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Cancels and replaces AMAFI / 20-08

2002 ISDA MASTER AGREEMENT
(FRENCH LAW)
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Assessment criteria

The *International Swaps and Derivatives Association* (ISDA), which counts more than 900 members[1] from 71 countries, has worked since 1985[2] on the standardisation of the contractual documentation pertaining to over-the-counter (OTC) derivatives transactions. It is that standardisation which enabled the tremendous growth of derivatives markets. The ISDA Master agreement, which serves to document OTC derivative transactions in respect of all types of underlying instruments entered into between two counterparties, has not only helped achieve better coordination of all participants involved in these financial markets, but also and above all created a new contractual framework governing their relationships.

According to the Bank for International Settlements and in spite of the compression requirements stemming from the *Dodd Franck Act* in the United States and from EMIR in the European Union (the Union), the notional amount of outstanding OTC derivatives rose to USD640 trillion at end-June 2019, this being up from USD544 trillion at end-2018[3]. Over 90% of these transactions are governed by the ISDA documentation, making it the market standard for OTC derivative transactions.

Since 1987, ISDA agreements have traditionally been subject to common law systems (English law or New York's state law). However, in June 2018 ISDA published a new master agreement governed by French law (2002 ISDA Master Agreement (French Law))[4], alongside which additional documentation on collateral is now available, in order to provide market participants with an alternative to English law documentation which may cause serious issues following Brexit, such as the difficult enforcement of English court decisions in the Union.

It is in this context of legal uncertainty surrounding Brexit that this new master agreement was elaborated. After having considered other options, French law was finally selected[5]. Indeed, certain specificities arising from German law rendered it unsuitable (e.g. applicability of consumer law in business, uncertainties in case law on netting, complexities surrounding the certification of the validity of protocols or issues relating to electronic contract management).

By contrast, the recent modernisation of the French contract and netting law, the creation of international chambers within the Paris Tribunal of Commerce and the Court of Appeal, the signature of procedural protocols with the Paris Bar, the free access to the justice system, the high quality of our regulatory supervision, and the strength of French case law on netting, especially insofar as bankruptcy law is concerned, were decisive factors in making this choice.

However, despite the numerous benefits associated with the use of the 2002 ISDA Master Agreement (French Law) and despite the adjustments made to French law for the purpose of facilitating its use, it appears that its expansion is not as rapid as we might have hoped. It therefore seemed useful to encourage its broader support, in light of the importance of the initiative.

[1] These members comprise a broad range of derivatives market participants, whether on the buy or sell side, including investment managers, government and supranational entities, insurance companies, international and regional banks, corporations, financial intermediaries, trading platforms etc.
[2] The first ISDA Master agreement dates back from 1987.
[3] Bank for International Settlements, Statistical release: OTC derivatives statistics at end-June 2019, 8 November 2019
[4] The ISDA Master agreement (French Law) is available for ISDA members on the ISDA's online library and in hard format for non-members.
[5] An Irish Master Agreement was created as well – for those who wish to continue using the common law.

It is in this context that the ***Association française des marchés financiers***, *AMAFI*, which represents financial market participants based in France, drafted this note in cooperation with, on ISDA and netting questions, **Alban Caillemer du Ferrage**, Partner at Jones Day, and Professor at the University of Paris II (Assas) and **Gilles Kolifrath**, Partner, Kramer Levin Naftalis & Frankel.

The aim is to reiterate that the 2002 ISDA Master Agreement (French law) constitutes a useful tool to resolve a number of issues generated by Brexit and to demonstrate that the French legal environment, as recently adapted, represents a viable alternative.

I – Advantages of the ISDA Master agreement (French Law) in the context of Brexit

- ### European judicial cooperation

The management of disputes arising from contracts subject to English law and jurisdiction constitutes one of the many issues stemming from a no-deal Brexit[6].

It is worth recalling that, in accordance with the provisions of the 2001 European regulation, as amended in 2012[7], a revised enforcement mechanism enables decisions issued by the courts of all Member States to be enforced within the European Union without prior authorisation (*exequatur*).

Such an automatic and immediate recognition of foreign court decisions implies, for a country, a loss of sovereignty, which is only conceivable within a political union such as the one we know in the EU. Besides, the European judicial cooperation has no equivalent elsewhere in the world. Thus, irrespective of the form Brexit takes, no extension of the judicial cooperation to any third country is being considered.

This does not mean that English court decisions will not be capable of being executed in the Union. Certain international treaties such as the Lugano Convention[8] facilitate the recognition and enforcement of foreign judgments. It is therefore possible, probably through the means of the Hague conventions[9], for the Union and the United Kingdom to reach an agreement on that matter in the foreseeable future. However, the issue lies with the fact that all of these international conventions merely harmonise the conditions under which their signatories permit the *exequatur* of foreign court decisions – they certainly do not compare to the automatic and immediate application of judgements within the Union.

