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LCH Limited
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27 July 2018

Dear Sirs

Opinion Letter in respect of the LCH Limited EMIR-compliant model

You have asked us to provide this opinion in respect of the laws of Germany ("**this jurisdiction**") in response to certain specific questions raised by LCH Limited ("**LCH**") in relation to membership, insolvency, security, set-off and netting and client clearing with respect to entities incorporated in Germany (the "**Relevant Jurisdiction**") becoming clearing members of LCH (each a "**Relevant Clearing Member**") and entering into the Clearing Membership Agreement, the Deed of Charge and LCH's Rulebook (all as defined in paragraph 1.9 below).

The relevant questions are set out in full in paragraph 3 of this Opinion Letter together with the corresponding responses.

This Opinion Letter is given in respect of German Clearing Members which are Companies and hold the requisite licence to act as Credit Institutions or Financial Services Institutions each incorporated in, and acting through their offices in Germany.

For purposes of this Opinion Letter, "**Company**" means a stock corporation (*Aktiengesellschaft*, "**AG**") established under the German Stock Corporation Act (*Aktiengesetz*, "**AktG**"), or a European public limited liability company (*Societas Europaea*, "**SE**") established under the Regulation (EC) No 2157/2001 on the Statute for a European Company (SE) ("**SER**")[1] or a limited liability company (*Gesellschaft mit beschränkter Haftung*, "**GmbH**") established under

[1] According to Article 10 SER, subject to the SER, an SE is treated in every EU member state as if it were a stock corporation formed in accordance with the law of the EU member state in which it has its registered office. Therefore, the provisions of the AktG apply to SEs having their registered office in Germany unless special provisions of SER prevail.

the German Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*);

"**Credit Institution**" means a credit institution (*Kreditinstitut*) within the meaning of section 1 para 1 of the German Banking Act (*Kreditwesengesetz*, "**KWG**") established as Companies under German private law or established under German public law as a separate legal entity (*juristische Person des öffentlichen Rechts*) in the form of a corporation (*Körperschaft des öffentlichen Rechts,* "**KöR**") or an agency with full legal capacity (*rechtsfähige Anstalt des öffentlichen Rechts*, "**AöR**");[2] and

"**Financial Services Institution**" means a financial services institution (*Finanzdienstleistungsinstitut*) within the meaning of section 1 para 1a KWG established as Company.

1. INTRODUCTION, TERMS OF REFERENCE

1.1 Formal statement

This opinion letter (the "**Opinion Letter**") contains formal statements of opinion as to German law on the matters set out in paragraph 3 (Opinion) below. It is based on our understanding of LCH's clearing services as they are described in the Opinion Documents listed in paragraph 1.9 below, and is subject to assumptions set out in paragraph 2 (Assumptions) and to the additional qualifications set out in paragraph 3.5 (Qualifications). The opinions given in this Opinion Letter are strictly limited to the specific questions raised by you as set out in paragraph 3 (Opinion) hereafter and do not extend to any other matters. We have assumed that all matters which are or could be material in the context of our delivery of this Opinion Letter have been disclosed to us.

1.2 No advice

We have not been responsible for advising any party to the Opinion Documents. We have been instructed to issue this Opinion Letter and the delivery of this Opinion Letter to any other person to whom a copy of this Opinion Letter may be disclosed pursuant to paragraph 1.11 does not evidence the existence of any relationship of client and lawyer between us and such person.

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[2] We do not opine on the enforceability of the liquidation, set-off, netting and credit support provisions if the relevant laws or statutes of Credit Institutions established under public law provide for specific limitations on such rights and obligations.

1.3 Scope of examination and investigation

For the purpose of issuing this Opinion Letter, we have made no investigation or verification, and we express no opinion, express or implied, with respect to:

1.3.1 any liability to tax as a result of or in connection with the Opinion Documents, or the tax treatment of any transaction or the tax position of any party thereto;

1.3.2 any regulatory or accounting matters except to the extent that we address relevant provisions of Regulation (EU) No 648/2012 of 4 July 2012 on OTC derivatives, central counterparties and trade repositories ("**EMIR**") where relevant for assessing the effects of Article 102b of the German Introductory Act to the Insolvency Code (*Einführungsgesetz zur Insolvenzordnung*, "**EGInsO**");

1.3.3 any matters of fact or the reasonableness of any statements of opinion or intention expressed in relation to the Opinion Documents, including any facts, events or circumstances arising as a result of the execution of any related documents by the parties thereof or the performance of the parties' obligations deriving therefrom;

1.3.4 the validity and enforceability of any of the Opinion Documents (other than set out in paragraph 3 below);

1.3.5 the enforceability of any net obligation resulting from any netting or set-off;

1.3.6 any laws of any jurisdiction other than Germany, including jurisdictions in which our firm has an office or correspondents;

1.3.7 German credit institutions holding a licence as a covered bond bank (*Pfandbriefbank*) with respect to any transactions relating to or included in the cover register (*Deckungsregister*) and we do not give an opinion on general regulatory restrictions under the German Covered Bond Act (*Pfandbriefgesetz*); and

1.3.8 with respect to obligations and assets otherwise allocated by a credit institution to a specific asset or cover pool as required under applicable statutory law.[3]

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[3] See section 13 para 3 of the Act on the Landwirtschaftliche Rentenbank (*Gesetz über die Landwirtschaftliche Rentenbank*), section 9 para 4 of the Act on the Conversion of the Deutsche Genossenschaftsbank (*Gesetz zur*

1.4 Enforceability

In this Opinion Letter, references to the word "**enforceable**" and cognate terms are used to refer to the ability of a party to exercise its contractual rights in accordance with their terms and without risk of successful challenge. We do not opine on the availability of any judicial remedy or on the factual or commercial success of any enforcement measures.

1.5 German law

This Opinion Letter is confined to matters of German law in force as at the date on which this Opinion Letter is given (including any European Union regulations (*Verordnungen*) directly applicable in Germany), as applied and construed according to published court decisions in Germany. We express no opinion on European Union law as it affects or would be applied in any jurisdiction other than Germany.

1.6 No updating

We assume no duty to update this Opinion Letter or inform LCH or any other person to whom a copy of this Opinion Letter may be communicated of any change in German law (including, in particular, applicable court decisions), or the legal status of any party to the Opinion Documents, or any other circumstance that occurs, or is disclosed to us, after the date on which this Opinion Letter is given, which might have an impact on the opinions given in this Opinion Letter.

1.7 Date

This Opinion Letter is given as of 27 July 2018.

1.8 Interpretation

The opinions given in this Opinion Letter express and describe German legal concepts in the English language rather than in their original form and such expressions and/or descriptions may not be fully identical in their meaning to the underlying German law concepts. Any issues of interpretation arising in respect of the Agreement or the

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Umwandlung der Deutschen Genossenschaftsbank) and section 7 para 4 of the Act on the Conversion of the Deutsche Siedlungs- und Landesrentenbank into a Stock Corporation (*Gesetz über die Umwandlung der Deutschen Siedlungs- und Landesrentenbank in eine Aktiengesellschaft*) and section 1 para 1 of the Act relating to the Industriekreditbank Aktiengesellschaft (*Gesetz betreffend die Industriekreditbank Aktiengesellschaft*).

opinions given in this Opinion Letter will be determined by the German courts in accordance with German law and we express no opinion on the interpretation that the German courts may give to any such expressions or descriptions.

Translations of German legal provisions into English are non-official translations and are provided by us for convenience only. The German version is the only binding version and German courts and authorities will have regard only to such German version.

For the avoidance of doubt, the point in time of formal commencement of Insolvency Proceedings (i.e. the opening of Insolvency Proceedings) is in all likelihood not the point in time in which a party is insolvent.

1.9 Documents reviewed

For the purposes of preparing our opinion we have reviewed electronic versions of the following documents:

1.9.1 the General Regulations, the Default Rules and the Settlement Finality Regulations published on LCH's website dated December 2017 ("**Rulebook**"),

1.9.2 the Clearing Membership Agreement (as defined in the Rulebook) which is substantially in the form appended as Appendix 1 of this opinion letter ("**Clearing Membership Agreement**"), and

1.9.3 a deed of charge entered into between a Clearing Member and LCH in respect of all Charged Property transferred to LCH by that Clearing Member which is substantially in the form of the Deed of Charge set out in Appendix 2 and which contains no material modifications to the wording set out in Clause 2 of that annexed form (for the avoidance of doubt, a change to the numbering of the clause or other provision in which the relevant wording appears in a particular deed of charge would not (in either such case) of itself constitute a "material modification" for these purposes) (the "**Deed of Charge**" and together with the Clearing Membership Agreement, the "**Agreements**").

The documents referred to in paragraphs 1.9.1 to 1.9.3 are referred to as the "**Opinion Documents**". We have reviewed the Opinion Documents in connection with the instructions to counsel dated 10 August 2017 ("**Instructions**").

1.10 Defined terms

Unless otherwise defined herein, terms defined under the Opinion Documents shall have the meaning ascribed to such terms in the Opinion Documents.

1.11 Reliance

1.11.1 This Opinion Letter is addressed to and solely for the benefit of LCH and the Relevant Clearing Members (the "**Addressees**").

1.11.2 We accept responsibility to the Addressees in relation to the matters opined on in this Opinion Letter but the provision of this Opinion Letter is not to be taken as implying that we assume any duty or liability to any Addressee in relation to the Documents or the content of the Documents and the commercial and financial implications arising from them.

1.11.3 This Opinion Letter may be relied upon only by the Addressees and for the purposes of the Documents and, except with our prior written consent or where required by law or regulation, is not to be:

(a) transmitted or disclosed to or used or relied upon by any other person, save that a copy of it may be disclosed, on a confidential and non-reliance basis and for information purposes, to the Addressees' affiliates and auditors, any entity that applies to become a Relevant Clearing Member for information purposes only and solely on the basis that we assume no responsibility to any such parties as a result of such disclosure; or

(b) used or relied upon for any other purpose.

2. ASSUMPTIONS

We assume the following:

2.1 LCH is validly authorised under English law as a central counterparty ("**CCP**") within the meaning of Article 2 no. 1 EMIR.

2.2 The Opinion Documents and Contracts have been validly entered into between all parties and incorporated and form part of the legal relationship between LCH and its Clearing Members.

2.3 The Opinion Documents and Contracts are enforceable in accordance with their terms (other than those provisions of the Opinion Documents on which we opine).

2.4 Each party is, and will continue to be, a validly existing legal entity with capacity, power and authority, under all applicable law(s), to enter into and to exercise its rights and to perform its obligations in connection with Opinion Documents.

2.5 Each party has obtained, complied with the terms of and maintained all authorisations, approvals, licences and consents required to enable it lawfully to enter into and perform its obligations under the Opinion Documents and Contracts and to ensure the legality, validity, enforceability or admissibility in evidence of the Opinion Documents in Germany.

2.6 The Opinion Documents and each Contract have been properly authorised, executed and delivered by each party in accordance with all applicable laws.

2.7 The Opinion Documents and each Contract have been entered into, and each of the Contracts referred to therein is carried out, by each of the parties thereto in good faith, for the benefit of each of them respectively, on arms' length commercial terms and for the purpose of carrying on, and by way of, their respective businesses.

2.8 Each party is at all relevant times solvent and not subject to any regulatory pre-insolvency, reorganisation or insolvency proceedings under the laws of any jurisdiction.

2.9 There is no current or pending stoppage of payment situation (including German law *Zahlungsunfähigkeit*), no status of over-indebtedness (including German law *Überschuldung*) and no reasons justifying a filing for the opening of insolvency proceedings (including on a voluntary basis) (*drohende Zahlungsunfähigkeit*) in respect of any Relevant Clearing Member and that no Relevant Clearing Member is subject to any regulatory pre-insolvency, reorganisation or insolvency proceedings under the laws of any jurisdiction as of the date of this opinion. Each of the Opinion Documents is entered into by the parties prior to the opening of any insolvency or bankruptcy proceedings against either party.

2.10 None of the parties is entitled to claim in relation to itself or its assets immunity from suit, attachment, execution or other legal process. To the extent any entity established under German public law enters into the Opinion Documents or Contracts, the execution of such agreement constitutes, and the exercise of that party's rights and performance of its obligations thereunder will constitute, private and commercial acts done and performed for private and commercial purposes.

2.11 Any Collateral provided in connection with the Opinion Documents will exclusively consist of either cash or securities. Securities will be collectively held (*girosammelverwahrt*) or dematerialised securities booked to an account (*Buchrechte*).

2.12 That any cash provided as collateral is in a currency that is freely transferable internationally under the laws of all relevant jurisdictions.

2.13 To the extent any transfers of cash or securities or the creation of security interests over, cash or securities, are subject to mandatory property laws (*Sachenrecht*), such property laws are complied with.

2.14 The pledges granted and the outright title transfers made by Clearing Members under the Opinion Documents to LCH are made over accounts held in England and/or assets booked on accounts held in England, are valid, and the requirements of the relevant applicable law governing the creation, transfer and/or enforcement of these pledges and title transfers are complied with, under all applicable laws (other than this jurisdiction).

2.15 There are no rights of third parties in respect of the assets comprising the Collateral nor any other impediments which would in any way affect the transfer of the Collateral as contemplated by the Opinion Documents.

2.16 That none of the parties qualifies as a consumer (*Verbraucher*) within the meaning of section 13 BGB, i.e. a natural person entering into a legal transaction for a purpose which belongs neither to its commercial business nor to its self-employed business, but qualifies – as appropriate – as a merchant (*Kaufmann*) within the meaning of section 1 HGB or as an entrepreneur (*Unternehmer*) within the meaning of section 14 BGB, i.e. any natural or legal person or partnership entering into a legal transaction in the course of its commercial business or its self-employed business.

2.17 There is no other agreement, instrument, arrangement or dealing between any of the parties to the Opinion Documents and Contracts which modifies, supersedes or affects the Opinion Documents and Contracts.

2.18 The obligations assumed under the Opinion Documents and Contracts are mutual between the parties, in the sense that the parties are each individually and solely liable as regards obligations owing by each other and are solely entitled to the benefit of obligations owed to each other, respectively. Mutuality (*Gegenseitigkeit*) generally exists where each party is individually and solely liable as regards obligations owed by it and is solely entitled to the benefit of obligations owed to it. Circumstances in which the requisite mutuality is missing include, without limitation, where a party is acting as agent for another person, or is a trustee, or in respect of which a party has a joint interest (including partnership) or such in respect of which a party's rights or obligations or any interest therein have been assigned, charged or transferred (whether in whole or in part) whether unilaterally, by agreement or by operation of law.

2.19 The opinions given in this Opinion Letter relate only to German law as applied by the German courts as at today's date. We express no opinion on the laws of any other jurisdiction, even where, under German law, a foreign law would be applicable. All acts, conditions or things required to be fulfilled, performed or effected in connection with the Opinion Documents under the laws of each relevant jurisdiction have been duly fulfilled, performed and effected.

3. OPINION

On the basis of the foregoing terms of reference and assumptions and subject to the qualifications set out under paragraph 3.5 below we are of the following opinions in response to specific questions which are set out in italics:

3.1 Membership

3.1.1 *Are there any statutory limitations on the capacity of, or specific regulatory requirements associated with, any Relevant Clearing Member entering into the Agreements (including for the purpose of granting of security under the Deed of Charge)*?

As to the relevance of any limitations imposed by the constitutional documents of a Relevant Clearing Member, see paragraph 3.1.3 below.

There are no specific statutory limitations or regulatory requirements which would limit the capacity of an appropriately authorised Relevant Clearing Member to enter into the Agreements.

The activities of the Relevant Clearing Member may, however, be subject to licence requirements under section 32 para 1 KWG. To the extent a Relevant Clearing Member purchases or sells financial instruments (such as OTC derivatives) in its own name for the account of Clients, it would conduct principal broking services (*Finanzkommissionsgeschäft*) (section 1 para 1 sentence 2 no 4 KWG). Furthermore, to the extent the Relevant Clearing Member either keeps securities in safe custody or administers securities for Clients, such activities would constitute licensable safe custody business (*Depotgeschäft*) (section 1 para 1 sentence 2 no 5 KWG), which is subject to a licence requirement. Since the Opinion Documents exclusively deal with clearing, performance by a Relevant Clearing Member of the obligations under the Opinion Documents alone and in itself would not trigger licence requirements for investment brokering (*Anlagevermittlung*) under section 1 para

1a sentence 2 no 1 KWG or other financial services under the KWG.[4] For the avoidance of doubt, we do not express any opinion in respect of activities Relevant Clearing Members may perform in addition to strictly providing clearing services under the Opinion Documents in particular any payment services.

Contractual agreements violating statutory law are generally null and void under German law only if they are in breach of prohibition provisions which apply to both parties (mutual prohibitions, *beiderseitige Verbotsgesetze*). [5] The provisions of the KWG prohibiting the conduct of banking business for unregulated entities are generally not seen as such mutual prohibitions within the meaning of section 134 BGB.[6] However, as a general principle, courts could find an agreement to be invalid if both of the parties knew about the licence requirements and acted together willingly breaching the law.[7]

Where one or both of the parties violate a licence requirement under the KWG by entering into an agreement, the respective agreements may either have to be terminated in accordance with their terms upon instruction of the German

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[4] Licenseable financial services are, among others, investment advice (section 1 para 1a sentence 2 no. 1a KWG, *Anlageberatung*), contract broking (section 1 para 1a sentence 2 no. 2 KWG, *Abschlussvermittlung*), portfolio management (section 1 para 1a sentence 2 no. 3 KWG, *Finanzportfolioverwaltung*) and own account trading (section 1 para 1a sentence 2 no. 4 KWG, *Eigenhandel*).

[5] German Federal Court of Justice (*Bundesgerichtshof*, "**BGH**") NJW 2000, 1186, 1187; Higher Administrative Court (*Verwaltungsgerichtshof*, "**VGH**") Kassel WM 2009, 1889, 1893; *Körner*, ZHR 131, 127, 135; *K.P. Berger*, in: Münchener Kommentar BGB, 7th ed. (2016), § 488 BGB no. 96; *Ellenberger*, in: Palandt, BGB, 77th ed. (2018), § 134 BGB no. 20. Except for section 3 para 1 no. 1 KWG.

[6] Any individual person engaging in providing financial services without a licence commits a criminal offence and will be punished (i) in case of willful misconduct by a term of imprisonment of up to five years or (ii) in case of acting negligently by a term of imprisonment of up to three years or, alternatively in both cases by a monetary fine. In addition to the criminal sanctions for individuals, the German law also provides for a possibility to impose sanctions upon a legal entity. Pursuant to the German Act on Administrative Offences (*Ordnungswidrigkeitengesetz*) a legal entity may be punished by an administrative fine amounting up to EUR 5 million for negligent acts, EUR 10 million for willful misconduct or even higher if the economic benefit of the breach of law exceeds the maximum amount of the monetary fine. Furthermore, a court may order the forfeiture (*Einziehung*) of the gross proceeds (*Bruttoertrag*) of the respective entity without expenses to be deducted, i.e. an unlimited amount of the proceeds made in connection with the unlicensed activity may have to be paid into court and will be distributed to charity.

[7] BGH MDR 1990, 416.

Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, "**BaFin**") or may be unwound by administrative order of the BaFin if it takes action against an entity for breach of German licensing requirements.[8] An agreement must usually be unwound so that the parties are put into the position they were in when they initially entered into the agreement. If both of the parties acted together willingly breaching the law, the counterparty would likely not be able to claim damages from the entity which breached the licence requirements.

3.1.2 *Would LCH be deemed to be domiciled, resident or carrying on business in the Relevant Jurisdiction by virtue of providing clearing services to a Relevant Clearing Member? If so, would LCH be required to obtain a licence or be registered before providing clearing services to a Relevant Clearing Member or are there any special local arrangements for the recognition of overseas clearing houses in these circumstances?*

Section 32 para 1 KWG in connection with section 1 para 1 sentence 2 no. 12 and para 31 KWG implements Article 14 EMIR and provides that any person which intends to act as a CCP in Germany must obtain a licence from BaFin. Article 14 para 1 EMIR provides that where a legal person established in the European Union ("**EU**") intends to provide clearing services as a CCP, it must apply for authorisation to the competent authority of the member state of the EU ("**Member State**") where it is established. Article 14 para 2 EMIR provides that once authorisation has been granted in accordance with Article 17 EMIR, it will be effective for the entire territory of the EU. Any additional or further licences from other authorities where the CCP performs its activities are therefore not required. This is expressly confirmed in BaFin's note – information on the activity of a central counterparty (*Merkblatt - Hinweise zum Tatbestand der Tätigkeit als zentrale Gegenpartei*).[9] Based on our assumption that LCH will be validly authorised as a CCP in accordance with EMIR (by the competent UK authorities) it may therefore act as a CCP in Germany without obtaining a licence from BaFin.

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[8] The legal basis for such an administrative order would be section 37 KWG. See further VGH Kassel WM 2009, 1889, 1893 and German Federal Administrative Court (*Bundesverwaltungsgericht*, "**BVerwG**") BKR 2011, 208, 211.

[9] See https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Merkblatt/mb_130812_tatbestand_zentrale_gegenpartei.html.

3.1.3 *What type of documents should be obtained by LCH to evidence that a Relevant Clearing Member and its officers have the capacity and authority to enter into the LCH Agreements? Is LCH required to verify such evidence*?

An AG validly established under German private law has its own legal personality (section 1 para 1 AktG). The same applies to a GmbH (section 13 para 1 GmbHG). Each such Company generally has full capacity to enter into all types of contracts and agreements. The concept of *ultra vires*, under which the power and capacity of an entity to validly enter into an agreement is restricted to its area of competence which is defined by the relevant law or constitutional documents establishing such entity (i.e. the statutes (*Satzung*) of an AG or the articles of association (*Gesellschaftsvertrag*) of a GmbH) and by the statutory tasks and functions attributed to it) only applies to entities established under public law, not to Companies (subject to paragraph 3.1.3(c) below).[10]

With respect to a Relevant Clearing Member established under private law, LCH should obtain at least the following documents:

- a commercial register extract (*Handelsregisterauszug*) which has been obtained less than fifteen (15) calendar days before (and including) the date on which reliance is sought and,

- where power of attorney of a representative is not evidenced by such commercial register extract, a written power of attorney evidencing authority of the representative that allows the authority of a signatory to be tracked back to a person properly authorised and named in the commercial register. This can also be in the form of a signatory list.

It is not necessary to review constitutional documents of a Relevant Clearing Member established under private law. Where a Relevant Clearing Member is established under public law, capacity needs to be checked individually. We also refer to our qualifications on the concept of *ultra vires* and other restrictions that may apply to public law entities in paragraphs 4.14 to 4.19.

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[10] Fleischer, NZG 2005, 529 *et seq.*

(a) Commercial register information evidencing corporate existence

To verify the corporate existence and capacity of a Relevant Clearing Member, LCH should obtain a commercial register extract of the Relevant Clearing Member.

As the commercial register is a public register, good faith of third parties in the correctness of the content of the commercial register is protected by section 15 of the German Commercial Code (*Handelsgesetzbuch*, "**HGB**"). Pursuant to section 15 para 2 HGB it is possible to rely (absent positive knowledge of contrary facts or negligent failure not to be aware of such contrary facts) for a period of fifteen (15) calendar days after inspection on the commercial register to be correct. Following the expiry of such time period, a commercial register extract no longer provides for a statutory protection against failure to know of any changes which have been entered into the commercial register. Upon request, the commercial register excerpt can be certified by the relevant local court which is, however, not a requirement for reliance and it should also be noted that some courts exclusively provide uncertified electronic commercial register extracts that, however, have a reduced evidential value.

(b) Power of representation and the function of the commercial register

The excerpt from the commercial register may also identify the persons entitled to duly represent the Relevant Clearing Member and the manner in which they are entitled to represent it (by acting alone or jointly with one or more other individuals).

(i) A Company is legally represented by those corporate bodies that have the statutory power to represent the relevant Company, i.e. the executive board (*Vorstand*) of an AG or the managing directors (*Geschäftsführer*) of a GmbH. In the absence of any other provisions in the constitutional documents, all members of the executive board of an AG or all managing directors of a GmbH must act jointly (*Gesamtvertretungsmacht*, sections 35 para 2 sentence 1 GmbH, 77 para 1 sentence 1 AktG) to represent the Company. Usually, the constitutional documents would provide that the Company may be validly represented by (i) one member of the executive board or managing directors acting alone (*Einzelvertretungsmacht*), or (ii) two members of the executive board acting jointly, or (iii) one member of the

executive board acting jointly with a holder of a *Prokura* (see below). A limitation of scope of authority of the executive board or managing directors by internal restrictions is generally invalid vis-à-vis third parties (sections 82 para 1 AktG, 37 para 2 GmbHG).

(ii) Business transactions on behalf of the Company can also be concluded by persons who have been granted a power of attorney covering the relevant transaction(s). The HGB provides for specific types of powers of attorney related to transactions on behalf of a Company (commercial powers of attorney), the most important type being the *Prokura* which confers the authority to represent the Company in all kinds of transactions or legal acts in and out of court that are related to the operation of any commercial business. Thus, it is not limited to the scope of the particular business carried out by the Company. However, transactions that affect the operation of the business as such (*Grundlagengeschäfte*, e.g., sale or closure of the business, change of the business name, application for opening of insolvency proceedings, application for registration of the business with the commercial register) or transfer or encumbrance of real property are not covered by the *Prokura*. The *Prokura* can be conferred either in such way that the *Prokurist* represents the Company acting alone (*Einzelprokura*), or in such way that the *Prokurist* represents the Company acting jointly with a statutory representative or a further *Prokurist* (*Gesamtprokura*). The *Prokura* can also be limited to the business of one of several branches of a business, provided that the branches operate under different business names. Any other limitation of the scope of authority covered by the *Prokura* is invalid vis-à-vis third parties.

(iii) As the statutory representative (i.e. members of the executive board of an AG, managing directors of a GmbH) and the *Prokuristen* are identified in the commercial register, LCH may also rely on the authority of the persons named in the commercial register to be members of the board or having *Prokura* if the contract is entered by two authorised persons provided, however, that the counterparty acts in the context of commercial

operations under private law (*Geschäftsverkehr*). [11] Where, however, one of the cases described in paragraph 3.1.3(c) below applies, a contract would not be validly concluded.

(iv) Where the person representing the Company is not named in the commercial register, such person can give evidence of its authorisation by providing the relevant document under which a power of attorney is granted.

(v) Pursuant to section 172 BGB a document under which a power of attorney is granted to a representative by the Company generally evidences its right to represent the Company. The authority remains effective until the power of attorney is either returned to the Company or declared invalid by the Company. The Company may declare the power of attorney invalid by public notice. Public notices are given to and published by the local court (section 186 para 2 of the German Code of Civil Procedure (*Zivilprozessordnung*, "**ZPO**")).

As a result, LCH when acting as a counterparty of a Company may rely on its capacity and the authorisation of the representatives if it has verified the existence of that Company and the authority of its representatives on the basis of a current commercial register excerpt and power of attorney (where applicable), where German law is relevant (see paragraph 3.1.3(e)). A breach of internal restrictions would not lead to the invalidity of the contract concluded in breach of such restrictions if the representative is duly authorised to act vis-à-vis third parties. Where, however, one of the cases described in paragraph 3.1.3(c) below applies, a contract would not be validly concluded.

(c) Exceptions

However, there are certain instances under German law in which an agreement cannot be validly concluded by a Relevant Clearing Member

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[11] BFH NJW 1978, 1944.

even if the representative of a Relevant Clearing Member is, in principle, authorised.

(i) If the breach of internal restrictions on the authorisation or power of the representative was unquestionably obvious (*offensichtlich*) for the counterparty, then an agreement is rendered invalid. Under the concept of misuse of authority (*Mißbrauch der Vertretungsmacht*), contracts entered into by a representative are not binding on the Company if the representative or apparent representative misused its authority to represent the Company and if such misuse was known or obvious to the counterparty.[12] Such a misuse may only occur where the power of a representative to bind a Company with regard to third parties exceeds the internal limits of the representative's authority as agreed between the representative and the Company or stipulated in the Company's internal documents which are binding on the representative.

(ii) Furthermore, in the case of collusive and abusive interaction (*Kollusion*), agreements are void or the claims thereunder are considered unenforceable. Collusion means that the respective person acting in the name and on behalf of the relevant Company and its counterparty are both aware of the lack of authorisation or power of (the person acting for) the respective Company, but, notwithstanding such explicit knowledge, enter into the agreement. However, collusion requires an understanding between the parties to jointly conclude the relevant agreement despite their knowledge of a lack of power or authority.

(iii) As a general matter of law, pursuant to section 181 BGB a representative may not without permission enter into a legal transaction (i) in the name of the principal with itself in its own name (prohibition of self-dealing, *Verbot des Insichgeschäfts*) or (ii) in the name of the principal and as an agent of a third party (prohibition of multi-representation, *Verbot der*

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[12] *Hopt,* in: Baumbach/Hopt, Handelsgesetzbuch 38th ed. (2018), § 50 HGB no. 5; *von Westphalen*, DStR 1993, 1186, 1188; BGH NJW 1984, 1461, 1462; BGH NJW 1988, 2241; BGH NJW 1999, 2883; BGH NJW 2011, 66, 69.

Mehrfachvertretung), unless the legal transaction solely consists in the fulfilment of an obligation. These particular restrictions deriving from section 181 BGB can be excluded by private contract, subject to certain formal requirements.

The legal consequence in each case to be determined by the underlying factual situation, would be that the counterparty may not rely on the binding effect of the legal acts of the representative.

(d) Constitutional and corporate documents (including powers of attorney)

Internal restrictions on the permitted activities of a Company or a representative's authorisation may be contained in the internal documents of a Company. A counterparty of a Company is, however, not obliged to review internal documents of a Company[13] in order to research restrictions on a representative's authorisation.[14] Rather it may rely on the excerpts from the commercial register or the wording of the power of attorney. However, if it does review the relevant documents, any limitation therein will be considered as obvious (*offensichtlich*) for the counterparty.

(e) Representation under conflict of laws considerations

The statements above, and in particular the principles of good faith in the commercial register (section 15 HGB) or power of attorney (section 172 BGB) apply under German law.

There is no explicit provision under the Regulation (EU) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations ("**Rome I**")[15] as to the law

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[13] In case of an AG the relevant internal documents consist of the articles of association, the by-laws (*Geschäftsordnung*) of the supervisory board (*Aufsichtsrat*) and the by-laws (*Geschäftsordnung*) of the executive board (*Vorstand*). In case of a GmbH, the relevant internal documents consist of the articles of association of a GmbH , the by-laws (*Geschäftsordnung*) of the supervisory board (*Aufsichtsrat*), if any, the by-laws (*Geschäftsordnung*) of the advisory board (*Beirat*), if any, and the by-laws (*Geschäftsordnung*) of the managing directors (*Geschäftsführer*). The relevant documents may provide that a resolution by the executive board managing director or supervisory board may be required.

[14] BGH NJW 1984, 1461 (in case of a GmbH).

[15] OJ No L 177 of 4 July 2008. Rome I applies to contracts concluded on or after 17 December 2009 (Article 28 of Rome I as revised by the corrigendum published in OJ No L 309 of 24 November 2009, p. 87).

governing the grant or use of a power of attorney. Pursuant to Article 1 para 2 lit. (g) Rome I the question of whether an agent is able to bind a principal, or a statutory representative to bind a company or other body corporate or unincorporated, in relation to a third party, is excluded from its scope. While statutory German conflict of laws provisions apply in the case of powers of attorney granted by contractual arrangement, no statutory German conflict of law provisions apply with respect to functional representatives (*organschaftliche Vertreter*). The following principles (where no statutory provisions exist, as developed by German courts) apply where a contract is entered into which is governed by a law different from German law (here the laws of England):

(i) Where the Company is represented by its statutory representatives, i.e. the executive board (*Vorstand*) of an AG or the managing directors (*Geschäftsführer*) of a GmbH, the question whether the statutory representatives are capable of validly representing the Company is a matter of the law governing the legal establishment and existence of a company (*Gesellschaftsstatut*) rather than of contract law. [16] Under German conflict of law rules generally the governing law has to be determined with regard to the effective place of administration of a company (*Sitztheorie*).[17]

(ii) Where a power of attorney is granted by contractual arrangement, different rules apply. Pursuant to Article 8 EGBGB, a choice of law by the grantor prior to the use of the power of attorney will be recognised, provided that the attorney and the third party are aware of such choice of law. The same applies to a choice of law by the grantor, the attorney and the third party, which may be

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[16] BGH NJW 1992, 618; Regional Court *(Landgericht*, "**LG**") Karlsruhe RIW 2002, 153; *Kegel/Schurig*, IPR, 9th ed. (2004), p. 620; *Schotten/Schmellenkamp*, Das Internationale Privatrecht in der notariellen Praxis, 2nd ed. (2007), § 5, nos. 91, 102; *Kindler*, in: Münchener Kommentar BGB, 7th ed. (2018), IntGesR, no. 581 *et seq.*

[17] European Court of Justice ("**ECJ**"), judgment of 9 March 1999, case C-217/99, Centros Ltd. ./. Erhvervs-og Selskabsstyrelsen, NJW 1999, 2027; ECJ, judgment of 5 November 2002, case C-208/00, Überseering BV ./. Erhvervs-og Selskabsstyrelsen, NJW 2002, 3614; ECJ, judgment of 30 September 2003, case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam ./. Inspire Art Ltd, NJW 2003, 3331.

made at any time. If no such choice has been made, the following applies:

(A) if the attorney acted in performance of its business activities (e.g. a sales agent), the law of the jurisdiction where the attorney has its ordinary place of residence at the time when the power of attorney is used applies, unless such place was not identifiable for the third party;

(B) if the attorney acted as employee of the grantor of the power of attorney (e.g. where the employees has been granted Prokura), the law of the jurisdiction where the grantor has its ordinary place of residence at the time when the power of attorney is used applies, unless such place was not identifiable for the third party;

(C) if the attorney acted neither in the performance of its business nor as employee of the grantor of the power of attorney), in the case of a power of attorney granted for continued use, the law of the jurisdiction where the power of attorney is ordinarily used applies, unless such place was not identifiable for the third party; and

(D) if none of the scenarios set out above applies, the laws of the jurisdiction where the power of attorney is used in the particular case applies, unless both the attorney and the third party should have know that the power of attorney was intended for use in a particular jurisdiction only, in which case the law of that jurisdiction applies. If the place of use is not identifiable for the third party, the law of that jurisdiction applies where the grantor has its ordinary place of residence at the time when the power of attorney is used.

(iii) The law applicable to the power of attorney is relevant for the existence thereof (in particular if the power of attorney has been

validly granted), its scope, whether self contracting is permissible and its termination.[18]

Foreign conflict of law rules might be inconsistent with the German conflicts of laws approach. Our recommendation on documents to be reviewed does not take foreign conflict of laws rules into account.

3.1.4 *Are there any formalities to be complied with upon entry into of any of the LCH Agreements and, if so, what is the effect of a failure to comply with these*?

There are no regulatory filings which need to be made by a Relevant Clearing Member upon the entry into of the Clearing Membership Agreement.[19]

To the extent German conflict of law provisions refer to English law, only applicable requirements under English law would need to be complied with as under German law there are no further filings, notifications or recordings or other formalities required in order for the Relevant Clearing Member to validly create a first priority perfected security interest under the Deed of Charge. Please see, however, paragraph 3.2.2 as to the effectiveness of the Deed of Charge in the context of Insolvency Proceedings below.

3.1.5 *Would the courts of the Relevant Jurisdiction uphold the contractual choice of law and jurisdiction set out in Regulation 51*?

(a) Choice of law

In court proceedings taken in Germany for the enforcement of the obligations of an obligor under any Opinion Document, the choice of English law under Regulation 51(a) of the General Regulations would be recognised, subject in each case to the provisions of Rome I and, where it concerns non-contractual obligations arising out of such Opinion Document, subject in each case to the provisions of the Regulation (EC) No 864/2007 of the European Parliament and of the

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[18] *Thorn,* in: Palandt, BGB, 77th ed. (2018), Article 8 EGBGB no. 6.

[19] Section 24b KWG provides for an obligation of an Institution to notify BaFin and Bundesbank of its intention to operate a System. Implementing Article 10 para 1 sub-para 4 SFD, section 24b KWG provides that each Institution participating in a System is obliged to inform anyone with a legitimate interest of the Systems in which it participates and to provide information about the main rules governing the functioning of those Systems.

