separate qualified financial contracts.

A master agreement that contains a provision such as Section 5(a)(v) of the ISDA Master Agreements ("Default under Specified Transaction") provides a basis for terminating all transactions thereunder if there is an attempt to repudiate any of those transactions. It is triggered by the default by a party under any transaction ". . . entered into between one party to this Agreement . . . and the other party to this Agreement . . . ". Therefore, if a FIRREA conservator (or receiver) were to try to repudiate a transaction or a group of transactions under such a master agreement, then the other party has the contractual right to terminate the entire master agreement and all transactions documented thereunder.

Once a party is contractually permitted to terminate all "qualified financial contracts" under a master agreement, including an ISDA Master Agreement, then that party should be able to exercise the close-out netting provisions to reach one net amount owed by or to such party for all qualified financial contracts documented thereunder. 25

3. Proposed Amendments. Legislation or regulations should be sought that confirm that parties to a master agreement may close-out and promptly terminate a master agreement under which not only swap agreements but also securities contracts and/or forward contracts or any other similar agreements are documented. Congress, in enacting the provisions contained in the U.S. Bankruptcy Code and FIRREA and, by implication, FDICIA, has recognized the need of market participants for certainty in the event of an insolvency of a counterparty under each of these types of contracts. As market practices have developed, however, participants have begun to consider including various contract types under one master agreement.

Congress recognized this practice in the amendments to the U.S. Bankruptcy Code and in FIRREA, and provided certainty in this regard to the extent the particular contract falls within the definition of "swap agreement" in the U.S. Bankruptcy Code or FIRREA, as the case may be. There is no principled reason why this master agreement treatment should not be extended to other types of contracts as Congress implicitly recognized in its definition of "netting contract" in FDICIA, which definition is not linked to any particular type of transaction.

Accordingly, we would encourage Congress to consider legislation with respect to the U.S. Bankruptcy Code, and the FDIC to consider a regulation with respect to FIRREA, allowing for the offset of amounts owing in respect of contract types specially treated under the U.S. Bankruptcy Code and FIRREA that are documented under a single master agreement and allow for the immediate liquidation of such a master agreement and the transactions documented thereunder after the commencement of an insolvency proceeding.

This end could best be accomplished through an expansion of the definition of "swap agreement" by legislation or regulation to include specifically contract types entered into in the over-the-counter derivatives market today (e.g., equity derivatives, bond options and spot FX transactions), and through a clarification of the language currently in the definition of "swap agreement" concerning "any other similar agreement" (e.g., clarify meaning through legislative history or consider casting in terms of other contract types which "presently or in the future become the subject of dealings in the over-the-counter derivatives market"). In addition, to account for the possibility that these amendments could miss developments in the derivatives market, the legislation or regulation additionally should provide that a master agreement under which more than one of the contract types specially treated under the U.S. Bankruptcy Code are documented may be liquidated immediately without regard to the automatic stay.

C. Capital Adequacy

Another area affected by the recognition of close-out netting is capital adequacy. Until recently, banking regulators have resisted the recognition in capital adequacy rules of the effects of bilateral close-out netting provisions contained in master agreements where and to the extent those provisions are enforceable (although netting by novation was so recognized); however, on April 30, 1993, the Basle Committee on Banking Supervision (the “Basle Committee”) of the Bank for International Settlements (the “BIS”) released a Consultative Paper that includes a proposal for the recognition of bilateral close-out netting as an amendment to the agreed framework for measuring bank capital adequacy (the “Basle Accord”) published by the Basle Committee in July 1988. The proposals in the Consultative Paper have been accepted and endorsed by the Governors of the BIS as a basis for wider consultations with interested parties over the remainder of 1993.

The Consultative Paper represents an important step in the recognition for capital purposes of bilateral close-out netting; however, central bank regulators in all the countries represented on the Basle Committee will need to recognize such netting for capital purposes once the proposal is adopted by the Basle Committee. The approach to the proposed amendment during the comment period should be to do the work necessary to permit prompt implementation by these national regulators, and includes obtaining legal opinions from counsel in all the countries represented on the Basle Committee indicating that bilateral close-out netting provisions will be upheld in insolvency proceedings in each of those countries.26

D. Multibranch Netting

The use of multibranch master agreements involves a netting issue that to date has not received sufficient attention from market participants and regulators. Multibranch master agreements permit a party to make or receive payments or deliveries under any derivatives transaction through any branch designated in the agreement.

Most of the legal work done to date on close-out netting concerns the enforceability of bilateral close-out netting between two legal entities and not across two or more branches of a single entity. Hence, once close-out netting is recognized for capital purposes, it should not be implemented across branches under a single master agreement until these issues have been resolved. Resolution will come when it is clear that the insolvency of a bank with several branches in different countries will be handled as a single proceeding and not as separate proceedings for the bank and each branch. Market participants and regulators should consult on the regulatory and legislative changes necessary to achieve this goal.

