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A PRIMER ON NETTING LEGAL OPINIONS FOR MASTER AGREEMENTS

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The reliance upon a netting legal opinion ("Netting Opinion") to support over-the-counter ("OTC") derivative transactions and related master netting agreements ("Master Agreements") is ubiquitous across the globe. Netting Opinions provide the due diligence that allow market participants to be confident that the termination and close-out provisions of Master Agreements will be enforceable in relevant jurisdictions, whether domestic or foreign. In fact, a party will often refuse to trade with a counterparty unless the party can rely upon a Netting Opinion.

Netting Opinions are so important that the International Swaps & Derivatives Association ("ISDA") and other industry trade groups have solicited Netting Opinions on behalf of their members for decades.[1] In the absence of a Netting Opinion solicited by ISDA, market participants will often solicit the Netting Opinion individually at considerable cost and effort, a much less efficient process. A Netting Opinion will typically serve as the foundation for conducting due diligence on the enforceability of the termination and close-out netting provisions of a Master Agreement under the relevant laws applicable to the counterparty and transaction types covered by the opinion.

A Netting Opinion primarily provides the due diligence to establish that "the relevant court and administrative authorities would find the agreement to be legal, valid and binding, and enforceable under the law of the relevant jurisdictions,"[2] in particular with respect to the termination and close-out netting provisions.[3] A Netting Opinion centers its discussion and analysis on several issues. First, whether the underlying OTC derivative transactions in a Master Agreement can be terminated upon the occurrence of the insolvency of its counterparty, as well as other termination events or events of default. Second, whether the early termination amounts of the terminated transactions can be netted together in a single close-out amount.

This due diligence supports a party's credit approval process for trading with its counterparty and is important for several reasons. It serves to minimize concerns about the risk of trade termination difficulties and "cherry picking" issues. A Netting Opinion will also often be determinative for regulatory capital purposes as to whether a financial institution will be permitted to reserve regulatory capital on a net basis versus a gross basis with re-

spect to the trades with its counterparty covered by the Master Agreement.[4] It can also be determinative as to whether collateral could further reduce the amount of regulatory capital required to be held. Finally, if close-out netting is enforceable, a party may be willing to expand the amount of trading that can be done with its counterparty.

Netting Opinions can provide key due diligence with respect to OTC derivative transactions and the Master Agreement. These transactions rely upon a contractual framework in the Master Agreement that provides a party with important rights and remedies in the event of its counterparty's insolvency or upon the occurrence of other events of default or termination events.[5] The most important of these rights and remedies govern the termination and close-out netting of the transactions between the parties.

A Netting Opinion may take considerable time and effort to develop and may be prohibitively expensive to obtain by an individual party performing due diligence on its own. A Netting Opinion can cost tens of thousands of dollars to obtain and typically must be updated annually.[6] A Netting Opinion can also often exceed 50 pages. To minimize these high costs and the administrative burden, ISDA, as well as trade associations in other areas, has been active for decades in soliciting and obtaining these Netting Opinions on behalf of its members.

A Netting Opinion solicited by a trade association is addressed to the trade association's members themselves and expressly states that it can only be relied upon by a member.[7] In addition, Netting Opinions are generally only available behind password protected websites accessible to members only. ISDA has solicited and obtained Netting Opinions for approximately seventy (70) jurisdictions to cover a wide range of OTC derivatives.[8] ICMA and ISLA have been equally active in soliciting Netting Opinions for repos and securities lending transactions.[9]

In the event that a party is not an ISDA member, or an opinion for a particular jurisdiction has not yet been solicited or completed, a party can solicit a Netting Opinion directly from a law firm. Even if a Netting Opinion has been delivered to ISDA, however, the opinion may not have covered all of the relevant issues or transaction types within the scope of a legal due diligence review or credit approval process, requiring the party to solicit additional legal advice, often from the law firm that rendered the Netting Opinion.

STRUCTURE OF NETTING OPINIONS

A Netting Opinion addresses enforceability issues in much the same way that law firms deliver legal opinions in connection with closings of financing agreements and other transactions,[10] but unlike financings, a law firm delivering a Netting Opinion is typically not involved in the underlying derivative transactions between the parties. Instead, local counsel in the relevant jurisdiction is engaged to deliver the opinion, with instructions to address a set of standardized questions developed by ISDA or another trade association. The law firm selected is often a major law firm with expertise in insolvency laws across a broad spectrum of counterparty types and may have a team of experienced derivatives specialists to assist with the analysis.[11] In spite of being generically referred to as a legal opinion, a Netting Opinion is often labelled or referred to as a memorandum of law.

The Netting Opinion solicited by a trade association is usually formulaic in its organization and the opinions that are solicited. The opinion sets out background information and key assumptions. The opinion is specific in its coverage and scope. It sets out the specific questions considered and provides a summary of its conclusions, accompanied by a detailed and lengthy analysis.

The Netting Opinion will typically set out the following with respect to the scope of the opinion:

- The privately negotiated transactions covered by the opinion;
- The Master Agreements covered by the opinion;
- The type of entities or firms of the counterparty covered by the opinion;
- The type of entities or firms of the counterparty not covered by the opinion; and
- The various statutory, regulatory, or administrative rules or judicial precedents analyzed with respect to transaction termination and close-out netting.