Council of 11 July 2007 on the law applicable to non-contractual obligations ("**Rome II**").[20]

Where property rights (*dingliche Rechte*) are created in respect of contractual claims, a choice of law can be validly made in accordance with Article 14 Rome I. Mandatory provisions of the German Introductory Act to the Civil Code (*Einführungsgesetz zum Bürgerlichen Gesetzbuch*, "**EGBGB**") apply in respect of the conflict of property laws in respect of the creation of rights over moveables (*bewegliche Sachen*). Whether an object (*Gegenstand*) is a moveable has, under German conflict of laws provisions, to be determined in accordance with the law of the jurisdiction in which such object is located (*lex rei sitae*).

(b) Choice of jurisdiction

Pursuant to Regulation 51(c) of the General Regulations, LCH and every Relevant Clearing Member irrevocably agrees for the benefit of LCH that the courts of England shall have exclusive jurisdiction to hear and determine any claim or matter arising from or in relation to any Contract or in relation to the General Regulations which does not fall to be referred to arbitration under Regulation 51(b) of the General Regulations, save that the submission to the exclusive jurisdiction of the English courts shall not limit the right of LCH to take proceedings in any other court of competent jurisdiction.

In general, and subject to Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and enforcement of judgments in civil and commercial matters (recast) ("**Brussels I Regulation (Recast)**")[21] the submission to the jurisdiction of the courts in England contained in Regulation 51(c) of the General Regulations would be recognised by the German courts.

However, the choice of jurisdiction contained in Regulation 51(c) of the General Regulations will not be recognised by German courts to the

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[20] OJ No L 199 of 31 July 2007, p. 40.

[21] OJ No L 351 of 20 December 2012, p. 1.

extent a dispute is effectively referred to arbitration under Regulation 51(b) of the General Regulations if such Regulation prevails.

In addition, the choice of jurisdiction contained in Regulation 51(c) of the General Regulations qualifies as a unilateral jurisdiction clause (*einseitig begünstigende Gerichtsstandsklausel*) as only the Relevant Clearing Member but not LCH irrevocably submits to the exclusive jurisdiction of the courts of England. There have been conflicting decisions of courts in other European Union jurisdictions as to whether jurisdiction clauses, similar in nature to the jurisdiction clause in Regulation 51(e) of the General Regulations, complied with the requirements of Article 23 of the Brussels I Regulation (Council Regulation (EC) No 44/2001) (now Article 25 of the Brussels I Regulation (Recast)) and, as a result, whether such clauses were effective to confer jurisdiction on the court identified in the clause. These decisions are not binding on the courts of other European Union jurisdictions. However, while we consider that currently the German courts would not on their own hold such clauses to be ineffective, the matter might be referred to the European Court of Justice ("**ECJ**") either by a court in another European Union jurisdiction or indeed by a German court. It is possible that the ECJ (whose decisions are binding on all courts within the European Union, including the German courts), would reach the conclusion that such clases were ineffective. If so, the Opinion Documents may be ineffective to confer jurisdiction on the courts specified therin, in which case the jurisdiction of the German and other courts would be determined by reference to the general law applicable in those courts, in the case of Germany, the ZPO.

(c) Recognition of arbitration agreement

The arbitration agreement contained in Regulation 51(b) of the General Regulations – which refers to Regulation 33 of the General Regulations – would be recognised by the German courts,. Accordingly, a civil law action before a German court would be considered inadmissible due to the arbitration agreement and subject to the preconditions of sections 1025 *et seq.* ZPO having been met. In line with those provisions, it is permissible to arrange for arbitration in a contract which is signed by the parties (or concluded in letters, telefax copies, telegrams, or other forms of transmitting messages exchanged by the parties that ensure proof of the agreement) by referring in this contract to another (unsigned)

document like the Rulebook that contains an arbitration clause if the reference is made such that this arbitration clause is incorporated into the contract. We do not opine on whether or not the Contracts contain effective references to the Rulebook.

It is not entirely clear whether the arbitration agreement contained in the Rulebook applies to the Clearing Membership Agreement. It is unclear if "Contract" in the meaning of Regulation 51(b) of the General Regulations includes the basic contract "Clearing Membership Agreement" or only the contracts entered into on the basis of the Rulebook. German courts generally demand that there must be a clear and non-ambigous choice for arbitration. In the absence of such choice, an arbitration agreement would not be recognized by a German court. Since the Clearing Membership Agreement contains a special choice of jurisdiction (see section 13.1) and since the Clearing Membersahip Agreement does not refer to arbitration as a method for dispute settlement a German court would most likely find that section 13.1 of the Clearing Membership Agreement prevails over the general rules under Regulation 51 of the General Regulations.

3.1.6 *Will the courts uphold the judgement of the English courts or an English arbitration award?*

(a) English court judgements

An English court judgement would be recognised by a German court in accordance with the Brussels I Regulation (Recast).

(b) English arbitral award

An English arbitral award would be recognised by a German court in accordance with sections 1060 and 1061 ZPO. Recognition and enforcement of the award may be refused in Germany, if any grounds for refusal of recognition and enforcement under the United Nations

Convention on Recognition and Enforcement of Foreign Arbitral Awards[22] apply.

An order for the enforcement of an English arbitral award on a civil matter will be issued by a German court provided that the requirements for recognition are met and provided further that the party interested in the enforcement has filed for enforcement of the arbitral award with the competent court in Germany in compliance with applicable legal requirements for such filings, including but not limited to, the submission of the relevant documentation.

3.1.7 *Are there any "public policy" considerations that the courts may take into account in determining matters related to choice of law and/or the enforcement of foreign judgements*?

Yes, "public policy" considerations are taken into account by German courts in determining matters related to choice of law and/or the enforcement of foreign judgements. For details see paragraph 4.1 below.

3.2 Insolvency, Security, Set-off and Netting

3.2.1 *Please opine on insolvency proceedings and pre-insolvency reorganisation, restructuring and/or resolution measures under the laws of Germany. Would any of these not be covered by those events entitling LCH to liquidate, transfer or otherwise deal with Contracts as provided for in Rule 3 of the Default Rules? Are any other events or procedures not envisaged in Rule 3 of the Default Rules relevant*?

Under paragraph 3.2.1(a) to, and including, 3.2.1(d) we provide an overview of mandatory insolvency, regulatory, reorganisation, recovery and resolution and related proceedings under German law and in each case their international scope of application. Our specific answers are given in paragraph 3.2.1(h).

(a) Insolvency Proceedings under German law

The only bankruptcy, composition, rehabilitation or other insolvency or reorganisation procedures to which a Relevant Clearing Member could

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[22] Germany adhered to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1 June 1958 on 30 June 1961 (BGBl. II 1961, p. 122).

be subject under the laws of this jurisdiction, and which are relevant for the purposes of this opinion, are the procedures laid down in the German Insolvency Code (*Insolvenzordnung*, "**InsO**"). The main insolvency procedures (*Hauptinsolvenzverfahren*) under the InsO are referred to as "**Insolvency Proceedings**".[23] A Party who is subject to Insolvency Proceedings is called an "**Insolvent Party**" and its counterparty is called the "**Solvent Party**". When using the term Insolvency Proceedings we do not refer to opening proceedings (*Eröffnungsverfahren*), in particular not to any provisional insolvency measures (*vorläufige Maßnahmen*) taken under sections 21 *et seq.* InsO ("**Provisional Insolvency Measures**") (in respect of which see paragraph 3.2.1(c)).

Generally, Insolvency Proceedings may be opened by the competent insolvency court (*Insolvenzgericht*) upon the filing of an application by the debtor itself or any creditor provided such creditor has a legal interest in the opening of Insolvency Proceedings and substantiates (*glaubhaft machen*) a reason for the opening of Insolvency Proceedings (sections 13 para 1 and 14 para 1 InsO) and provided further a reason for the opening of Insolvency Proceedings is existing. The InsO enumerates the following reasons for the opening of Insolvency Proceedings:

(i) Illiquidity (*Zahlungsunfähigkeit*) is defined as the debtor's inability to settle its payment obligations when due (section 17 para 1 InsO). This is generally indicated if the debtor has ceased to make payments (*Zahlungseinstellung*) (section 17 para 2 sentence 2 InsO). Illiquidity does not exist if there is only a temporary delay in payments (*Zahlungsstockung*), which according to the BGH, means the debtor's inability to

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[23] As a matter of principle, the InsO does not provide for group insolvency proceedings, i.e. each insolvent party being part of a group of companies would be subject to separate proceedings which may be spread throughout Germany (depending, as a general rule, on the relevant registered seat of the debtor) and involve different Insolvency Administrators. On 13 April 2017, the German Parliament (*Bundestag*) has adopted a law to facilitate the management of group insolvencies (*Gesetz zur Erleichterung der Bewältigung von Konzerninsolvenzen*, BGBl. 2017 I, p. 866 *et seqq.*) which will enter into force on 21 April 2018. The law introduces changes to the Insolvency Code which, inter alia, allow an insolvent debtor being part of a group of companies in Germany to request the court to declare itself competent in respect of any subsequent proceedings of any member of the group in Germany. In the absence of any conflicts of interest, it may be possible for the same Insolvency Administrator to be appointed for all group companies. In addition, the new law provides for rules governing the cooperation between insolvency courts and Insolvency Administrators.

make payments does not last for more than three weeks and then the debtor's gap in liquidity will be closed by expected payments, newly provided financing by other parties or the proceeds from the liquidation of assets.[24]

(ii) Impending illiquidity (*drohende Zahlungsunfähigkeit*) means that the debtor will not be able to fulfil existing payment obligations when they become due (section 18 para 1 InsO). Since the assessment whether there is an impending illiquidity is based on a prognosis, the insolvency court may require the debtor to submit a liquidity plan (*Liquiditätsplan*). An application to open Insolvency Proceedings on the basis of an impending illiquidity may only be filed by the debtor itself.

(iii) Over-indebtedness (*Überschuldung*) exists if the debtor's assets no longer cover its liabilities unless the existence of the debtor as a going concern is more likely (*überwiegend wahrscheinlich*) under the given circumstances (section 19 para 2 InsO). Over-indebtedness only applies to legal entities (*juristische Personen*) or partnerships that do not have a natural person as personally liable partner (section 19 paras 1 and 3 InsO). Over-indebtedness is determined on the basis of an insolvency balance sheet test. Claims for the repayment of shareholder loans or equivalent claims are not considered as liabilities in this context, if the shareholder has subordinated its claim (section 19 para 2 sentence 2 InsO).

(iv) Illiquidity and over-indebtedness are mandatory insolvency filing reasons. The management of the debtor is obliged to file for insolvency without undue delay (*ohne schuldhaftes Zögern*) and within a maximum period of 21 days if illiquidity or over-indebtedness exists (section 15a InsO). If the management fails to file for insolvency within that deadline, it risks personal civil and criminal liability.

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[24] BGH NZI 2005, 547. The BGH further held that, as a rule, a debtor is not illiquid if the debtor is able to fulfil its payment obligations when due, except for a marginal amount of up to 10% of the whole sum. The 10% threshold is, however, not a fixed limit which would automatically allow the conclusion that a debtor is illiquid if it is exceeded or that it is not illiquid where the threshold is not reached.

With respect to Credit Institutions and Financial Services Institutions (Credit Institutions and Financial Services Institutions collectively, "**Institutions**") only the BaFin may file an application for the opening of Insolvency Proceedings (section 46b para 1 sentence 4 KWG). In respect of Institutions, BaFin may file an application for the opening of Insolvency Proceedings by reason of impending illiquidity only upon the Institution's approval (section 46b para 1 sentence 5 KWG). Where a legal requirement to file for the insolvency exists, Institutions need only to notify BaFin (section 46b para 1 sentence 2 KWG).

For purposes hereof, the opening of Insolvency Proceedings refers to the time of the issue of an opening order (*Eröffnungsbeschluss*) for the opening of main insolvency proceedings (*Hauptverfahren*) by the competent insolvency court.

In the opening order the insolvency court appoints an insolvency administrator (*Insolvenzverwalter*, "**Insolvency Administrator**"). Upon the opening of Insolvency Proceedings the insolvent Relevant Clearing Member's right to manage and transfer assets belonging to the insolvency estate is vested in the Insolvency Administrator (section 80 InsO). Any dispositions of the insolvent Relevant Clearing Member over its property made after the opening of Insolvency Proceedings are void unless the relevant insolvency court otherwise orders (section 81 para 1 InsO).[25] If a creditor of the insolvent debtor obtained a security in respect of assets that form part of the insolvent debtor's assets by means of enforcement measures (*Zwangsvollstreckungsmaßnahmen*) up to one month prior to the opening of Insolvency Proceedings or after the opening of Insolvency Proceedings, such security is void (section 88 InsO). Pursuant to section 91 para 1 InsO, after the opening of Insolvency Proceedings rights in objects forming part of the insolvency estate cannot be acquired with legal effect even if such acquisition of rights is not based on the Insolvent Party's transfer or effected by way of execution.

Where an insolvency court has, upon application of the insolvent Relevant Clearing Member, ordered the management of the insolvent Relevant Clearing Member to continue its activities in accordance with

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[25] Please refer to paragraph 3.2.1(e) with respect to exemptions for "Financial Collateral" (as defined herein).

section 270 InsO (*Eigenverwaltung*, "**Self Administration Proceedings**"), numerous rights of the Insolvency Administrator are exercised by the creditors' trustee (*Sachwalter*) (including any challenge in insolvency rights under sections 129 *et seq.* InsO as referred to in paragraph 3.2.4(a) below, see section 280 InsO). The insolvent Relevant Clearing Member may also exercise certain rights itself but in consultation with the creditors' trustee (including the Selection Right as defined in paragraph 3.2.3(c) below, see section 279 InsO). Self Administration Proceedings are not limited to a certain type of insolvent parties and are therefore generally available in respect of Institutions. An insolvency court may order Self Administration Proceedings when it releases an order for the opening of Insolvency Proceedings provided the insolvent Relevant Clearing Member has applied for Self Administration Proceedings and provided further there are no circumstances which would give rise to the assumption that Self Administration Proceedings would be detrimental to the insolvent Relevant Clearing Member's creditors (section 270 para 2 InsO).

Legal entities which are established under public law and subject to the supervision of a German Federal State (*Bundesland*) may be exempt from Insolvency Proceedings in Germany under the law of such Federal State (section 12 para 1 no 2 InsO). Instead, special rules may apply or be enacted under public law to the winding-up of such entities and such special rules may have an impact on the enforceability of the Opinion Documents and the enforcement of any security interest or title transfer arrangements. Where a legal entity established under public law is not exempt from Insolvency Proceedings, it will generally be treated similar to entities established under private law. Legal entities incorporated under private law which are publicly owned are not exempt from Insolvency Proceedings.[26]

(b) Territorial scope of application of Insolvency Proceedings

Insolvency Proceedings under German law apply universally to all assets of the insolvent Relevant Clearing Member, irrespective of the location of such assets (*Universalitätsprinzip*), subject to recognition

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[26] *Sternal*, in: Heidelberger Kommentar InsO, 8th ed. (2018), § 12 InsO no. 7; *Gundlach/Frenzel/Schmidt*, NZI 2000, 561, 565.

under applicable foreign laws where such assets are from a German law perspective deemed to be located outside Germany.

Whether or not German insolvency courts have jurisdiction for opening Insolvency Proceedings over the assets of a Relevant Clearing Member depends on the rules governing the relevant proceedings. The international scope of application of Insolvency Proceedings and any Provisional Insolvency Proceedings and Regulatory Proceedings is governed by Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast) ("**Recast EUIR**"),[27] Article 102 of the German Introductory Act to the InsO (*Einführungsgesetz zur Insolvenzordnung*, "**EGInsO**"), sections 3, 335 *et seq.* InsO and sections 46d to 46f KWG.

(i) Jurisdiction of German insolvency courts within the scope of application of the Recast EUIR

The Recast EUIR applies to insolvency proceedings as specified in Article 1 para 1, Annex A Recast EUIR. The Recast EUIR is not applicable, *inter alia*, to insolvency proceedings concerning insurance companies, credit institutions,[28] investment firms (*Wertpapierfirmen*)[29] and other firms, institutions and undertakings to the extent that they are covered by the Directive 2001/24/EC of 4 April 2001 on the Reorganisation and Winding-

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27 OJ No L 141 of 5 June 2015, p. 19. The Recast EUIR entered into force on 26 June 2015 and amends and replaces the Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings ("**EUIR**") (OJ No L 160 of 30 June 2000, p. 1). The Recast EUIR applies to Insolvency Proceedings opened after 26 June 2017 while the EUIR continues to apply to relevant Insolvency Proceedings opened before that date.

28 In our view Article 1 para 2 Recast EUIR refers to CRR Credit Institutions; see also *Kindler*, in: Münchener Kommentar BGB, 7th ed. (2018), Article 1 EuInsVO no. 15 and, with respect to the EUIR, *Nerlich/Hübler*, in: Nerlich/Römermann, InsO, 35th update (as of April 2018), Article 1 EuInsVO 2000 no. 10 *et seqq.*

29 Pursuant to Article 1 para 2 lit (c) Recast EUIR, investment firms as defined in Article 4 para 1 no. 2 CRR and other firms, institutions and undertakings are outside the scope of application of the Recast EUIR insofar as they fall within the scope of the WUD (as amended). Article 4 para 1 no. 1 Directive 2014/65/EU of the European Parliament and the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) ("**MiFID II**") (OJ No L 173 of 12 June 2014, p. 349) defines the term "investment firm" to include any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis.

Up of Credit Institutions ("**WUD**")[30] and collective investment undertakings[31] (Article 1 para 2 Recast EUIR).[32]

The ECJ takes the view that the application of provisions of the EUIR and (consequently the Recast EUIR) does not generally depend on the existence of a cross-border link (*grenzüberschreitender Bezug*) to another EU member state (other than Denmark) unless a relevant provision of the EUIR and the Recast EUIR expressly requires such link. A cross-border link to a non-EU member state is sufficient.[33]

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30 OJ No L 125 of 5 May 2001, p. 15. The WUD has been amended by Article 117 of Directive of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ No L 173 of 12 June 2014, p. 190) ("**BRRD**").

31 In our view, for purposes of the Recast EUIR the term "collective investment undertaking" means undertakings for collective investment in transferable securities ("**UCITS**") as defined in the Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (recast) ("**UCITS Directive**") and alternative investment funds ("**AIFs**") as defined in Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 ("**AIFM Directive**") (see also Article 2 no 2 Recast EUIR).

32 The WUD is applicable to CRR Credit Institutions and their branches as defined under Article 4 para 1 no. 17 CRR set up in Member States other than those in which they have their head offices ("**EU Branches**"), subject to the conditions and exemptions laid down in Article 2 para 5 of the Directive 2013/36/EU of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ No L 176 of 26 June 2013, p. 338, "**CRD IV**"). It also applies to the financial institutions, firms and parent undertakings falling within the scope of the BRRD. If a CRR Credit Institution has its head office outside the EU, the WUD only applies if such CRR Credit Institution has at least two EU Branches.

33 Judgment of 16 January 2014, Case C-328/12, *Ralph Schmid v Lilly Hertel*, NJW 2014, 610, 611 *et seq.* See *Kindler*, in: Münchener Kommentar BGB, 7th ed. (2018), Article 1 EuInsVO no. 23; *Virgos/Schmit*, Report on the Convention on Insolvency Proceedings, no. 11. See also the overview given by *Reinhart*, in: Münchener Kommentar InsO, 3rd ed. (2016), Article 1 EuInsVO 2000 no. 15 *et seq.*

Within this scope of application, Article 3 para 1 Recast EUIR gives the courts of the EU member states (other than Denmark[34]) where the "centre of main interests" of a debtor is situated the ability to open main insolvency proceedings (as specified in Annex A of the Recast EUIR). In case of a legal entity, the place of the registered office is presumed to be the centre of its main interests in the absence of proof to the contrary (Article 3 para 1 Recast EUIR). These proceedings are generally governed by the law of the EU member state where such proceedings are opened. They are, with regard to other EU member states, international in scope being effective in all EU member states unless secondary proceedings are opened in another EU member state. The only main insolvency proceedings permitted under Annex A of the Recast EUIR under the laws of Germany would be Insolvency Proceedings.

If the "centre of main interests" of a debtor is in an EU member state (other than Denmark), under Article 3 para 2 Recast EUIR, the courts of another EU member state (other than Denmark) may open "territorial proceedings" or, after the opening of main proceedings, "secondary proceedings" in the event that such debtor possesses an "establishment" within the territory of such other EU member state. The applicable law of such territorial or secondary insolvency proceedings is the law of that other EU member state. However, territorial or secondary insolvency proceedings are limited in scope to the debtor's assets in that EU member state and will, thus, not extend beyond the EU member state where they are opened. Furthermore, under Article 3 para 3 Recast EUIR, secondary proceedings are limited to winding-up proceedings.

As a result of the implementation of the WUD, the opening of secondary or territorial insolvency proceedings is excluded in

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[34] See *Tashiro,* in: Braun, InsO, 7th ed. (2017), before §§ 335-358 no. 13; *Kindler,* in: Münchener Kommentar BGB, 7th ed. (2018), Article 1 EuInsVO no. 22; *Virgos/Schmit*, Report on the Convention on Insolvency Proceedings, no. 11.

respect of CRR Institutions (section 46e KWG).[35] Insolvency Proceedings may only be opened by the competent authorities of the home state (*Herkunftsmitgliedsstaat*) of such CRR Institution.

(ii) Jurisdiction of German insolvency courts outside the scope of application of the Recast EUIR

Outside the scope of application of the Recast EUIR if an insolvent Relevant Clearing Member has its place of general jurisdiction in Germany, Insolvency Proceedings are opened in Germany with respect to the insolvent Relevant Clearing Member irrespective of whether or not the relevant authorities in any other jurisdiction have initiated proceedings in respect of a branch of the insolvent Relevant Clearing Member in such jurisdiction. In case of a legal entity, the place of general jurisdiction is the registered seat. If the centre of that legal entity's independent business activity is located elsewhere (e.g. if the management is located at a place other than the registered seat) such place determines the competent insolvency court (section 3 para 1 sentence 2 InsO). If the centre of an independent business activity of the insolvent Relevant Clearing Member is located outside Germany, German insolvency courts have no jurisdiction except for the opening of (separate) territorial or secondary Insolvency Proceedings (which are limited in their scope to the assets of the insolvent Relevant Clearing Member located in Germany).

Territorial Insolvency Proceedings can be commenced in Germany under section 354 para 1 InsO if the debtor has an establishment [36] in Germany. Where an insolvent Clearing

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[35] Section 46e KWG also applies to Resolution Orders (as defined below) and to any other resolution actions under sections 78 to 87 SAG (section 46e para 6 KWG).

[36] There is no definition of the term "establishment" (*Niederlassung*) in the InsO. Some legal authors (*Kindler*, in: Münchener Kommentar BGB, 7th ed. (2018), § 354 InsO no. 3; *Lüer*, in: Uhlenbruck, InsO, 14th ed. (2015), § 354 InsO no. 9) suggest to refer to the definition given in Article 2 lit (h) EUIR while the Regional Court (*Landgericht*, "**LG**") Frankfurt am Main in its decision of 30 October 2012 (2-9 T 418/12) and others (*Reinhart*, in: Münchener Kommentar InsO, 3rd ed. (2014), § 354 InsO no. 7) apply the definition which has been developed for purposes of section 21 ZPO), i.e. any branch office which is separate from the owner's seat and acts for a certain time in the owner's name and for its account independently, i.e. the branch office

Member has no establishment in Germany, a sufficient basis for separate proceedings in Germany under the InsO is also provided in respect of assets located or deemed to be located in Germany upon request of a creditor, if such creditor provides evidence for its "special interest" in the opening of German territorial proceedings due to the fact that it would have worse prospects (*erheblich schlechter stehen*) for the settlement of its debt in the non-German proceedings (section 354 para 2 InsO).[37] The recognition of foreign main insolvency proceedings under section 343 InsO does not exclude secondary proceedings. If territorial or secondary insolvency proceedings are opened in Germany, they take precedence over the non-German insolvency proceedings in relation to those assets of the insolvent Relevant Clearing Member which are situated in Germany. Such territorial or secondary insolvency proceedings and, thus, the applicability of German insolvency law are, however, limited in scope to the debtor's assets in Germany.

If the Relevant Clearing Member is not a CRR Institution, Insolvency Proceedings may be opened in Germany with respect to the Insolvent Party irrespective of whether or not the relevant authorities in any other jurisdiction have initiated proceedings in respect of a branch of the Insolvent Party in such jurisdiction. If a Relevant Clearing Member qualifies as a CRR Institution, Insolvency Proceedings may be opened in Germany only if Germany is considered to be the home member state (section 46e para 1 KWG), which is the case if the main office (*Hauptniederlassung*) is located in Germany (section 1 para 4 KWG (which implements Article 2 WUD in connection with Article 4 para 1 no 17 CRR)); the opening of secondary or territorial proceedings in other EU member states is excluded (section 46e para 2 KWG).

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acts and enters into agreements upon its own decision (*Heinrich*, in: Musielak/Voit, ZPO, 15th ed. (2018), § 21 ZPO no. 2).

[37] Legal commentators suggest that this provision should be construed narrowly (see *Wenner*, in: Mohrbutter/Ringstmeier, Handbuch der Insolvenzverwaltung, 9th ed. (2015), Chapter 20 no. 129).

(iii) Location of payment claims

Under the Recast EUIR, payment claims are deemed to be located in the country in which the debtor of such claim has the centre of its main interests (Article 2 no 9 viii) Recast EUIR). Therefore, if the centre of main interests of the Solvent Party is in another EU member state (other than Denmark), and there are secondary proceedings under the Recast EUIR in respect of the Insolvent Party in that EU member state, then under the Recast EUIR the claims of such Insolvent Party against the Solvent Party would be deemed to be situated outside of Germany. The Insolvency Administrator would be required to defer to the jurisdiction of the insolvency administrator appointed in such other EU member state in relation to such claims (to the extent they have not been extinguished at the time of opening of Insolvency Proceedings).

Under the InsO, payment obligations are assets deemed to be located in Germany if they are payable by the debtor out of Germany to the Insolvent Party. Therefore, only such payment obligations are assets deemed to be located in Germany which are payable by the Solvent Party out of Germany and could provide a sufficient basis for separate Insolvency Proceedings in relation to such Insolvent Party.

(c) Provisional Insolvency Measures

Upon an application for the opening of Insolvency Proceedings but before the opening of Insolvency Proceedings a German insolvency court may appoint a provisional insolvency administrator (*vorläufiger Insolvenzverwalter*) and to release orders to protect the Insolvent Party's assets.

Provisional Insolvency Measures are limited to attachments (freezing injunctions) that prevent the Insolvent Party from disposing of its assets and thus jeopardising the purpose of Insolvency Proceedings. Such a freezing injunction may cover all the assets of the Insolvent Party or parts thereof. The insolvency court may impose a general prohibition of dispositions on the Insolvent Party (section 21 para 2 sentence 1 no. 2 InsO), order that the Insolvent Party's transfers of property require the consent of the provisional insolvency administrator (section 21 para 2

sentence 1 no. 2 InsO) or order a restriction (or temporary restriction) in certain measures of enforcement (*Zwangsvollstreckungsmaßnahmen*) against the Insolvent Party (section 21 para 2 sentence 1 no. 3 InsO). According to the BGH, Provisional Insolvency Measures pursuant to section 21 para 2 sentence 1 nos. 2 and 3 InsO do not exclude the permissibility of set-off since the provisions concerning insolvency set-off pursuant to sections 94 through 96 InsO (see paragraph 3.2.3(i) below) are deemed as both comprehensive and exclusive.[38]

A provisional insolvency administrator does not have any powers which would entail a Selection Right, i.e. to choose whether or not to perform certain contracts in accordance with section 103 InsO (see paragraph 3.2.3(c)(i) below). As a Provisional Insolvency Measure, an insolvency court may particularly order that assets of an Insolvent Party which are subject to a security interest that entitles a creditor to separate satisfaction in accordance with section 166 InsO or entitles the creditor to a right for segregation must not be enforced nor must the creditor appropriate such assets (section 21 para 2 sentence 1 no. 5 InsO). However, pursuant to section 21 para 2 sentence 2 InsO, these restrictions do not apply to Financial Collateral.

(d) Regulatory Proceedings

LCH's rights under Rule 3 of the Default Rules may be affected by restructuring measures under the German Bank Reorganisation Act (*Kreditinstitute-Reorganisationsgesetz*, "**KredReorgG**"), the KWG, the German Recovery and Resolution Act (*Sanierungs- und Abwicklungsgesetz*, "**SAG**") and Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 ("**SRMR**").[39]

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[38] BGH NJW 2004, 3118, 3119; BGH ZIP 2005, 181.

[39] OJ EU No L 225 of 30 July 2014, p. 1.

Regulatory proceedings may be instituted and measures may be taken by BaFin or any other relevant competent authority, including the European Central Bank ("**ECB**") when acting in its capacity as supervisory authority for CRR Credit Institutions[40], with respect to Credit Institutions or Financial Services Institutions licensed under the KWG (sections 45 to 46g KWG), with respect to Credit Institutions under the KredReorgG or by the competent resolution authority ("**Resolution Authority**") with respect to CRR Credit Institutions, directly supervised by the ECB under the SRMR[41] and with respect to other CRR Credit Institutions, Resolution Investment Firms[42] and group companies [43] (CRR Credit Institutions and Resolution Investment Firms which may be subject to resolution collectively, "**Resolution Firms**") under the SAG, in order to avoid the insolvency of any such institution or company.[44]

For purposes hereof, the procedures described in this paragraph 2.3.2 are collectively referred to as "**Regulatory Proceedings**". If the Resolution

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40 "**CRR Credit Institution**" means a credit institution as defined in Article 4 para 1 no. 1 of Regulation 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation 648/2012 (OJ No L 321 of 30 November 2013, p. 6, "**CRR**") as an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account (*CRR-Kreditinstitut*).

41 The single resolution board ("**SRB**") acting within a single resolution mechanism ("**SRM**") exercises resolution powers in respect of certain institutions and companies which are currently subject to the resolution powers of the Resolution Authority if they are subject to direct prudential supervision by the ECB. The SRB and the SRM are established under the SRMR which has direct effect in Germany and supersedes the SAG where the SRMR and the SAG govern the same scenario.

42 "**Resolution Investment Firms**" are CRR Investment Firms which need to have a minimum initial capital of EUR 730,000 as provided in section 33 para 1 sentence 1 no. 1 KWG. "**CRR Investment Firms**" are investment firms within the meaning of Article 4 para 1 no. 2 CRR and "**CRR Institutions**" are CRR Investment Firms and CRR Credit Institutions.

43 "**Group company**" means a parent undertaking or a subsidiary of a group (of companies), section 2 para 3 no. 30 SAG. In our view it is not entirely clear which affiliates of CRR Credit Institutions and Resolution Investment Firms can become subject to resolution action. The powers of the Resolution Authority generally relate to CRR Credit Institutions and Resolution Investment Firms as well as their group companies. However, section 64 SAG specifies the conditions for resolution only for certain subsidiaries (other than CRR Credit Institutions and Resolution Investment Firms), but does not refer to all group companies (see footnote 59 below).

44 We do not opine on any proceedings etc. applicable on the basis of a consolidated supervision or as a consequences of supervision as financial conglomerate or similar provisions.

Authority has already instituted a resolution order (*Abwicklungsanordnung*) under sections 136, 77 SAG ("**Resolution Order**"), then measures under section 46 and section 46g KWG may only be instituted upon approval by the Resolution Authority (section 82 para 5 SAG).

(i) Federal Moratorium

In respect of Credit Institutions, if the German Federal Government (*Bundesregierung*) determines that a Relevant Clearing Member that is a Credit Institution is in economic difficulties which give rise to the assumption that the national economy, in particular payment transactions in general, are severely jeopardised, it may under section 46g KWG, among others, grant such Relevant Clearing Member a payment moratorium by the legal instrument of a regulation (*Rechtsverordnung*) and order that enforcement proceedings or Provisional Insolvency Measures against such Relevant Clearing Member or Insolvency Proceedings over its assets may not be opened for as long as the moratorium continues. It may also order that Credit Institutions must be closed for business with customers and may neither make nor accept payments or remittances with customers; such order may be restricted to a limited number of Credit Institutions or types of banking activities.

(ii) Regulatory measures by BaFin

The relevant competent authority may take various regulatory measures in respect of a Relevant Clearing Member. Under section 45 KWG, BaFin may take measures for the reinforcement of such a Relevant Clearing Member's own funds and liquidity. In particular, BaFin can prohibit withdrawals by shareholders and the distribution of dividends, restrict or prohibit the granting of loans, order the Institution to take measures to reduce risks to the extent these risks result from certain types of transactions or products or the use of certain systems or order that the Relevant Clearing Member implements measures laid down in its recovery plan (*Sanierungsplan*).

Under section 45c KWG, BaFin may appoint a special representative (*Sonderbeauftragter*), to assume certain functions

within an Institution (including management functions) and would confer the requisite powers on it.

Where the fulfilment of an Institution's obligations towards its creditors and, in particular, the security of the assets entrusted to it are jeopardised or if effective supervision is no longer possible, BaFin may take temporary measures under section 46 para 1 KWG, in particular:

(A) issue instructions for the management of the Institution's business;

(B) prohibit the acceptance of deposits or funds or securities from customers and the granting of loans;

(C) prohibit owners and managers from carrying out their activities or limit such activities;

(D) temporarily prohibit the disposition of assets or the making of any payments by such Institution (such prohibitions to dispose assets and to make payments, which are different from those under a Federal Moratorium referred to in paragraph 3.2.1(d)(i) above, collectively "**Moratorium**");

(E) close the Relevant Clearing Member for ordinary business with customers; and

(F) unless an applicable deposit or customer protection scheme ensures full satisfaction of the customers, prohibit the Relevant Clearing Member from accepting payments except those made in respect of obligations owed to a Relevant Clearing Member.

It has been suggested in a court decision that the imposition of a Moratorium has the effect of a deferral (*Stundung*), i.e. extension of the due date.[45] Accordingly, set-off of obligations would not

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[45] See OLG Frankfurt ZinsO 2013, 388 *et seq*. The judgment has been given in respect of the former section 46a para 1 sentence 1 no. 1 KWG but the wording of section 46 para 1 sentence 2 no. 4 of the revised KWG is

be permissible in circumstances where a Moratorium is imposed in respect of assets of and payments by a Relevant Clearing Member (as set-off may not be effected where the claim against which it is to be effected is not due).[46]

The BGH, however, has repealed the above-mentioned decision and confirmed that a Moratorium against an Institution such as a Relevant Clearing Member under section 46 para 1 sentence 2 no 4 KWG would not result in a deferral.[47] Rather, the Moratorium creates a temporary obstacle to specific performance and, if imposed on such Relevant Clearing Member, would entitle such Relevant Clearing Member to refuse specific performance *vis-à-vis* its counterparty for as long as the Moratorium continues to exist (based on an analogous application of section 275 para 1 BGB).[48]

While the BGH has left this question open, it has made *obiter* remarks indicating that a Moratorium does not prevent set-off. The BGH points out that the purpose of section 46 para 1 sentence 2 no 4 KWG to secure the assets of the Institution concerned (e.g. the Relevant Clearing Member) and prevent its insolvency would not prevent set-off. Even Provisional Insolvency Measures by an insolvency court and the opening of Insolvency Proceedings would generally not prevent set-off (see

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identical. This view has also been shared by the German legislator (BT-Drucksache 7/4631, p. 8 and BT-Drucksache 14/8017, p. 141).

46 We do not believe that the acceleration of any obligations resulting from the operation of the Netting Provisions (as defined below) would be prohibited by a Moratorium but we are not aware of any court decisions dealing with this point.