In any event, as of now, and pending potential negotiations to this effect, no such convention exists between the Union and the United Kingdom. Any authorisation process applicable to English court decisions in the Union will necessarily be subject to national, member state rules. Relying on the *exequatur* process entails a number of undeniable risks, delays and costs. This procedure is indeed subject to appeal and may take between 12 to 36 months. It is expensive (e.g. procedural and associated legal fees). It is unpredictable (i.e. the *exequatur* might not be delivered[10]).

No such procedure is necessary with the 2002 ISDA Master Agreement (French law) which provides for the competence of the Paris Tribunal of Commerce and the Paris Court of Appeal.

[6] Or a lack of post-Brexit deal on this particular subject.
[7] Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters
[8] Convention on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters of 30 October 2007
[9] List of conventions
[10] A Member State can refuse to grant permission for example where it considers that the cross-border element is not materialised in the case of both parties being domiciled in its territory.

- **Replication of existing master agreements**

Article 3 of the "Brexit" Ordinance dated 6 February 2019[11] contains measures ensuring contract continuity in relation to derivative transactions.

This legal instrument, which shall apply only in the event of a hard Brexit, puts in place a simplified procedure available to counterparties, British on the one hand and French on the other, wishing to replicate their existing master agreements:

  - A notification is sent by the British entity to its French counterparty, offering to conclude a new but identical master agreement with a European entity of its group, save for the provisions concerning applicable law and jurisdiction (French in both instances),

  - A simplified and secure acceptance process is available: the French counterparty is deemed to have accepted the offer if, within five days following the notification, it concludes a transaction with the European entity.

This process was only designed to provide British institutions, relocating their trading activities within the continental EU, a tool allowing them to facilitate their dealings with French counterparties.

[This solution may have lost some of its interest with the possibility of a hard Brexit becoming less likely. Nevertheless, the fact remains that these contractual replications must be carried out and many have already taken place.]

Otherwise, if a mere replication has the advantage of avoiding a renegotiation of the commercial terms of the master agreement, it does not in itself turn the agreement into the 2002 ISDA Master Agreement (French law), the replicated version being identical to the initial contract and remaining subject to English law and courts.

This situation may cause significant issues if the succeeding institution selected by the British counterparty is domiciled in France (a contract between two French entities but subject to English law is an unusual situation which should be avoided), but more generally in any Member State (given the issues surrounding the enforcement of English court decisions in the EU).

In light of the above, it would be in the best interest of financial institutions to request, without delay, from their British counterparties that, rather than a mere replication, a "replication & amend" be undertaken. In other words, besides the details of the new counterparty (succeeding to the British entity) and the applicable law and jurisdiction clauses, it should also be agreed to amend the few others necessary to render it subject to French law and jurisdictional competence (*per III below*).

- **Directive on the reorganisation and winding up of credit institutions[12] (CIWUD)**

Under European law, in the event of bankruptcy, the *lex fori* (the law of the country in which the bankruptcy procedure takes place) generally governs creditors' rights.

However, Article 25 of the CIWUD provides, by exception, a special conflict-of-laws rule for the enforceability of netting provisions included in netting agreements (typically ISDA Master Agreements) entered into by EU credit institutions and investment firms.
Article 25 provides that the enforceability of netting (as provided for in such master netting agreements) in respect of third parties and/or a judicial administrator must be exclusively subject to the law chosen by the

[11] Ordinance n°2019-75 of 6 February 2019 on preparatory measures taken regarding financial services in the context of the United Kingdom's withdrawal from the Union.
[12] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions.

parties in the contract where those provisions are included - without restricting the choice of law to one of a Member State.

Aside from the fact that it is rather curious for the Union to allow for the law of a third country to determine the conditions of enforceability of netting provisions in the event of an EU credit institution or investment firm's bankruptcy, the implementation of this conflict-of-laws rule has encountered a number of serious procedural issues.

- Article 25 of the CIWUD is a two-stage process, each governed by a specific jurisdictional order. It is first necessary to determine, in accordance with the law of the bankruptcy court, whether or not the contract is a netting agreement. If so, it is then a matter of referring to the law of the contract (if different) in order to determine the conditions of enforceability of the said contract's clauses.

- The conflict-of-law rule of Article 25 of CIWUD is further complicated by the fact that there is no indication as to whether contract law or bankruptcy law should be looked at to consider enforceability. The choice of the latter is not so obvious since (i) most of the time, its scope is limited to the country's citizens and (ii) the CIWUD prohibits any secondary insolvency proceedings in a country other than the one of the institution's headquarters.