If a bank with branches in countries outside its home country becomes insolvent, complex legal and practical problems can arise when there is an insolvency proceeding in the home country of the bank as well as separate proceedings for one or more branches in other countries. These problems were graphically illustrated in the aftermath of the collapse of the Bank of Credit and Commerce International (“BCCI”) when English and U.S. banking regulators, among others, clashed over the proper disposition of the bank’s assets that were scattered around the globe.

In June 1993, the State of New York Banking Department submitted revised legislation to the New York State Legislature to address this uncertainty in situations where a Federal insurer (e.g., the Federal Deposit Insurance Corporation) is not the receiver or liquidator of a New York branch or agency. In the case of the liquidation of a New York branch or agency of a non-U.S. bank by the New York Superintendent of Banks, the proposal allows the home country regulator of the non-U.S. bank to assume or repudiate qualified financial contracts (including swaps and other over-the-counter derivatives) entered into by that bank or its New York branch or agency that are subject to a multi-branch netting agreement or arrangement. Under the proposal, the counterparty also may terminate a multi-branch master agreement in accordance with its terms.

26 Legal opinions from 10 jurisdictions (Belgium, Canada, England, France, Germany, Italy, Japan, the Netherlands, Sweden and the United States) have been obtained that support such netting under the 1987 ISDA Master Agreements, and are currently being updated with respect to the 1992 Master Agreements.
Upon such repudiation or termination, the liability of the Superintendent to the counterparty will be the lesser of (i) the amount, if any, owed by the non-U.S. bank as a whole after netting under the multi-branch master agreement (the "Global Net Payment Obligation") and (ii) the amount, if any, that would have been owed by the non-U.S. bank to a counterparty after netting only those transactions entered into by the New York branch or agency. The definition of qualified financial contract resembles that set forth in FIRREA and enables the Superintendent to define or expand by regulation the transactions covered by the definition.

Counterparties also are protected by a provision permitting collateral held in New York to secure obligations under a qualified financial contract to be applied toward outstanding claims up to the Global Net Payment Obligation.

This legislation has been submitted to the New York State Legislature for consideration during the current term. The proposed legislation, if enacted, will enhance significantly the enforceability of multi-branch netting agreements that involve New York branches or agencies of non-U.S. banks. It also establishes a constructive pattern for the future of international banking regulation by recognizing for over-the-counter derivatives the global as well as the local interests at stake following an international bank insolvency.

CRAVATH, SWaine & MOORE
State Statutes Authorizing Governmental Entities to Engage in Swap Transactions*

ALABAMA
General Provisions

ARKANSAS
Taxable Bond Act of 1989

CALIFORNIA
Public Bonds and Obligations

Powers and Duties Common to Cities, Counties and Other Agencies

Health Facilities Financing Authority Act

Municipal Utility District Act

COLORADO

CONNECTICUT
Municipal Resource Recovery Authorities

DISTRICT OF COLUMBIA
General Obligation Bond Act of 1992
District of Columbia Laws 9-251 (Act 9-397) § 8(h)(3)

General Fund Recovery Act of 1991
District of Columbia Laws 9-46 (Act 9-64) § 107(h)

FLORIDA
Florida Industrial Development Financing Act

Taxable Bonds

Public Lands and Property

* This Appendix is based upon material provided by Thomas A. McGavin, Jr., Esq. of Rogers & Wells, New York.
GEORGIA
Municipal Gas Authority of Georgia

Housing and Finance Authority

HAWAII
County Organization and Administration

ILLINOIS
Rural Bond Bank Act

Land Bank Fund

Build Illinois Bond Act

LOUISIANA
Securities of Public Entities

Louisiana Water Control Law

MAINE
Finance Authority of Maine

MASSACHUSETTS
Massachusetts Industrial Finance Agency

State Finance

College Savings Programs

Water Pollution Abatement Revolving Loan Program

MICHIGAN
State Housing Development Authority

Municipal Finance Act
Hospital Finance Authority Act

Low-Level Radioactive Waste Authority

MINNESOTA
Public Facilities Authority

Public Indebtedness
Minn. Stat. (1991) § 475.54

MISSISSIPPI
Municipal Gas Authority
Miss. Code Ann. (1990) §§ 7-1-403 and 77-6-15

NEVADA
Municipal Obligations

NEW YORK
New York State Thruway Authority
NY CLS Pub A (1991) § 380

New York Local Government Assistance Corporation
NY CLS Pub A (1991) §§ 3235 and 3240