47 BGH WM 2013, 742, 748.

48 In dismissing that a Moratorium results in a deferral, the BGH argues that, as an administrative act (*Verwaltungsakt*) directed against the relevant Institution, the Moratorium would have to be made known to the Institution to become effective against it (section 43 para 1 sentence 1 of the German Act on Administrative Proceedings (*Verwaltungsverfahrensgesetz*), but would not become effective vis-à-vis its creditors as a notification (*Bekanntgabe*) vis-à-vis the creditors is not provided for under applicable laws (BGH WM 2013, 742, 747). Moreover, the counterparty's set-off right which is a protected property right under the German Constitution (*Grundgesetz*) can, according to the BGH, not be restricted without a clearly defined legal basis; see BGH WM 2013, 742, 744

below, paragraph 3.2.3(i)) and section 46 para 1 sentence 2 no 4 KWG is not intended to impose restrictions beyond the restrictions Insolvency Proceedings entail.[49] From a German law perspective these remarks are, in our view, convincing. The BGH did, however, not address the question whether a temporary obstacle for the performance of a claim would still prevent set-off against such claim given that German civil law allows for set-off only, if the claim against which set-off is to be effected can be performed (*Erfüllbarkeit der Hauptforderung*) (section 387 BGB). Whether and under which circumstances set-off in accordance with non-German law against claims of a Relevant Clearing Member which is subject to the Moratorium can be effected is, however, an open question.[50] The protection afforded to Systems and Financial Collateral under the InsO applies *mutatis mutandis* to every Moratorium (section 46 para 2 sentence 7 KWG).

Following the institution of a Resolution Order, measures under sections 46 and 46g KWG may only be instituted upon the approval by the Resolution Authority (section 82 para 5 SAG). The relevant competent authority is also entitled to take crisis prevention measures (*Krisenpräventionsmaßnahmen*) as summarised in section 2 para 3 no. 37 SAG, such as the exercise of powers to direct the removal of deficiencies or impediments for the recoverability (section 16 SAG) or the reduction or the removal of impediments to the resolvability (sections 59, 60 SAG), the application of an early intervention measure under sections 36 to 38 SAG or the exercise of the power to write down or convert capital instruments (sections 89 SAG).

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[49] BGH WM 2013, 742, 747.

[50] Prior to the BGH's decision, some authors argued that a ban of sales and payments would not exclude the possibility of set-off to the extent such possibility of set-off comes into existence upon or prior to the coming into force of the ban on payment and sales (*Binder*, Bankeninsolvenzen im Spannungsfeld zwischen Bankenaufsichts- und Insolvenzrecht (2005), p. 313; *Lindemann*, in: Boos/Fischer/Schulte-Mattler, KWG, 4th ed. (2012), § 46 no. 92).

(iii) Restructuring and Reorganisation Procedures

The KredReorgG contains a further set of regulatory restructuring and reorganisation measures in order to limit systemic risks resulting from financial difficulties of Credit Institutions having their seat in Germany.

The KredReorgG provides for restructuring proceedings (*Sanierungsverfahren*) involving the appointment of a restructuring advisor (*Sanierungsberater*) to implement a restructuring plan. Restructuring proceedings can only be voluntarily initiated by the Credit Institution itself by notifying BaFin and are commenced by a court order of the Higher Regional Court (*Oberlandesgericht*, "**OLG**") Frankfurt upon application by BaFin (section 2 KredReorgG). The Credit Institution must submit a restructuring plan when notifying BaFin. If the application is permissible and not obviously inappropriate, the OLG Frankfurt orders the implementation of restructuring proceedings and appoints a restructuring advisor (*Sanierungsberater*) to implement the restructuring plan (sections 3 para 1 and 6 para 1 KredReorgG). Restructuring plans may not affect creditors' rights (section 2 para 2 sentence 2 KredReorgG).[51]

If restructuring proceedings have failed or are without prospect of success, reorganisation proceedings (*Reorganisationsverfahren*) may be opened (section 7 KredReorgG). Reorganisation proceedings are initiated by the Credit Institution itself, or, if restructuring proceedings have failed, by the restructuring advisor with the Credit Institution's consent, by notifying BaFin. The Credit Institution or the restructuring advisor must submit a reorganisation plan when notifying BaFin. Following the notification, reorganisation proceedings may be opened by the

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[51] Section 2 para 2 KredReorgG provides that the restructuring plan may provide that certain loans granted in the context of the restructuring within the approved aggregate limit not exceeding 10 per cent. of the own capital of the relevant institution may rank superior to claims of all other insolvency creditors in case that Insolvency Proceedings are commenced within a period of three years following the commencement of the restructuring proceedings.

OLG Frankfurt upon an application by BaFin if the conditions for a Resolution Order are met.

Pursuant to section 12 KredReorgG the reorganisation plan may provide that claims of creditors are partially reduced, deferred or modified in another way. This right to reduce, defer or modify claims may also be extended to creditors' rights with respect to collateral provided as security interest if under such security interest the relevant creditors are entitled to separate satisfaction (*absonderungsberechtigt*) such as pledges over securities by applying section 223 InsO by analogy to the reorganisation proceeding. Section 9 KredReorgG provides that claims of a creditor may be converted into equity ("debt-equity-swap"), however, this is subject to the affected creditors' consent.

The approval process for the reorganisation plan is as follows: First, the measures proposed in the reorganisation plan are subject to a positive majority vote of the creditors and shareholders of the respective Credit Institution accepting such measures. If the votes approve the reorganisation plan, the reorganisation is subject to the approval by the OLG Frankfurt, upon which it becomes effective (section 21 KredReorgG). If the reorganisation plan as approved by the OLG Frankfurt affects rights which are not governed by German law, the recognition of such measures is a matter of the relevant applicable law. The German legislator takes the view [52] that reorganisation proceedings qualify as reorganisation measures for purposes of Article 2 no. 7 and Article 3 WUD.

Furthermore, the KredReorgG provides for certain mandatory temporary limitations of the rights of counterparties to terminate contractual relationships with the Credit Institution if it becomes subject to reorganisation proceedings (section 13 KredReorgG). Contracts may not be terminated from the day on which the notification pursuant to section 7 para 1 KredReorgG is filed

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[52] BT-Drucksache 17/3024, p. 49. As a result, the authorities of other EU member states in which the WUD has been implemented are generally obliged to recognise the effects of the reorganisation plan.

with BaFin until the end of the following business day.[53] The effect of any termination events (for example in case of a payment default) occurring during this period is suspended until the expiration of that period. Contractual clauses that provide for the contrary (i.e. for an immediate termination) are ineffective.

(iv) Recovery and Resolution Proceedings

Additional regulatory proceedings may be instituted and measures may be taken by the Resolution Authority with respect to CRR Credit Institutions and Resolution Investment Firms or group companies under the SAG in order to avoid the insolvency of any such institution or company.

(A) Competent Resolution Authority

In Germany, BaFin is the competent national Resolution Authority (section 3 para 1 SAG).[54]

Acting within the SRM, the SRB has assumed certain resolution tasks and may take certain resolution actions or require BaFin acting in the capacity as the competent national resolution authority to implement a resolution scheme designed by the SRB although practical experience on the cooperation between the authorities is still limited. Article 1 SRMR states that the uniform rules and the uniform procedure for the resolution of the entities referred to in Article 2 SRMR and established in the participating member states (such as Germany) are to be applied by the SRB. Article 2 SRMR refers to CRR Credit Institutions established in a participating member state, parent undertakings, including financial holding companies and mixed financial holding companies, established in a participating member state, if they are

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[53] Section 13 KredReorgG refers to the business day of a System as defined in section 1 para 16b KWG which comprises the usual business cycle of the System including day and night settlement.

[54] As of 1 January 2018 BaFin has replaced the Federal Agency for Financial Market Stabilisation (*Finanzmarktstabilisierungsanstalt*, "**FMSA**") in this capacity.

subject to consolidated supervision carried out by the ECB in accordance with Article 4 para 1 lit (g) of Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions ("**SSMR**")[55] and investment firms and financial institutions established in a participating member state, where they are covered by the consolidated supervision of the parent undertaking carried out by the ECB in accordance with Article 4 para 1 lit (g) SSMR (each an "**SSMR Institution**").

The SRB and the Resolution Authority are under a duty to cooperate and Article 7 para 2 SRMR clarifies that the SRB is responsible for drawing up the resolution plans and adopting all decisions relating to resolution for: (a) SSMR Institutions that are not part of a group and for groups: (i) which are considered to be significant in accordance with Article 6 para 4 SSMR or (ii) in relation to which the ECB has decided in accordance with Article 6 para 5 lit (b) SSMR to exercise directly all of the relevant powers; and (b) other cross-border groups. In relation to entities and groups other than those referred to in Article 7 para 2 SRMR the Resolution Authority is entitled to perform, and is responsible for, the resolution tasks enumerated in Article 7 para 3 SRMR.

Article 29 para 1 SRMR states that the national resolution authorities shall take the necessary action by taking the necessary measures in accordance with Article 35 or 72 BRRD and by ensuring that the safeguards provided for in the BRRD are complied with when implementing decisions under the SRM. Article 29 SRMR also clarifies that the national resolution authorities shall exercise their powers under national law transposing the BRRD and in accordance with the conditions laid down in national law. This means that to

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[55] OJ EU No L 287 of 29 October 2013, p. 63.

the extent BaFin is the competent national resolution authority BaFin would exercise its powers under the SAG. Under Article 29 para 2 SRMR, where a national resolution authority has not applied or has not complied with a decision by the SRB pursuant to the SRMR or has applied it in a way which poses a threat to any of the resolution objectives under Article 14 SRMR or to the efficient implementation of the resolution scheme, the SRB may order an institution under resolution (a) in the event of an action pursuant to Article 18 SRMR, to transfer to another person specified rights, assets or liabilities of an SSMR Institution under resolution, (b) in the event of an action pursuant to Article 18 SRMR, to require the conversion of any debt instruments which contain a contractual term for conversion in the circumstances provided for in Article 21 SRMR or (c) to adopt any other necessary action to comply with the decision in question.

Notwithstanding the provisions of Article 29 SRMR (and other relevant references throughout SRMR) the interaction between the SRMR and the SAG is, due to lack of practical experience, in our view not entirely clear. Therefore, to the extent a relevant entity is covered by the SRMR and subject to a resolution decision by the SRB affected entities and their creditors might need to not only review the consequences under the SAG following implementation of such decisions but also the requirements under the SRMR for making such decisions and to assess the potential application of powers under the SRMR (in particular, as the relevant provisions under the SRMR, the BRRD and the SAG are not identical and they also may be subject to review by different courts). We are not aware of any court decision or any further guidance by the SRB or BaFin on this topic. Section 1 SAG provides that as far as the SRMR is not applicable the SAG applies. In the following, when referring to the SAG, we describe the powers of BaFin under the SAG but, as mentioned, the SRB may require BaFin to take resolution action based on the SRMR and the SRB or

BaFin may under certain circumstances be entitled to exercise similar powers under the SRMR. In particular, the SRMR contains bail-in powers and powers to transfer assets and liabilities (Articles 24 *et seqq*. SRMR). However, the powers under the SAG and the SRMR may differ.

(B) Resolution order

If the conditions for resolution are met, the Resolution Authority can take any action in accordance with the SAG to achieve the resolution objectives including issuing Resolution Orders under sections 77 para 1 no. 1, 136 SAG and together with or independent from a Resolution Order any other action under sections 78 to 87 SAG. [56] A Resolution Order may involve the following resolution tools: write down or conversion of relevant capital instruments (section 89 SAG), the bail-in tool (section 90 SAG), the sale of business tool (section 107 para 1 no. 1 lit (a) SAG), the bridge institution tool (section 107 para 1 no. 1 lit (b) SAG) and the asset separation tool (section 107 para 1 no. 2 SAG).[57]

The Resolution Authority may also, *inter alia*, order the modification (including any suspension) of the due date of any debt instruments issued or other eligible liabilities (*berücksichtigungsfähige Verbindlichkeiten*) incurred by a Resolution Firm and any group companies or of the amount of any interest payable or the date when such interest is payable (section 78 para 1 no. 3 SAG).

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[56] As regards the resolution objectives please refer to section 67 SAG, as regards the general principles on resolution please refer to section 68 SAG and as regards to the various valuation procedures please refer to sections 69 to 76 SAG.

[57] While we use the original terms of the English version of the BRRD this does not imply that the BRRD has been implemented on a one-by-one basis into German law.

(C) Conditions for resolution

The conditions for the resolution of Resolution Firms are met if the ongoing existence of such entities is endangered (*Bestandsgefährdung*), the implementation of a resolution action (*Abwicklungsmaßnahme*) to achieve one or more resolution objectives (*Abwicklungsziele*) is necessary and proportionate (*erforderlich und verhältnismäßig*), and the situation cannot be remedied through measures other than resolution action with the same certainty, also having regard to the time available (section 62 para 1 sentence 1 SAG).[58] The ongoing existence of Resolution Firms is endangered if either (1) the Resolution Firm infringes or there are objective elements to support the view that the Resolution Firm will, in the near future, infringe the requirements for holding a licence under section 32 KWG in a way that would justify the withdrawal of the licence by the relevant competent authority, (2) the assets of the Resolution Firm are or there are objective elements to support the view that the assets of the Resolution Firm will, in the near future, be, less than its liabilities or (3) the Resolution Firm is, or there are objective elements to support the view that the institution will, in the near future, be, unable to pay its debts or other liabilities as they fall due unless there is a serious chance (*ernsthafte Aussicht*) that following the issuance of a state guarantee (*staatliche Garantie*) (as referred to in the next sentence) the Resolution Firm is in a position to meet its liabilities when they fall due); section 63 para 1 SAG. The ongoing existence of a Resolution Firm is deemed to be endangered if extraordinary financial support is granted from public sources except when, in order to remedy a serious disturbance of the economy and preserve financial stability, the extraordinary public financial support takes any of the following forms: (i) a state

[58] Section 62 para 1 sentence 2 SAG does not require that any crisis prevention measures or any other appropriate measures under the KWG are instituted before a resolution action.

guarantee to back liquidity facilities provided by central banks according to the central banks' conditions; (ii) a state guarantee of newly issued liabilities; or (iii) an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution (for further details and exemptions refer to section 63 para 2 SAG).[59]

(D) Bail-in powers

With respect to the individual resolution tools, the bail-in tool (*Instrument der Gläubigerbeteiligung*) (section 90 SAG) empowers the Resolution Authority to either convert eligible liabilities (*berücksichtigungsfähige Verbindlichkeiten*) of a Resolution Firm or group company into shares or other Common Equity Tier 1 (for purposes of Article 28 CRR) items or partially or fully write down or cancel eligible liabilities. Liabilities are eligible for bail-in unless relevant liabilities are covered by one of the exemptions in section 91 SAG or the Resolution Authority, exercising due discretion and having regard to the criteria in section 92 SAG, decides to exempt liabilities from the application of section 90 SAG in certain specified cases.

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[59] Section 64 SAG provides that the conditions for the resolution of a financial institution as defined in Article 4 para 1 no. 26 CRR which is a subordinated undertaking of a parent undertaking subject to prudential supervision at a consolidated level are met if the conditions for the resolution of the parent undertaking pursuant to section 62 SAG are met. In respect of financial holding companies as defined in Article 4 para 1 no. 20 CRR), mixed financial holding companies (as defined in Article 4 para 1 no. 21 CRR), parent financial holding companies in a member state (as defined in Article 4 para 1 no. 30 CRR), EU parent financial holding companies (as defined in Article 4 para 1 no. 31 CRR), parent mixed financial holding companies in a member state (as defined in Article 4 para 1 no. 32 CRR) and EU parent mixed financial holding companies in a member state (as defined in Article 4 para 1 no. 34 CRR), the conditions are met if the conditions for resolution are met (a) both in respect of one such entity and in respect of at least one of its subordinated undertakings which qualifies as a Resolution Firm (or if a non-EU resolution has determined that a third country subordinated undertaking can be resolved in accordance with the laws of such non-EU country) or (b) if (i) the conditions for resolution are met in respect of at least one of its subordinated undertakings which qualify as Resolution Firms, (ii) the threat to the existence of the subordinated undertaking could result in the entire group's existence being endangered and (iii) resolution action in respect of the holding company is necessary to resolve at least one of the subordinated undertakings or the group.

With respect to derivatives in general (as defined in section 2 para 3 no. 11 SAG by reference to the definition of financial instruments under section 1 para 11 sentence 3 KWG) the bail-in tool may only be applied after or simultaneously with the "closing-out" (*Glattstellung*) of such derivatives (section 93 para 1 SAG). Hence, only the relevant net settlement amount would be subject to bail-in.

Pursuant to section 93 para 2 SAG the Resolution Authority is empowered to terminate and close out derivatives transactions. If transactions are entered under an agreement qualifying as netting arrangement (*Saldierungsvereinbarung*) the Resolution Authority or an independent valuation expert is obliged to determine the net amount of the derivative transactions and to simultaneously or subsequently apply the bail-in tool to the net claim (section 93 para 3 SAG).

Pursuant to section 2 para 3 no. 43 SAG, "netting arrangement" means an arrangement under which a number of claims or obligations can be converted into a single net claim, including (1) arrangements under which, upon the occurrence of an enforcement event the obligations of the parties are accelerated so as to become immediately due or are terminated, and in either case are converted into or replaced by a single net claim (close-out netting arrangement), (2) set-offs based on a termination (close-out netting) as defined in Article 2 para 1 lit (n) of Directive 2002/47/EC of 6 June 2002[60] on financial collateral arrangements as amended by Directive 2009/44/EC [61] ("**Financial Collateral Directive**" or "**FCD**") and (3) netting (*Aufrechnung*) as defined in Article 2 lit (k) of the Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on Settlement Finality in Payment and Securities

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[60] OJ No L 168 of 27 June 2002, p. 43.

[61] OJ No L 146 of 10 June 2009, p. 37.

Settlement Systems as amended by Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 ("**Settlement Finality Directive**" or "**SFD**").[62]

We note that there is currently no guidance on the meaning of the definitions in section 2 para 3 no. 43 SAG and any restrictions the Resolution Authority might apply in construing these terms. Section 93 para 5 SAG extends the scope of section 93 paras 1 to 4 SAG also to obligations arising under financial transactions within the meaning of section 104 para 1 InsO which are included in a master agreement as defined in section 104 para 3 InsO. As the purpose of section 93 para 5 InsO is to extend the exemption to instruments which may not qualify as derivatives[63] we believe that when construing the term "netting arrangement" under sections 93 para 3, 2 para 3 no 43 SAG such term does not need to be construed by reference to the definition of "master agreement" used in section 104 para 3 InsO. Such definition would only be relevant in the context of section 93 para 5 SAG, i.e. where the relevant liability potentially subject to bail-in does not qualify as derivative but may still qualify as financial transaction under section 104 para 1 sentence 2 InsO. We are not aware of any court decision on this question.[64]

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62 The SFD was amended by Regulation (EU) No 909/2014 of the European Parliament and of the Council of 23 July 2014 on improving securities settlement in the European Union and on central securities depositories and amending Directives 98/26/EC and 2014/65/EU and Regulation (EU) No 236/2012 ("**CSDR**"). In the English language version, both Article 2 para 1 lit (n) of the FCD and Article 2 lit (k) of the SFD refer to "close-out netting" or "netting" while the German language version refers to set-off (*Aufrechnung*).

63 See BT-Drucksache 18/6091, p. 86.

64 Please refer to paragraph 3.2.3(c)(ii) as to how the BGH understands the term "netting agreement" (the decision was rendered on the basis of a version of section 104 InsO which is no longer applicable). The

The Netting Provisions provide for the termination of mutual obligations between LCH and a relevant Relevant Clearing Member upon the occurrence of an Automatic Early Termination Event or the sending of a Default Notice and the calculation of a single claim to replace the mutual obligations (Rules 3, 6 and 8 of the Default Rules). The Netting Provisions would in our view qualify as a netting arrangement as they provide for the conversion of various obligations of a Relevant Clearing Member *vis-à-vis* LCH. However, we understand that LCH has discretion to terminate certain but not all Contracts. Hence, there is a risk that a competent court would not recognise the Netting Provisions as a netting arrangement under section 2 para 3 no 43 lit (a) SAG (see also paragraph 3.2.1(d)(iv)(E)). Based on the above, in our view the Netting Provisions would still qualify as a netting arrangement, and as a result the Resolution Authority would be prevented from applying write-off or conversion powers to individual claims under Contracts covered by the netting provision, but it would be entitled to close out the outstanding transactions, to calculate a net claim and to write off or convert such net claim pursuant to section 93 para 3 SAG.[65] We note that Article 27 SRMR does not provide for an exemption similar to section 93 SAG (or Article 49 BRRD). It is therefore not entirely clear whether the SRB when exercising any

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definition of "master agreement" under section 104 para 3 InsO refers to a master agreement or rules of a central counterparty, which provide that the transactions may, upon the occurrence of certain events, only be terminated in their entirety; see paragraph 3.2.3(d).

[65] Please refer to Article 5 of Commission Delegated Regulation (EU) 2016/1401 of 23 May 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms with regard to regulatory technical standards for methodologies and principles on the valuation of liabilities arising from derivatives (OJ EU No L 228 of 23 May 2016, p. 7) stating that collateral is included in the calculation of the early termination amount. As collateral is already included in the calculation of the relevant net settlement amout available for bail-in we do not believe that to the extent section 93 SAG applies, Cleared Transactions need to be protected from bail-in under the exemption for secured liabilities unless the net settlement amount as such would be protected by such (additional) collateral.

discretion under Article 27 para 1 SRMR will recognise any netting or whether section 93 SAG can still be applied by BaFin when implementing the SRB's decision under Article 29 SRMR.

Secured liabilities within the meaning of section 91 para 2 no. 2 SAG would not be subject to bail-in to the extent the secured liability is secured or covered by value of the secured collateral asset. [66] There is no definition of "secured liabilities" in the SAG. In our view, the fact that in the context of derivatives, generally margin is provided does not mean that derivatives in general qualify as secured liabilities. As we understand and construe section 91 para 2 no. 2 SAG such exemption would only be available for derivatives if the relevant net settlement amount resulting from the application of close-out netting were to be secured separately. This is also in line with the fact that under section 93 SAG only the net settlement amount would be subject to bail-in. The exemption under section 91 para 2 no. 2 SAG does not apply to collateral which has been granted under transfer of title arrangements and is therefore enforced by way of close-out netting by inclusion in the calculation of the net claim. We are not aware of any court decisions on this question.

(E) Powers to transfer assets and liabilities

Shares or all or any assets including the liabilities of a Resolution Firm or group company in resolution or may be transferred to a third party under the sale of business tool (section 107 para 1 no. 1 lit (a) SAG) or to a bridge

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[66] With respect to the definition of secured liabilities see the following paragraphs; see also Art. 6 of the Commission Delegated Regulation (EU) 2016/1401 of 23 Mai 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms with regard to regulatory technical standards for methodologies and principles on the valuation of liabilities arising from derivatives (OJ EU No L 228 of 23 August 2016, p. 7).

institution[67] under the bridge institution tool (section 107 para 1 no. 1 lit (b) SAG) if the Resolution Authority determines that the conditions for resolution of the Resolution Firm or group company are met.

Under the asset separation tool (section 107 para 1 no. 2 SAG) all or any assets including the liabilities of the Resolution Firm or group company in resolution may be transferred to an asset management company. Secured assets and liabilities may not be separated from the relevant collateral assets serving as security as such assets or liabilities may only be transferred if they are transferred together with any relevant collateral assets and all collateral assets may only be transferred together with the relevant assets or liabilities which are secured by such collateral assets; section 110 para 1 SAG. This prohibition of partial transfers is extended by section 110 para 3 SAG to collateral assets securing liabilities included in a System, to netting arrangements (*Saldierungsvereinbarungen*) and set-off arrangements (*Aufrechnungsvereinbarungen*).

As mentioned, based on the definition of netting arrangements in the SAG (above, paragraph 3.2.1(d)(iv)(D)), we believe that the Netting Provisions would qualify as a netting arrangement

If the Netting Provisions do not qualify as a netting arrangement, they may qualify as a set-off agreement. There is no definition of "set-off arrangement" in the SAG. However, under Article 2 para 1 no 99 BRRD "set-off arrangement" means an arrangement under which two or more claims or obligations owed between the institution under resolution and a counterparty can be set

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[67] "Bridge institution" (*Brückeninstitut*) means a legal entity which (1) is entirely held by the Resolution Authority or another public authority, (2) is controlled by the Resolution Authority on the basis of corporate law, contract law or public law powers to exercise influence and (3) has been established as a bridge institution for purposes of section 107 SAG (section 128 SAG).

off against each other. Based on this broad wording, the term "set-off arrangement" seems to cover any agreement by which parties set off their liabilities.[68] The Netting Provisions would appear to contain sufficient elements of set-off to qualify as a set-off agreement. Therefore, even if the Netting Provisions do not qualify as a netting arrangement, they might qualify as a set-off agreement. [69] If so, a partial transfer of transactions subject to them should in our view not be permissible but there is currently no clarity on the meaning of these terms and we are not aware of any court decision.

As long as the conditions to resolution are fulfilled, the asset transfer tools can be used multiple times and each transfer is valid (and the transfer of title is actually effected) upon the publication of the relevant Resolution Order (sections 114, 136 SAG). Separately, section 79 para 2 SAG empowers the Resolution Authority to modify or cancel (*ändern oder beseitigen*) the rights of third parties in respect of the Resolution Firm's assets.

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[68] However, the European Banking Authority ("**EBA**") has concluded that rules preventing a separation of rights and liabilities should be applied in a restrictive manner (see technical advice by the European Banking Authority on classes of arrangements to be protected in a partial property transfer of 14 August 2015 http://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-15+Opinion+on+protected+arrangements.pdf: "In any event, the protection should be limited to liabilities clearly identified in the set-off arrangement (at least by category). In addition, the delegated acts should specify precise criteria when such arrangements and liabilities qualify for this protection. Ideally the scope of the safeguard should be limited to certain qualifying arrangements and certain liabilities." Conversely, the EBA also notes that "qualifying arrangements could for example include only financial contracts as defined in point (100) of Article 2 para 1, and the protection apply only to them (this term would need to include options, futures, swaps, forward rate agreements and any other derivative contracts)". See also Article 3 para 2 of the Commission Delegated Regulation (EU) 2017/867 of 7 February 2017 on classes of arrangements to be protected in a partial property transfer under Article 76 of the BRRD (OJ L 131 of 20 May 2017, p. 15) for further limitations on which set-off arrangements are protected and covered by Article 76 para 2 lit (c) BRRD.

[69] Regulation 10 (e) of the General Regulations contains a set-off right but see footnote 68 above with respect to a proposal for limiting the interpretation of "set-off arrangement" as the relevant liabilities may be subject to numerous generally applicable contractual or even statutory set-off rights.

Section 79 para 5 SAG further empowers the Resolution Authority, in respect of a contract to which the Resolution Firm or group company is a party, (i) to amend some or all provisions, (ii) to refuse performance or (iii) to replace the Resolution Firm or group company with a transferee entity as the counterparty. The power pursuant to section 79 para 5 SAG must not be exercised (i) in respect of Financial Collateral as well as netting and set-off arrangements, (ii) so as to result in a cancellation of transfer orders for purposes of Article 5 SFD and or (iii) so as to affect the validity of transfer orders or set-offs in accordance with Articles 3 and 5 SFD, credit entries, securities or credit facilities for purposes of Article 4 SFD or rights *in rem* for purposes of Article 9 SFD (section 79 paras 6 and 7 SAG).

The powers under section 79 SAG are generally available to the Resolution Authority and may be ordered if required to effectively implement Resolutions Orders or achieve any resolution goals. Given that the collateral arrangements under the Rulebook should qualify as Financial Collateral (below, paragraph 3.2.1(e)) and that the Netting Provisions should qualify as a set-off agreement (whereas it is not entirely clear whether it qualifies as a netting arrangement, see paragraph 3.2.1(d)(iv)(D)) and in light of the exemptions in relation to Financial Collateral and set-off agreements, the application of section 79 para 5 SAG should be excluded in respect of Relevant Clearing Members rights under the Rulebook.

(F) Powers to temporarily suspend the enforcement of rights, claims and security interests and exemptions

The Resolution Authority is entitled under section 82 para 1 SAG to suspend any payment or delivery obligations under any contract to which a Resolution Firm or group company under resolution is a party from the publication of a notice of the suspension in accordance with section 137 SAG until the end of the

business day following such publication. Such suspension may also affect payment and delivery obligations arising under a Contract. Any suspension under section 82 para 1 SAG does not apply to payment and delivery obligations owed to Systems, system operators within the meaning of section 1 para 16a KWG, central counterparties within the meaning of section 1 para 31 KWG and central banks. With respect to the qualification of the LCH as a System please see paragraph 3.2.1(f). Given the clear wording, this exemption should only apply to liabilities owed by Relevant Clearing Members to LCH but not the liabilities LCH owes to its Relevant Clearing Members. Whether claims that Relevant Clearing Members have against LCH can be temporarily suspended is not a question of German law as LCH is not subject to the SAG.

A payment or delivery obligation which would have been due during the suspension period becomes due immediately upon expiry of the suspension period. If the payment or delivery obligations of an institution under resolution under a contract are suspended, the payment or delivery obligations of such institution under resolution's counterparties under that contract are suspended for the same period of time.

The Resolution Authority has the power to temporarily prevent secured creditors of a Resolution Firm or group company under resolution from enforcing security interests in relation to any assets of that institution under resolution from the publication of a notice of the restriction in accordance with section 137 para 1 SAG until the end of the business day following that publication (section 83 para 1 SAG). Such restrictions do not apply in relation to any security interest provided by the Resolution Firm or group company under resolution to Systems, system operators within the meaning of section 1 para 16a KWG, central counterparties within the meaning of section 1 para 31 KWG and central banks.

As mentioned, there is no definition of "secured liabilities" in the SAG. However, Article 2 para 1 no 67 BRRD provides that secured liabilities include title transfer collateral arrangements and the term "secured liabilities" should in our view be construed accordingly. Conversely, the SAG as well as the BRRD address netting arrangements and security arrangements separately. Therefore, a competent authority or court would in our view likely not consider a netting arrangement as a form of security for purposes of the SAG.

Under section 84 para 1 SAG the Resolution Authority is entitled to suspend the termination rights[70] of any party to a contract with a Resolution Firm or group company under resolution from the publication of such suspension pursuant to section 137 para 1 SAG until the end of the business day following that publication. The Resolution Authority may also suspend the termination rights of any party to a contract with a group company forming part of the group of an institution under resolution from the publication of such suspension pursuant to section 137 para 1 SAG until the end of the business day following that publication where (1) the obligations under that contract are guaranteed or are otherwise supported by the group company under resolution, (2) the termination rights under that contract are based solely on the insolvency or the conditions for resolution or the institution or implementation of resolution actions and (3) in the case of a transfer power that has been or may be exercised in relation to the institution or group company under resolution, (i) all rights and liabilities of the Resolution Firm or group company under resolution of the subsidiary relating to that contract have been or may be transferred to and assumed by the recipient or (ii)

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[70] Section 84 para 7 SAG states that section 84 SAG applies to all termination events arising under a contract with a Resolution Firm or group company in resolution which, in our view, should also include automatic termination rights.

the Resolution Authority provides in any other way adequate protection for the rights of the other parties (section 84 para 2 SAG). Again, exemptions from such suspension of termination rights apply for participants in Systems, System operators within the meaning of section 1 para 16a KWG, central counterparties within the meaning of section 1 para 31 KWG and central banks.

A party may exercise a termination right under a contract before the end of the period referred to in paragraphs 1 or 2 of section 84 SAG if that party receives notice from the Resolution Authority under section 84 para 5 SAG that the rights and liabilities covered by the Rulebook are (i) not to be transferred to another entity and (ii) not subject to write down or conversion upon the application of the bail-in tool. Subject to sections 82 and 144 SAG, where no notice has been given pursuant to section 84 para 5 SAG, such a creditor of a Relevant Clearing Member may exercise termination rights after the expiry of the period of suspension if, (1) in cases where the rights and liabilities covered by the contract have been transferred to a recipient entity, the contractual requirements for terminating the contract are still met after the transfer to the recipient entity and (2) in cases where the rights and liabilities covered by the contract remain with the Resolution Firm or group company under resolution and the Resolution Authority has not applied the bail-in tool, the contractual requirements for terminating the contract are still met upon the expiry of the suspension.

(G) Statutory safeguards

Pursuant to section 144 para 1 SAG, a crisis prevention measure or a crisis management measure (*Krisenmanagementmaßnahme*), including the occurrence of any event directly linked to the application of such a measure, shall not in relation to the Resolution Firm or the group and all group companies be deemed to be an enforcement or termination event within the meaning of

the FCD or as insolvency proceedings within the meaning of the SFD provided that the main obligations (*Hauptleistungspflichten*) under the contract, including payment and delivery obligations and the provision of collateral, continue to be performed.

Under section 144 para 3 SAG, a crisis prevention measure or crisis management measure, including the occurrence of any event directly linked to the application of such a measure, do not entitle a party to (1) exercise any termination, suspension, modification, netting (*Verrechnung*) or set-off rights vis-à-vis a Resolution Firm or group company, (2) acquire title over any property of the Resolution Firm or group company, exercise control over it or enforce any rights under a security and (3) impair any contractual rights of the Resolution Firm or group company. This does only apply if the main obligations under the contract, including payment and delivery obligations, and provision of collateral, continue to be performed. A suspension or restriction under sections 82 to 84 SAG is not regarded as non-performance of contractual main obligations.[71]

Section 144 SAG does not affect the right of a person to take an action referred to in paragraph 3 of section 144 SAG where that right arises by virtue of an event other than the crisis prevention measure, the crisis management measure or the occurrence of any event directly linked to the application of such a measure. Section 144 para 5 SAG provides that agreements violating sections 144 para 1 to 3 SAG are not

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[71] With respect to financial contracts governed by the laws of a non-EU Member State and generally coming into existence after 1 January 2016, the Resolution Firm is obliged to agree on contractual terms with relevant creditors pursuant to which the creditors recognise that section 144 para 3 SAG may be applied to such financial contracts and to obtain the creditors' consent to the application of such powers (section 60a SAG).

enforceable.[72] As section 144 para 5 SAG implements Article 68 para 6 BRRD (which clarifies that the provisions of the BRRD implemented by section 144 SAG are to be considered as overriding mandatory provisions within the meaning of Article 9 Rome I)[73] we understand that section 144 SAG would be enforced in accordance with Article 9 Rome I even where German courts do not have jurisdiction. However, we do not opine on whether or not section 144 SAG would be recognised in any jurisdiction other than Germany.

(H) "No creditor worse off" principle

Under section 146 SAG the Resolution Authority must ensure that, immediately after the resolution action or actions have been effected a valuation is carried out by an independent person (such valuation must be distinct from the valuation carried out under section 69 SAG) to assess if and to what extent shareholders and creditors would have received better treatment if the institution under resolution had been subject to normal insolvency proceedings. If such assessment shows that creditors are worse off than they would have been in insolvency proceedings, such creditors are entitled to seek compensation from the German bank restructuring fund (*Restrukturierungsfonds*) (section 147 SAG).

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[72] Resolution Firms and group companies may only use standard agreements if they comply with those requirements, section 144 para 5 sentence 2 SAG.

[73] Article 9 para 2 Rome I provides that the conflict of law provisions under Rome I do not restrict the application of the overriding mandatory provisions of the law of the forum and Article 9 para 3 sentence 1 Rome I provides that effect may be given to the overriding mandatory provisions of the law of the country where the obligations araising out of the contract have to be or have been performed, insofar as those overriding mandatory provisions render the performance of the contract unlawful. An overriding mandatory provision as defined in Article 9 para 1 Rome I is a provision which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organization, to such an extent that such provision is applicable to any situation falling within its scope, irrespective of the law otherwise applicable to a contract under Rome I. Pursuant to Recital 37 of Rome I the concept of overriding mandatory provisions should be distinguished from the expression "provisions which cannot be derogated from by agreement" and should be construed more restrictively.

This means that creditors of Relevant Clearing Members that are Resolution Firms should at least receive compensation if the imposition of resolution measures results in a situation where they would be more detrimentally affected than in Insolvency Proceedings. In this respect, where German law applies it should be assessed whether relevant transactions fall within the scope of section 104 InsO and, accordingly, would not be subject to a Selection Right by the Insolvency Administrator or if transactions qualify as mutual transactions which have not been completely fulfilled by one party and, therefore, are not protected by section 104 InsO (see paragraph 3.2.3(c)).