    - The legal doctrine on this matter has evolved as far as ISDA Master Agreements (English Law) are concerned. After initially considering the application of English contract law, the doctrinal opinion moved, with no certainty however, following Lehman Brothers' bankruptcy, towards a solution consisting in creating a "hypothetical" bankruptcy in the United Kingdom and in consequently applying the British rules pertaining to a local bankruptcy procedure similar to the one pending in the Union against the institution in question.

    - The solution with regard to ISDA agreements subject to New York law is not any more satisfactory as bankruptcy is an exclusively federal matter (in other words, the State of New York has no specific bankruptcy law)[13].

Using the 2002 ISDA Master Agreement (French Law) eliminates these uncertainties by applying French law and its solid netting regime, one of the most well-established in the Union, and the conditions of its applicability being clearly written and confirmed through significant case law.

- **British regime governing the disclosure of evidence[14]**

AMAFI has already drawn its members' attention to a sometimes little known aspect of English law: its rules of civil procedure as concerns the rules of evidence and disclosure, based on the concept of discovery. Whilst not Brexit-related, both Brexit and the aforementioned issues could be an opportunity for market participants to take notice of this regime fraught with consequences.

The disclosure process is often long and complex; standard disclosure, as briefly presented below, is comprised of the following:

- Standard disclosure requires a party to disclose the documents on which it relies, and the documents which adversely affect its own case, adversely affect another party's case, or support another party's case, provided that those documents are or have been under the disclosing party's control.

- The process can become quite complex given the number and variety of form of documents, especially in an increasingly dematerialised environment. Moreover, the obligation can even extend

[13] On these questions see: *Rapport d'étape, Impact du Brexit sur les contrats bancaires et financiers et la stabilité du financement des acteurs continentaux, HCJP, 29 septembre 2017, p. 10*

[14] This section reproduces an AMAFI communication to its members: AMAFI CB/NN/19-0840 dated 23 September 2019.

to erased data or third parties' documents. Related documents may also have to be disclosed - *train of inquiry documents* – and might lead to the discovery of other evidence.

Market participants whose contracts are subject to English law must therefore maintain document retention policies in order to protect themselves against a potential future violation of their disclosure obligation in the event of litigation.

If there are any exceptions, so complex are the conditions for them to be claimed that they ultimately become meaningless. The famous *privilege* protecting communications between a client and its lawyer, for instance, even if seen as a fundamental right, may sometimes be rendered invalid in practice. As a striking example, where legal entities are concerned, only communications between lawyers and those employees expressly instructed by their employer to seek and receive legal advice can claim the benefit of the Privilege.

A procedure this onerous, generating extremely high costs, coupled with the imminence of Brexit, led the United Kingdom to rethink its system. If the procedural transparency of its justice system formerly attracted parties towards British jurisdictions, its advantages are now being overshadowed by the costs it implies. An initial reform effort in 2013 did not deliver on its promises; however, a second one is under consideration (a *pilot scheme* has even been set up) even if the consensus is that it will be insufficient.

The ISDA Master Agreement (French Law) agreement, subject to the civil law rules on evidence, erases the above identified flaws by not requiring that the onerous, time-consuming and expensive disclosure procedure be complied with.

II – A French legal framework adapted to accommodate the 2002 ISDA Master Agreement (French law)

- **Amendments recently made to certain aspects of French Law**

The "Brexit" Ordinance of 6 February 2019 (*s. above*) also served to adapt certain specific aspects of French law in order to guarantee the enforceability of all of the 2002 ISDA Master Agreement (French Law) clauses:

- Under French Law, owed interest can only be validly compounded if due for at least one entire year (*"anatocisme"*). However, compounding interest over any period of time is standard market practice in relation to OTC derivative transactions, and this is provided for in the ISDA master agreement subject to English law. At the time of drafting the 2002 ISDA Agreement (French law), authorities realised that providing for this possibility under French law could prove decisive in encouraging the transition to the new contract.

  The "Brexit" Ordinance therefore modifies the *anatocism* rule, provided for in article L. 211-40 of the French Monetary and Financial code, but only insofar as interest calculated under a master agreement documenting derivative transactions is concerned. The general ban on *anatocisme*, particularly for credit or financing operations, remains otherwise unchanged.

- The "Brexit" Ordinance also extends the scope of the netting **regime by modifying article L. 211-36 of the French Monetary and Financial code, in accordance with the UNIDROIT general principles (the drafting of which France was actively involved in 2012), to additional transaction types commonly documented in ISDA agreements: emission allowance units, spot foreign exchange transactions or transactions for the sale, purchase of precious metals.**

- **Specialised international chambers**

The French justice system used to be seen as ill-suited for disputes involving international or financial issues. This is no longer the case since the creation, in 2018, of chambers specialising in international – mainly commercial – matters[15] within the Paris Tribunal of Commerce and Court of Appeal.

Among their numerous advantages:

- Their ability to consider disputes relating to financial instruments and products, including master agreements,

- The judges' expertise in banking and financial matters (bilingual former market professionals).

