Insolvency law and close-out netting in Greece: A case for legal reform

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ABSTRACT

This paper analyses the validity and enforceability of close-out netting under Greek bankruptcy law in the context of financial contracts. It concludes that there is a high legal risk that close-out netting may not be enforceable in the case of bankruptcy of Greek counterparties. Therefore, a legal reform is imperative in order to provide transparency for complex financial products with computerised, almost instant, price adjustments. With a number of EU legal acts on winding-up waiting to be transposed into national law, the legislator should take the opportunity to recognise close-out netting in the context of master agreements with credit institutions.

INTRODUCTION

Market associations have not yet provided any legal opinion for the European Master Agreement (EMA), sponsored by the Banking Federation of the European Union (EBF), in cooperation with the European Savings Banks Group and the European Association of Cooperative Banks, or the 1995 Global Master Repurchase Agreement (GMRA), sponsored by the International Securities Markets Association and the Bond Market Association, under Greek law. Regarding the GMRA, the sponsors of the 2000 GMRA have, however, announced their intention to commission a legal opinion supporting the usage of the 2000 GMRA under Greek law. After Asia's crisis, the collapse of Barings Bank and the initiatives of UNCITRAL and the Group of Thirty to reduce the risk of international insolvency, insolvency law has gained momentum. With the birth of the EMA, close-out netting had to be revisited in a number of jurisdictions. It is, therefore, important to analyse the current legal regime as regards validity and enforceability of netting, in particular close-out netting provisions of a master agreement, under general Greek bankruptcy law.

APPLICATION OF GREEK INSOLVENCY LAWS

Greek bankruptcy laws apply to companies and merchants and provide that bankruptcy proceedings start with the decision of the court, at the request of the bankrupt entity or its creditors. The court shall examine whether the bank is in a situation

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of 'cessation of payments' which makes it unable to meet its obligations and will determine that date in the court's order.[1] The date of the cessation of payments may not be more than two years prior to the publication of the court's order declaring the bankruptcy.[2]

In addition to bankruptcy, there are other regimes such as compulsory administration by creditors, special liquidation procedure, special bankruptcy regimes for banks (and investment services firms) which are outside the scope of this paper.

VALIDITY AND ENFORCEABILITY OF NETTING UNDER GENERAL BANKRUPTCY LAW IN GREECE

There is currently a disparity under Greek supervisory law and bankruptcy or substantive law as regards the validity and enforceability of close-out netting provisions in master agreements outside the scope of regulated payment systems.[3]

The Governor's Act of the Bank of Greece No 2054/92 implemented into Greek law Directive 89/647/EC. Set-off of claims is recognised under certain conditions although netting itself is not explicitly defined or regulated. The recognition for supervisory reasons of calculating capital adequacy requirements creates some expectation that netting agreements will or should be valid under Greek law. This legal act specifies that netting agreements must have been entered into prior to the suspect period or the instigation of insolvency proceedings in order to be valid and enforceable in case of bankruptcy against all creditors. Since there is no bankruptcy provision, however, there is a risk that the amount of the set-off will form part of the bankruptcy estate.[4]

If the counterparties of the transactions are Greek banks, Greek bankruptcy law shall apply. It is recognised that bankruptcy law has as a mandatory and public policy nature and its provisions shall prevail over contractual arrangements with a contrary content and irrespective of the law governing the contract.

As from the first hour of the day (zero-hour rule[5]) on which the decision is published in court, the bank is deprived of its powers, and all powers over its entire bankruptcy estate are transferred to the liquidator appointed by the court. Any act of the bankrupt entity after this point, including any payment, is null and void. All claims against the bankruptcy estate mature automatically[6] and interest on these claims cease accruing. Therefore, it is useful that, if the EMA is used with market participants in Greece, the EMA's special provisions do not opt out of the automatic termination of the master agreement. There is a legal risk, however, in the case of bankruptcy of a Greek entity, as described below. Except for certain categories of secured creditors, creditors may only declare their claims to the liquidator. From the above, it may be argued that set-off is no longer admissible after the decision on the bankruptcy has been published, even if the agreement dates before the decision.

By provision of law, acts of the bankrupt entity concluded during ten days prior to the official date of cessation of payments (suspect period) are null and void.[7] Acts void *per se* are gratuities, any payment and set-off of debts immature on the date of payment, payment of mature debts by any means (including set-off) other than cash and commercial paper, and any creation of pledge on assets of the debtor to secure pre-existing claims. Any other payments made by the debtor of mature debts and any onerous contract may be declared void if concluded during the suspect period, provided that the counterparty was aware of the cessation of payments.[8]

Therefore, contractual set-off of existing claims entered into during the suspect period, which may be up to two years and

ten days prior to the court's order, or after the declaration of bankruptcy by the court, shall not be valid. It can be deduced that a set-off agreement entered into prior to the suspect period and affecting claims which came into effect before the bankruptcy should be valid and therefore upheld by Greek courts.[9] As for unilateral set-off rights conferred upon the counterparty of a debtor, there may be conflicting views as to their validity.[10]

There is no rule in Greek law providing for an automatic termination of a contract in the case of bankruptcy of the counterparty, unless the nature of the agreement is such that the counterparty's soundness is substantial for the contract. Nevertheless, an agreement providing for an automatic termination of a contract in the case of bankruptcy of a counterparty is valid.[11] Any contract which is not terminated on the day of the court's order will be suspended and the liquidator shall have the power to decide that a suspended agreement may be continued and performed (cherry picking).