NORTH CAROLINA
North Carolina Air Cargo Airport Authority

OHIO
Uniform Public Securities Law
Ohio Rev. Code Ann. § 133.22

Aid to Local Government Improvements
Ohio Rev. Code Ann. § 164.01

Economic Development Program
Ohio Rev. Code Ann. § 166.08

Coal Research and Development
Ohio Rev. Code Ann. § 1555.08

Unemployment Compensation: Employment Services
Ohio Rev. Code Ann. § 4141.48

PENNSYLVANIA
College Savings Bonds
RHODE ISLAND
Rhode Island Clean Water Protection Finance Agency
R.I. Gen. Laws § 46-12.2-2

TENNESSEE
Metropolitan Airport Authorities
Tenn. Code Ann. § 42-4-109

TEXAS
Regional Transit Authorities

Texas Housing Agency

VIRGINIA
Public Finance Act

WASHINGTON
Economic Development Finance Authority
Wash. Rev. Code 43.163.010

WEST VIRGINIA
State Refunding Bond Act
Draft Model Statute Authorizing Governmental Entities to Engage in Swap Transactions

The Legislature finds and declares that the incurring or carrying of obligations and making and managing of investments by this government, subdivisions hereof and related governmental entities involves a variety of interest rate, payment, exchange and other risks and that a number of financial instruments are available to offset, hedge, or reduce, and improve net costs and we therefore desire to clearly establish that this government, subdivisions hereof and related governmental entities have express statutory authority to take advantage of those instruments. Notwithstanding any other provision of law applying to this government, subdivisions hereof and related governmental entities, all of the following may apply:

(a) Definitions. As used in this Statute, the following definitions apply, unless the context otherwise indicates:

   (i) “Obligations” mean bonds, notes, bond anticipation notes, commercial paper, or other evidences of indebtedness, or lease, installment purchase, or other agreements or other purchasing programs or certificates of participation therein.

   (ii) “Governmental Entity” means the state (or the equivalent thereof) or any political subdivision thereof, or any department, agency, board, commission, or authority of the state or any such political subdivision, or any public corporation, authority, agency, board, commission, or other public entity controlled by the state or any such political subdivision.

   (iii) “Swap Agreement” means (A) an agreement (including terms and conditions incorporated by reference therein) which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement (including any option to enter into any of the foregoing), (B) any combination of the foregoing or (C) a master agreement for any of the foregoing together with all supplements.

(b) Swap Agreements.

   (i) Subject to clause (ii) below, any Governmental Entity may from time to time enter into (and modify, amend and terminate) one or more Swap Agreements that it determines to be necessary or desirable in connection with, or incidental to, the conduct of its activities, whether commercial or governmental in nature, including in connection with the issuance, carrying or securing of Obligations, purchases or sales of goods or products or the acquisition or carrying of investments. Swap Agreements entered into by a Governmental Entity shall contain such provisions, including payment, term, security, default and remedy provisions, and shall be with such parties, as the Governmental Entity shall determine to be necessary or desirable after due consideration of the creditworthiness of such parties at the time of entering into the Swap Agreements.

   (ii) No Governmental Entity shall enter into any Swap Agreement pursuant to this subdivision other than for the purpose of managing an interest rate, currency, commodity price, investment or other similar risk that arises in connection with, or incidental to, the activities of the Governmental Entity, and no Governmental Entity shall carry on a business of acting as a dealer in Swap Agreements.

   (c) Foreign Currency. Obligations issued by a Governmental Entity may be payable in accordance with their terms, in whole or in part, in currency other than lawful money of the United States of America, provided that the Governmental Entity enters into a Swap Agreement or similar agreement for payments in lawful money of the United States of America, which covers the entire amount of the debt service payment obligation of the Governmental Entity with respect to the Obligations payable in other currency, and provided further that if the term of that agreement is less than the term of the Obligations, the Governmental Entity shall covenant to enter into additional agreements as may be necessary to cover the entire amount of the debt service payment obligation.
(d) **Credit Enhancement.** In connection with entering into any Swap Agreement the Governmental Entity may enter into credit enhancement or liquidity agreements with such payment, security, default, remedy, and other terms and conditions as the Governmental Entity determines.

(e) **Enforceability.** Absent bad faith or actual knowledge to the contrary, a counterparty that enters into any Swap Agreement with a Governmental Entity may rely on a representation by that Governmental Entity that it is authorized or empowered to enter into such Swap Agreement, and notwithstanding the failure by that Governmental Entity to comply with the provisions in this Statute, that counterparty may enforce such Swap Agreement against the Governmental Entity.

(f) **Preemption.** To the extent that this Statute is inconsistent with any other general statute or parts thereof, now or hereafter enacted, this Statute is controlling.

(g) **Construction.** It is the intent of the Legislature that this Statute be liberally construed.