(I) Legal remedies

A resolution action may be challenged before the VGH Kassel within one month upon its publication (section 150 SAG). The law does not expressly foresee any appeal against any such judgment, although legal remedies may from time to time be available under generally applicable laws, including German constitutional law. The filing of a law suit does not suspend or otherwise affect the validity of a relevant resolution action.

(J) Summary

To summarise, upon the imposition of crisis prevention measures or crisis management measures in respect of a Resolution Firm, contractual termination, set-off or netting rights as well as the enforcement of security may be temporarily suspended or otherwise restricted or affected, subject to applicable exemptions.

Claims against a Relevant Clearing Member that is a Resolution Firm may be subject to mandatory conversion or write off and may also be transferred to another party and/or modified although a partial transfer would be excluded to the extent such rights and obligations are part of a netting arrangement. For derivatives transactions, the bail-in tool may only be applied after or

simultaneously with the "closing-out" of such derivatives.

If the Netting Provisions are not triggered before any SAG measures are imposed and before restrictions under the InsO apply, measures that temporarily prevent a creditor of a Relevant Clearing Member that is a Resolution Firm from exercising termination rights to trigger the close-out netting mechanism may impact the timing of the close-out netting and, if the respective Relevant Clearing Member that is a Resolution Firm subsequently becomes insolvent, this may (in particular in conjunction with the temporary suspension of enforcement, set-off or netting rights under the SAG) result in a situation where the counterparty would continuously be prevented from exercising any termination, set-off or netting rights, first under the SAG and subsequently under the InsO. However, the following exemptions and mitigating factors should apply to each scenario:

A temporary stay of enforcement rights can be imposed on liabilities due by a Relevant Clearing Member that is a Resolution Firm. However, such restrictions do not apply to Systems, system operators within the meaning of section 1 para 16a KWG, central counterparties within the meaning of section 1 para 31 KWG and central banks.

Creditors of a Relevant Clearing Member that is a Resolution Firm cannot exercise termination rights based exclusively on the imposition of crisis prevention or crisis management measures as long as the respective Relevant Clearing Member continues to perform the main obligations under the Rulebook. However, as soon as such Relevant Clearing Member ceases to perform its main obligations, such creditor would be entitled to exercise its termination rights.

(v) International scope of application of Regulatory Proceedings

In accordance with section 46d para 3 sentence 3 KWG, section 340 paras 2 InsO which provides for specific conflicts of law rules for "netting agreements" (*Schuldumwandlungsverträge und Aufrechnungsvereinbarungen*) applies by analogy to reorganisation measures (*Sanierungsmaßnahmen*). The same applies to section 340 para 3 InsO which provides for specific conflicts of law rules applicable to participants in a System. Among such reorganisation measures are, in particular, measures taken under section 46 KWG which are intended to preserve or restore the financial status of a CRR Credit Institution and which may affect existing rights of third parties in a host member state of the European Economic Area ("**EEA**") (section 46d para 3 sentence 1 KWG). The view of the German legislator appears to be that such "reorganisation measures" qualify as "reorganisation measures" as defined in Article 2 no. 7 WUD because section 46d para 1 sentence 1 KWG requires BaFin to inform the competent authorities of host EEA member states when taking "reorganisation measures" under the KWG.[74] However, the scope of section 46d para 3 KWG is not clear as the term "reorganisation measure" is not used elsewhere in the KWG.

The same issue arises under section 7 para 5 sentence 2 KredReorgG providing that section 46d paras 1 to 4 KWG applies to reorganisation proceedings under the KredReorgG. Whether restructuring proceedings (*Sanierungsverfahren*) or reorganisation proceedings (*Reorganisationsverfahren*) under the KredReorgG are covered by the reference is in our view not entirely clear, although, given the purpose of the KredReorgG to stabilise Credit Institutions and to allow them to operate as going concerns, there is good reason to conclude that at least the

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[74] BT-Drucksache 17/3024, p. 49. As mentioned, Article 117 BRRD provides for certain changes to the WUD and in particular extends the scope of institutions subject to the WUD (previously only CRR Credit Institutions) to also include CRR Investment Firms. Key provisions of the WUD are implemented in Germany by sections 46d and 46e KWG but it is not entirely clear whether the general widening of the scope of covered entities means that all provisions of the WUD must be construed accordingly. In contrast to section 46e KWG, section 46d KWG has not been amended to cover CRR Investment Firms.

measures under the KredReorgG qualify as reorganisation measures for purposes of the WUD and section 46d para 3 sentence 3 KWG. In such case, sections 338 and 340 InsO would be applicable and if a court were to follow our interpretation of sections 338 and 340 para 2 InsO (paragraph 3.2.3(b)(B)), the effects of the regulatory measures and reorganisation proceedings on Contracts would therefore have to be decided on the basis of English law as the law governing the Rulebook and Contracts.[75]

There is no similar conflict of laws provision in the SAG and section 46d KWG does not refer to the SAG. However, Article 25 WUD as amended by the BRRD clarifies that without prejudice to Articles 68 and 71 BRRD netting agreements are to be governed solely by the law of the contract which governs such agreements (Article 25 WUD has been implemented in Germany by section 340 para 2 InsO but section 340 InsO has not been amended following the amendment of Article 25 WUD). We understand and construe the reference to Articles 68 and 71 BRRD to allow for the exclusion of certain contractual rights and the suspension of termination rights irrespective of the law governing the relevant netting agreement and, thus, as a special conflict of laws provision. We do not express any opinion as to whether the complete implementation of Article 25 WUD will lead to further changes of German law or whether the German legislator considers that Article 25 WUD has already been fully implemented.[76]

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75 However, absent any authoritative precedents from courts and at least a detailed analysis in legal literature, it is unclear whether a German court would also apply Article 9 Rome I and, if so, in which way the court would resolve the conflict between section 340 InsO on the one hand and the direct application of overriding mandatory provisions of German law under Article 9 Rome I on the other hand. We believe that any potential conflict between section 340 InsO and Article 9 Rome I should be solved in favour of section 340 InsO to the extent the relevant provision directly refers to section 340 InsO, as section 340 Inso is more specific than the generally applicable Article 9 Rome I and such reference shows in our view the intention of the legislator to achieve a higher degree of claritiy and certainty on application of the relevant applicable laws.

76 Please refer to *Lindemann*, in: Boos/Fischer/Schulte-Mattler, KWG 5th ed. (2016), § 46d no. 22, arguing that resolution measures under the SAG would also fall under section 46d KWG. If a court follows this view such

Under German law, the termination restrictions under section 144 SAG (which implements Article 68 BRRD) are considered to qualify as overriding mandatory provisions within the meaning of Article 9 para 1 Rome I.[77] Thus, a German court would generally have to recognise the termination restrictions, irrespective of the law governing the transactions (Article 9 para 2 Rome I). However, to the extent bound by Rome I, a court outside Germany would have to consider applying such termination restrictions only if the obligations arising out of the transactions had to be or have been performed in Germany (Article 9 para 3 Rome I). In such case, effect may be given to the overriding mandatory provisions of German law, in so far as those overriding mandatory provisions render the performance of the contract unlawful. The fact that the termination restrictions under section 144 SAG are from a German law perspective overriding mandatory provisions within the meaning of Article 9 para 1 Rome I, would not require a court outside Germany to apply the termination restrictions if obligations arising out of the transactions were not to be performed in Germany.

We are not aware of any guidance from BaFin, the ECB or the Resolution Authority or court decisions on the KredReorgG, the SAG and the aforementioned provisions of the KWG.

(e) Exemptions for Financial Collateral

Specific exemptions from certain mandatory restrictions apply to financial collateral as defined in section 1 para 17 KWG ("**Financial Collateral**") which comprises cash deposits (*Barguthaben*), cash amounts (*Geldbeträge*), securities, money market instruments and other credit claims within the meaning of Article 2 para 1 lit (o) FCD[78] and

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court would then also need to apply section 46d para 3 sentence 3 KWG which, as mentioned, refers to section 340 InsO.

77 See Article 68 para 6 BRRD and BT-Drucksache 18/2575, p. 187, stating that section 144 SAG is intended to implement Article 68 BRRD.

78 Article 1 para 6 FCD as amended states that Articles 4 to 7 FCD do not apply to any restriction on the enforcement of financial collateral arrangements or any restriction on the effect of a security financial collateral arrangement, any close out netting or set-off provision that is imposed by virtue of Title IV, Chapter

payment claims under an agreement pursuant to which an insurance company as defined in section 1 para 1 of the German Insurance Supervisory Act (*Versicherungsaufsichtsgesetz*) has granted credit in the form of a loan in each case including all related rights or claims which have been transferred as collateral either by way of an *in rem* security arrangement (*beschränktes dingliches Sicherungsrecht*) or by way of a money transfer or by way of full title transfer on the basis of an agreement between a secured party and a security provider[79], each belonging to one of the categories named in Article 1 para 2 lit (a) to (e) FCD.[80] Should the security provider be a person or business undertaking

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V or VI of BRRD, or to any such restriction that is imposed by virtue of similar powers in the law of a Member State to facilitate the orderly resolution of any entity referred to in points (c)(iv) and (d) of paragraph 2 which is subject to safeguards at least equivalent to those set out in Title IV, Chapter VII of BRRD.

[79] The FCD provides in Article 2 para 2 that "References in this Directive to financial collateral being "provided", or to the "provision" of financial collateral, are to the financial collateral being delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral taker or of a person acting on the collateral taker's behalf. Any right of substitution or to withdraw excess financial collateral in favour of the collateral provider or, in the case of credit claims, right to collect the proceeds thereof until further notice, shall not prejudice the financial collateral having been provided to the collateral taker as mentioned in this Directive." In a recent decision (C-156/15 of 10 November 2016), the ECJ, dealing with the question what "control" means with respect to collateral in respect of monies deposited in a bank account, has ruled that "the taker of collateral... in the form of monies lodged in an ordinary bank account may be regarded as having acquired 'possession or control' of the monies only if the collateral provider is prevented from disposing of them." There is no express reference in section 1 para 17 KWG to "control", but we are of the view that the term "provide" in that section would need to be interpreted in conformity with European Union law. To the extent that the security provider is entitled to dispose over collateral (at least in cases which do not relate to a right to substitution or withdrawal of excess collateral), there would be a risk that a court could take the view that the qualification as Financial Collateral is endangered.

[80] An extract from Article 1 para 2 lit (a) to (e) FCD reads as follows:

"The collateral taker and the collateral provider must each belong to one of the following categories:

[...]

(c) a financial institution subject to prudential supervision including:

(i) a credit institution as defined in Article 4(1) of Directive 2006/48/EC, including the institutions listed in Article 2 of that Directive;

(ii) an investment firm as defined in Article 4(1)(1) of Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments;

(d) a central counterparty, settlement agent or clearing house, as defined respectively in Article 2(c), (d) and (e) of Directive 98/26/EC, including similar institutions regulated under national law acting in the futures, options and derivatives markets to the extent not covered by that Directive, and a person, other than a

named in Article 1 para 2 lit (e) FCD, financial collateral is only given, if the collateral secures obligations arising under agreements or the procurement of agreements which serve the (a) acquisition and sale of financial instruments, (b) sale and repurchase, lending or similar transactions on financial instruments or (c) loans to finance the acquisition of financial instruments.

As we understand, Relevant Clearing Members are Institutions licensed in accordance with MiFID II or CRD IV[81] they fall within the scope of Article 1 para 2 lit (c) FCD.[82] Since the Rulebook provides for the clearing of Contracts, it involves the acquisition and sale of financial instruments. Security created over cash deposits, cash amounts and securities in the form of outright transfers would therefore qualify as Financial Collateral. To the extent Relevant Clearing Members qualify

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natural person, who acts in a trust or representative capacity on behalf of any one or more persons that includes any bondholders or holders of other forms of securitised debt or any institutions as defined in points (a) to (d);

(e) a person other than a natural person, including unincorporated firms and partnerships, provided that the other party is an institution as defined in points (a) to (d)"

The references in the FCD to Directives 2006/48/EC and 2004/39/EC are to be construed as references to CRD IV (see Article 163 CRD IV) or MiFID II (see Article 94 MiFID II)

81 Article 4 para 1 point 1 CRD IV refers to Article 4 para 1 CRR. See also footnote 17 as only CRR Credit Institutions would be covered by Article 4 para 1 CRR. Subject to certain exemptions, section 1a para 1 KWG extends the application of the CRR also to German Credit Institutions which do not qualify as CRR Credit Institutions. While this is not directly addressed in section 1a para 1 KWG we hold the view that such reference is also meant to extend the scope of the FCD to such Credit Institutions as otherwise Financial Services Institutions would be covered but not Credit Institutions not qualifying as CRR Credit Institutions. Excluding Credit Institutions not qualifying as CRR Credit Institutions from the scope of FCD (and thus from certain protection in the event of an insolvency of a counterparty) appears to be counterproductive and as such cannot have been intended by the legislator since the relevant exemptions under the FCD as implemented into German law create the necessary legal certainty for applying certain techniques relevant for the capital treatment under CRR. We also note that the wording of Article 2(c) FCD refers to financial institutions subject to prudential supervision including those mentioned in Article 2(c)(i) to (vi) FCD. We are not aware of any court decision on this question.

82 Please refer to Article 94 MiFID II stating that references to Directive 2004/39/EC need to be construed as references to MiFID II and references to terms defined in, or Articles of, Directive 2004/39/EC need to be construed as references to the equivalent term defined in, or Articles of, MiFID II they would fall within the scope of Article 1 para 2 lit (c) (i) or, respectively (ii) FCD.

as Institutions they would fall under Article 1 para 2 lit (c) FCD. LCH SA would fall under Article 1 para 2 lit (d) FCD.

Section 21 para 2 sentence 2 InsO provides that the institution of Provisional Insolvency Measures under section 21 InsO must not affect the validity of dispositions (*Verfügungen*) over Financial Collateral. The same applies, if Financial Collateral is created on the day on which such order was released, provided the security taker can prove that it neither had been aware of, nor had to be aware of, such release.

Section 46 para 2 sentence 6 KWG provides that exemptions for Financial Collateral under the InsO apply analogously in respect of measures under section 46 para 1 sentence 2 no. 4 to 6 KWG (section 46 para 2 sentence 6 KWG) and to restructuring and reorganisation proceedings (section 23 KredReorgG). An exemption for Financial Collateral is contained in section 79 para 6 SAG pursuant to which the Resolution Authority may not modify the provisions of a contract with a Resolution Firm or group company under resolution in connection with the transfer of assets or liabilities to a recipient entity. Section 83 SAG, which empowers the Resolution Authority to restrict the enforcement of security, does not exempt Financial Collateral.[83]

Dispositions of Financial Collateral made after the opening of Insolvency Proceedings are valid (subject to any challenge in insolvency), provided that such dispositions were made on the day of the opening of Insolvency Proceedings and the other party proves that it did not know, nor should have known, of the opening of the Insolvency Proceedings (section 81 para 3 sentence 2 InsO). Financial Collateral further benefits from certain exemptions in respect of insolvency-related set-off and challenge in insolvency (paragraphs 3.2.3(i)(iv) and 3.2.4(b)) and the enforcement of security (paragraph). Further, section 104 para 1 sentence 3 no. 6 InsO expressly refers to Financial Collateral as types of arrangements that are in scope of such section and therefore not

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[83] This is in line with the BRRD which does not provide for such an exemption (Article 69 BRRD) and modifies the FCD so as to provide that the imposition of measures under Title IV, Chapters IV and V BRRD do not fall within the scope of potential impediments to the enforcement of security that member states must remove under the FCD (Article 118 BRRD). Further, pursuant to Article 9a FCD the FCD is generally without prejudice to the BRRD.

subject to the Insolvency Administrator's Selection Right (see the detailed analysis of section 104 InsO below at paragraph 3.2.2(c)(ii)).

(f) Exemptions for Systems

Further specific exemptions from certain mandatory restrictions apply to systems (*Systeme*) as defined under section 1 para 16 KWG ("**Systems**"), i.e. a written agreement within the meaning of Article 2 lit (a) SFD, including an agreement between a participant and an indirectly participating credit institution which has been notified by Deutsche Bundesbank or a competent authority of an EU member state of the EEA to the European Securities and Markets Authority ("**ESMA**"). Systems from third countries are treated similar to the systems referred to in sentence 1 if they largely correspond with the requirements enumerated in Article 2 lit (a) SFD.

Article 2 lit (a) SFD defines "system" as follows:

"'system' shall mean a formal arrangement

- between three or more participants, excluding the system operator of that system, a possible settlement agent, a possible central counterparty, a possible clearing house or a possible indirect participant, with common rules and standardised arrangements for the clearing, whether or not through a central counterparty, or execution of transfer orders between the participants,

- governed by the law of a Member State chosen by the participants; the participants may, however, only choose the law of a Member State in which at least one of them has its head office, and

- designated, without prejudice to other more stringent conditions of general application laid down by national law, as a system and notified to the European Securities and Markets Authority by the Member State whose law is applicable, after that Member State is satisfied as to the adequacy of the rules of the system.

Subject to the conditions in the first subparagraph, a Member State may designate as a system such a formal arrangement whose business

consists of the execution of transfer orders as defined in the second indent of (i) and which to a limited extent executes orders relating to other financial instruments, when that Member State considers that such a designation is warranted on grounds of systemic risk.

A Member State may also on a case-by-case basis designate as a system such a formal arrangement between two participants, without counting a possible settlement agent, a possible central counterparty, a possible clearing house or a possible indirect participant, when that Member State considers that such a designation is warranted on grounds of systemic risk.

An arrangement entered into between interoperable systems shall not constitute a system."

We note that the securities settlement services operated by LCH are included in the list of Designated Payment and Securities Settlement Systems maintained by ESMA.[84] If the list of Systems had constitutive legal effect, a system entered into the list would in our view constitute a System for purposes of German law. The European Commission and the European Central Bank take the view that the list of Designated Payment and Securities Settlement Systems provides legal certainty with respect to the qualification of Systems.[85] Such view would appear to be based on the idea that an entry into the list does have constitutive effect under the laws of the EU member states implementing the SFD. However, there is no statutory provision which expressly provides for a constitutive legal effect of the entry which would result in such legal certainty. Based on the wording of Article 2 lit (a) SFD an entry into the list is one of several requirements that must be met for an arrangement to be treated as a System. The legal effects of the notification and the entry into the list of Designated Payment and Securities Settlement

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84 Available at https://www.esma.europa.eu/sites/default/files/library/designated_payment_and_securities_settlement_systems.pdf

85 Opinion of the European Central Bank of 7 August 2008 on a proposal for a directive amending Directive 98/26/EC and Directive 2002/47/EC (CON/2008/37), OJ No C 216 of 23 August 2008, p. 1 ("**ECB Opinion**"), item 4.2 at p. 3; Report from the European Commission – Evaluation report on the Settlement Finality Directive 98/26/EC (EU 25) of 27 March 2006 (COM(2005) 657 final/2) ("**European Commission Report**"), p. 5.

Systems are therefore not entirely clear. We therefore analyse the clearing services operated by LCH on the basis of the definition under section 1 para 16 KWG.

On the basis of the wording of section 1 para 16 KWG in connection with Article 2 lit (a) SFD, it could be argued that LCH qualifies as a System[86] since the Rulebook consists of standardised terms, is intended to be used with various Relevant Clearing Members and, amongst other things, provides for the clearing through a central counterparty[87] and for the execution of transfer orders of participating Relevant Clearing Members in course of the settlement. The Opinion Documents are, however, not entered into between Relevant Clearing Members but between LCH and each of its Relevant Clearing Members separately.[88] We understand that, based on the ECB Opinion which was published in 2008 and assuming that the European Parliament and the Council were aware of the concerns expressed in the ECB Opinion when making the amendments to the SFD under Directive 2009/44/EC (as quoted above) in 2009, a System within the meaning of the SFD does not necessarily require that all contractual relationships are multilateral agreements but rather that three or more participants are bound by the same formal arrangements, such as the Opinion Documents. While the legislative history indicates that the EU legislator does not necessarily draw a clear distinction between clearing and settlement, the wording of Article 2 lit (a) SFD and legislative materials[89] indicate that Article 2 lit (a) SFD comprises clearing services.

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86 When referring to LCH as "System" we refer to the Rulebook and any other relevant documents as the definition of System under the KWG as well as under the SFD refer to arrangements rather than to the relevant legal entity or organisational setup operating the System.

87 We note, however, that the material provisions of the SFD such as Articles 3 and 5 SFD refer to transfer orders.

88 See also the ECB Opinion, item 4.1 at p. 2 which concludes that "the current definition in the first and second indents of Article 2 (a) does not accurately reflect the way in which a majority of systems are established".

89 The European Commission concludes its evaluation report on the SFD by stating that "... in the area of payment and securities settlement systems, some important changes may be underway which could have an influence on the SFD. The European Commission may propose legal instruments to increase the efficiency and safety of clearing and settlement services...".

To summarise, given that the European Commission and the European Central Bank take the view that the list of Designated Payment and Securities Settlement Systems provides legal certainty, LCH's securities settlement systems should be considered as a System by competent authorities. Given that often no clear distinction is made between payment, settlement and clearing systems, LCH's clearing services should be treated similarly. This view is supported by Article 17 para 4 EMIR as we would construe the reference to the notification as a System pursuant to the SFD as a reference to the clearing function rather than to the settlement or payment function by processing transfer orders. We are not aware of any court decisions and a court may not follow our analysis. With respect to the following analysis we therefore assume that LCH qualifies as a System. If this assumption does not hold true, then the exemptions available to Systems are not applicable.

In Insolvency Proceedings specific conflict of laws provisions apply with respect to rights and obligations of participants in Systems (Article 12 Recast EUIR and section 340 para 3 InsO (paragraph 3.2.3(b)(C)). Within the scope of application of the InsO, exemptions for Systems apply with respect to insolvency related set-off (paragraph 3.2.3(i)(iv)) and the enforcement of security (paragraph 3.2.2(c)(ii)). Such exemptions apply analogously to measures under section 46 para 1 sentence 2 no. 4 to 6 KWG (section 46 para 2 sentence 6 KWG) and to restructuring and reorganisation proceedings (section 23 KredReorgG).

(g) Exemptions for clearing

Where German insolvency laws apply, Article 102b EGInsO might create an exemption with respect to Insolvency Proceedings and Provisional Insolvency Measures. Article 102b EGInsO was introduced into German law to ensure that the implementation of certain measures under Article 48 EMIR are not impaired by the opening of Insolvency Proceedings.

In accordance with Article 102b section 1 para 1 EGInsO the opening of Insolvency Proceedings must not impair (1) the performance of the necessary measures (*gebotene Maßnahmen*) to administer, close out or otherwise settle client positions and own account positions of a clearing member in accordance with Article 48 paras 2, 3, 5 sentence 3 and para 6 sentence 3 EMIR, (2) the necessary transfer of client positions in

accordance with Article 48 paras 4 to 6 EMIR and (3) the necessary utilisation and disbursement of clients' collateral in accordance with Article 48 para 7 EMIR where such measures have been taken in accordance with Article 48 EMIR. Furthermore, Article 102b section 2 EGInsO provides that the measures referred to in section 1 of Article 102b EGInsO are not subject to insolvency challenge (see paragraph 3.2.4(b) below). Article 102b EGInsO also applies to Provisional Insolvency Measures.

Based on its wording and on the legislative reasoning according to which Article 102b EGInsO is intended to ensure the validity of certain measures a CCP takes upon the default of one of its clearing members in order to mitigate such default[90], we construe Article 102b EGInsO as a provision of substantive law rather than as a conflict of laws provision.[91] Therefore, Article 102b EGInsO only applies if German insolvency law applies. Article 102b EGInsO is an insolvency law provision and does therefore not address any property or contractual law aspects in connection with Article 48 EMIR and any necessary measures thereunder.

Article 48 EMIR largely addresses the relationship between a CCP and its clearing members. Systematically, Article 48 EMIR is a risk management provision and pursues for the main part regulatory goals. Some of the measures upon a default of a clearing member also serve the interests of clearing clients but this will not necessarily result in a legal relationship between a CCP and a relevant clearing client. Rather, the clearing client's interests are protected by Article 39 EMIR by requiring the segregation of assets and positions. It is therefore not entirely clear whether Article 102b EGInsO was also intended to govern the relationship between a clearing member and its clearing clients and with a view to also protecting the positions of a clearing client from the application of mandatory insolvency laws, if such mandatory insolvency laws limit the enforceability of necessary measures instituted under the relevant clearing conditions or clearing rules. This question is a matter to be determined under German law, as the reference in Article 102b EGInsO to Article 48 EMIR does not result in Article 102b EGInsO

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90 BT-Drucksache 17/11289, p. 28.

91 See also *Holzer*, DB 2013, 444, 445.

becoming a provision of EU law and the question at hand is not a question of the interpretation of Article 48 EMIR.

The wording of Article 102b section 1 para 1 no. 1 EGInsO refers to the performance of the necessary measures to administer, close out or otherwise settle client positions and own account positions of a clearing member. In Article 102b section 1 para 1 nos. 2 and 3 EGInsO the necessary transfer of clients' positions and the necessary utilisation and disbursement of clients' collateral is addressed. In those cases where it is not entirely clear whether the relationship between clearing member and clearing client is directly addressed or whether this is a mere function of the "clearing cascade", the reference to "necessary measures to administer, close out or otherwise settle client positions and own account positions of a clearing member" is in our view intended to ensure that both relationships in the clearing cascade, CCP with clearing member and clearing member with clearing client, are covered. A different treatment of those relationships producing different results would in our view not be in line with the intention and purpose of Article 102b EGInsO.

In the following, we therefore take the view that all necessary measures of a CCP under Article 102b section 1 para 1 nos. 1 and 2 EGInsO and the utilisation and disbursement of clients' collateral under Article 102b section 1 para 1 no. 3 EGInsO are not impaired by the opening of Insolvency Proceedings. Whether the term "necessary" is intended to restrict the application of Article 102b EGInsO or whether it lacks substantial meaning is unclear. The legal reasoning qualifies "necessary measures" by a reference to "regulatory necessary measures" which in our view should cover all measures which have been approved by the relevant competent authority when assessing compliance of the Rulebook with Article 48 EMIR pursuant to Article 14 EMIR.[92] As a result, the provisions of the Opinion Documents prevail over mandatory provisions under the InsO, however, only to the extent the measures under the Opinion Documents correspond to the measures referred to under Article 48 EMIR and Article 102b EGInsO or implement such measures provided that these measures are necessary within the meaning

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[92] See BR-Drucksache 606/12, p. 42. Please also see *Scholl*, in: Wilhelmi/Achtelik/Kunschke/Sigmundt, Handbuch EMIR, 2016, p. 378.

of Article 102b section 1 para 1 EGInsO. We cannot exclude that discretion exercised in selecting one of various available individual measures or the actual implementation of an available measure has an impact on the analysis, in particular whether or not such measure would still be regarded as "necessary".

In our view, the exemptions implemented by Article 102b EGInsO go beyond the generally applicable exemptions for Financial Collateral and Systems.[93] Where we discuss in the following the effects of Insolvency Proceedings we will refer to Article 102b EGInsO.

Please note that our interpretation of Article 102b EGInsO has not been confirmed by any court decisions and we cannot exclude that our understanding of Article 102b EGInsO would be treated differently in any court decisions.

(h) Proceedings covered by Rule 3 of the Default Rules

Rule 3 of the Default Rules provides that LCH may take steps as defined in Rule 6 of the Default Rules (among others, terminating all or part of the relevant Contracts) "... in the event of a Relevant Clearing Member appearing to the Clearing House to be unable, or to be likely to become unable, to meet its obligations in respect of one or more Contracts." While this provision is governed by English law under which its preconditions (for example the term "likely") and effects have to be construed (on which we do not opine), it appears that any steps may already be taken by LCH at an early stage, i.e. in the case of a likely payment default as regards one single Contract.

In any event, we understand that Rule 3 of the Default Rules generally enables LCH to take steps prior to the opening of Insolvency Proceedings. If applicable, upon the opening of Insolvency Proceedings, section 104 InsO provides for a mandatory automatic early termination of those Contracts which fall within the scope of section 104 InsO. If the relevant date for early termination falls after the opening of Insolvency Proceedings the provisions of section 104 InsO would prevail and govern the close-out netting of those Contracts which fall within its scope (see paragraph 3.2.3(c)) unless Article 102b EGInsO were

[93] See further *Bornemann*, in: Graf -Schlicker, InsO, 4th ed. (2014), § 104 InsO no. 52.

applicable. Please also refer to paragraph 3.2.3(c)(i) below whether there is a risk of any "cherry-picking right" being exercised.

LCH's right to take steps under Rule 3 of the Default Rules covers situations of financial difficulties of a Relevant Clearing Member at a very early stage, and therefore could generally arise in situations already preceding the actual opening of Insolvency Proceedings, Provisional Insolvency Measures or Regulatory Proceedings under the laws of Germany. Subject to the interpretation of the Default Rules under English law, we cannot exclude that Regulatory Proceedings may be taken for reasons that do not (yet) affect the Relevant Clearing Member's ability to meet its obligations under a Contract (which would enable LCH to take steps in accordance with Rule 3 of the Default Rules). However, a general termination event preceding a situation in which a Clearing Member "... is likely to become unable, to meet its obligations in respect of one or more Contracts ..." may be difficult to define and prove.

The opening of Regulatory Proceedings themselves would also be covered by Rule 5(e) of the Default Rules: " ... a Regulatory Body takes or threatens to take action against or in respect of the Clearing Member under any statutory provision or process of law ..." as we would construe that provision (which is, however, a matter of English law, on which we do not opine).

However, the restriction pursuant to section 13 KreditReorgG may already apply prior to the BaFin as "Regulatory Body" taking any upon the initiation of reorganisation proceedings within the meaning of section 7 KredReorgG by the Credit Institution itself and would, therefore apply to a termination covered by Rule 5(e) of the Default Rules, but only if a court considered the provision applicable on a termination pursuant to the Default Rules under conflict of law aspects (see paragraph 3.2.1(d)(v)). Whether or not the relevant Resolution Authority qualifies as "Regulatory Body" is a matter of interpretation of the Rulebook which is governed by English law and on which we do not opine. We can also not exclude that measures under the SAG will be initiated before Rule 5(e) of the Default Rule is triggered.

3.2.2 *Would the Deed of Charge be effective in the context of Insolvency Proceedings or Reorganisation Measures in respect of a Relevant Clearing Member? Is there anything that would prevent LCH from enforcing its rights under the Deed of Charge? Would LCH be required to take any particular steps or abide by any particular procedures for the purposes of enforcing against Collateral provided to it by a Relevant Clearing Member under the Deed of Charge?*

We understand that under the Deed of Charge collateral is provided by the Relevant Clearing Member in favour of LCH in order to secure all obligations of that Relevant Clearing Member arising under and in connection with the Clearing Membership Agreement and the Clearing House's Rulebook. Collateral consists of securities and rights relating thereto and held by the Relevant Clearing Member with LCH as custodian in designated securities accounts. We understand that these accounts are established in England and the relevant account relationship is governed by English law. These accounts are subject to a security interest in favour of LCH under the Deed of Charge.

The Deed of Charge provides that all cash forming part of the collateral shall be paid to and retained by LCH in a cash account and any such monies which may be received by the Relevant Clearing Member shall pending such payment be held in trust for LCH. We further understand that the Deed of Charge does not permit LCH as the secured party to dispose of any of the Charged Property prior to a Default (as defined in the Deed of Charge) and that LCH does not become unrestricted title holder in the Charged Property. LCH does not acquire a right of reuse or comparable rights with respect to the Charged Property.

We first describe in the following paragraphs relevant German conflict of laws provisions and then analyse the application of these provisions to the security to be provided by Clearing Members to LCH under the Deed of Charge thereby mentioning steps to be taken by LCH to realise collateral.

(a) Security under German conflict of laws provisions

Under German law, a distinction has to be drawn between the contractual obligation to create security and the creation of the security itself. The obligation to provide security and the choice of English law to govern such obligation is recognised by the German courts under Article 3 para 1 Rome I. This holds true for the general obligation to enter into a Deed of Charge under LCH's Rulebook as a precondition for

becoming a Clearing Member but also for the contractual obligations under the Deed of Charge which do not have an *in rem* aspect.

The law applicable to the creation of the security interest itself (i.e. the property law or *in rem* aspect of the Deed of Charge) needs to be determined on the basis of applicable German conflict of laws principles and would, amongst other things, depend on the nature of the relevant collateral asset, its location and the rights the security provider gives to the secured party in respect of the relevant collateral asset. From a German law perspective, the law governing the creation of the relevant security interest also determines the rights of the secured party under such security interest. In respect of the security interest itself and depending on the type of security interest it should be noted that different legal and factual requirements must be fulfilled to ensure the validity of such security interest and, as a separate matter, its enforceability and the possibilities to enforce it.

(b) Conflict of laws provisions governing creation of a security

(i) Security over cash

Any cash forming part of the Charged Property as defined in the Deed of Charge must be paid by the Relevant Clearing Member to LCH. LCH will hold that cash in an account maintained in England and opened in its own name.

Cash credited to an account is represented by the payment claim of the relevant account holder against the entity maintaining the account, such as a bank or a custodian. Therefore, under German law, a security interest over cash credited to an account is established by creating a security interest in the relevant payment claim of the account holder against the relevant account bank. However, where the account is held in the name of the secured party, any transfers of cash made into such account *prima facie* constitute assets of the secured party and no security interest needs to be created over such account. In other words, where the cash is transferred to an account opened in the name of the secured party it is treated as an "outright title transfer" arrangement (*Vollrechtsübertragung*), rather than as a security interest (*Sicherheit* or *beschränkt dingliches Recht*). Where the cash is booked in an account held in the name of the security

provider, a security interest over such account needs to be created.[94]

(ii) Security over contractual claims

Article 14 Rome I contains the relevant conflict of laws provisions for security over contractual claims. Article 14 para 1 Rome I provides that the relationship between assignor and assignee is governed by the law that applies to the contract between the assignor and assignee under Rome I, i.e. the parties may choose the governing law under Article 3 para 1 Rome I. Recital 38 of Rome I clarifies that this also covers the property aspects of the assignment in countries such as Germany where these aspects are legally separate from the law of obligations. The same applies in respect of pledgor and pledgee in case a claim is pledged (Article 14 para 3 Rome I). The law governing the pledged claim is relevant for determining whether the claim can be pledged, the relationship between the pledgee and the pledgor, the conditions under which the pledge can be invoked against the pledgor and whether the pledgor's obligations have been discharged (Article 14 para 2 Rome I).

In principle, if cash collateral is not provided by way of an outright title transfer, depending on the parties' agreement, different types of security interests over cash held in an account

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[94] Where an account is held in the name of the account holder but for the account of another person, for example a fiduciary account (*Treuhandkonto*), the secured party should verify whether the account holder may dispose of such account and validly create a security interest over such account and, as the case may be, the relevant beneficiary under such account has approved the creation of the security interest. If the secured party is aware that the account is a fiduciary account (*offenes Treuhandkonto*), the secured party cannot in good faith acquire a security interest in the beneficiary's assets booked into the account. If the secured party is not aware that the account is a fiduciary account (*verdecktes Treuhandkonto*), the secured party can acquire a security interest in the account. However, when a secured party later becomes aware the relevant account is a fiduciary account, it must not enforce a security interest acquired in such account or exercise any set-off rights (BGH WM 1990, 1954, 1955; BGH WM 1996, 249, 251; *Hadding/Häuser*, in: Schimansky/Bunte/Lwowski, Bankrechts-Handbuch, 5th ed. (2017), § 37 no. 43 *et seq.*). This means that even if a security interest has been validly created over a fiduciary account because it was created without the awareness of the secured party, this can subsequently be frustrated by making a person that has taken such security subsequently aware of the fiduciary nature of the account.

can be created under German law, such as a pledge (*Pfandrecht*) or an assignment for security purposes (*Sicherungsabtretung*) (please refer to paragraph 3.2.2(c)(i) as to mandatory rules on the enforcement of security in Insolvency Proceedings as defined in paragraph 3.2.1(a)). As mentioned above, transfer or payment of cash by the security provider to an account of the secured party should neither qualify as a pledge nor as an assignment for security purposes but as an "outright title transfer" in the cash.