Therefore, there is a legal risk in the case of bankruptcy of a bank incorporated in Greece for its counterparties.

Nevertheless, this legal risk may be reduced after the implementation of the Settlement Finality Directive.[12] Article 9 of Law 2789/2000 provides that collateral provided to central banks of the European Union (EU), to the European Central Bank (ECB) and other participants of payment systems may not be stayed, declared void or terminated or otherwise discarded due to insolvency proceedings against a counterparty of the central banks of the EU and the ECB or insolvency proceedings against a counterpary of a participant to the payment systems.

MULTI-BRANCH NETTING

Multilateral netting deviates from the definition of set-off under the Greek civil code, which presupposes bilateral netting and mutuality of claims.

Legal uncertainty exists with respect to the validity of multilateral set-off agreements or novation. Some academics have argued that multilateral set-off should be enforceable even after the decision of the court declaring the bankruptcy, if the agreement is dated prior to the suspect period.

Single agreement provisions will be recognised under the contractual freedom principle and may prevent cherry picking from the liquidator according to some views. Moreover, clauses of automatic termination in the case of insolvency may be recognised if entered into prior to the suspect period according to some views. However, the set-off may not become effective on a date prior to the date of the court decision declaring the bankruptcy because that would be against general provisions of Greek bankruptcy law according to some views, which have not yet been tested by the jurisprudence.

RISK OF RECHARACTERISATION OF REPOS

Repos transactions and buy–sell back transactions involve the sale of securities with the simultaneous agreement of the parties to repurchase at a specified date. The applicability of foreign law in a contract is not problematic under the Convention on the Law Applicable to Contractual Obligations (Rome Convention of 19th June, 1980). The transfer of *in rem* rights on securities located in Greece will be subject according to Article 27 AK (Greek civil code) to the *lex cartae sitae*.

Greek law would recognise the transfer of ownership on the securities purchased. There is a theoretical risk of recharacterisation according to some scholars' views in Greece, pursuant to which the fiduciary transfer would be null and void.

In response to that view, it should be

noted that repurchase agreements are defined in Law 2396/1996 for the purposes of such law implementing the Capital Adequacy Directive (CAD) Directive. Furthermore, repos are referred to in a number of provisions implementing EC Directives, and in particular in Article 9(2) of Law 2789/2000 implementing the Settlement Finality Directive into Greek law, which refers to repos as a form of providing collateral. Article 9 of Law 2789/2000 empowers the central bank, the manager of the system and the ECB immediately to dispose of securities transferred to them as collateral under a repurchase agreement. Article 9 of 2789/2000 provides that collateral transferred to a central bank or the ECB may not be stayed or declared void or null due to the bankruptcy of a participant to the system.[13]

In addition, pursuant to the same article, if there is a claim mature for more than 24 hours, the manager of the system, a central bank or the ECB may dispose of securities pledged to those entities outside the civil procedure provisions provided that such entities have informed the debtor officially in writing.

Thus, the theoretical risk according to some academic views mentioned above is eliminated in light of the law transposing the Settlement Finality Directive into Greek law.

As regards repos on foreign securities, there are no known limitations with respect to entering into and performing transactions on foreign securities.

REPURCHASE AGREEMENTS ON DOMESTIC GOVERNMENT SECURITIES

Article 2(30) of Law 2396/1996 defines repos for the purposes of this law implementing the CAD, the ISD Directives and numerous other provisions of EU secondary legislation.

As regards the custodian risk, government securities are held in the system for monitoring transactions in securities in electronic book – entry form (BOGS) through a participant. Pooled customer accounts held in the system are not subject to seizure or attachment and therefore are separated from the remaining assets and property of the participant (Articles 6(6), 6(7) and Article 7(2) of Law 2198/1994). In the case of bankruptcy of a participant, however, investors have a claim in respect of their securities only against the participant (Article 8(2) of Law 2198/1994) and not against the system. Article 8 of Law 2198/1994 regulates the satisfaction of investors if the portfolio account of the participant is not sufficient. Investors have in this case a legal privilege to be satisfied against the participant's own portfolio account.