- Their specific procedural rules, such as:
  - The possibility for submissions and documents to be filed in English,
  - The procedural calendar negotiated between the court and the parties,
  - The auditions of parties, experts and witnesses,
  - The decisions drafted in both French and English.

The existence of these chambers should serve to reassure foreign (even national[16]) counterparties with regard to the capacity of the French justice system to deal with disputes arising from the 2002 ISDA Master agreement (French Law).

III – MAIN DIFFERENCES BETWEEN THE *2002 ISDA MASTER AGREEMENT (FRENCH LAW)* AND ITS ENGLISH COUNTERPART

Putting aside the changes relating to applicable law and choice of jurisdiction, only five changes were made to the ISDA Master agreement (English Law) in order to comply with French law.
None of those changes affect the netting provisions at the heart of the ISDA agreement (*s. sections 5 and 6*), or the way OTC derivative transactions have been carried out in the financial markets for the past 30 years.

- **Section 2(a)(iii) – Flawed Assets / Conditionality**

A party may, following a default or a potential default of its counterparty, suspend the execution of its obligations for a period of 90 days (indefinite suspension being prohibited under French law).

This provision gave rise to significant case law following the bankruptcy of the investment bank Lehman Brothers because of the use some of its counterparties sought to make of it. Indeed, the resolution of the issues this provision presented revealed significant differences in the way a particular clause of the ISDA Master Agreement could be interpreted by English and New York jurisdictions[17].

[15] The international chambers in fact already existed but a decision was made to strengthen them, in particular by setting in stone a number of unwritten rules such as the use of the English language during hearings. It was also decided to create, within the Paris Court of appeals, an international chamber.
[16] ISDA Master agreements between two French counterparties being sometimes subject to English law, even if this should generally be avoided.
[17] In the Metavante case (*US Bankruptcy Court*, 15 September 2009), New York judges saw in the use of the Flawed assets clause, a violation of the automatic stav principle, ordering Metavante to execute its obligations until a decision by its defaulting counterparty to proceed – or not – with the contract. On the contrary, in the Lomas decision (*English Court of Appeal*, 3 April 2012), the Court of Appeals rejected the existence of an implicit term under which the suspension of the obligations would have come to an end. In order to avoid possible abuse, ISDA published, on 19 June 2014, an amendment adding a time limit to the Flawed Assets provision.

Following ISDA's work to correct the pernicious effects of that clause, and because the "Flawed Asset" theory has no equivalent in civil law, it had been decided to include ISDA's proposed amendments in the new French agreement.

- **Section 2(c) – Netting of Payments**

Payment netting allows positive and negative values to offset each other provided that the amounts are denominated in the same currency and owed under one or more transactions.

Payment netting occurs by way of novation under English law.

It is not the case under French law where netting is a method of payment.

The concept of novation has therefore simply been deleted from the French master agreement. As such, this change bears no practical consequences on the parties.

- **Section 3 – Representations**

Representations are promises made by one party on its present and/or future conduct.

In this section, the reference to "*equity as a source of law*" - specific to English law (more broadly, to common law) was deleted, but the word "equity" was retained as it may be used in the interpretation of the parties' intentions.

- **Section 9(f) – No Waiver of Rights**

In accordance with this provision, a party can decide whether to strictly enforce contractual provisions without losing its right to assert a breach.

A clarification has been introduced in order to specify that under French law, the statute of limitations applicable to contractual obligations can be reduced but not extended.

- **Section 13(a) – Governing Law**

Quite logically, the ISDA Master Agreement is subject to French law.

- **Section 13(b) – Jurisdiction**

If the 2002 ISDA Master Agreement (French Law) provides for the jurisdiction of the Paris Tribunal of Commerce and its Court of Appeal, parties can however choose between exclusive or non-exclusive jurisdiction.

The non-exclusive jurisdiction clause expressly provides for disputes to be heard in the above-mentioned courts but without prejudice to the right of one or the other of the parties to take the dispute to the courts of any other jurisdiction if appropriate. This possibility generates a certain degree of uncertainty, which can be easily mitigated by introducing an arbitration provision[18], should the counterparty reject an exclusive jurisdiction clause.

[18] The *Haut Comité Juridique de Place* is working on a report on a simplified arbitration procedure for banking and financial disputes, that could also facilitate the use of the *2002 ISDA Master Agreement (French law)*

- **Section 13(c) – Process Agent**

Under English law, it is mandatory for non-resident parties to designate an entity located in the United Kingdom in order to receive, on its behalf, notifications relating to the contract.

French law acknowledges the concept of legal residency and the 2002 ISDA Master Agreement (French law) allows parties to elect its domicile or designate a local entity upon which it may serve process.
It is however important to remember that, unlike English law, French law does not make it compulsory. Non-resident market participants using the French Master Agreement can therefore choose not to include this provision.