(iii) Security over securities

Under German conflict of laws provisions, the validity of the transfer of title to securities is generally determined by the laws of the jurisdiction in which the securities are located (*lex cartae sitae*) in accordance with Article 43 EGBGB (*Wertpapiersachstatut*).[95] The following principles apply in respect of the *in rem* title to any physical certificate of a security. The rights represented by the securities (*Wertpapierrechtsstatut*) (e.g. the acquisition of voting, dividend or interest rights) are determined by the laws governing such right, for example in relation to shares the jurisdiction in which the issuer is located or established and in relation to bonds the jurisdiction the issuer has chosen to govern the bonds.

Subject to the rules on collectively held securities set out below, if the law governing the transfer of title to the securities provides that the transfer of title in the securities requires the delivery of a certificate (such as bearer securities under German law, *Inhaberpapiere*), the transfer of title to such securities is governed by the laws of the jurisdiction in which the certificate is physically located.[96]

In respect of negotiable registered securities (*Orderpapiere*), on the other hand, the analysis under German conflict of laws is

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[95] *Welter*, in: Schimansky/Bunte/Lwowski, Bankrechts-Handbuch, 5th ed. (2017), § 26 no. 172 *et seq.*; *Wendehorst*, in: Münchener Kommentar BGB, 7th ed. (2018), Article 43 EGBGB no. 194 *et seq.*; *Mansel*, in: Staudinger BGB, Neubearbeitung 2015, Anhang zu Article 43 EGBGB no. 29.

[96] *Wendehorst*, in: Münchener Kommentar BGB, 7th ed. (2018), Article 43 EGBGB no. 197.

different.[97] The law governing the rights represented by the securities (*Wertpapierrechtsstatut*) determines whether the transfer of the title to the negotiable registered securities requires an endorsement, delivery of the certificate or both. If negotiable registered securities bear a blank endorsement (*Blankoindossament*) and the law which governs the securities provides that the transfer of title to the securities may be transferred by delivery of the certificate, the transfer of title to such negotiable registered securities is governed by the laws of the jurisdiction in which the certificates are physically located on completion of delivery.

If an instrument under its governing law qualifies as a claim transferable by assignment rather than as a bearer instrument or negotiable registered security (for example, *Schuldschein* loans or non-negotiable registered bonds governed by German law (*Namensschuldverschreibungen*)), the instrument may only be transferred by assignment of such claim.

Section 17a German Safe Custody Act (*Depotgesetz*, "**DepotG**")[98] does not follow the *lex rei (cartae) sitae* rule. In respect of "collectively held securities" which are transferable by booking into an account with constitutive legal effect for the benefit of the transferee, section 17a DepotG provides that the law governing the disposition of such securities (*Verfügung*, e.g. the transfer of title or creation of a security interest) is determined by reference to the location of the principal or branch

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97 *Wendehorst*, in: Münchener Kommentar BGB, 7th ed. (2018), Article 43 EGBGB no. 198 *et seq.*

98 Section 17a DepotG has been enacted, among other things, to implement Article 9 para 2 SFD and provides that dispositions of securities or interests in securities held in collective safe custody, which are, with constitutive legal effect, entered into a register or booked in an account are governed by the laws of the country under whose supervision the register is kept in which such entry with constitutive legal effect is made directly *vis-à-vis* the person affected by the disposition (*Verfügungsempfänger*) or in which the main or branch office of the custodian which maintains the account and makes the account entry with constitutive legal effect *vis-à-vis* the person affected by the disposition is located. Securities are defined in section 1 para 1 DepotG to comprise shares, mining shares (*Kuxe*), interim certificates, interest, dividend and renewal coupons, bearer bonds or bonds transferable by endorsement as well as other securities provided that they are fungible (*vertretbar*). Non-negotiable registered bonds (*Namensschuldverschreibungen*) are also covered if they were issued to the name of a central securities depository. See *Dittrich*, in: Scherer, DepotG (2012), § 17a no. 36, proposing a wide interpretation of scope of application of section 17a DepotG in light of the European Directives on which section 17a DepotG was based.

office of the custodian bank (or, as the case may be, the central securities depository) making the account entry which directly results in the transfer of the *in rem* right to the transferee (*unmittelbar zugunsten des Verfügungsempfängers*). "Collectively held securities" are (i) securities which are kept in collective safe custody (*Sammelverwahrung*) by a central securities depository, (ii) securities represented by a global certificate, or (iii) securities represented by a book entry for the benefit of a central securities depository (for example, certain German government bonds).

With respect to "dematerialised securities" which are transferable by book entry in a register with constitutive legal effect for the benefit of the transferee (*Buch-* or *Wertrechte*), section 17a DepotG provides that the law governing the transfer of such securities is determined by reference to the jurisdiction of the country under whose supervision the register is maintained making the account entry which directly results in the transfer of the *in rem* right to of the transferee. However, to date, certain questions relating to section 17a DepotG remain unresolved, and no court decisions exist in respect of the interpretation of such rule, in particular with respect to the meaning of "constitutive legal effect".[99] In particular, section 17a DepotG is only a conflict of laws provision and does not override any issues resulting from different national laws regarding the questions which instruments qualify as "securities" and which steps need to be taken to validly dispose of securities.

(iv) Outright title transfers

In our view, an outright title transfer to collateralise obligations can be validly made under German law. Parties are entitled to agree expressly that the secured party shall become the unrestricted title holder in respect of assets which are transferred serving as collateral. Such an outright title transfer arrangement

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[99] See also *Einsele*, WM 2001, 2415, 2421 *et seq.*; *Reuschle*, RabelsZ 68 (2004), 687, 720; *Dittrich*, in: Scherer, DepotG (2012), § 17a, no. 51 *et seq.*

does in our view not violate general principles of property laws. Furthermore, the concept of outright title transfers in order to collateralise obligations has been established under German law in section 1 para 17 KWG which refers to outright title transfers[100] as one form of Financial Collateral.[101] While there are no German court decisions confirming the validity of an outright title transfer to collateralise an obligation, we take the view that an outright title transfer is valid under German law. In particular, in our view, an agreement on an outright title transfer to collateralise an obligation should not be regarded as a loan agreement, as in case of such an outright title transfer agreement the secured party is not obliged to return the collateral assets following a default of the security provider. Such agreement does therefore not provide for an obligation which is characteristic (*vertragstypische Leistungspflicht*) of a loan agreement, such as the repayment of the loan amount upon maturity.

(v) Recharacterisation

The BGB uses the term "recharacterisation" (*Umdeutung*) only in the context of the recharacterisation of a void legal transaction (*Rechtsgeschäft*) into another type of legal transaction, if the requirements for such other type of legal transaction are met and the entry into such other legal transaction reflects the intentions of the parties (section 140 BGB). However, where a transaction is valid, where German law applies, German courts seek to give effect to the true economic intentions of the parties as a matter of interpretation (*Auslegung*). As a result, under German law, a German court may construe a purported outright title transfer as a security interest e.g. in the form of a pledge or a security assignment, if it finds that a pledge or security assignment

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[100] The FCD uses the term "title transfer financial collateral arrangement". Pursuant to Article 1 lit (b) FCD "title transfer financial collateral arrangement" means an arrangement, including repurchase agreements, under which a collateral provider transfers full ownership of, or full entitlement to, financial collateral to a collateral taker for the purpose of securing or otherwise covering the performance of relevant financial obligations.

[101] *Bliesener*, in: Lwowski/Fischer/Langenbucher, Das Recht der Kreditsicherung, 9th ed. (2011), § 17 no. 4; *Behrends*, in: Zerey, Finanzderivate, 4th ed. (2016), § 6 no. 65 *et seqq.*

reflects the true economic intentions of the parties. If German law applies, German courts therefore generally recognise the validity of the agreement between the parties unless they find that the form of security as agreed does not reflect the true economic intentions of the parties.

(vi) Renvoi

Under Article 20 Rome I, the application of the law of any country specified by Rome I generally means the application of the rules of law in force in that country other than its rules of conflict of laws (exclusion of *renvoi*).

Conversely, where the EGBGB applies, Article 4 para 1 sentence 1 EGBGB provides that any references of German law to the laws of another jurisdiction include the conflict of laws provisions of the other jurisdiction. If these conflict of laws provisions refer back to German law, German courts will accept such reference (*renvoi*) and apply German substantive law (Article 4 para 1 sentence 2 EGBGB). It is unclear whether the general rule of Article 4 para 1 EGBGB also applies to the more specific conflict of laws provision stipulated by section 17a DepotG or section 340 InsO.

To summarise, as matter of contract law, the choice of English law concerning the obligation to create security under the Opinion Documents will generally be recognised by the German courts.

Further, the choice of English law to govern the Deed of Charge is also generally recognised by the German courts if the Deed of Charge is granted over claims governed by English law and securities held in safe custody with LCH in England.

As German conflict of laws provisions refer to English law with respect to the creation of a security interest, no filing or registration requirements apply under German law in addition to any English law requirements to ensure that German law recognises the validity of the security interest as the recognition of the English law as the law governing the security interest will also extend to any filing or registration requirements. Further, there are no filing or registration requirements under German law which are merely based on the status of

the Relevant Clearing Member having its place of establishment, incorporation or registration Germany.

(c) Enforcement of collateral in Insolvency Proceedings

While as a general matter, collateral can be enforced in accordance with its contractual terms and with the provisions of the relevant laws governing creation of the security (which may prevail over the contractual terms), mandatory restrictions which may affect the enforceability of security upon the opening of Insolvency Proceedings have to be observed.

(i) Rights to segregation and to separate satisfaction

LCH as creditor of a Relevant Clearing Member is entitled to enforce its rights in case of Insolvency Proceedings being commenced if it has a right to segregation (*Aussonderungsrecht*) from the insolvency estate with respect to an asset or if it has a right for separate satisfaction (*Absonderungsrecht*) within Insolvency Proceedings. If a security interest was validly created under a jurisdiction other than Germany and such security interest allows for segregation under German insolvency laws, it could be enforced without being affected by the opening of Insolvency Proceedings. If such security interest allowed for separate satisfaction, LCH as secured party may benefit from preferential treatment within Insolvency Proceedings but if such security interest further constituted Financial Collateral or secured claims under a System, the situation would even be comparable to a right to segregation.

We are not aware of any court decisions which provide guidance as to how German courts would determine whether and under which circumstances rights created under foreign law such as an English law charge would grant a right to segregation under section 47 InsO. Section 47 InsO not only refers to rights *in rem* but also to contractual claims that can give rise to a segregation right. However, the BGH held that in general only "absolute" rights *in rem* which can be asserted against any third party would

be covered by section 47 InsO.[102] Only in exceptional cases would contractual claims entitle the creditor to a right of segregation. In any event, a creditor secured under an outright title transfer arrangement is entitled to a right of segregation if the title in the relevant collateral asset has been validly acquired and is not re-characterised.

It is disputed in German legal literature which law applies when determining the effects of Insolvency Proceedings on security over assets located outside Germany (i.e. to determine whether such secured party would be entitled to a right to segregation).

Article 8 Recast EUIR refers to assets which are situated within the territory of another EU member state at the time of the opening of insolvency proceedings and thereby refers to the territory of the EU member state which is not the EU member state in which the insolvency proceedings have been opened. Section 351 para 1 InsO provides that in the event a creditor has a right to segregation under German law for assets that are located in Germany at the opening of foreign insolvency proceedings, such segregation right will not be affected. Section 351 InsO nor any other provision under German insolvency law does, however, address the reverse scenario, i.e. that (German) Insolvency Proceedings are opened but third party rights exist with respect to non-German assets.

Generally, it is determined pursuant to the *lex fori concursus* (i.e. German insolvency law) which assets form part of the insolvency estate. As a consequence, certain legal commentators take the view that the *lex fori concursus* would also determine the question which consequences a certain right *in rem* would have in Insolvency Proceedings, e.g. whether it would entitle a third party to claim segregation of certain assets from the insolvency estate.[103] Other authors take the view that this should

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[102] BGH VIZ 2004, 196, 197 *et seq.*

[103] *Kindler*, in: Kindler/Nachmann: Handbuch Insolvenzrecht in Europa (2014), § 4 no. 51; *Ehret*, in: Braun, InsO, 7th ed. (2017), § 351 no. 1.

be subject to the *lex causae* (contract law) or *lex rei sitae* (property law), depending on the nature of the relevant asset.[104] If a court followed this view it would have to apply the *lex causae* or *lex rei sitae* either of the Deed of Charge or of the relevant security interest. As the *lex causae* or *lex rei sitae* on the one side and the respective national insolvency laws on the other side could possibly lead to different results a court would have to decide on this query. A third group of legal commentators is of the view that the *lex fori concursus* and the *lex causae* should be combined so that with respect to an asset that is located in a country other than Germany, German insolvency law should be applicable but only to the extent that it does not restrict the creditor's right in a more restrictive way than it would be restricted by the insolvency law identified by way of the process according to the first view.[105]

We take the view that the treatment of assets located outside Germany upon the opening of Insolvency Proceedings should be determined in accordance with the rules of the InsO but the characterisation of any rights in relation to such assets should be determined in accordance with the governing law of these rights. A court would therefore have to determine, on the basis of the specific characteristics of the relevant security interest under its governing law (as determined under German conflict of laws principles), whether for purposes of the InsO a security interest benefits from preferential treatment in the form of segregation or preferred satisfaction or whether it would rank *pari passu* with all other unsecured creditors as its specific characteristics were not comparable to a security interest benefiting from preferential treatment in the form of segregation or preferred satisfaction.

(ii) Enforcement of rights to separate satisfaction

Where a security interest provides the secured party with a right to separate satisfaction rather than with a right for segregation, a

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[104] *Kolmann/Keller*, in: Gottwald, Insolvenzrechts-Handbuch, 5th ed. (2015), § 133 no. 25 *et seq.*; *Geimer*, Internationales Zivilprozessrecht, 7th ed. (2014), no. 3553.

[105] See *Reinhart*, in: Münchener Kommentar InsO, 3rd ed. (2014), § 335 InsO no. 58 for an overview.

distinction generally has to be drawn between such security interests which may be enforced by the secured party and security interests which are enforced by the Insolvency Administrator. Where section 166 paras 1 and 2 InsO applies, a security interest would be enforced by the Insolvency Administrator (e.g. in respect of movable goods in the possession of the Insolvency Administrator[106] or claims assigned for security purposes). Section 166 para 1 InsO applies to security interests over moveables where the Insolvency Administrator has possession. The Insolvency Administrator would in such case be obliged to transfer any proceeds realised after deduction of a lump sum fee for the determination of the existence of the security interest amounting to 4 per cent (*Feststellungskosten*) plus up to 5 per cent (in certain cases even more than 5 per cent) for any cost incurred in the context of the realisation of the security interest (*Verwertungskosten*) (plus applicable VAT on the proceeds of realisation to the creditor).

A secured party entitled to separate satisfaction may in any event realise security interests which collateralise claims under a System as well as security interests which qualify as Financial Collateral itself even within Insolvency Proceedings (section 166 para 3 nos. 1 and 3 InsO). If the preconditions for these exemptions are met, they apply irrespective of the specific type of the foreign security interest. Please refer to paragraph 3.2.1(f) with respect to the exemptions relating to Systems and with respect to Financial Collateral please refer to paragraph 3.2.1(e). Furthermore, a secured party may enforce (German law) pledges over contractual claims itself (section 173 para 1 InsO).

As a result, in our view, the enforcement of the security interest granted under the Deed of Charge would be subject to restrictions under the InsO applicable to the realisation of collateral. Whether the security interest could be seen as a right to segregation (*Aussonderungsrecht*) from the insolvency estate with respect to an asset or a right for separate

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[106] The BGH has ruled that the Insolvency Administrator does not have possession within the meaning of section 166 para 1 InsO in respect of pledged shares held in collective safe custody by a central securities depository where the debtor can no longer exercise membership rights due to the transfer of such rights to a trustee (BGH ZIP 2015, 2286).

satisfaction (*Absonderungsrecht*) would be determined in accordance with the law governing the security interest.

However, if LCH qualifies as a System, the effects of Insolvency Proceedings on the rights and obligations of participants in a System within the meaning of section 1 para 16 KWG would be governed by the laws of the state which applies to that System rather than being subject to the provisions of the InsO, please see as to the effects and scope of application of section 340 para 3 InsO; paragraph 3.2.3(b)(C).

3.2.3 *Would LCH have the right to take the actions provided for the Default Rules (including exercising rights to deal with Contracts under Rule 6 and rights of set-off under Rule 8 but not at this stage considering those actions specifically provided for in the Client Clearing Annex to the Default Rules) in the event that a Relevant Clearing Member was subject to Insolvency Proceedings or Reorganisation Measures? Is it necessary or recommended that LCH should specify that certain Insolvency Proceedings and/or Reorganisation Measures will constitute an Automatic Early Termination Event in accordance with Rule 3 of the Default Rules?*

To answer this question, we first summarise our understanding of the actions provided in Rules 3, 5, 6 and 8 of the Default Rules followed by an analysis of the respective restrictions on such actions in Insolvency Proceedings.

Pursuant to Rule 3 of the Default Rules, any steps taken under Rule 6 shall serve the purpose (i) to discharge all the Clearing Member's rights and liabilities under or in respect of all Contracts to which it is party or upon which it is or may be liable and (ii) to complete the process set out in Rule 8. Accordingly, Rule 6 entitles LCH to terminate Contracts entered into with the Relevant Clearing Member, and we understand that Contracts which are dealt with in Rule 6 may or may not be automatically terminated in accordance with Rule 5 of the Default Rules (stipulating certain events which give LCH the right to take the actions as contemplated by Rule 6). Furthermore, under Rule 6 LCH may also take other steps, including incurring new and additional obligations of such defaulting Relevant Clearing Member for the purpose of settling or liquidating any open Contracts (for example by way of entering into opposite Contracts or by exercising any options on behalf of the defaulting Relevant Clearing Member). Rule 6 also enables LCH to realise security granted to LCH by the defaulting Relevant Clearing Member.

In a second step, Rule 8 as we understand, provides for a process to be completed by LCH to determine net amounts remaining payable between LCH and the defaulting Relevant Clearing Member, i.e. LCH is permitted to aggregate, i.e. set off any sums payable by and to a defaulting Relevant Clearing Member with respect to each "kind of account" (as such term is defined in Rule 11 (b) of the Default Rules, i.e. each separated client account and the Relevant Clearing Member's own account) including any cash collateral.

In our view, the termination rights under Rules 3 and 6, the automatic termination under Rule 5 and the set-off under Rule 8 constitute close-out netting provisions (in this context together the "**Netting Provisions**") and therefore, where we refer in the following to the German law treatment of netting, our reasoning is applicable to these provisions. Contractual close-out netting provisions provide for a method of reducing the parties' exposure by terminating outstanding transactions, calculating their values and determining compensation payments for all outstanding transactions that are subsequently netted against each other. Accordingly, they are subject to both the laws applicable to early termination and to set-off.

Where the event of default is not related to the insolvency of the Defaulter[107], the conflict of laws analysis given under paragraph 3.1.5(a) would apply both in respect of the agreement on a deemed or specified liquidation and the calculation of the liquidation amount. Pursuant to Article 12 para 1 lit (d) Rome I, the law applicable to a contract by virtue of Rome I shall govern, amongst other things, the various ways of extinguishing obligations. Agreements on termination rights are therefore covered by the parties' rights to choose the law governing the Rulebook (above, paragraph 3.1.5(a)). The contractual validity under contract law of the right of LCH to declare Contracts to be terminated, would therefore be a matter of the laws of England.

Article 17 Rome I provides that where the right to set-off is not agreed by the parties, set-off shall be governed by the law applicable to the claim against which the right to set-off is asserted. Given the clear wording of Article 17 Rome I, any contractual agreements relating to set-off of netting of obligations are outside the scope of Article 17 Rome I and the parties may therefore agree

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[107] A non-insolvency related termination event is a termination event that is based on a the occurrence of a situation which bears no specific relation to any reason for the opening of Insolvency Proceedings, but relates, for example, to the counterparty's default or other types of breach of contract (BGH WM 2013, 274).

on set-off or netting agreements such as the Netting Provisions in accordance with Article 3 para 1 Rome I. The validity under contract law of the agreement on the set-off of all the reciprocal payment obligations of the Defaulter and LCH, so that these payment obligations will be deemed satisfied, in whole or in part, to the extent of the set-off would thus have to be assessed in accordance with the laws of England.

The question whether the Netting Provisions are enforceable following an insolvency-related event of default[108] raises several legal issues.

(a) Conflict of laws provisions as regards netting and set-off under the Recast EUIR

With respect to netting under German international insolvency law within the scope of the Recast EUIR the following applies:

(A) Scope of the *lex fori concursus* rule (Article 7 Recast EUIR)

When applicable, Article 7 Recast EUIR provides that the law applicable to insolvency proceedings and their effects shall be the law of the EU member state in which the proceedings are opened. Insolvency proceedings are opened in the jurisdiction where the centre of main interests of the Insolvent Party is located except where there is another, more specific, provision within the Recast EUIR itself – subject to any secondary proceedings. Secondary proceedings are governed by the law of the EU member state (other than Denmark) in which they are opened (Articles 3 para 2, 35 Recast EUIR).

Cases where rights may be immunised from the effects of insolvency law are, for example, "*rights in rem*" over assets outside the jurisdiction where the insolvency proceedings are conducted (Article 8 Recast EUIR) and

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[108] An insolvency related termination event means a termination event which is linked to a cessation of payments, the opening of Insolvency Proceedings or the filing of an application for the opening of Insolvency Proceedings (BGH WM 2013, 274).

rights of set-off permitted by the law applicable to the insolvent debtor's claim (Article 9 Recast EUIR).

(B) Conflict of laws rule regarding insolvency set-off

Under the Recast EUIR set-off is permitted in each of the two following situations:

(1) if it is permitted under the insolvency laws[109] of the jurisdiction in which insolvency proceedings have been opened in relation to the insolvent debtor (Article 7 para 2 lit (d) Recast EUIR) or

(2) if it is permitted by the law applicable to the insolvent debtor's claim (Article 9 para 1 Recast EUIR).

Article 9 para 1 Recast EUIR establishes an insolvency conflict of laws rule regarding insolvency set-off as an exception to the lex fori concursus rule as set forth by Article 7 para 1 Recast EUIR. In relation to (1), the laws of Germany would be applicable in the case of Insolvency Proceedings being opened by a court in Germany.[110] In relation to the situation mentioned under (2), set-off will be allowed if it is permitted under the laws governing the Rulebook and the relevant Contracts.

In our view, close-out netting arrangements do not fall within the scope of application of Article 9 para 1 Recast EUIR. The wording of Article 9 para 1 Recast EUIR

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[109] According to many legal commentators in Germany (*Reinhart,* in: Münchener Kommentar InsO, 3rd ed. (2016), Article 4 EuInsVO no. 3; *Haß/Herweg,* in: Haß et al., EU-Insolvenzverordnung (2005), Article 4 EuInsVO no. 32) of the EUIR (and, hence, also the Recast EUIR) only concerns set-off restrictions that stem from the insolvency law of the jurisdiction in which insolvency proceedings have been opened. The scope of the *lex fori concursus* thus would be limited to such laws. The general legal requirements relating to set-off (e.g. in Germany sections 387 *et seq.* BGB), however, are determined according to the generally applicable conflict of law rules.

[110] This includes insolvency law, e.g. in Germany sections 94 *et seq.* InsO (*Kindler*, in: Münchener Kommentar BGB, 7th ed. (2018), § 340 InsO no. 8; *Gruber*, in: Haß *et al.*, EU-Insolvenzverordnung (2005), Article 6 EuInsVO no. 9; *Reinhart,* in: Münchener Kommentar InsO, 3rd ed. (2016), Article 6 EuInsVO no. 9).

supports this interpretation as the term "set-off" only covers one element of close-out netting but does not refer to other integral parts such as the early termination (closing-out) of transactions or the valuation and conversion of the terminated transactions into claims which are eligible for set-off. While it has been argued with respect to Article 6 para 1 EUIR (which corresponds to Article 9 para 1 Recast EUIR) that this provision should be construed broadly to include close-out netting arrangements to enable financial market participants to choose the insolvency law applicable to close-out netting,[111] Recital 71 Recast EUIR in connection with Article 12 Recast EUIR clarify that the European legislator distinguishes between set-off and netting agreements and that the later shall only be exempted from the *lex fori concursus* rule of Article 7 para 1 Recast EUIR if agreed in the context of a payment or securities settlement system. Moreover, the European legislator uses the terms set-off and netting agreements differently in other relevant European legal acts as well.[112] Therefore, we take the view that Article 9 para 1 Recast EUIR does not refer to close-out netting arrangements.

(C) Financial markets under the Recast EUIR

Pursuant to Article 12 para 1 Recast EUIR, the effects of insolvency proceedings on the rights and obligations of the parties to a payment or settlement system or to a

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[111] See European Financial Markets Lawyers Group, Protection for Bilateral Insolvency Set-off and Netting Agreements under EC Law, A report by the European Financial Market Lawyers Group (EFMLG), October 2004, no. 72 *et seq.*

[112] See also the proposal of the European Commission dated 12 December 2012 (COM(2012) 744 final), which intended to include Article 6a covering "netting arrangements". However, Article 6a has not been included in the final version of the Recast EUIR.

financial market are governed solely by the law of the EU member state applicable to that system or market.

The application of Article 12 Recast EUIR with respect to LCH is not entirely clear and we are not aware of any guidance by a competent authority or any relevant court decisions on the interpretation of Article 12 Recast EUIR.[113] The term "financial market" is not defined in the Recast EUIR but is understood to be a market in a EU member state (other than Denmark) where financial instruments, other financial assets or commodity futures and options are traded.[114] Whether the reference to payment or settlement systems would include central counterparty clearing is not entirely clear. In our view, the definition of "system" as set out Article 2 lit (a) SFD may generally be referred to when construing Article 12 Recast EUIR.[115] When referring to "payment systems" Recital 71 sentence 1 Recast EUIR also mentions "position-closing agreements and netting agreements to be found in such systems". Sentence 3 of Recital 71 refers to "the payment and settlement of transactions, and provided for in payment and set-off systems". Such reference to payment or settlement systems would appear to be a reference to systems,[116] i.e. the term is a reference to European Union law on payment and settlement

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[113] Save for a cross reference to a restated provision in Recast EUIR the wording of Article 12 Recast EUIR is identical to the wording of the predecessor regulation under Article 9 EUIR and hence the relevant analysis relevant for Article 9 EUIR would also be relevant for Article 12 Recast EUIR; see *Jahn/Fried*, in: Münchener Kommentar InsO, 3rd ed. (2014). Art. 12 EuInsVO 2015, no. 1, arguing in favour of construing Article 12 Recast EUIR in light of Article 9 EUIR to which we agree. However, we are not aware of any official guidance under Article 9 EUIR either.

[114] Cf. *Virgos/Schmit*, Report on the Convention on Insolvency Proceedings, paragraph 102. See also Recital 71 sentence 3 Recast EUIR referring to "regulated financial markets".

[115] *Dornblüth*, in: Heidelberger Kommentar zur Insolvenzordnung, 9th ed. (2018), Article 12 EuInsVO no. 4, *Huber*, in: Haß *et al.*, EU-Insolvenzverordnung (2005), Article 9 no. 2.

[116] *Wenner/Schuster*, in: Wimmer, Frankfurter Kommentar InsO, 9th ed. (2018), Article 12 EuInsVO no. 3; *Kemper*, in: Kübler/Prütting/Bork, InsO, Loseblatt (as of March 2018), Article 9 EuInsVO no. 5; *Virgos/Schmit*, Report on the Convention on Insolvency Proceedings, paragraph 123, stating that "work in progress in the Community on those systems" should be taken into account to determine the applicable law.

systems. As mentioned, the EU legislator does not strictly distinguish between payment, settlement and clearing systems and in light of subsequent developments clearing systems can also qualify as Systems (see paragraph 3.2.1(f)).

The reference in Recital 71 sentence 4 Recast EUIR to the SFD clarifying that the SFD contains special provisions which should take precedence over the general rules laid down in the Recast EUIR is not entirely clear. No such reference is made in the wording of Article 12 Recast EUIR. The reference may be construed that the SFD is intended to prevail over the Recast EUIR and that even within the scope of application of the Recast EUIR the relevant conflicts of law provisions under the SFD, which with respect to this jurisdiction would result in the application of section 340 para 3 InsO, have to be applied. Recital 71 sentence 4 Recast EUIR may also be construed to provide further clarity on the interpretation of Article 12 Recast EUIR and thereby ensuring that such article applies to systems covered by the SFD. Under both interpretations, within the scope of application of the Recast EUIR, Article 12 Recast EUIR would apply and the position as regards Systems is in our view similar to the position under the InsO.

If LCH qualifies as a System and such definition is also relevant for construing Article 12 Recast EUIR, Article 12 Recast EUIR would refer to English law.

(D) Effects of Article 9 para 2 Recast EUIR

Pursuant to Article 7 para 2 lit (m) Recast EUIR the law of the EU member state opening the insolvency proceedings (*lex fori concursus*) determines the rules relating to the voidness, voidability or unenforceability of legal acts which are detrimental to all creditors. Article 9 para 2 Recast EUIR provides that the protection for set-off pursuant to Article 9 para 1 Recast EUIR does not preclude actions for voidness, voidability or

unenforceability as referred to in Article 7 para 2 lit (m) Recast EUIR. Consequently, Article 9 para 2 Recast EUIR preserves the ability of the *lex fori concursus* to declare the provision void despite the protection in Article 9 para 1 Recast EUIR.

(b) Conflict of laws provisions as regards netting and set-off under the InsO

With respect to netting under German international insolvency law outside the scope of the Recast EUIR the following applies:

(A) Principles of German international insolvency law

Under German international insolvency laws, section 335 InsO provides that insolvency proceedings and their effects are, in general, governed by the laws of the jurisdiction in which the proceedings have been opened. However, the InsO provides for some exceptions to this principle.

With respect to insolvency proceedings instituted in a jurisdiction other than Germany, section 351 InsO provides that rights *in rem* of creditors or third parties in assets of the insolvent estate are not affected by the foreign proceedings provided that the relevant assets are situated in Germany at the time of the opening of the foreign proceedings and such right *in rem* entitles the creditor or, as the case may be, the third party to segregation of the relevant asset from the insolvency estate (*Aussonderung*) or separate satisfaction (*Absonderung*).

Section 338 InsO provides that any right to declare a set-off is not affected by the opening of Insolvency Proceedings, provided that such right exists in accordance with the law governing the relevant claim of the Insolvent Party at the time the Insolvency Proceedings are instituted. Section 339 InsO provides that the validity of specific legal acts may be challenged if the requirements for doing this in insolvency proceedings are met in accordance with the law

governing the insolvency proceedings, unless the party whose acts are to be challenged provides conclusive evidence that the relevant act is governed by the laws of another state and cannot be challenged thereunder.

(B) Effect of section 340 para 2 InsO on the Netting Provisions

Where the Recast EUIR does not apply, section 340 para 2 InsO provides for an insolvency conflict of laws rule for "netting agreements". According to the BGH the substantive insolvency laws of the jurisdiction the laws of which have been chosen by the parties to govern the relevant netting agreement apply.[117]

Even though section 340 para 2 InsO does not provide any guidance on the interpretation of the term "netting agreement", the legislative history reveals that master agreements within the meaning of section 104 para 3 sentence 1 InsO fall within the scope of section 340 para 2 InsO.[118] Pursuant to the BGH, master agreements which

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[117] Before the 9 June 2016 decision of the BGH, it was not entirely clear to which set of rules the wording "law of the country which governs such agreements" refers. Basically, section 340 para 2 InsO could refer to (i) the substantive insolvency laws of the jurisdiction that has been chosen by the parties to govern the relevant agreement (*Tashiro*, in: Braun, InsO, 7th ed. (2017) § 340 InsO nos. 3 and 4; *Jahn/Fried*, in: Münchener Kommentar InsO, 3rd ed. (2014) § 340 InsO no. 6 *et seq.*), (ii) the substantive contract law of the jurisdiction that has been chosen by the parties to govern the relevant agreement (*Kindler*, in: Münchener Kommentar BGB, 7th ed. (2018) § 340 InsO no. 5 (*lex causae*); *Swierczok*, in: Heidelberger Kommentar InsO, 9th ed. (2018), § 340 InsO no. 7 *et seq.*) or (iii) directly to the terms of the relevant agreement without any regard to the substantive insolvency or contract laws (this interpretation is supported by *Schneider*, in: Kohler/Obermüller/Wittig, Kapitalmarkt – Recht und Praxis, Gedächtnisschrift für Ulrich Bosch (2006), p. 211). This is now settled, as the BGH has applied substantive insolvency laws when referring to section 340 para 2 InsO (BGH WM 2016, 1168, 1172).

[118] BT-Drucksache 15/16, p. 20; see also *Gottwald/Kolman*, in: Insolvenzrechts-Handbuch, 5th ed. (2015), § 133 no. 86. Section 340 para 2 InsO implements Article 25 WUD into German law. Article 25 WUD (addressing netting agreements (*Saldierungsvereinbarungen*)) has been amended by Article 117 BRRD and should as from now be construed as referring to netting arrangements within the meaning of Article 2 para 1 no. 98 BRRD. Even though the wording of Article 25 WUD has been amended the wording of section 340 InsO was left unchanged but presumably was considered sufficient to address the change of the WUD. However, we construe the scope of section 340 InsO still on its wording rather than based on the changes made to Article

contain netting agreements such as financial market specific offsetting provisions (*finanzmarktspezifische Verrechnungsformen*), such as the German law governed Master Agreement for Financial Derivatives Transactions (*Rahmenvertrag für Finanztermingeschäfte*) fall within the scope of section 340 para 2 InsO.[119] When analysing what constitutes a netting agreement, the BGH emphasised the "balancing" or "netting" (*Saldierung*) of payment streams without referring to any other relevant features.[120]

It is unclear whether section 340 para 2 InsO applies to rulebooks or clearing conditions of central counterparties in a clearing context. The currently applicable version of section 104 para 3 sentence 1 InsO refers to master agreements and the rules of a central counterparty. Furthermore, we understand that clearing of Contracts under the Rulebook results in bilateral contractual relationships between LCH and a Relevant Clearing Member as well as between a Relevant Clearing Member and a client. However, irrespective of whether or not section 340 para 2 InsO can be construed in light of section 104 para 3 sentence 1 InsO the Rulebook would likely not qualify for treatment under section 340 para 2 InsO as section 104 para 3 sentence 1 InsO requires that the relevant transactions covered by the rules of the central counterparty can only be terminated in their entirety, which is not the case with respect to the Rulebook as we understand.

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25 WUD. While under the relevant applicable requirements a direct application of a EU Directive or at least an interpretation of national law serving the purpose of implementing a specific EU Directive in conformity with EU law (*richtlinienkonforme Auslegung)* is generally possible (see *Ruffert*, in: Calliess/Ruffert, EUV/AEUV, 5th ed. 2016, Art. 288 AEUV no. 77), we do not think that there is sufficient evidence for meeting these requirements.

[119] BGH WM 2016, 1168, 1172.

[120] BGH WM 2016, 1168, 1172.

(C) Effect of section 340 para 3 InsO on the Netting Provisions

Section 340 para 3 InsO provides that the effects of insolvency proceedings on the rights and obligations of participants in a System within the meaning of section 1 para 16 KWG are governed by the laws of the state which applies to that System.

We would construe section 340 para 3 InsO so as to refer to the substantive insolvency laws of the country the laws of which govern the relevant System given its wording, context and the legislator's intention to provide clarity on the applicable insolvency laws.[121] This would also be in line with the decision of 9 June 2016 of the BGH relating to section 340 para 2 InsO as set out above.[122]

To the extent LCH qualifies as a System, (paragraph 3.2.1(f)) section 340 para 3 InsO will apply. Should both section 340 para 2 InsO and section 340 para 3 InsO apply, we believe that section 340 para 3 InsO should prevail over section 340 para 2 InsO as section 340 para 3 InsO is more specific than section 340 para 2 InsO.[123]

(c) Close-out netting under the InsO

However, should LCH not qualify as a System and if also no other conflict of laws provisions provide for the application of English substantive insolvency law with respect to the effects of the opening of Insolvency Proceedings over the assets of a Relevant Clearing Member, the following principles of substantive German law apply, subject to Article 102b EGInsO (see paragraph 3.2.1(g)).