All government securities are traded and issued in dematerialised form (Law 2198/1994). All transactions on such government securities are booked in the BOGS operated by the Bank of Greece. Each participant has two accounts: its own portfolio account and an investor/customer portfolio account pooling all the securities of its customers. Dematerialised government securities are traded by the Electronic Secondary Securities Market for government securities (HDAT) operated by the Bank of Greece (Article 26 Law 2515/1997, as amended by Law 2733/1999). The clearing and settlement is effected through the BOGS. The Bank of Greece has published the different types of repurchase agreements that can be quoted.

With respect to claims of the Bank of Greece and the ECB, Article 57A of the Statute of the Bank of Greece creates a safe harbour from the zero-hour rule for the above referenced entities, with the result that the liquidator will not be able retroactively to prevent central banks from automatically terminating contracts in the event of insolvency. The statute stipulates that bankruptcy proceedings shall not have

retroactive effects on the rights and obligations of an undertaking arising from its participation in a system organised and managed by the Bank of Greece earlier than the moment of notification of the decision declaring the bankruptcy to the Bank of Greece. Therefore, the bankruptcy of a bank declared by the court shall not have any retroactive effects on obligations of such a bank effected through a settlement or clearing system.

In this regard, Article 7 of Law 2789/2000 hinders the retroactive effect of the court's decision declaring the bankruptcy of a participant to the system. The effects of the zero-hour rule are discarded in the event that rights and obligations in relation to a bankrupt entity are settled through a clearing or settlement system, which is recognised by the national law as a system subject to the Settlement Finality Directive such as the BOGS and the central securities depository, provided that such rights and obligations were created prior to the notification of the bankruptcy by the Bank of Greece to that system (Article 6(3) of Law 2789/2000).

Furthermore, Article 3 of Law 2789/2000 stipulates that orders to transfer and set-off are valid if entered into the system prior to the commencement of bankruptcy proceedings, which is meant to be the time of the publication of the decision by the competent authority. Thus, property rights conferred upon a counterparty in a repos transaction could not be challenged in the case of bankruptcy of a counterparty. If such orders to transfer have been effected after the publication of the bankruptcy order, such orders are valid if the manager of the system was not aware of the publication. In general, rights and obligations deriving from or related to participation in a system are governed by the law governing that system, according to Article 8 of Law 2789/2000.

LEGAL REFORM

Master agreements for the conclusion of repos in general have not been widely used by Greek market participants in the domestic market because such transactions are concluded in a simple manner without margin maintenance or calculation of net exposure provisions. As a result, additional costs may be incurred since Greek banks usually conclude master agreements through their subsidiaries in the UK due to the above mentioned legal risk. Price considerations of financial instruments may be an issue due to the legal risk existing with respect to close-out netting in the case of bankruptcy of a Greek credit institution.

In order to make the use of financial contracts safe and to level the playing field for Greek banks, a comprehensive legal reform of Greek bankruptcy law would be warranted. Such a legal reform should focus on recognising the validity and enforceability of close-out netting provisions of repurchase agreements and master agreements documenting derivatives[14] in the case of bankruptcy of a Greek credit institution or an investment firm.

The timing is opportune because Directive EC 2001/24 of the European Parliament and of the Council of 4th April 2001on the reorganisation and winding up of credit institutions[15] will have to be implemented into the national laws of member states by 5th May, 2004. The law implementing the said directive could be a suitable way to codify the Greek bankruptcy and provide the necessary legal certainty for close-out netting of financial contracts in Greek bankruptcy law.

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References

(1) Article 537 Commercial Code.
(2) Article 529 Commercial Code.
(3) Michalopoulos, G. (2000), *O Simpsifismos Stin Ptohefsi [Close-out Netting in Bankruptcy]*, Athens, Nomiki Vivliothiki, pp. 165–166.
(4) *Ibid.* Provisions for termination in a currency other than the euro is valid under Law 2844/2000, which entered into force on 1st January, 2001.
(5) Article 2 of Law 635/1937.
(6) Article 535 Commercial Code.
(7) Article 537 Commercial Code.
(8) Article 538 Commercial Code.
(9) It is a matter of interpretation of decision. AP 906/1996, *Elliniki Dikaiosini*, 38 (1997), pp. 133–134; Zerey, J-C. (1999) *Exohrimatistiriakes Simvaseis Paragogon (OTC Derivatives Contracts)*, Athens, Sakoulas, pp. 80–88; For the invalidity of contractual close out netting agreements, Michalopoulos, ref. 3 above, pp. 156–157.
(10) Michalopoulos, ref. 3 above, p. 157.
(11) *Ibid.*, p. 156.
(12) Directive EC 98/26 of the European Parliament and of the Council of 19th May, 1998 on settlement finality in payment and securities settlement systems, *Official Journal* L 166, 11th June, 1998, pp. 45–50.
(13) Recognised systems for the purposes of Law 2789/2000 include HERMES, BOGS, and Central Depository of Titles S.A., the settlement system for transactions on derivatives.
(14) Usually collectively referred to as *financial contracts*.
(15) *Official Journal* L 125, 5th May, 2001, pp. 15–23.