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[121] See BT-Drucksache 15/16, p. 20.

[122] BGH, WM 2016, 1168, 1172.

[123] This is, however, only relevant where the netting agreement and the System are governed by different laws which is not the case with respect to the Rulebook.

(i) Protection of the Selection Right

Following the opening of Insolvency Proceedings, mutual contracts[124] which have not, or not (yet) fully, been performed (*nicht oder nicht vollständig erfüllt*) by either party ("**Executory Contracts**") and which have not been effectively terminated prior to such opening of Insolvency Proceedings are, pursuant to section 103 InsO, subject to the Selection Right.[125]

An English translation of section 103 InsO reads as follows:

"Section 103

Selection right by the insolvency administrator

(1) If a mutual contract was not or not fully performed by the debtor and the other party at the date when the insolvency proceedings were opened (executory contract), the insolvency administrator may perform such contract in place of the debtor and claim performance by the other party.

(2) If the insolvency administrator refuses to perform such contract the other party is entitled to assert its claims for non-performance only as an insolvency creditor. If the other party requires the insolvency administrator to decide whether it chooses performance or non-performance the insolvency administrator is obliged to state his intention to claim performance without undue delay. If the insolvency administrator does not give his statement he may no longer insist on performance."

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[124] Mutual contracts are contracts giving rise to mutual rights and obligations (*gegenseitige Verträge*) within the meaning of sections 320 *et seq.* BGB, whereby each of the parties only agrees to perform its obligations in exchange for the other party performing its obligation (*Huber,* in: Münchener Kommentar InsO, 3rd ed. (2013), § 103 InsO no. 55)

[125] The opening of Insolvency Proceedings does not lead to the termination of the contractual obligation to perform. Rather, the opening of Insolvency Proceedings only affects the enforceability of the respective claims since both parties to a contract may raise the objection of non-performance of a contract (BGH ZIP 2002, 1093, 1095). Therefore, neither the opening of Insolvency Proceedings nor the decision of the Insolvency Administrator result directly in a termination of the contractual agreement.

In the event that the Insolvency Administrator refuses to perform a relevant contractual obligation the contractual agreement is terminated and the Solvent Party may assert claims arising from non-performance only as a creditor in the Insolvency Proceedings. Such claims rank *pari passu* with the claims of all other unsecured creditors.

Section 119 InsO provides that agreements excluding or limiting the application of sections 103 to 118 InsO in advance are invalid and therefore protects the Insolvency Administrator's Selection Right. As an early termination following the exercise of the termination right under the Netting Provisions restricts the Selection Right, it may be invalid if it violates sections 103, 119 InsO. In the following we analyse the scope of sections 103, 119 InsO with respect to a termination under the Netting Provisions and any potential exceptions.

Based on its wording, section 119 InsO only applies after the opening of Insolvency Proceedings. However, based on the purpose of such section to protect the rights under sections 103 to 118 InsO, the BGH held that section 119 InsO applies from the point in time in which, based on a valid application for the opening of Insolvency Proceedings, such opening of Insolvency Proceedings is to be seriously expected (*mit der Eröffnung eines Insolvenzverfahrens ernsthaft zu rechnen ist*).[126] Any contractual early termination right based on insolvency related events is therefore void if the termination is triggered resulting from the occurrence of such event.[127]

Whereas, according to the BGH, "non-insolvency related" termination provisions are not intended to "undermine" the Selection Right and therefore non-insolvency related termination provisions would generally not be covered by section 119 InsO, the validity of contractually stipulated termination rights that are based on insolvency related events

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[126] BGH WM 2013, 274.

[127] BGH WM 2013, 274, 275 *et seq.* (relating to a contract for the supply of energy), confirmed by BGH WM 2016, 1168, 1173 also in respect of other contracts; see also *Obermüller*, ZInsO 2013, 476, 480 *et seq.*

depends on whether or not the respective agreement is deemed as an exclusion or limitation of the application of the Selection Right. However, the BGH also confirmed that the Selection Right cannot be undermined where there is an exemption from the Selection Right.

(ii) Exemption from the Insolvency Administrator's Selection Right

Section 104 InsO provides for an exemption from the Insolvency Administrator's Selection Right for fixed date transactions (*Fixgeschäfte*) and financial transactions (*Finanzleistungen*). To the extent section 104 InsO applies, it overrides the Insolvency Administrator's Selection Right under section 103 InsO.

The current version of section 104 InsO entered into force on 29 December 2016 and has been changed significantly compared to the previously applicable version. While these changes are, to some extent, intended to adapt the wording to market developments such as product innovation, they also have to be regarded as a response to the BGH decision of 15 November 2012 and, in particular to the BGH decision of 9 June 2016.[128] Understanding the purpose of the changes and the exemptions created thereby for contractual close-out netting arrangements is relevant for assessing to what extent the limits set by the BGH need still to be observed.

On 9 June 2016[129] the BGH did not explicitly decide whether or not an insolvency related contractual early termination right triggered upon the filing of an application for the opening of Insolvency Proceedings or any other relevant point in time before the opening of Insolvency Proceedings was void *per se*.[130] Rather, the BGH explained in its reasoning that the Selection Right cannot be "undermined" by such contractual termination right as there is no Selection Right where section 104 InsO

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[128] BT-Drucksache 18/9983, p. 8, 10.

[129] BGH WM 2016, 1168.

[130] With respect to the 2012 decision, please refer to *Obermüller*, ZInsO 2013, 476.

applies.[131] However, in its decision of 9 June 2016, the BGH went beyond this statement by holding that, if parties to a transaction governed by German law entered into a netting agreement (in the reasoning referred to as "*Abrechnungsvereinbarung*") for the event of an insolvency which is contradictory to section 104 InsO (in the version applicable before 10 June 2016), the netting agreement is void in this respect and the provisions of section 104 InsO are directly applicable. The BGH has explicitly ruled that section 104 InsO prevails over contractual arrangements. A contractually agreed early termination of a transaction covered by section 104 InsO based on the filing for the opening of Insolvency Proceedings was held to be valid, as such early termination right *per se* does not modify the legal consequences under section 104 InsO, but the valuation method must not deviate from the method set forth in, and also the point in time relevant for the valuation must not deviate from, section 104 InsO.[132] As a consequence it follows from the BGH's decision that, if the contractually agreed valuation method or the timing of the valuation are not based on the method, and timing stipulated in the version of section 104 InsO in force before 10 June 2016 then such agreement is void under section 119 InsO. Based on the changes made to section 104 Inso after the BGH's decision this strict interpretation can in our view no longer be upheld.

Referring to the BGH decision of 9 June 2016, the legislative reasoning given for the changes to section 104 InsO clarifies that contractual close-out netting provisions are enforceable in insolvency.[133] The legislative reasoning also clarifies that parties may enter into contractual agreements which deviate from the statutory netting mechanism. However, the relevant contractual agreement must not deviate from the fundamental principles of the statutory provision which is to remedy the uncertainties that would arise from the application of the Selection Right to

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[131] BGH WM 2016, 1168, 1173.

[132] BGH WM 2016, 1168, 1173 *et seq.*

[133] BT-Drucksache 18/9983, p. 8, 9, 10, 13.

transactions that fall within the scope of section 104 InsO. While section 119 InsO was not amended, we construe the legislative reasoning to imply that section 119 InsO needs to be construed in light of the changes made to section 104 InsO. In any event, there is no scope for the Selection Right under section 103 InsO to the extent section 104 InsO applies and, hence, there is also no room for section 119 InsO in such case.

(iii) Scope and analysis of section 104 InsO

Upon the opening of Insolvency Proceedings, section 104 InsO provides for a mandatory automatic termination of those transactions which fall within its scope. If the relevant date for early termination falls after the opening of Insolvency Proceedings the provisions of section 104 InsO would govern the close-out netting of those transactions which fall within its scope. Section 104 InsO would have no effect on those transactions which fall outside its scope and the analysis described above in paragraph 3.2.3(c)(i) would apply thereto, i.e. section 103 InsO would apply to transactions if they qualify as Executory Contracts and the Insolvency Administrator is entitled to exercise the Selection Right.

As mentioned, the currently applicable version of section 104 InsO entered into force on 29 December 2016 and applies pursuant to Article 5 para 1 of the Third Law Amending the Insolvency Code and the Introductory Act to the Code of Civil Procedure (*Drittes Gesetz zur Änderung der Insolvenzordnung und zur Änderung des Gesetzes betreffend die Einführung der Zivilprozessordnung*, "**Third Insolvency Code Amendment Act**")[134] to all Insolvency Proceedings opened on or after such date. For Insolvency Proceedings opened during the period from 10 June 2016 to 28 December 2016 a further version of section 104 InsO applies, as set out in Articles 1 and 5 para 2 of the Third Insolvency Code Amendment Act.[135] An English translation of

[134] BGBl. 2016 I, p. 3147.

[135] An English translation of section 104 InsO in the version applicable to Insolvency Proceedings opened during the period from 10 June 2016 to 28 December 2016 is attached as Appendix A hereto. The version of section

Section 104 InsO in the version entered into force on 29 December 2016 is attached as Appendix B hereto. All references in this Opinion to section 104 InsO are to such version, unless otherwise indicated.

Section 104 para 1 sentence 1 InsO covers fixed date transactions (*Fixgeschäfte*) on commodities (*Waren*) and section 104 para 1 sentence 2 InsO covers financial transactions (*Finanzleistungen*), which are further defined in sentence 3. Section 104 para 2 InsO provides for a calculation method for the claim for non-performance following the early termination of transactions by section 104 InsO.[136]

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104 InsO applying from 10 June 2016 to 28 December 2016 which entered into force retroactively is intended to replicate the contents of a general decree (*Allgemeinverfügung*) which was issued by the BaFin immediately after the BGH's decision was announced based on section 4a of the Securities Trading Act (*Wertpapierhandelsgesetz*). Such provision empowers the BaFin to eliminate or prevent irregularities which may adversely affect the stability of the financial markets or the confidence in the functioning of the financial markets. The general decree clarified that contractual netting arrangements in existing master agreements should continue to be settled as agreed in order to allow recognition of such netting arrangements for supervisory purposes. According to the legislative reasoning, the retroactive effect is justified as, in view of the general decree, no reliance could be placed by market participants on the interpretation of section 104 InsO as made by the BGH in its 9 June 2016 decision; BT-Drucksache 18/9983, p. 10.

136 It is unclear whether it is required that, given that section 104 InsO is a special rule to section 103 InsO, a transaction must qualify as an Executory Contract to fall within its scope (affirming this view with respect to section 104 InsO as in force prior to 10 June 2016, *Jahn/Fried*, in: Münchener Kommentar InsO, 3rd ed. (2013), § 104 InsO no. 34; *Bosch*, Kölner Schrift zur Insolvenzordnung, 2nd ed. (1999), p. 1018 no. 33). Unlike the previous version of the provision (section 104 para 2 sentence 3 InsO as in force prior to 10 June 2016), section 104 InsO in its amended form no longer refers to section 103 InsO. While systematically section 104 InsO is part of the same chapter of the InsO as section 103 InsO, other provisions in this chapter do not require Executory Contracts (see sections 115 and section 108 para 2 InsO, in respect of the discussions in legal literature see *Eckert*, in: Münchener Kommentar InsO, 3rd ed. (2013), § 108 InsO no. 203). The purpose of section 104 InsO (also in its previous version) is the protection of the counterparty from uncertainties resulting from the Insolvency Administrator's Selection Right (see BT-Drucksache 12/2443, p. 145 and BT-Drucksache 18/9983, p. 19). It could therefore be argued that the application of section 104 InsO requires an Executory Contract within the meaning of section 103 InsO, as otherwise there would be no need for an exemption. However, some of the transactions enumerated in section 104 para 1 sentence 3 InsO (such as certain options) have already been fulfilled by one of the parties and others (such as financial collateral and contracts for difference) do not constitute Executory Contracts (some of them are not even mutual contracts) (see: *Balthasar*, in: Nerlich/Römermann, InsO, 35th update (as of April 2018), § 104 InsO no. 31). According to the legislative reasoning to the version of section 104 InsO which entered into force on 29 December 2016, however, rather than the transaction fulfilling the formal requirement of an "Executory Contract", it should

Section 104 para 3 InsO expressly recognises "single agreement clauses" with respect to transactions which have been entered into under a master agreement or the rules of a central counterparty (see paragraph 3.2.3(d) below). Section 104 para 4 sentence 1 InsO clarifies that parties to a contract may agree on terms deviating from the statutory netting provision as long as these are compatible with the fundamental principles applicable for the relevant statutory requirement which is being amended and sentence 2 gives examples of permitted deviations.

To summarise, any automatic termination by virtue of section 104 InsO results in a claim for non-performance calculated on the basis of market or exchange prices subject to section 104 para 2 InsO. The claim for non-performance would, irrespective of the law governing the relevant transaction or agreement, be governed by German law and would generally rank *pari passu* with claims of all other unsecured creditors. The claim for non-performance is expressed in Euro and may be subject to set-off.[137]

(iv) Fixed date transactions (*Fixgeschäfte*)

Section 104 para 1 sentence 1 InsO applies to fixed date transactions (*Fixgeschäfte*) on tangible goods with a market or exchange price only. Fixed date transactions are transactions where performance has to occur at a specific point of time because the creditor puts special emphasis on the timeliness of the performance.

(v) Financial transactions within the meaning of section 104 para 1 sentences 2, 3 InsO

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be decisive whether the market risks to which the transaction is subject should be captured by the scope of protection awarded by section 104 InsO to the parties, and, in particular, the Solvent Party (BT-Drucksache 18/9983, p. 19).

[137] Section 104 InsO does in our view not include any set-off but, by transforming the former payment and delivery claims into an Euro denominated payment claim, provides a basis for set-off (subject to the general set-off restrictions under contract and insolvency law, as applicable), please also refer to footnote 165 below.

Section 104 para 1 sentence 2 InsO applies to financial transactions (*Finanzleistungen*) as further defined in section 104 para 1 sentence 3 InsO. Financial transactions are transactions which have a market or exchange price, and for which a particular time or period was agreed which only occurs or expires after the opening of insolvency proceedings.[138] Whereas section 104 InsO does not define what would constitute a market or exchange price, in our view, the interpretation of this requirement can be based on generally applicable principles of civil law such as section 385 BGB.[139]

Section 104 para 1 sentence 3 InsO gives examples of financial transactions. The wording of section 104 para 1 sentence 3 InsO indicates that the enumeration of financial transactions is not conclusive (indicated by the words "in particular"). The legislative reasoning also shows that the words "in particular" are intended to address any future developments with respect to financial transactions.[140] Furthermore, based on the purpose of section 104 InsO, which is to limit the Insolvency Administrator's ability to speculate on price or market developments with respect to volatile instruments by not deciding whether to assume or reject any obligations subject to

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[138] Based on its wording, undated transactions (e.g. transactions which are due upon the giving of notice or transactions with an undetermined period of time) are outside the scope of application of section 104 para 1 sentence 2 InsO.

[139] Pursuant to section 385 BGB, which is a generally applicable provision under civil law, a market or exchange price is given if at the relevant place the relevant assets are traded to an extent which allows the determination of a market or exchange price on the basis of the transactions which have taken place. A market price is available where based on the frequency of transactions an average price can be determined. According to the reasoning of the German legislator to the version of section 104 InsO applicable before 10 June 2016 (see BT-Drucksache 12/7302, p. 168), the term "market or exchange price" within the meaning of section 104 para 1 sentence 2 InsO needs to be construed broadly. With respect to the version of section 104 InsO currently in force the references to market and exchange price in the legislative reasoning are focusing on the calculation methods under section 104 para 2 InsO. The BGH has referred to the possibility of entering into replacement transactions, BGH WM 2016, 1168, 1174.

[140] BT-Drucksache 18/9983, p. 11, 18.

the Selection Right,[141] a court may accept that transactions showing comparable features to the enumerated financial transactions and in respect of which the same concerns may arise which the legislator has raised to justify the exemptions from the Selection Right under section 104 InsO, could be covered by section 104 para 1 sentence 2 InsO even if not explicitly mentioned.[142] In this respect the legislative reasoning clarifies that interests of the Solvent Party and the interests of the insolvency estate need to be balanced.[143]

Financial transactions are transactions on the delivery of precious metals (no. 1), the delivery of financial instruments or comparable rights, except where there is an intention to acquire an interest in another enterprise with the aim of establishing a long-term relationship with that enterprise (no. 2), payments of money which are to be made in a foreign currency or in a mathematical unit, or the amounts of which are calculated, directly or indirectly by referencing to the exchange rate of a foreign currency or a unit of account, to the interest rate for borrowings or to the price of other goods (*Güter*) or services (no. 3), deliveries and payments from derivative financial instruments except where there is an intention to acquire an interest in another enterprise with the aim of establishing a long-term relationship with that enterprise (no. 4), options and other rights to demand delivery of commodities (*Waren*) or for delivery, payment or options and rights within the meaning of numbers 1 to 5 above (no. 5) and financial collateral within the meaning of section 1 para 17 KWG (no. 6). Pursuant to section

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[141] BT-Drucksache 18/9983, p. 9. This was already the case with respect to the version of section 104 InsO applicable before 10 June 2016; BT-Drucksache 12/2443, p. 145; BT-Drucksache 12/7302, p. 167.

[142] With respect to the version of section 104 InsO applicable before 10 June 2016 see: *Jahn/Fried*, in: Münchener Kommentar InsO, 3rd ed. (2013), § 104 InsO no. 52; *Balthasar*, in: Nerlich/Römermann, InsO, 35th update (as of April 2018), § 104 InsO no. 40 *et seq.*; *Kroth*, in: Braun, InsO, 7th ed. (2017), § 104 InsO no. 6; *Lüer*, in: Uhlenbruck, InsO, 14th ed. (2015), § 104 InsO no. 11. Even though the scope of financial transactions covered by section 104 InsO has been broadened by the amendments, the versions before and after the amendments are based on the same principles.

[143] BT-Drucksache 18/9983, p. 10.

104 para 1 sentence 4 InsO financial instruments within the meaning of section 104 para 1 sentence 3 numbers 2 and 4 InsO are those instruments listed in Annex I Section C MiFID II.[144]

According to the legislative reasoning the newly enacted enumeration of financial transactions is not intended to exclude any financial transactions which were already covered by the version of section 104 InsO applicable prior to 10 June 2016. Rather, the changes are intended to simplify the definition of financial transactions.[145] Whether or not a transaction would be covered by section 104 para 1 sentence 3 no. 2 InsO depends on whether the transaction is aiming at the delivery of a financial instrument rather than whether the transaction giving rise to such entitlement is a financial instrument.[146] Options and other rights to demand delivery of commodities (*Waren*) covered by section 104 para 1 sentence 1 InsO as well as options and other rights to demand delivery or payment, option rights under section 104 para 1 sentence 3 nos. 1 to 5 InsO, including options on such options are covered, too.

With respect to the version of section 104 InsO applicable before 10 June 2016, the majority of German legal authors held the view that section 104 InsO may also apply to spot transactions (*Kassageschäfte*).[147] Based on the wording of section 104 InsO

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[144] It is not entirely clear whether the reference to MiFID II is intended to be static or whether this also encompasses future amendments of MiFID II. Ultimately, this appears to be irrelevant, since the non-conclusive enumeration of covered financial transactions ensures that future developments in this respect can be captured.

[145] BT-Drucksache 18/9983, p. 18.

[146] BT-Drucksache 18/9983, p. 18. The legislative reasoning also clarifies that repurchase agreements and securities lending agreements fall within the scope of section 104 para 1 sentence 3 no. 2 InsO.

[147] One of the arguments brought forward is that there may be a risk of loss in between signing of a contract and settlement due to market movements similar to forward transactions and which are covered by section 104 InsO. Furthermore, the wording of section 104 InsO only provides for a "specified time or a specified period agreed for the performance of financial transactions", i.e. requires a specified period or time to be agreed for performance of the obligations does, however, not stipulate a minimum period and therefore only excludes cash transactions. For more details please refer to: *Jahn/Fried*, in: Münchener Kommentar InsO, 3rd ed. (2013), § 104 InsO no. 88 *et seq.*; *Wegener*, in: Frankfurter Kommentar InsO, 8th ed. (2015), § 104 InsO no.

and the legislative reasoning we believe that this view can still be followed but we are not aware of any court decisions on this matter. Where the qualification as a financial transaction within the meaning of section 104 InsO depends on the qualification as a derivative transaction within the meaning of MiFID II, spot transactions would not qualify as financial transactions within the meaning of section 104 InsO.[148]

Spot transactions are transactions with short term delivery or respectively, fulfilment dates which are not entered into at a futures or forward market. The participants in a spot transaction agree to buy and sell, respectively, at the present market value and to settle the transaction a few days later (usually few more or even less than two business days).[149] Spot transactions, however, have to be distinguished from mere cash transactions (*Bargeschäfte*) which are settled same day and not covered by section 104 InsO.

(vi) Financial Collateral as financial transaction

Under section 104 para 1 sentence 3 no. 6 InsO, Financial Collateral within the meaning of section 1 para 17 KWG also qualifies as a financial transaction. According to the legislative reasoning this provision is intended to implement Article 7 FCD by ensuring that Financial Collateral can also be enforced by set-off under a close-out netting agreement.[150] The wording of

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23; *Bosch*, Kölner Schrift zur Insolvenzordnung, 2nd ed. (1999), p. 1027 no. 72; for a different view see: *Meyer*, in: Smid, Insolvenzordnung, 2nd ed. (2001), § 104 InsO no. 11.

[148] See also Recital 8, Article 7 and Article 10 of the Commission Delegated Regulation of 25 April 2016 as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of MiFID II (OJ No L 87 of 31 March 2017, p. 1, "**MiFID II Delegated Regulation**") pursuant to which spot contracts do not qualify as derivative instruments or financial instruments within the meaning of Annex I Section C(4) or C(7) MiFID II.

[149] BGH NJW 2002, 892, 892; *Bosch*, Kölner Schrift zur Insolvenzordnung, 2nd ed. (1999), p. 1027 no. 72. The term spot contract is defined in Article 7 para 2 MiFID II Delegated Regulation as a contract for the sale of a commodity, asset or right, under the terms of which delivery is scheduled to be made within the longer of the following periods: (a) two trading days; (b) the period generally accepted in the market for that commodity, asset or right as the standard delivery period.

[150] BT-Drucksache 15/1853, p. 11, 12.

section 104 para 1 sentence 3 no. 6 InsO only refers to Financial Collateral, i.e. the asset constituting the Financial Collateral but it does not state that transactions which are secured by Financial Collateral are within the scope of this provision. The legislative reasoning is not clear either as reference is made to the creation of Financial Collateral and that Financial Collateral, other than transactions covered by section 104 para 1 sentence 3 nos. 1 to 5 InsO, are not regarded as the "main obligation" forming part of an Executory Contract. This appears to protect Financial Collateral as such from the Selection Right but it does not create an exemption for the transactions secured by Financial Collateral which themselves do not constitute financial transactions within the meaning of section 104 para 1 sentences 2,3 InsO. Article 7 FCD provides that EU member states shall ensure that a close-out netting provision can take effect in accordance with its terms. To achieve the purpose of Article 7 FCD there are good arguments to construe section 104 para 1 sentence 3 no. 6 InsO broadly. However, the definition of "close-out netting" under the FCD[151] refers to financial collateral arrangements and such term again refers in our view to the collateral asset as such but not to the secured obligation or any transaction to be secured. We would therefore construe section 104 para 1 sentence 3 no. 6 InsO such that Financial Collateral may be included in the close-out netting (and, accordingly, would not be being subject to any Selection Right[152]), but the mere collateralisation of a transaction normally not covered by section 104 para 1 sentence 3 InsO does not result in the application of section 104 para 1 sentence 3

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[151] Under Article 2 para 1 lit (n) FCD "close-out netting provision" means a provision of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any statutory rule by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise: (i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; and/or (ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party.

[152] With respect to the version of section 104 InsO applicable before 10 June 2016, see also *Jahn/Fried*, in: Münchener Kommentar InsO, 3rd ed. (2013), § 104 InsO no. 27 and no. 75a.

InsO. As far as we are aware, no court decisions exist in respect of the interpretation of section 104 para 1 sentence 3 no. 6 InsO.

(vii) Calculation of the amount of the claim for non-performance

Pursuant to section 104 para 2 sentence 1 InsO, the amount of any claim for non-performance is determined on the basis of the market or exchange value of the transaction.[153] Sentence 2 of section 104 para 2 InsO states that the market or exchange value is deemed to be the market or exchange price for a replacement transaction which is concluded without undue delay, but no later than on the fifth business day after the opening of insolvency proceedings (no. 1), or if no replacement transaction is entered into in accordance with no. 1, the market or exchange price for a replacement transaction, that could have been concluded on the second business day after the opening insolvency proceedings (no. 2).

To the extent that the market conditions do not allow for the conclusion of a replacement transaction pursuant to section 104 para 2 sentence 2 numbers 1 or 2 InsO, the market or exchange value is to be determined by way of methods and procedures allowing for an adequate assessment of the value of the transaction (section 104 para 2 sentence 3 InsO). This is the case if the relevant markets are inactive or if the prices available do not properly reflect the prices that would be determined under usual market conditions.[154]

(d) Section 104 InsO and rules of central counterparties

Section 104 para 3 sentence 1 InsO provides that where transactions pursuant to section 104 para 1 InsO are combined in a master agreement or the rules of a central counterparty within the meaning of section 1 para 31 KWG, which provides that the transactions may, upon the

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[153] Please also refer to BT-Drucksache 18/9983, p. 20.

[154] See the legislative reasoning in BT-Drucksache 18/9983, p. 16, by reference to Article 16 of the Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012 supplementing Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (OJ No L 52 of 23 February 2013, p. 11).

occurrence of certain events, only be terminated in their entirety, then the entirety of such transactions shall be deemed one single transaction within the meaning of section 104 para 1 InsO. This also applies if transactions are covered by such agreement or rules, which neither qualify as fixed date transactions nor as financial transactions. Such transactions would be subject to the general provisions (section 104 para 3 sentence 2 InsO).[155] By referring to the generally applicable provisions section 104 para 3 sentence 2 InsO refers also to the Selection Right. So if and to the extent transactions neither qualify as fixed date transactions nor as financial transactions such transactions would be subject to the Selection Right.

The InsO does not provide for a more detailed definition of the term "master agreement". Express precondition is only that the master agreement must provide for a termination of the entire agreement (including all transactions under the master agreement) where specified reasons allow for such termination. The same applies with regard to the rules of a central counterparty within the meaning of section 1 para 31 KWG.

The Rulebook, however, does not provide for the termination of all Contracts following the insolvency of a Relevant Clearing Member. Rather, LCH is given discretion to terminate certain but not all Contracts as we understand. Based on the wording of section 104 para 3 sentence 1 InsO, the Rulebook would likely not qualify as rules of a central counterparty within the meaning of such provision as we would construe the reference to the termination of transactions in their entirety to exclude any discretion as regards which transactions are to be terminated

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[155] With respect to section 104 para 2 InsO as applicable prior to 10 June 2016, it was disputed among legal commentators whether (1) one non-qualifying transaction would also prevent the application of section 104 para 2 InsO for such transactions which would qualify as financial transactions, or (2) section 104 para 2 InsO applies to all transactions, even if only one or some of the transactions qualify as financial transactions or (3) only those transactions under the master agreement which qualify as financial transactions are covered by section 104 para 2 InsO, whereas such transactions which do not qualify as financial transactions remain outside its scope and are therefore individually subject to the Selection Right. This has now been clarified in section 104 para 3 sentence 2 InsO in favour of the third option.

and which not. We are not aware of any court decision on this question.[156]

Rule 8 of the Default Rules provide that the relevant net amounts are determined in respect of each "kind of account"; such term further defined in Rule 11 (b) and (c) of the Default Rules. The net amounts or net sums are calculated in respect of those Contracts which are allocated to the relevant "kind of account" and LCH may establish more than one net amount or net sum, based on the number of relevant "kind of accounts" created by the Relevant Clearing Member opting for various segregation or clearing models offered by LCH (the relevant segregation or clearing models are selected and the relevant Contracts are allocated to the various segregation and clearing models before the Relevant Clearing Member has become a Defaulter). While we are not aware of any court decision on the interpretation of section 104 para 3 InsO we would not construe the reference to "one single transaction" in sentence 1 of such section as prohibiting the parties to designate in the relevant master agreement or rules of a central counterparty which transactions are being netted against each other by allocating the relevant transactions to different "netting sets".[157] Contractual close out netting arrangements are permissible if the termination occurs before the opening of Insolvency Proceedings (see next paragraph) and the relevant net sums resulting from the different netting sets as agreed between the Parties would still be subject to insolvency set-off (subject to the exemption under Article 102b section 1 para 1 EGInsO with respect to necessary measures under Article 48 EMIR).

(e) Contractual close-out netting

Contractual close-out netting provisions under master agreements or rules of a central counterparty are recognised under German law and pursuant to section 104 para 4 sentence 1 InsO contractual parties may agree on provisions deviating from section 104 para 2 InsO as long as

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[156] We also do not believe that the reference to "certain events" indicates that it may be sufficient if a specific event results in the termination of all transaction covered by the relevant agreement.

[157] Rather, the purpose of section 104 para 3 InsO is to address master agreements or rules of a central counterparty which include transactions falling within and transactions falling outside the scope of section 104 para 1 InsO; see also BT-Drucksache 18/9983, p. 11.

these are compatible with the fundamental principles applicable to the relevant statutory provision which is to be amended.

(i) Scope of contractual close-out netting

Pursuant to section 104 para 4 sentence 2 InsO parties may, in particular, agree that the effects of section 104 para 1 InsO may apply prior to the opening of Insolvency Proceedings, in particular upon the application by a party to the contract for the opening of Insolvency Proceedings over its assets or upon the existence of a reason for the opening for Insolvency Proceedings (contractual termination) (no. 1), that a contractual termination will encompass also such transactions pursuant to section 104 para 1 InsO in respect of which the claim for delivery of the commodities (*Waren*) or the performance of the financial transaction becomes due prior to the opening of Insolvency Proceedings, but after the point in time agreed for the contractual termination (no. 2), that for the purposes of the determination of the market or exchange value of the transaction the point in time of the contractual termination applies instead of the point in time of the opening of Insolvency Proceedings (no. 3 lit (a)), the entering into of the replacement transaction pursuant to section 104 para 2 sentence 2 no. 1 InsO may occur until the 20th business day after the contractual termination, if this is required to ensure that the unwinding of the transaction is performed in a manner that will maximise value (no. 3 lit (b)), or instead of the point in time specified in section 104 para 2 sentence 2 no. 2 InsO a point in time or a period between the contractual termination and the expiry of the fifth business day following such termination shall apply (no. 3 lit (c)).

The reference to "in particular" indicates, as also stated in the legislative reasoning, that the above enumerated deviations are mere examples which are all guided by the principle that such deviations are permissible as long as these are compatible with the fundamental principles applicable to the relevant statutory

requirement which is to be amended.[158] Hence, section 104 para 4 InsO limits contractual close-out netting provisions and prohibits that they contradict the purpose of the statutory close-out netting.[159] The legislative reasoning also mentions the valuation on the basis of an actual or hypothetical replacement transaction and that the relevant extended periods for valuations may only be used if and to the extent such time is necessary due to the complexity of the relevant portfolio.[160]

While we are not aware of any court decision or any further guidance in the legislative reasoning we hold the view that there is no need to explicitly refer to section 104 para 4 InsO when agreeing on any deviations from the statutory netting requirements, in particular from the timing and method of valuation set out under section 104 para 2 InsO. As already mentioned above, while single agreement clauses are generally permissible in accordance with section 104 para 3 InsO, based on our understanding of section 104 para 4 InsO parties may not agree to extend section 104 InsO to such transactions which are not covered by section 104 para 1 InsO (however bearing in mind that, with respect to financial transactions, section 104 para 1 sentence 3 InsO is not conclusive but is intended to provide for examples of potentially covered transactions; see paragraph 3.2.3(c)(v) for more details).

Turning to the Rulebook, to the extent any Automatic Early termination Event or any other event preceding a Default Notice is an insolvency related termination event the restrictions under sections 119, 104 para 4 InsO need to be observed. Section 104 InsO does not limit LCH's ability to stipulate certain insolvency related termination events *per se*. Rather, LCH may provide that an early termination may be effected prior to the opening of Insolvency Proceedings, in particular upon the application by a Relevant Clearing Member for the opening of Insolvency

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[158] BT-Drucksache 18/9983, p. 14.

[159] BT-Drucksache 18/9983, p. 1, 14.

[160] BT-Drucksache 18/9983, p. 22. As regards the time period relevant for valuation the legislative reasoning refers to Article 285 para 3 CRR.

Proceedings over its assets or upon the existence of a reason for the opening for Insolvency Proceedings (contractual termination pursuant to section 104 para 4 sentence 2 no. 1 InsO). Pursuant to section 104 para 4 sentence 2 no. 2 InsO a contractual termination may also encompass such Contracts in respect of which the performance of the financial transaction becomes due prior to the opening of Insolvency Proceedings, but after the point in time agreed for the contractual termination. In the absence of any additionally stipulated requirements we believe that the Rulebook does not need to make explicit reference to section 104 para 4 sentence 2 no. 2 InsO but all Contracts qualifying under such provision would be captured automatically.

As regards the timing, any potentially available discretion with respect to the exercise of LCH's rights under the Rulebook needs to be exercised in light of section 104 para 4 InsO. More specifically, the reference to the point in time when the relevant market or exchange value of the Contracts needs to be determined (section 104 para 4 sentence 2 no. 3 lit (a) InsO) and the period in time which is relevant for the entering into any replacement transactions (section 104 para 4 sentence 2 no. 3 lit (b), para 2 sentence 2 no. 1 InsO) needs also to be observed, i.e. should not exceed the maximum period specified. If and to the extent LCH would like to make use of the discretion available under section 104 para 4 sentence 2 no. 3 lit (c), para 2 sentence 2 no. 2 InsO the Rulebook would need to provide for a specific date but not later than on the fifth working day after the opening of Insolvency Proceedings or, as the case may be, after the occurrence of the contractual termination.

(ii) Contractual close-out netting and section 119 InsO

Any contractual agreement including the rules of a central counterparty excluding or limiting the application of the Insolvency Administrator's Selection Right under section 103 InsO in advance is void (section 119 InsO). As also mentioned, in its judgments of 15 November 2012 and 9 June 2016 the BGH has construed section 119 InsO widely to better protect the insolvency estate and the Selection Right. While it is not clear to

what extent the BGH will follow such decisions in future, the BGH would need to consider the legislative reasoning on the amendment of section 104 InsO. Furthermore, the BGH has also ruled that there is no room for the Selection Right where section 104 InsO applies and, thus, there is also no room for protecting the Selection Right under section 119 InsO. Accordingly, as long as the Rulebook is in line with section 104 InsO, including any deviations from section 104 para 2 InsO as permitted by section 104 para 4 InsO, the Rulebook should not be rendered void under section 119 InsO in Insolvency Proceedings.

If a court considered that a specific provision of the Rulebook violates section 119 InsO, it would, have to consider whether any potential violation would render the relevant agreement void in whole or only in part or whether the agreement needs to be construed or applied in a way that it just meets applicable statutory requirements.[161] Generally the relevant contractual term which was void cannot be construed in a way that it continues to apply to the extent it would be valid (*Verbot der geltungserhaltenden Reduktion*). [162] However, to the extent the relevant provision containing the wording which violates applicable law also contains wording which does not violate applicable law can be separated both from the perspective of the textual presentation and the contents then the wording which violates applicable law can be stricken off (also sometimes referred to as the "blue pencil test"). This would however mean that, after striking off the wording violating applicable law, the remaining text of the provision is in itself understandable without the need of any further interpretation or explanation.[163] The aforementioned test

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[161] *Berberich*, in: Beck'scher Online-Kommentar InsO, 10th ed. 2018 (as of 26 April 2018), § 119 no. 37. The effects of a partial invalidity are also not addressed in section 104 para 3 sentence 2 InsO. By way of further background, the interpretation of section 119 InsO is a matter of German law only and not a matter of interpretation of the relevant contractual agreement which needs to be made under its respective governing law (see also Article 12 para 1 Rome I).

[162] See *Berberich,* in: Beck'scher Online-Kommentar InsO, 10th ed. (as of 26 April 2018), § 119 no. 37.

[163] See BGHZ 107, 185, 190 *et seq.*; BGHZ 145, 203, 212; *Basedow*, in: Münchener Kommentar BGB, 7th ed. (2016), § 306 no. 18; *Grüneberg*, in: Palandt BGB, 77th ed. (2018), § 306 no. 7; *Roloff*, in: Erman BGB, 15th

was developed with respect to contractual clauses rendered void under applicable contract law. However, in our view such test should also be applicable where a relevant provision is rendered void resulting from the application of section 119 InsO given that the effects of section 119 InsO are comparable to the effects of those provisions where the courts have applied the test. We are not aware of any court decisions on this question and court may not follow our view.

As the Rulebook is not governed by German law, outside Insolvency Proceedings, a German court would have to consider section 119 InsO an "overriding mandatory provision of German law" in accordance with Article 9 para 2 Rome I to hold any provisions of the Rulebook invalid. Mandatory provisions within this meaning are provisions the observance of which is regarded as crucial by a country for safeguarding its public interests, such as its political, social or economic organisation, to such an extent that they are applicable to any situation falling within their scope, irrespective of the law otherwise applicable to the contract under Rome I.

(f) Should the Netting Provisions be regarded as not being in line with section 104 para 4 InsO and should a court conclude that in such case the Netting Provisions would be held void pursuant to section 119 InsO in Insolvency Proceedings, netting is still permissible under section 104 para 1 InsO if and to the extent the relevant Contracts falls within the scope of section 104 para 1 InsO.

(g) Summary

If LCH qualifies as a System, the consequences of the opening of Insolvency Proceedings over the assets of a participant in such System should be determined in accordance with English law pursuant to section 340 para 3 InsO so that sections 103 and 104 InsO should not apply.

If however, the LCH does not qualify as a System, based on and subject to the above detailed reasoning, the impact of sections 103 and 104 InsO

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ed. (2017), § 306 no. 11; *Schmidt*, in: Ulmer/Brandner/Hensen AGB-Recht, 12th ed. (2016), § 306 BGB no. 12 *et seqq.*

on the Rulebook (if German insolvency law applies) can be summarised as follows:

(i) To the extent not otherwise agreed in compliance with section 104 para 4 InsO as described in paragraph 3.2.3(e) above, Contracts falling within the scope of section 104 para 1 InsO are automatically terminated upon the opening of Insolvency Proceedings and the claim for non performance resulting from such automatic termination ranks pari passu with any other claims of unsecured creditors (section 104 para 5 InsO).

(ii) If automatically terminated on the basis of section 104 para 1 InsO, section 104 para 2 InsO provides for the applicable valuation method, based on actual or hypothetical replacement transactions. To the extent the market conditions do not allow for the conclusion of a replacement transaction section 104 para 2 sentence 3 InsO provides that the market or exchange value is to be determined by way of methods and procedures allowing for an adequate assessment of the value of the transaction.

(iii) If a Contract is not terminated prior to the opening of Insolvency Proceedings, section 104 InsO overrides any contractual termination provision. Accordingly, fixed date transactions and financial transactions falling within the scope of section 104 para 1 InsO terminate automatically upon the opening of Insolvency Proceedings, unless such Contracts have been terminated before.

(iv) Contracts which do not fall within the scope of section 104 InsO are generally subject to the Insolvency Administrator's Selection Right pursuant to section 103 InsO, even if the Rulebook provides for a termination of such Contracts upon the filing for Insolvency Proceedings. Any contractual provisions deviating from this principle are void (section 119 InsO). The BGH held in its judgement of 15 November 2012 that section 119 InsO applies from the point in time in which, based on a valid application for the opening of Insolvency Proceedings, such opening of Insolvency Proceedings is to be seriously expected (*mit der Eröffnung eines Insolvenzverfahrens ernsthaft zu rechnen ist*).

(v) Article 102b section 1 para 1 no. 1 EGInsO, which provides that the performance of necessary measures to administer, close out or otherwise settle client positions and own account positions of a clearing member in accordance with Article 48 paras 2 and 3, 5 sentence 3 and 6 sentence 3 of EMIR are not impaired by the opening of Insolvency Proceedings.

(h) Other acts taken by LCH in accordance with Rule 6 of the Default Rules

In addition to or alternatively to terminating Contracts, under Rule 6 of the Default Rules LCH may incur new and additional obligations on behalf of a defaulting Clearing Member for the purpose of settling or liquidating open Contracts (for example by way of entering into opposite transactions or by exercising any options on behalf of the defaulting Clearing Member).

According to section 80 para 1 InsO upon the opening of Insolvency Proceedings an Insolvent Party's right to manage and transfer the insolvency estate shall be vested in the Insolvency Administrator. Furthermore, pursuant to section 81 InsO, any dispositions of the Insolvent Party over its property made after the opening of Insolvency Proceedings are void unless the relevant court otherwise orders. Only dispositions over Financial Collateral effected after the actual opening of Insolvency Proceedings are valid, provided that such dispositions were effected on the day of the opening of Insolvency Proceedings and the other party proves that it did not know, nor should have known of the opening of the Insolvency Proceedings. A "disposition" within the meaning of section 81 InsO is any act that has a direct and immediate effect on the Insolvent Party's assets.[164]

A contractual authorisation of a third party (such as LCH) to represent the Insolvent Party would, in accordance with section 115 *et seq.* InsO expire upon the opening of Insolvency Proceedings. If the exercise of LCH's rights under Rule 6 were therefore based on a contractual authorisation, such authorisation could not be upheld in Insolvency Proceedings.

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[164] *Lüke,* in: Kübler/Prütting/Bork, InsO, 75th ed. (March 2018), § 81 no. 5.

If LCH qualifies as a System, section 340 para 3 InsO may refer to substantial English insolvency laws also with respect to these further measures taken by LCH under Rule 6 instead of applying the provisions of the InsO. Section 340 para 3 InsO refers not only to specific types of agreements (unlike section 340 para 2 InsO) but constitutes a conflicts of laws provision for "rights and obligations of participants in the System". However, the precise scope of application of section 340 para 3 InsO has not been subject to any court decision and there is, in particular, no guidance as to what extent section 340 para 3 InsO prevails over conflicting conflict of laws provisions as for example section 339 InsO governing challenge in insolvency or section 351 InsO governing rights *in rem* as regards assets that are located in Germany at the opening of foreign insolvency proceedings.

To the extent section 340 para 3 InsO does not apply and, instead, the above-described restrictions under the InsO would apply, we refer to the exemption under Article 102b EGInsO as described in paragraph 3.2.3(j) below.

(i) Insolvency-related set-off

In addition, if substantive German insolvency law applies (please see for its scope of application the conflict of laws analysis in paragraphs 3.2.3(a) and 3.2.3(b) above) insolvency-related restrictions on set-off may be relevant because the netting provisions under the Rulebook, in particular Rule 8 of the Default Rules, involve elements of set-off and, as mentioned above, section 104 InsO provides for the termination of Contracts to form a basis for set-off and provides for the calculation of compensation claims which may serve as a basis for set-off (above, footnote 165) but, in particular absent a master agreement, does not effect the aggregation of compensation claims by set-off.

The following provisions govern set-off upon the opening of Insolvency Proceedings over the assets of the Relevant Clearing Member and are therefore relevant to any set-off agreements (such as settlement and general set-off arrangements irrespective of an early termination and aggregation) if German substantial insolvency law applies.

(i) Set-off after the opening of Insolvency Proceedings

The right of a Solvent Party to effect set-off after the opening of Insolvency Proceedings is governed by sections 94 through 96 InsO. The extent to which a set-off after the opening of Insolvency Proceedings is permissible mainly depends on the point in time when the situation giving one party the right to set off comes into existence *(Entstehung der Aufrechnungslage)*. This is in our view to be determined in accordance with the applicable contract law as determined in accordance with applicable conflict of laws provisions.

Pursuant to section 94 InsO and subject to the restrictions and prohibitions of set-off pursuant to sections 95 and 96 InsO, a right to set off a claim is preserved after the opening of Insolvency Proceedings if by force of law or on the basis of an agreement the Solvent Party was already entitled to set off the claim at the time the Insolvency Proceedings were opened irrespective of whether or not the declaration to set off the claim was made before or after the opening of such Insolvency Proceedings.[165]

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[165] It could be argued it is not required to assess whether a contractual netting arrangement falling within the scope of section 104 InsO meet the requirements of sections 94 *et seqq.* InsO where the netting (*Verrechnung*) of claims is made through the calculation of the relevant claim for non-performance within the meaning of section 104 InsO. Section 104 paras 1 and 2 InsO refer to the relevant single transaction, however pursuant to section 104 para 3 InsO the entirety of the transactions combined in a master agreement or the rules of a central counterparty are deemed to be a single transaction within the meaning of section 104 para 1 InsO. Accordingly, if this deeming provision results in a single transaction, set-off would not be required, as all respective amounts would simply be items to be included in the single payment claim resulting in a single settlement amount. As set out above, however, we interpret section 104 InsO such that it does not include any set-off but, by transforming the former payment and delivery claims into a Euro denominated payment claim, provides a basis for set-off. Since pursuant to the legal reasoning the amendments to section 104 InsO was made for clarification purposes (see BT-Drucksache 18/9983, p. 9), we refer to the statements by legal commentators made prior to the new provision entering into force: *Lüer*, in: Uhlenbruck, InsO, 14th ed. (2015), § 104 InsO no. 44; *Fuchs*, Close-out Netting, Collateral und systemisches Risiko, 2013, p. 106; *Ehricke*, ZIP 2003, 273 *et seqq.*, 277; *Bosch*, WM 1995, 413 *et seqq.*, 419 (differing view von Hall, Insolvenzverrechnung in bilateralen Clearingsystemen, 2010, p. 152, 156 *et seqq.*). Section 104 Abs. 4 InsO allows, within the limits of the provision, contractual arrangements, which, however, have the characteristics of a contractual set-off agreement and must therefore comply with section 94 *et seqq.* InsO. Unclear in this respect *Berberich*, in:

The InsO explicitly preserves rights to set off a claim under valid contractual agreements. With respect to the overall intention of the InsO in general and the purpose of section 94 InsO in particular, i.e. the aim to protect the legitimate expectations of the creditors of the Insolvent Party, the preservation of contractual rights to set off has been criticised since it enables the parties to extend the rights to set off to the detriment of creditors of the Insolvent Party as such agreements might reduce the assets involved in insolvency.[166] The validity of contractual agreements concerning set-off is therefore called into question in German legal literature and a restrictive interpretation of section 94 InsO pursuant to which agreements concerning set-off may not override prohibitions of set-off that aim at protecting third parties' rights is proposed.[167] According to this view, such agreements also have to comply with sections 95 and 96 InsO and might be challenged pursuant to section 129 at seqq. InsO.

However, this restrictive approach particularly applies to agreements deviating from the requirement of mutuality of the claims under German statutory law and should not affect the validity of the contractual provision of automatic aggregation and set-off of all existing mutual payment obligations of the parties under the transactions where the relevant contractual provisions do not contain a contractual deviation from the requirement of mutuality of the claims.

(ii) Restrictions under section 95 InsO

In circumstances where the right to set off emerges after the opening of Insolvency Proceedings, set-off will only be permissible if the mutual claims originated before the opening of Insolvency Proceedings. If on the date when Insolvency Proceedings are opened one or more of the claims to be set off

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Beck'scher Online-Kommentar InsO, 10th ed. (as of 26 April 2018), § 104 nos. 32 and 43. The statement in BT-Drucksache 18/9983, p. 21, in our view refers to other circumstances.

166 *Lüke*, in: Kübler/Prütting/Bork, InsO, 75th ed. (March 2018), § 94 InsO no. 7.

167 *Kroth*, in: Braun, InsO, 7th ed. (2017), § 95 InsO no. 20; *K. Schmidt*, NZI 2005, 138, 140 *et seq.*; see also *Brandes/Lohmann*, in: Münchener Kommentar InsO, 3rd ed. (2013), § 94 InsO no. 44 *et seq.*

against each other are conditional, not yet due or do not cover similar types of obligations, such set-off will not be effected before such conditions are met (section 95 para 1 sentence 1 InsO). Pursuant to section 95 para 1 sentence 2 InsO, section 41 InsO concerning claims not yet due at the date when Insolvency Proceedings are opened and section 45 InsO concerning the conversion of certain claims do not apply.

Set-off is excluded if the claim against which a set-off is to be effected becomes unconditional and mature before it can be set off (section 95 para 1 sentence 3 InsO). With respect to set-off after the opening of Insolvency Proceedings, timing, therefore, is of fundamental importance. Set-off is permissible if the Solvent Party's claim is unconditional and matures prior to the Insolvent Party's claim or at the same time at the latest.[168]

Pursuant to section 95 para 2 InsO, the fact that claims are expressed in different currencies or mathematical units would not exclude set-off, if these currencies or mathematical units are freely exchangeable at the place of payment of the claim against which the set-off is to be effected.[169] The claims have to be converted according to the exchange value applicable to this place at the time of receipt of the declaration to set-off.

(iii) Further restrictions under section 96 InsO

In addition, pursuant to section 96 para 1 InsO, set-off is prohibited if (i) a creditor in the Insolvency Proceedings has become a debtor of the insolvency estate only after the opening of Insolvency Proceedings, (ii) a creditor in the Insolvency Proceedings acquired his claim from another creditor only after the opening of Insolvency Proceedings, (iii) a creditor in the

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[168] Moreover, section 95 para 1 sentence 3 InsO has been construed restrictively by the BGH in NJW 2005, 3574, 3575 *et seq*. According to the BGH, section 95 para 1 sentence 3 InsO does not apply if the Insolvent Party's claim, against which set-off is declared, has become mature and unconditional before the Solvent Party's claim but at the same time was not enforceable due to a right to refuse performance by the Solvent Party against such claim.

[169] This is considered as a general principle of German law which also applies under section 94 InsO even though it is not mentioned therein (*Höhn/Kaufmann*, JuS 2003, 751, 753).

Insolvency Proceedings acquired the opportunity to set off his claim by a legal act subject to challenge in insolvency (below, paragraph 3.2.4(a) or (iv) a creditor with a claim to be satisfied from the debtor's free property is a debtor of the insolvency estate (section 96 para 1 InsO).

(iv) Set-off and challenge in insolvency

In the event an insolvency creditor acquired the right to set off his claim by a transaction which may be challenged, set-off is prohibited pursuant to section 96 para 1 no 3 InsO. This prohibition applies irrespective of whether or not the Insolvency Administrator has actually challenged the transaction. The BGH has decided that a legal act will not be prevented from becoming subject to challenge in insolvency and, consequently, the prohibition on set-off under section 96 para 1 no 3 InsO is not excluded if the legal act at hand caused the claim against which set-off is declared to come into existence.[170] In particular, the BGH rejected the argument that the fact that such a legal act does not only create the right to set-off but also the claim against which set-off is declared and which becomes part of the Insolvent Party's assets should be taken into account in determining whether the legal act is detrimental to creditors (as required by section 129 para 1 InsO (see paragraph 3.2.4(a)(ii))). Therefore, if a German court took the view that German law on insolvency-related set-off apply to the Default Rules (see, however, paragraphs 3.2.3(a) and 3.2.3(b) with respect to the conflict of laws analysis), it could reach the conclusion that the exercise of powers of LCH to bring claims into existence under Rule 6 of the Default Rules as a result of a Relevant Clearing Member's default constitute legal acts which are potentially subject to challenge in insolvency and therefore prevent set-off

[170] BGH WM 2013, 1132, 1133.

in respect of claims created by such legal acts pursuant to section 96 para 1 no 3 InsO.

(v) Exemptions for Financial Collateral and Systems

The prohibitions of set-off pursuant to section 95 para 1 sentence 3 InsO and section 96 para 1 InsO do neither apply to the transfer of Financial Collateral nor to the set-off of claims and benefits from transfer, payment or settlement agreements introduced into a System where set-off is effected at the latest on the day of opening of the Insolvency Proceedings (section 96 para 2 InsO).

(j) Effects of Article 102b EGInsO on restrictions under the InsO as regards further measures taken by LCH upon default of a Clearing Member

To the extent sections 103, 104 and 94 to 96 InsO restrict measures taken by LCH, a general exemption applies in our view under Article 102b section 1 EGInsO if such measures by LCH constitute "necessary measures" (*gebotene Maßnahmen*) under Article 102b EGInsO (see generally above, paragraph 3.2.1(g)). Article 102b section 1 EGInsO also protects further measures involving dispositions over the assets of an Insolvent Party which are restricted according to sections 80 *et seq.* InsO or the transfer of its assets (subject to a prohibition to acquire rights in assets of the insolvency estate according to section 91 InsO). In our view, Article 102b EGInsO does not apply to measures taken upon default of LCH.

Article 102b section 1 para 1 no. 1 EGInsO provides that the performance of necessary measures to administer, close out or otherwise settle client positions and own account positions of a clearing member in accordance with Article 48 paras 2 and 3, 5 sentence 3 and 6 sentence 3 EMIR must not be impaired by the opening of Insolvency Proceedings. LCH's various rights to settle Contracts in accordance with Rule 6 of the Default Rules other than by way of termination (in particular by entering into offsetting transactions) may therefore fall under the description of measures within the meaning of Article 48 paras 2 and 3, 5 sentence 3 and 6 sentence 3 EMIR.

As mentioned previously, in the absence of any court decisions, we construe Article 102b section 1 para 1 no. 1 EGInsO as a provision of

substantive law rather than as a conflict of laws provision (paragraph 3.2.1(g)).

Based on our understanding that LCH qualifies as a CCP for purposes of Article 2 no. 1 EMIR and provided that the close out of Contracts is a necessary measure in accordance with Article 48 EMIR, Article 102b section 1 para 1 no. 1 EGInsO would in our view prevent the application of restrictions under the InsO and Article 102b section 2 EGInsO would also exclude challenge in insolvency under German law. The application of Article 102b EGInsO is not limited to certain types of Contracts as it is applicable on the performance of necessary measures, i.e. it would apply in respect of all Contracts which are cleared in accordance with the Opinion Documents.

While the validity of the close-out under contract law is a matter of English law and while we do not express any opinion as to any matters of English law, if the closing-out complies with Article 48 EMIR, Article 102b EGInsO would prevent the application of, amongst other provisions, sections 80, 94 to 96, 103 and 104 and 129 *et seq.* InsO as far as the legal relationship between the Relevant Clearing Member and LCH is concerned. As set out under paragraph 3.2.1(g) above, we also believe that Article 102b EGInsO applies to the legal relationship between a Relevant Clearing Member and a Client if any necessary measures under Article 48 EMIR would also affect such relationship. The effects of Article 102b section 1 para 1 no. 1 EGInsO are limited to the exclusion of restrictions under the InsO; other legal restriction under German or foreign laws (as the case may be) would continue to apply (see above, paragraph 3.2.1(g)).

3.2.4 *Is there a "suspect period" prior to Insolvency Proceedings and/or Reorganisation Measures where Contracts with a Relevant Clearing Member could be avoided or challenged and, if so, what are the grounds? What are the risks for LCH in entering into Contracts and in taking Collateral in respect of those Contracts during such a period? Are any special protections or exemptions from the relevant arrangements for avoidance or challenge available under the law of the Relevant Jurisdiction in respect of contracts in financial markets?*

(a) Challenge in insolvency

Any legal acts performed in accordance with the Opinion Documents may be subject to challenge in insolvency. The applicable German conflict of laws provisions as regards these rules are determined either by the EUIR or the InsO.

(i) Conflict of laws analysis

Article 16 Recast EUIR provides that the law of the EU member state of the opening of proceedings does not apply, if the beneficiary of the relevant act proves that the act is subject to the laws of an EU member state other than that of the EU member state of the opening proceedings and that such law does not allow any means of challenging that act in the relevant case. Where the InsO applies, section 339 InsO provides that German provisions on challenge in insolvency do not apply, if the beneficiary of the relevant act proves that the act as a whole is subject to the laws of an EU member state other than Germany and that such law does not allow any means of challenge in insolvency the act at the case in point.

(ii) German challenge in insolvency in general

If BaFin has, prior to a Relevant Clearing Member's insolvency, taken measures under section 46 para 1 KWG such as a Moratorium to prevent the Relevant Clearing Member from becoming illiquid and Insolvency Proceedings are subsequently opened, challenge periods begin to run (counting backwards) on the day on which such an order has been issued (section 46c para 1 KWG) rather than on the later day of the filing for Insolvency Proceedings which is usually relevant. Furthermore, where legal acts have been made between the imposition of regulatory measures by BaFin in accordance with section 46 para 1 sentence 2 nos. 4 to 6 KWG and an application for the opening of Insolvency Proceedings, such legal acts are deemed not to be detrimental to creditors as a whole (section 46c para 2 sentence 1 KWG).

(iii) Challenge provisions relevant to legal acts made in connection with a Clearing Member's clearing through LCH

Legal acts made in connection with the Opinion Documents may, in particular, be subject to challenge in insolvency under the following circumstances:

(A) Under section 130 para 1 sentence 1 InsO, a legal act is subject to challenge, if it gives or makes available to a creditor security or satisfaction and (i) it was effected during the last three months prior to the filing for the opening of Insolvency Proceedings, if the insolvent Relevant Clearing Member was unable to pay its debts when due at the time of the legal act and if the creditor had knowledge of such inability to make payments at such time; or (ii) it was effected after the filing for the opening of Insolvency Proceedings and the creditor had knowledge of the insolvent Relevant Clearing Member's inability to make payments or the petition for opening of Insolvency Proceedings at the time of the legal act ("congruent coverage" (*kongruente Deckung*)).

Knowledge of circumstances which necessarily lead to the conclusion that the Relevant Clearing Member was unable to make payments is regarded as equivalent to actual knowledge of the insolvent Relevant Clearing Member's pending inability to make payments or of the filing for opening of Insolvency Proceedings (section 130 para 2 InsO).

(B) Pursuant to section 131 InsO, a challenge period of one to three months applies where a legal act gives or makes available to a creditor, security or satisfaction to which it has no right or no right to claim in such manner or at such time, and the corresponding legal act is subject to challenge if either, (i) the legal act is effected during the last month prior to filing for the opening of Insolvency Proceedings or following such filing; or, (ii) the legal act is effected during the second or third month prior to filing for the opening of Insolvency Proceedings and the

insolvent Relevant Clearing Member was unable to make payments at the time of the legal act or, (iii) if the legal act is effected during the second or third month prior to filing for the opening of Insolvency Proceedings and the creditor has knowledge at the time of the legal act that it is detrimental to the insolvent Relevant Clearing Member. In relation to (iii), knowledge of circumstances that necessarily lead to the conclusion that a legal act is detrimental to the insolvent Relevant Clearing Member is equivalent to actual knowledge of such detriment (section 131 para 2 InsO ("incongruent coverage" (*inkongruente Deckung*))).

(C) A legal transaction (*Rechtsgeschäft*) by the insolvent Relevant Clearing Member that is directly detrimental to the creditors is subject to challenge action, (i) if it was effected in the last three months prior to the filing for the opening of Insolvency Proceedings, if the insolvent Relevant Clearing Member was unable to pay its debts when due at the time of the legal transaction and if the other party had knowledge of such inability to make payments at such time; or, (ii) where it was effected after filing for the opening of Insolvency Proceedings and the other party had knowledge of the inability of the insolvent Relevant Clearing Member to make payments or of the petition for opening of Insolvency Proceedings at the time of the legal transaction (section 132 para 1 InsO).

A legal transaction which involves the Insolvent Party losing a right, or pursuant to which the Insolvent Party is no longer able to assert such a right, or which results in a property claim against the Insolvent Party being maintained or becoming enforceable is equivalent to a legal act that is directly detrimental to the creditors (section 132 para 2 InsO).

(D) A legal act made by the Insolvent Party during the last ten years prior to the filing for the opening of Insolvency Proceedings, or subsequent to such request, with the

intention to disadvantage his creditors may be subject to challenge in insolvency, if the other party was aware of the debtor's intention on the date of such legal act (section 133 para 1 sentence 1 InsO). If such legal act was made to satisfy or secure an existing obligation, the challenge period is shortened to four years (section 133 para 2 InsO). Awareness of the other party is presumed if such party knew (1) of the imminent inability of the Insolvent Party to make payments when due (*drohende Zahlungsunfähigkeit*) or, where the other party is entitled to receive the satisfaction or security in such way or at such time, of the (actual) inability of the Insolvent Party to pay its debt (*eingetretene Zahlungsunfähigkeit*) and (2) that the legal act constituted a disadvantage for the creditors (section 133 para 1 sentence 2, para 2 sentence 1 InsO). Awareness of corresponding circumstances provides severe evidence for knowledge of the other party of the imminent inability of the Insolvent Party to make payments when due. Further, pursuant to section 133 para 3 sentence 2 InsO, the other party is deemed not to have had knowledge of the inability to pay, if it has agreed upon special payment terms with, or has granted any other form of payment relief to, the Insolvent Party.

Under section 133 para 4 InsO, a contract for a consideration entered into by the Insolvent Party and a person with whom the Insolvent Party has a close relationship which is directly detrimental to the creditors is subject to challenge in insolvency unless it was entered into more than two years prior to the filing for the opening of Insolvency Proceedings or the other party was unaware of an intention of the Insolvent Party to prejudice the creditors.[171] In respect of person with whom the Insolvent Party has a close relationship, the requisite knowledge or awareness of the relevant circumstance under the different challenge provisions is deemed to

[171] If the Insolvent Party is a legal person, the term "person with whom the insolvency debtor has a close relationship" is defined in section 138 para 2 InsO.

exist (sections 130 para 3, 131 para 2 sentence 2 and 132 para 2 InsO)

(E) Under section 147 sentence 1 InsO legal acts which are performed after the opening of the Insolvency Proceedings but are legally effective in accordance with section 81 para 3 sentence 2 InsO (above, paragraph 3.2.1(e)) may be subject to challenge in insolvency. The provisions governing a challenge in insolvency in respect of legal acts performed before the Insolvency Proceedings were opened (as set out in this paragraph) apply under section 147 sentence 1 InsO as if the relevant legal acts had been made before Insolvency Proceedings were opened. In respect of legal acts relating to claims and performances which fall within the scope of section 96 para 2 InsO (below, paragraph 3.2.3(i)(iv)) the application of section 147 sentence 1 InsO shall, however, not reverse the set-off of account balances or affect the validity of the payment orders, orders of payment services providers or intermediate providers or orders for the transfer of securities (section 147 sentence 2 InsO).

(b) Defences to challenge in insolvency

Section 130 para 1 sentence 1 InsO is not applicable where the relevant legal act is based on a security agreement which contains the obligation to provide Financial Collateral, to replace Financial Collateral by other Financial Collateral or to provide additional Financial Collateral in order to readjust the relation between the value of the obligation and the value of the collateral as set forth in the security agreement (*Margensicherheit*; margin collateral (section 130 para 1 sentence 2 InsO). Any English law charge (or any security interest under the laws of another state) or full title transfer qualifying as Financial Collateral and made to secure obligations under the Opinion Documents would therefore not be subject to challenge in insolvency pursuant to section 130 para 1 sentence 1 InsO to the extent any legal assets serve the provision or replacement of (additional) Financial Collateral in order to readjust the relation between the value of the obligation and the value of the collateral as set forth in the security agreement. Initial margin is calculated to cover LCH's potential future exposures to counterparties in

the interval between the last margin requirement and the close-out of Contracts and liquidation of collateral following a counterparty's default. Variation margin may therefore qualify as margin collateral whereas initial margin should not qualify as such.[172]

Section 142 para 1 InsO provides that a payment on the part of the Insolvent Party in return for which the Insolvent Party's property benefited directly (*unmittelbar*)[173] from an equivalent (*gleichwertig*) consideration may only be challenged if such payment was made with the intention to prejudice the creditors as set out in section 133 paras 1 to 3 InsO and the other party is aware that the Insolvent Party was acting dishonestly (*unlauter*).

As mentioned before (paragraph 3.2.1(g)), under Article 102b section 2 EGInsO all necessary measures which are permissible in accordance with Article 102b section 1 para 1 EGInsO are not subject to challenge in insolvency.

(c) Avoidance outside Insolvency Proceedings

Under the German Avoidance Act (*Anfechtungsgesetz*, "**AnfG**") a creditor is entitled to challenge outside Insolvency Proceedings legal acts of a debtor which are detrimental to creditors if the creditor has obtained an enforcement order (*vollstreckungsfähiger Titel*) and its claims are due and payable, but any enforcement actions against the debtor's estate either did not result in the full satisfaction of the creditor's claim or it can be assumed that any such enforcement actions will not be

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[172] Section 130 para 1 sentence 1 InsO refers to the adjustment of the relation between the values of the secured obligations and the value of the collateral. While initial margin may be adjusted as well this is not normally due to a change in the values of secured obligations and security provided but rather constitutes a measure based on the generally perceived volatility in the market; see *Kayser*, in: Münchener Kommentar InsO, 3rd ed. (2013), § 130 nos. 5d and 5e; *de Bra*, in: Braun, InsO, 7th ed. (2017), § 130 InsO no. 41.

[173] Pursuant to section 142 para 2 InsO, the reciprocal obligations are performed "directly" (*unmittelbar*) if there is – taking into account the nature of the goods and services exchanged and the relevant business practices in relation to relevant types of contract – only a short delay between the respective performances (*enger zeitlicher Abstand*). This does not necessarily require a simultaneous performance. However, in order to be able to rely on this exemption, the exchange would still ideally take place simultaneously as it could be difficult to prove any particular business practice in this type of transaction so that there remains a risk that, where the exchange is not simultaneous, this exemption may not apply.

successful to satisfy the creditor's claim. Section 19 AnfG provides for a special conflict of laws rule as regards avoidance under the AnfG and refers to the laws of the jurisdiction which governs the relevant legal act.[174] For a successful challenge the relevant legal act muss fall within the applicable suspect periods.

Under section 3 para 1 AnfG a legal act made by the debtor during the last ten years prior to the challenge, with the intention to disadvantage its creditors may be subject to challenge, if the other party was aware of the debtor's intention on the date of such legal act (such awareness is presumed if the other party knew of the imminent inability of the debtor to make payment when due, and that the transaction constituted a disadvantage for the creditors). Additional challenge rights apply, *inter alia*, to legal acts with closely related persons and to legal acts without consideration.

3.2.5 *Is there relevant netting legislation in the Relevant Jurisdiction that, in the context of Insolvency Proceedings or Reorganisation Measures in respect of a Relevant Clearing Member, might apply as an alternative to the relevant arrangements set out in the Default Rules*?

Yes, within the scope of application of the InsO, section 104 InsO provides for a mandatory automatic termination of those transactions which fall within the scope of section 104 InsO upon the opening of Insolvency Proceedings (see above paragraph 3.2.3(c)).

3.2.6 *Can a claim for a close-out amount be proved for in Insolvency Proceedings without conversion into the local currency*?

In order to receive payment of claims in Insolvency Proceedings, the creditor of an Insolvent Party should register its claims with the Insolvency Administrator within a certain period of time supporting the registration with the relevant

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[174] *Kirchhof*, in: Münchener Kommentar zum Anfechtungsgesetz, 1st ed. (2012), § 19 AnfG no. 7 *et seq.* Depending on the relevant legal act, this may be the *lex causae, lex rei sitae or lex cartae sitae*, see paragraph IV.C.3.15(c) above for further details.

documents and state the basis and amount of the claim (section 174 para 1 InsO).[175]

After the opening of Insolvency Proceedings, for the purposes of such registration cash payment claims against an Insolvent Party in a currency other than Euro must be converted into Euro at an exchange rate applicable at the place of performance at the time of the opening of the Insolvency Proceedings (section 45 sentence 2 InsO).

According to the BGH, the official exchange rate applicable on the date of the opening of Insolvency Proceedings at the place of payment applies and the place of payment is the place where the Insolvency Proceedings have been opened.[176] With respect to enforcement proceedings, however, it is proposed that cash payment claims in a currency other than Euro are converted at the official conversion rate on the date and at the place of payment.[177]

3.3 Client Clearing

3.3.1 *Please opine on the availability and effectiveness of any law, regulation or statutory provision (having the force of law) in the Relevant Jurisdiction which (if so designated by LCH) would be expected to qualify as an Exempting Client Clearing Rule. Please clarify whether the relevant Exempting Client Clearing Rule would be expected to apply to Relevant Clearing Members of all entity types or to only certain entity types.*

If, and to the extent that, you consider such an Exempting Client Clearing Rule to be available, please (i) assume for the purposes of answering the following Questions that LCH will rely upon the existence of the relevant Exempting Client Clearing Rule and will not require those Relevant Clearing Members to which that Exempting Client Clearing Rule applies to enter into a Security Deed; and (ii) ignore Questions 3.3.7 to 3.3.9.

In cases where you do not consider an Exempting Client Clearing Rule to be available, please: (i) assume for the purposes of answering the following

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[175] This does not apply to claims of a creditor having a right to segregation (*Aussonderungsrecht*) or creditors of the estate, *Riedel*, in: Münchener Kommentar InsO, 3rd ed. (2013), § 174 no. 6.

[176] BGH NJW 1989, 3155 (on the KO); *Andres*, in: Nerlich/Römermann, InsO, 35th update (as of April 2018), § 45 no. 4; see, however, *Bitter*, in: Münchener Kommentar InsO, 3rd ed. (2013), § 45 no. 20.

[177] *Bach*, in: Beck'scher Online-Kommentar ZPO, 29th ed. (1 July 2018), § 722 Rn. 27.

Questions that LCH will require Relevant Clearing Members to enter into a Security Deed; (ii) assume that the Security Deed is legal, valid, binding and enforceable under English law (as its governing law) and complies with all relevant perfection requirements under the law of any jurisdiction(s) other than the Relevant Jurisdiction which you consider to be relevant to that matter; and (iii) provide a response to Questions 3.3.7 to 3.3.9.

We understand that an "Exempting Client Clearing Rule" would be any law or regulation protecting the validity of actions taken under the Client Clearing Annex of the Default Rules (in particular the porting of client assets and positions to a backup clearing member) from challenge under the insolvency laws applicable to the Relevant Clearing Member.

As already outlined in paragraph 3.2.1, the InsO and EGInsO provide for different exemptions from application of its restrictions, in particular the challenging rights thereunder.

(a) Article 102b EGInsO

Where German insolvency laws apply, Article 102b EGInsO provides for a general rule under which certain mandatory provisions in Insolvency Proceedings and Provisional Insolvency Measures do not apply if they would impair measures considered necessary in accordance with Article 48 EMIR (see paragraph 3.2.1(f)). In particular, the opening of Insolvency Proceedings must not impair (1) the performance of the necessary measures to administer, close out or otherwise settle client positions and own account positions of a clearing member in accordance with Article 48 para 2, para 3, para 5 sentence 3 and para 6 sentence 3 EMIR, (2) the necessary transfer of client positions in accordance with Article 48 paras 4 to 6 EMIR and (3) the necessary utilisation and disbursement of clients' collateral in accordance with Article 48 para 7 EMIR where such measures have been taken in accordance with Article 48 EMIR. Furthermore, these measures are not subject to insolvency avoidance and challenge.

With respect the scope of application of Article 102b EGInsO and its effects in general, see paragraph 3.2.1(g) above and with respect to its effect on measures taken by LCH under Rule 6 and 8 of the Default Rules, please see also paragraph 3.2.3(j) above.

In particular, there are two limitations of the scope of application of Article 102b EGInsO: (i) It protects necessary measures taken by a CCP in accordance with Article 48 EMIR only and (ii) it is an insolvency law provision therefore not addressing any property or contractual law aspects in connection with Article 48 EMIR and any necessary measures thereunder. It is not entirely clear how the term "necessary" should be construed in this context and whether CCPs have discretion in determining the measures which are necessary under specific circumstances.

Accordingly, we cannot confirm that Article 102b EGInsO provides for the required level of protection from insolvency laws and other laws affecting measures to be taken by LCH as would be expected to be granted under an Exempting Client Clearing Rule.

(b) Rules applicable to Systems

Further specific exemptions from certain mandatory restrictions under the InsO apply to Systems, please see also paragraph 3.2.1(f) above.

In Insolvency Proceedings specific conflict of laws provisions apply with respect to rights and obligations of participants in Systems (Article 12 Recast EUIR, see paragraph 3.2.3(a), and section 340 para 3 InsO, see paragraph 3.2.3(b)(C)). Within the scope of application of the InsO, exemptions for Systems apply with respect to insolvency related set-off (paragraph 3.2.3(h) below) and the enforcement of security (paragraph 3.2.2(c) below).

While we take the view that the LCH qualifies as a System, absent any court decisions on the definition of the term "System" and on the scope of application of section 340 para 3 InsO, a German court may also take a different view.

(c) Relationship between section 340 para 3 InsO and Article 102b EGInsO

Special conflict of law provisions referring to English substantive law (section 340 para 3 InsO) would apply to LCH if it qualifies as a System. In such case, Article 102b EGInsO would not be applicable because Article 102b EGInsO is a provision of substantive law rather than as a conflict of laws provision. Therefore, Article 102b EGInsO only applies if German insolvency law applies.

However, if LCH does not qualify as a System or section 340 para 3 InsO cannot be construed that English substantive insolvency law applies with respect to the effects of the opening of Insolvency Proceedings over the assets of a Relevant Clearing Member, then substantive German law applies. In such case, Article 102b EGInsO would apply to the Opinion Documents.

The legal risk resulting from the uncertainties described in paragraphs 3.3.1(a) and 3.3.1(b) above can be mitigated by entering into a Security Deed, thereby creating a security interest in favour of the Relevant Clearing Member's clients (see also paragraphs 3.3.8 *et seq.* below).

3.3.2 *If LCH were to: (i) declare a Relevant Clearing Member to be in Default in circumstances other than the commencement of Insolvency Proceedings or Reorganisation Measures in respect of that clearing member and (ii) seek to port the Client Contracts and Account Balance of a Clearing Client to a Backup Clearing Member as a result, could the Relevant Clearing Member or any other person successfully challenge the actions of LCH and claim for the amount of the Account Balance*?

(a) Porting under the Rulebook

Prior to analysing the rights of a Relevant Clearing Member or other person to successfully challenge the actions of LCH, we summarise our understanding of the term "porting" as used herein as follows:

"Porting" includes the transfer of Client Contracts of a Relevant Clearing Member (by way of novation) to a Backup Clearing Member, together with the Account Balances pursuant to the Default Rules, including the Client Clearing Annex.[178] In such case, the Relevant Clearing Member is "deprived" of any entitlement to the collateral posted by it (in the form of either the Account Balance or the Client Clearing Entitlement) as it is transferred to the Backup Clearing Member. The term "Account Balance" as defined in the General Regulations means such part of the collateral granted by the Relevant Clearing Member which is attributable to the relevant client account

[178] The relevant rules are General Regulation 11 and Rules 6 to 9 of the Client Clearing Annex (set out in Schedule 1 to the Default Rules).

held by the Relevant Clearing Member on behalf of such client and which is attributed by LCH to the relevant client.

Collateral granted in this context means either security over cash which is granted by way of outright title transfer or, with respect to non-cash collateral granted under the Deed of Charge, any cash amounts after realisation of the relevant security interest that exceed the Relevant Clearing Member's obligations to LCH.

(b) Contractual law analysis

If Insolvency Proceedings have not been opened over the assets of a Relevant Clearing Member, the choice of English law to govern the transfer or termination and re-establishment of Contracts as a contractual matter and the agreement on the scope and preconditions for release of collateral as a contractual matter would, from a German conflict of laws perspective generally be recognised unless it involved the transfer of property rights, in which case mandatory conflict of laws rules must be observed (see paragraph 3.2.2(b) above).

(c) Insolvency laws affecting porting

If Insolvency Proceedings are opened, German mandatory insolvency laws including provisions on challenge in insolvency would apply to the transfer (see generally paragraph 3.2.4(a) above).

However, special conflict of law provisions would apply to LCH if it qualifies as a System and refer to English substantive law (section 340 para 3 InsO). If LCH does not qualify as a System and German insolvency law applies, section 102b EGInsO provides for exemptions from mandatory insolvency provisions under the following circumstances: Based on our understanding that LCH qualifies as a CCP for purposes of EMIR and provided that the transfer of the Contracts and collateral are necessary measures in accordance with Article 48 EMIR, an exemption from German insolvency laws would potentially apply although its scope is unclear (please refer to paragraph 3.2.1(g) above). We also note that no specific amendments have been made to other laws such as property laws to fully implement this provision.

3.3.3 *If LCH were to: (i) declare a Relevant Clearing Member to be in Default in circumstances other than the commencement of Insolvency Proceedings or*

Reorganisation Measures in respect of that clearing member; and (ii) seek to return the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such client, could the Relevant Clearing Member or any other person successfully challenge the actions of LCH and claim for the amount of the Client Clearing Entitlement?

If Insolvency Proceedings have not been opened over the assets of a Relevant Clearing Member, the choice of English law to govern the scope of the Relevant Clearing Member's claim for return of the Client Clearing Entitlement[179] as a contractual matter would, from a German conflict of laws perspective generally be recognised unless it involved the transfer of property rights, in which case different conflict of laws rules apply (see paragraph 3.2.2(b) above).

With respect to Insolvency Proceedings being subsequently opened, please see paragraph 3.3.2(c) above and paragraph 3.3.6 below.

3.3.4 *If (i) following the commencement of Insolvency Proceedings, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event); and (ii) LCH were to seek to port the Client Contracts and Account Balance of a Clearing Client to a Backup Clearing Member as a result, could an insolvency officer appointed to the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Account Balance*?

(a) Effects of the opening of Insolvency Proceedings

If LCH qualifies as a System both, Article 12 Recast EUIR and section 340 para 3 InsO would refer to English substantive law with respect to effects of Insolvency Proceedings (see paragraphs 3.2.3(a), 3.2.3(b) and 3.2.4(a)(i) above) given that the Opinion Documents (including the account relationships of all collateral accounts) are governed by English law. On this basis, provided the arrangements of the Opinion Documents are effective and allow the distinction of a Client's assets from any other assets as a matter of English law (as to which we express no opinion) neither porting of assets related to Accounts which are segregated under

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[179] Such term defined in Clause 9.1 of the Client Clearing Annex as "the entitlement to Collateral (and any close-out amounts referred to in (a) of this paragraph 9.1) (the "**Client Clearing Entitlement**") of the Defaulter in respect of each such Clearing Client [...]".

the Opinion Documents nor the porting of Client Contracts and the Account Balance of a Clearing Client to a Backup Clearing Member would be affected by the opening of Insolvency Proceedings if the arrangements providing for segregation and portability as between LCH, the defaulting Relevant Clearing Member, its Client and the backup Clearing Member are valid and all transfers are validly made as a matter of English law.

As mentioned previously, the precise scope of application of section 340 para 3 InsO has not been subject to any court decision and there is, in particular, no guidance as to what extent section 340 para 3 InsO prevails over conflicting insolvency conflict of laws provisions as for example section 339 InsO governing challenge in insolvency or section 351 InsO governing rights *in rem* as regards assets that are located in Germany at the opening of foreign insolvency proceedings. Furthermore, section 340 para 3 InsO does not address property law aspects and it is therefore necessary to ensure that all transfers comply with applicable property law.

However, if German insolvency laws apply, the restrictions set out under paragraph 3.2.1(a) above in particular the prohibitions on the Insolvent Party to dispose of its assets apply and have to be observed. To the extent the porting of Client Contracts is not effected in accordance with Article 48 EMIR and Article 102b EGInsO is not applicable, the transfer would potentially be subject to all the restrictions the opening of Insolvency Proceedings entails (see paragraph 3.2.1(a)), including challenge in insolvency (see paragraph 3.2.4) but partial exemptions may apply. Such partial exemptions are available if Financial Collateral is granted (see paragraph 3.2.1(e)). Furthermore, where "porting" is effected by means of close-out and re-establishment, the analysis given in respect of close-out netting at paragraph 3.2.3(c) above applies. Upon the opening of Insolvency Proceedings security interests generally must be enforced in accordance with the InsO, i.e. it would have to be determined whether a security interest grants a right for segregation or separate satisfaction (paragraph 3.2.2(c)).

In addition to restrictions under insolvency laws (and even if an exemption applied), any transfer would have to be made in accordance with applicable civil and property law requirements. If applicable, German law, for example, would not allow for the transfer of pledged

assets unless the pledgor, the legal owner of the assets, has given its consent. Where Insolvency Proceedings are opened over the assets of a pledgee this would under German law not result in the pledge ceasing to exist. Rather, the pledge would continue to exist until the security purpose ceased to exist.

According to the legislative materials, the German legislator wrote the exemption to ensure that measures taken by a CCP in accordance with EMIR upon a default of one of its Relevant Clearing Members are valid as a matter of German insolvency law.[180] We note that no specific amendments have been made to other laws such as property laws to fully implement this provision.

(b) Provisional Insolvency Measures

Where applicable, Article 102b section 1 para 2 EGInsO exempts necessary measures taken in accordance with Article 48 of EMIR from the effects of Provisional Insolvency Measures and therefore our reasoning given at the preceding paragraph applies analogously to Provisional Insolvency Measures.

3.3.5 *If (i) following the commencement of Insolvency Proceedings, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event); and (ii) LCH were to seek to return the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such client, could an insolvency officer appointed to the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Client Clearing Entitlement?*

Please refer to our comments made in paragraph 3.3.4.

3.3.6 *If (i) following the implementation of Reorganisation Measures, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event); and (ii) LCH were to seek to port the Client Contracts and Account Balance of a Clearing Client to a Backup Clearing Member as a result, could the representative appointed to reorganise/manage the Defaulter or any*

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[180] BT-Drucksache 17/11289, p. 27.

other person successfully challenge the actions of LCH and claim for the amount of the Account Balance?

Please see paragraph 3.2.1 for an overview of Insolvency Proceedings, Provisional Insolvency Proceedings and Regulatory Proceedings under the laws of Germany.

Certain measures under Regulatory Proceedings such as the closure of a Relevant Clearing Member for ordinary business with clients (section 46 para 2 sentence 2 no. 5 KWG), the imposition of a Moratorium and, in particular, a Resolution Order may affect portability (see further paragraph 3.2.1(d) above). Taking the view that LCH qualifies as a System or that ported positions qualify as Financial Collateral, however, exemptions are available (above, paragraphs 3.2.1(f)).

Since Article 102b EGInsO only refers to Insolvency Proceedings and Provisional Insolvency Measures, it would not apply to prevent the application of any restriction under other laws, i.e. porting would have to be made in accordance with applicable substantive civil law (including property law) and may be affected by the opening of Regulatory Proceedings.

To summarise, German law generally refers to English law as far as contract aspects of actions taken in connection with the Default Rules are concerned, while restrictions under Insolvency and Regulatory Proceedings as well as Provisional Insolvency Measures may affect porting. A general exemption from Insolvency Proceedings and Provisional Insolvency Measures apply if porting constitutes a necessary measure under Article 48 EMIR. Further (albeit less comprehensive) exemptions would be available if LCH qualifies as a System or if porting involves Financial Collateral.

3.3.7 *If (i) following the commencement of Reorganisation Measures, a Relevant Clearing Member was designated a Defaulter (whether due to the delivery of a Default Notice or (if applicable) the occurrence of an Automatic Early Termination Event); and (ii) LCH were to seek to return the Client Clearing Entitlement to the relevant Clearing Client or to the Defaulter for the account of such client, could the representative appointed to reorganise/manage the Defaulter or any other person successfully challenge the actions of LCH and claim for the amount of the Client Clearing Entitlement*?

Please see paragraph 3.3.6 above.

3.3.8 *Would the Security Deed provide an effective security interest under the laws of the Relevant Jurisdiction over the Account Balance or Client Clearing Entitlement in favour of the relevant Clearing Client?*

We understand from the fact pattern that German conflict of laws provisions on the creation of a security interest refer to English law because no assets located in Germany are the subject of the security interest to be created under the Security Deed.

Please see above in paragraph 3.2.2 for an analysis with respect to a security interest governed by English law including an analysis of applicable mandatory conflict of laws provisions as regards the valid creation of a security interest.

3.3.9 *Are there any perfection steps which would need to be taken under the laws of the Relevant Jurisdiction in order for the Security Deed to be effective?*

To the extent German conflict of laws provisions refer to English law with respect to the creation of a security interest, no filing or registration is required under German law in addition to any English law requirements to ensure that German law recognises the validity of the security interest as the recognition of the English law as the law governing the security interest also extends to any filing, registration or perfection requirements.

Further, there are no filing or registration requirements under German law which are merely based on the status of the Relevant Clearing Member having its place of establishment, incorporation or registration Germany.

3.3.10 *Is there any risk of a stay on the enforcement of the Security Deed in the event of Insolvency Proceedings or Reorganisation Measures being commenced in respect of a Relevant Clearing Member?*

Please see above in paragraph 3.2.2 applicable provisions of German law as regards the enforcement of a security interest governed by English law in particular in Insolvency Proceedings.

3.4 *Please provide brief details of any other significant legal or regulatory issues which might be expected to arise in connection with the provision by a Relevant Clearing Member of Client Clearing Services and which are not covered by the Questions above.*

We are not aware of any such issues but we are happy to look into this again upon further guidance on the issues you are looking for.

3.5 Settlement Finality

This section is concerned with the impact on the finality of settlement of a Payment Transfer Order or Securities Transfer Order (or both), including the corresponding transfer of funds or securities, respectively, from a Relevant Clearing Member to LCH through a Settlement Services Provider or PPS Bank (or both) in the event of that Relevant Clearing Member entering Insolvency Proceedings or becoming subject to Reorganisation Measures.

3.5.1 *Would the commencement of Insolvency Proceedings in respect of a Relevant Clearing Member affect the finality of settlement of a Payment Transfer Order, including the corresponding transfer of funds, from the Relevant Clearing Member to LCH through a Settlement Services Provider or PPS Bank (or both)? If so, please clarify from which point in time and in which circumstances finality protections in respect of such settlement would be lost.*

As mentioned under paragraph 3.2.1(a) above, upon the opening of Insolvency Proceedings the insolvent Relevant Clearing Member's right to manage and transfer the insolvency estate is vested in the Insolvency Administrator (section 80 InsO). Any dispositions of the insolvent Relevant Clearing Member over its property made after the opening of Insolvency Proceedings are void unless the relevant insolvency court otherwise orders (section 81 para 1 InsO). If a creditor of the insolvent debtor obtained security in respect of assets that form part of the insolvent debtor's assets by means of enforcement measures (*Zwangsvollstreckungsmaßnahmen*) up to one month prior to the opening of Insolvency Proceedings or after the opening of Insolvency Proceedings, such security is void (section 88 InsO). Pursuant to section 91 para 1 InsO, after the opening of Insolvency Proceedings rights in objects forming part of the insolvency estate cannot be acquired with legal effect even if such acquisition of rights is not based on the Insolvent Party's transfer or effected by way of execution.

With respect to settlement finality, section 81 para 3 InsO clarifies that if the Insolvent Party has transferred an asset forming part of the insolvency estate on the day on which the Insolvency Proceedings were opened, such transfer shall be presumed to have been effected after the opening of the Insolvency Proceedings. However, any transfer by the Insolvent Party in respect of Financial Collateral following the opening of Insolvency Proceedings is, notwithstanding the provisions on challenge in insolvency, legally valid if it

occurred on the day of the opening and the other party proves that it was neither aware of nor had to be aware of the opening of the Insolvency Proceedings.

To the extent Article 102b EGInsO applies (see paragraph 3.2.1(g) above), the restrictions under sections 81 *et seqq.* InsO must not impair any necessary measures under Article 48 EMIR and accordingly would not apply.

3.5.2 *Would the commencement of Insolvency Proceedings in respect of a Relevant Clearing Member affect the finality of settlement of a Securities Transfer Order, including the corresponding transfer of securities, from the Relevant Clearing Member to LCH through a Securities System Operator? If so, please clarify from which point in time and in which circumstances finality protections in respect of such settlement would be lost.*

Please refer to our answer to paragraph 3.2.1(a) above, as section 81 para 3 InsO covers both, transfer of payments and delivery of securities.

3.5.3 *Are there any circumstances (such as the commencement of reorganisation measures) which might give rise to a loss of finality protections before the commencement of Insolvency Proceedings? If so, please clarify from which point in time and in which circumstances finality protections would be lost.*

Please refer to paragraph 3.2.1(e) above with respect to exemptions for Financial Collateral and to paragraph 3.2.1(f) with respect to any exemptions applicable to Systems.

4. QUALIFICATIONS

4.1 Even where a German court would normally have to recognise the choice of the laws of England to govern the contractual obligations under the Opinion Documents, it may,

4.1.1 give effect to mandatory provisions of the law of the country where the obligations arising out of the Opinion Documents have to be or have been performed, insofar as those overriding mandatory provisions render the performance of the contract unlawful (Article 9 para 3 Rome I);

4.1.2 apply overriding mandatory provisions of German law (Article 9 para 2 Rome I) irrespective of the choice of the laws of England for the Opinion Documents;

4.1.3 refuse to apply the laws of England to the Opinion Documents, to the extent the application of the laws of England is manifestly incompatible with German public policy (Article 21 Rome I);

4.1.4 have regard to the law of the country in which performance takes place in relation to the manner of performance and the steps to be taken in the event of defective performance (Article 12 para 2 Rome I); and

4.1.5 apply the provisions of the law of another Member State which cannot be derogated from by agreement, if all elements relevant to the situation at the time that the Opinion Documents were entered into were located in a Member State other than England (Article 3 para 3 Rome I).

4.2 Pursuant to Article 34 Brussels I Regulation (Recast) German courts do generally not recognise a judgment under the Brussels I Regulation (Recast)

4.2.1 if such recognition would be manifestly contrary to public policy in the Member State in which recognition is sought;

4.2.2 where it was given in default of appearance, if the defendant was not served with the document which instituted the proceedings or with an equivalent document in sufficient time and in such a way as to enable him to arrange for his defence, unless the defendant failed to commence proceedings to challenge the judgment when it was possible for him to do so;

4.2.3 if it is irreconcilable with a judgment given in a dispute between the same parties in the Member State in which recognition is sought; and

4.2.4 if it is irreconcilable with an earlier judgment given in another Member State or in a third State involving the same cause of action and between the same parties, provided that the earlier judgment fulfils the conditions necessary for its recognition in the Member State addressed.

4.3 The German law principle of *Treu und Glauben* (section 242 BGB) requires that contracts are performed in good faith. Actions *contra bonos mores* may provide certain rights in favour of a contracting party or may render contracts or commitments void or voidable. In addition, public policy may lead to "equitable" rights being upheld in German courts or may make contracts or commitments void or voidable or may lead to the re-characterisation of such contracts or commitments and German courts may declare provisions providing for strict liability invalid.

4.4 If a party is substantially over-collateralised, a security interest governed by German law can be void in case of an initial over-collateralisation for being contrary to public

policy (section 138 para 1 BGB).[181] If over-collateralisation occurs subsequently, the secured party is required to release part of the security it has provided. Whether or not a party is substantially over-collateralised generally depends on the relation of the value of the secured obligation towards the realisable value of the collateral.[182]

However, if a security interest is governed by non-German law, German courts would only in exceptional cases not recognise the security interest by reason of over-collateralisation. Even if the granting of collateral results in a substantial over-collateralisation of the secured party by German standards, this does not necessarily lead a German court to conclude that the security interest is in breach of German public policy and that such security interest can therefore not be recognised under Article 21 Rome I or Article 6 EGBGB, as the case may be (i.e. the standards for assessing any infringement of German public policy are not the same under section 138 para 1 BGB as under Article 21 Rome I or Article 6 EGBGB[183]). We are not aware of any court precedents supporting the application of the *ordre public* in such case.

4.5 The general terms and conditions of German banks ("**AGB-Banken**") as published by the Association of German Private Banks (*Bundesverband deutscher Banken*) are frequently used by private Credit Institutions. Where the AGB-Banken govern a business relationship with a Credit Institution, any account maintained with the Credit Institution will usually be subject to a first ranking account pledge created in favour of the bank. Even where the AGB-Banken are not used, similar general terms and

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[181] BGH NJW 1998, 2047. The BGH has not yet given any guidance as to when initial over-collateralisation would be considered as "substantial" and therefore void under section 138 para 1 BGB.

[182] Pursuant to the BGH (NJW 1998, 671, 674) the claim for release of security is triggered once the realisable value of the collateral not only temporarily exceeds the value of the secured obligation by 10 per cent. The BGH further stated that even if an agreement whereby a security transfer is effected does not provide for provisions on the release of the collateral, the debtor has an inherent claim for release if a (subsequent) over-collateralisation has occurred. Therefore, such security interest should not be void due to a substantial over-collateralisation (however, this does not apply in case of an initial over-collateralisation); the secured party would only be obliged to return the excess collateral. The same applies to the release of a pledge. We are not aware of any judgment according to which this also applies where collateral is provided by way of a outright title transfer. In case of a pledge under German law, an over-collateralisation should not occur because due to the accessory nature of a pledge, the pledge only exists in the amount of the secured obligation (including any future obligation). However, if pledged assets have been transferred to the pledgee or a third party (for example, a depository), the pledgor may request the return of such assets which are not subject to the pledge anymore.

[183] *v. Hein,* in: Müchener Kommentar BGB, 7th ed. (2018), Article 6 EGBGB no. 132 *et seqq.*; *Mülbert/Bruinier*, WM 2005, 105, 100. The BGH has not yet given any guidance as to when initial over-collateralisation would be considered as "substantial" and therefore void under section 138 para 1 BGB.

conditions are most likely to be in place when dealing with a Credit Institution and possibly when dealing with a Financial Services Institution. Similar restrictions may apply under general business conditions used by savings banks and cooperation banks. For purposes of this Opinion Letter, we have only reviewed the Opinion Documents and only expressed opinions on the Opinion Documents without taking into consideration further documents which may have an impact on our analysis.

4.6 By virtue of Article VIII section 2(b) of the Articles of Agreement of the International Monetary Fund (in connection with the German IMF Accession Act (*IWF-Beitrittsgesetz*) and the IMF Act (*IWF-Gesetz*)), as interpreted and applied by German courts, any obligation which involves the currency of any member of the International Monetary Fund and which is contrary to the exchange control regulations of that member may not be enforceable (*unklagbar*) in the German courts.

4.7 Any transfer of rights or payment in respect, or other performance, of an obligation under the Opinion Documents involving the government of any country which is currently the subject of United Nations or EU sanctions, any person or body resident in, incorporated in or constituted under the laws of any such country or exercising public functions in any such country or any person or body controlled by any foregoing or by any person acting on behalf of any of the foregoing may be subject to restrictions pursuant to such sanctions as implemented in German law.

4.8 In respect of cross-border cash payments the notification requirements under the German Foreign Trade Act (*Außenwirtschaftsgesetz*) and the German Foreign Trade Regulation (*Außenwirtschaftsverordnung*) need to be observed. The reports have to be submitted to the Deutsche Bundesbank using the applicable notification forms. Any failure to comply would, however, not affect the validity of the respective transaction.

4.9 We do not express any opinion on data protection requirements or on German law principles governing bank secrecy.

4.10 We express no opinion as to whether any party has complied with any applicable provisions of Title II EMIR, any delegated or implementing acts adopted under EMIR, the provisions KWG, the German Securities Trading Act (*Wertpapierhandelsgesetz*) or the German Exchange Act (*Börsengesetz*) which were amended or enacted to implement EMIR, or any regulations adopted thereunder in respect of anything done by it in relation to or in connection with the Opinion Documents other than provisions on which we expressly opine. However, Article 12 para 3 EMIR provides that any infringement of the rules under Title II EMIR "shall not affect the validity of an OTC derivative contract or the possibility for the parties to enforce the provisions of an OTC

derivative contract", consequently any failure by a party to so comply should not make the Opinion Documents invalid or unenforceable.

4.11 We express no opinions as to whether any party has complied with any applicable provision of Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015 on transparency of securities financing transactions and of reuse and amending Regulation (EU) No 648/2012 ("**SFTR**").[184] Article 15 SFTR imposes obligations relating to rights of reuse where these are exercised. The SFTR has entered into force on 12 January 2016. Article 15 SFTR has taken effect from 13 July 2016 onwards.

4.12 We express no opinions on Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June November 2016 on indices used as benchmarks in financial instruments and financial contracts or to measure the performance of investment funds and amending Directives 2008/48/EC and 2014/17/EU and Regulation (EU) No 596/2014.[185]

4.13 Any set-off against a claim of a Credit Institution which is established as a public law entity is only permissible if payment is to be attributed to the same fund (*Kasse*) (i.e. where the entity has an administrative sub-division administering its own budget) of such German public law entity from which the claim of the party intending to effect the set-off is to be paid (section 395 BGB).

4.14 Credit Institutions which are established as public law entities may enter into contracts under private law where this is not expressly prohibited. However, where they engage in commercial acts under private law they are bound by the general restrictions applicable to German public law entities. In particular, they are bound by the fundamental rights (*Grundrechte*) of the German Constitution and the rule of law (*Rechtsstaatsprinzip*). On the facts of each individual case, the German courts may therefore reach the conclusion that general restrictions of Credit Institutions under public law prevent them from entering into certain types of transactions or oblige to refrain from exercising certain rights or to exercise their rights in a certain manner.

4.15 Under the German public law doctrine of *ultra vires*, the power and capacity of a legal entity established under public law to validly enter into a legally binding agreement under private law is limited. Public law entities may principally only enter into

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[184] OJ EU No L 337 of 23 December 2015, p. 1

[185] OJ EU No L 171 of 29 June 2016, p. 1.

transactions that fall within their scope of competence (*Verbandskompetenz*) and functions (*Wirkungskreis*) as defined by the laws establishing or applicable laws conferring its powers and capacities upon such public law entity.[186] If a public law entity purports to enter into a contract under private law that is beyond or exceeding its functions, such a contract might be considered *ultra vires* and, therefore, void.[187] Provided that the *ultra vires* doctrine is applicable, it applies regardless of the good faith of the counterparty or any representation by the public law entity to the contrary. As a rule, *ultra vires* measures are unenforceable. They may not be ratified.

4.16 It is often argued that public sector entities are subject to a prohibition on speculation even though the legal basis of such prohibition is very unclear.[188] The prohibition on speculation would prevent public sector entities from entering into transactions for speculative purposes. In the absence of a clear legal basis or this principle the position of German courts has been that the prohibition on speculation – irrespective of the question whether and to what extent it constitutes a rule of law – would not lead to the voidness of contracts under section 134 BGB.[189]

4.17 Budgetary provisions are under German law considered to constitute internal law of the relevant public sector entity meaning that the violation of the budgetary laws does not affect the dealings with third parties.[190] In particular, it would not make contracts void under section 134 BGB which provides for the voidness of contracts violating a legal prohibition (*Verbotsgesetz*). However, under extraordinary circumstances the violation of budgetary provisions may make agreements entered into by a public sector entity void.

4.18 There is also considerable uncertainty as to whether a principle of connectivity (*Konnexität*) applies in respect of derivatives entered into by public sector entities.[191]

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[186] BGH NJW 1956, 746, 747; BGH NJW 1969, 2198, 2199; OVG Lüneburg NVwZ-RR 2010, 639, 641.

[187] BGH NJW 1956, 746, 747 *et seq.*; *Gurlit*, in: Erichsen/Ehlers, Allgemeines Verwaltungsrecht, 14th ed. (2010), § 31 no. 5. Pursuant to a judgement of the BGH of 28 April 2015 (XI ZR 378/13), the doctrine of *ultra vires* is, however, not applicable if a municipality enters into a derivatives agreement in breach of its own budgetary restrictions.

[188] OLG Bamberg BKR 2009, 288, 292.

[189] OLG Naumburg NJOZ 2005, 3420, 3425; LG Düsseldorf, judgment of 11 May 2012 – 8 O 77/11.

[190] German Federal Constitutional Court (*Bundesverfassungsgericht*, "**BVerfG**"), BVerfGE 20, 56, 89 *et seq.*; *Kirchhof*, NVwZ 1983, 505, 506.

[191] *Endler*, in: Zerey, Finanzderivate, 4th ed. (2016), § 30 no. 22 *et seq.*

The principle of connectivity would require such entities to only enter into transactions to hedge against certain risks from underlying contracts which the transaction matches.

4.19 In one case, a German court has argued that Credit Institutions may be under an obligation to inform a public sector entity of its restrictions under public law prior to the entry into a derivative and, failing to do so, that it may be liable to pay damages for wrongful investment advice.[192]

This Opinion Letter is given for the exclusive benefit of the addressee. In this opinion we do not assume any obligation to notify or inform you of any developments subsequent to its date that might render its content untrue or inaccurate in whole or in part at such time. It may not, without prior written consent, be relied on by any other person. We consent to a copy of this Opinion Letter being made publically available on its website and to it being shown to the relevant regulators and/or any counsel appointed by the addressee to advise on matters of the laws of other jurisdictions, for information purposes only and solely on the basis that we assume no responsibility to any such parties as a result or otherwise.

Yours faithfully,

Dr. Marc Benzler

CLIFFORD CHANCE DEUTSCHLAND LLP

[192] OLG Naumburg NJOZ 2005, 3420, 3427 *et seq.*

APPENDIX A

Section 104 InsO (incorporating the amendments in Article 1 of the Third Insolvency Code Amendment Act) – Please note that this version only applies to Insolvency Proceedings opened between 10 June 2016 and 28 December 2016

§ 104

Fixed Date Transactions, Financial Transactions, contractual close-out netting

(1) In the event that a particular time or period was agreed upon for delivery of commodities (*Waren*) with a market or exchange price, and such time occurs or such period lapses after the opening of insolvency proceedings, specific performance may not be demanded, but rather only a claim for non-performance may be asserted.

(2) Where a specified time or a specified period has been agreed for the delivery of financial products which have a market or exchange price, and where this time, or the expiry of this period, is not until after the opening of insolvency proceedings, performance may not be demanded, but rather only damages for non-performance may be claimed. Financial transactions shall include in particular

1. delivery of precious metals,

2. delivery of securities or comparable rights, except where there is an intention to acquire an interest in another enterprise with the aim of establishing a long-term relationship with that enterprise,

3. payments of money which are to be made in a foreign currency or in a mathematical unit,

4. payments of money the amounts of which are calculated, directly or indirectly by referencing to the exchange rate of a foreign currency or a unit of account, to the interest rate for borrowings or to the price of other goods (*Güter*) or services,

5. options and other rights to demand delivery of something or performance of payment obligations within the meaning of numbers 1 to 4 above,

6. financial collateral within the meaning of section 1 para 17 Banking Act.

Where the contracts involving financial transactions are combined in a master agreement for which it has been agreed that, where reasons for the opening of insolvency proceedings exist, it can only be terminated in its entirety, then such contracts shall together be deemed to form one single mutual agreement within the meaning of sections 103, 104.

(3) The amount of any claim for non-performance shall be the difference between the agreed price and such a market or exchange price which is applicable at the place of performance to an agreement with the stipulated time for performance on the date agreed between the parties on the second working day after the opening of insolvency proceedings.

(4) The parties to the contract may agree deviating provisions as long as these are compatible with the fundamental principles applicable to the statutory provision which is to be amended. They may, in particular, agree that,

1. the effects of paragraph 1 or paragraph 2 may apply prior to the opening of proceedings, in particular upon the application by a party to the contract for the opening of insolvency proceedings over its assets or upon the existence of a reason for the opening for proceedings (contractual termination),

2. that a contractual termination will encompass also such transactions pursuant to paragraph 1 or paragraph 2 in respect of which the claim for delivery of the commodities (*Waren*) or the performance of the financial transaction becomes due prior to the opening of proceedings, but after the point in time agreed for contractual termination,

3. that the claim for non-performance

   a) is determined by virtue of the market or exchange price for a replacement transaction which is entered into without undue delay, but no later than on the fifth business day after the contractual termination,

   b) is determined by virtue of the market or exchange price for a replacement transaction which could have been entered into at a contractually agreed point in time, but no later than on the fifth business day after the contractual termination,

   c) in case the market conditions do not allow for the conclusion of a replacement transaction pursuant to lit. a and b, may be determined by way of methods and procedures allowing for an adequate assessment of the value of the terminated transaction.

(5) The other party may assert the claim for non-performance only as an insolvency creditor.

APPENDIX B

Section 104 InsO (incorporating the amendments in Article 2 of the the Third Insolvency Code Amendment Act) - This version applies to Insolvency Proceedings opened from 29 December 2016 onwards

§ 104

Fixed Date Transactions, Financial Transactions, contractual close-out netting

(1) In the event that a particular time or period was agreed upon for delivery of commodities (*Waren*) with a market or exchange price, and such time occurs or such period lapses after the opening of insolvency proceedings, specific performance may not be demanded, but rather only a claim for non-performance may be asserted. This also applies to financial transactions which have a market or exchange price, and for which a particular time or period was agreed which only occurs or expires after the opening of insolvency proceedings. Financial transactions shall include in particular

1. delivery of precious metals,

2. delivery of financial instruments or comparable rights, except where there is an intention to acquire an interest in another enterprise with the aim of establishing a long-term relationship with that enterprise,

3. payments of money

   a) which are to be made in a foreign currency or in a mathematical unit, or

   b) the amounts of which are calculated, directly or indirectly by referencing to the exchange rate of a foreign currency or a unit of account, to the interest rate for borrowings or to the price of other goods (*Güter*) or services,

4. deliveries and payments from derivative financial instruments not excluded pursuant to number 2 above,

5. options and other rights to demand delivery pursuant to sentence 1 or for delivery, payment or options and rights within the meaning of numbers 1 to 5 above,

6. financial collateral within the meaning of section 1 para 17 Banking Act .

Financial instruments within the meaning of sentence 3 numbers 2 and 4 are those instruments listed in Annex I Section C of Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ. L 173 of 12.6.2014, p. 349; L 74 of 18.3.2015, p. 38; L 188 of 13.7.2016, p. 28), as last amended by Directive (EU) 2016/1034 (OJ. L 175 of 30.6.2016, p. 8).

(2) The amount of any claim for non-performance shall be determined on the basis of the market or exchange value of the transaction. The market or exchange value is deemed to be

1. market or exchange price for a replacement transaction which is concluded without undue delay, but no later than on the fifth business day after the opening of insolvency proceedings, or

2. if no replacement transaction is entered into in accordance with number 1, the market or exchange price for a replacement transaction, that could have been concluded on the second business day after the opening insolvency proceedings.

To the extent that the market conditions do not allow for the conclusion of a replacement transaction pursuant to sentence 2 numbers 1 or 2, the market or exchange value is to be determined by way of methods and procedures allowing for an adequate assessment of the value of the transaction.

(3) Where transactions pursuant to paragraph 1 are combined in a master agreement or the rules of a central counterparty within the meaning of Section 1 paragraph 31 of the German Banking Act, which provides that the covered transactions may, upon the occurrence of certain events, only be terminated in their entirety, then the whole of such covered transactions shall be deemed to be a single transaction within the meaning of paragraph 1. This shall also apply, if other transactions are covered by such agreement or rules; such transactions shall be subject to the general provisions.

(4) The parties to the contract may agree deviating provisions as long as these are compatible with the fundamental principles applicable to the relevant statutory provision which is to be amended. They may, in particular, agree that,

1. the effects of paragraph 1 may apply prior to the opening of proceedings, in particular upon the application by a party to the contract for the opening of insolvency proceedings over its assets or upon the existence of a reason for the

opening for proceedings (contractual termination),

2. that a contractual termination will encompass also such transactions pursuant to paragraph 1) in respect of which the claim for delivery of the commodities (*Waren*) or the performance of the financial transaction becomes due prior to the opening of proceedings, but after the point in time agreed for the contractual termination,

3. that for the purposes of the determination of the market or exchange value of the transaction

   a) the point in time of the contractual termination applies instead of the point in time of the opening of insolvency proceedings,

   b) the entering into of the replacement transaction pursuant to paragraph 2, sentence 2, number 1 may occur until the 20th business day after the contractual termination, if this is required to ensure that the unwinding of the transaction is performed in a manner that will maximise value,

   c) instead of the point in time specified in paragraph 2 sentence 2, number 2 a point in time or a period between the contractual termination and the expiry of the fifth business day following such termination shall apply.

(5) The other party may assert the claim for non-performance only as an insolvency creditor.

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Appendix 1 – Clearing Membership Agreement

Appendix 2 – Deed of Charge