The list of privately negotiated transactions and Master Agreements covered by a Netting Opinion can be quite comprehensive and specific. For example, a Netting Opinion covering OTC derivative transactions could include everything from an interest rate swap to a freight derivative.[12]

The Netting Opinion will also set out the Master Agreements covered. For example, ISDA has published a multitude of Master Agreements and accompanying definitional booklets, amendments, bridges and additional provisions/addenda over the decades with respect to OTC derivative transactions.[13] A party would want to ensure that the Netting Opinion specifically addresses the Master Agreement to be used with the counterparty.

The Netting Opinion is particular in setting out exactly what statutes, regulations or rules are being reviewed for purposes of the Netting Opinion. For example, the Netting Opinion will typically cover any relevant insolvency statutes or regulations issued by regulators with jurisdiction over the types of entities or firms covered in the opinion. With respect to a U.S. counterparty, for example, a Netting Opinion would usually cover the U.S. bankruptcy code, relevant federal regulatory and insolvency provisions covering certain financial institutions and relevant state laws.

A Netting Opinion will generally opine on questions dealing with the enforceability of provisions governing the termination of transactions and close-out netting:

- Whether the provisions governing the early termination of transactions governed by a master agreement would be enforceable under the relevant statutory, regulatory, or administrative rules or case law of a counterparty's jurisdiction ("Insolvency Rules"). This would include opining on whether an insolvency filing or proceeding would stay or delay a party from terminating transactions under a Master Agreement and, in such circumstances, whether electing "automatic early termination" in the Master Agreement would be an enforceable way of avoiding the stay or delay; and
- Whether the provisions providing for the netting of termination values in determin-

ing a single lump-sum close-out amount would be enforceable under the relevant Insolvency Rules applicable to the counterparty.

In addition to focusing on early termination and close-out netting, Netting Opinions will also often focus on a variety of ancillary issues related to obtaining and enforcing a judgment in the foreign counterparty's jurisdiction. These questions would include the following:

- Whether a claim can be filed and a judgement executed, in a counterparty's jurisdiction in a foreign currency;
- Whether it makes a difference whether a party executed a transaction through its home office or through a branch office;
- Whether there are choice of law issues in enforcing the provisions of a Master Agreement in another jurisdiction; and
- Whether there are any pending developments that might affect the opinions discussed above.

Netting opinions vary by jurisdiction and the laws they address, which may reveal a virtual treasure trove of specialized and key information about trading OTC derivatives with counterparties organized in the relevant jurisdiction.

INSOLVENCY RULES AND THE COUNTERPARTY'S JURISDICTION

As discussed above, a Netting Opinion focuses on whether the provisions of a Master Agreement would be enforceable under the rules of the counterparty's jurisdiction. This is because whether an insolvency event has occurred with respect to a counterparty would normally be governed by the rules of the counterparty's domicile or jurisdiction of organization or formation.[14] For example, even though an ISDA Master Agreement is governed by New York law, the determination of whether a counterparty organized or domiciled under Mexican law was insolvent would be a question of Mexican insolvency law.

To provide the required due diligence, a Netting Opinion is drafted by attorneys with the relevant subject matter expertise and licensed to practice in the counterparty's jurisdiction. The Master Agreement provisions have been drafted very broadly to include a variety of different forms of possible insolvencies under the laws of the counterparty's jurisdiction:

> [The insolvency events of default are] drafted so as to be triggered by a variety of events associated with bankruptcy or insolvency proceedings under New York or English law but recognizes that market participants will be located in and organized under the laws of different countries around the world. Accordingly, the Bankruptcy Event of Default has been drafted with the intention that it be broad enough to be triggered by analogous proceedings or events under any bankruptcy or insolvency laws pertaining to a particular party.[15]

Although there are parallels between the definition of an insolvency event in a non-U.S. jurisdiction and the U.S., a Netting Opinion should be delivered by attorneys that fully understand and appreciate any key jurisdictional differences with respect to an insolvency event and how the bankruptcy or insolvency will be administered and discharged in the non-U.S. jurisdiction.

TERMINATING TRANSACTIONS UNDER A MASTER AGREEMENT

A primary concern of a party and the focus of the Netting Opinion is whether an insolvency court or receiver would enforce the termination provisions under a Master Agreement. In particular, it is important to identify the date on which a counterparty becomes insolvent. The Netting Opinion will also opine as whether the election of "automatic early termination" would be enforceable, as discussed above.

Master Agreements provide for a wide variety of termination events and events of default. Upon the occurrence of a termination event or an event of default with respect to its counterparty, the party can elect to terminate all of the underlying transactions, calculate an early termination amount for each transaction, and then calculate a close-out amount that would net all of the individual termination amounts together. The Netting Opinion focuses on termination rights upon the occurrence of an insolvency to address the possibility that a counterparty's jurisdiction would not allow an early termination due to the insolvency.

The insolvency event of default is important, and a part of all Master Agreements,[16] to avoid or minimize future losses and assert a claim against the insolvent counterparty's estate in insolvency proceedings. A failure to pay is also an event of default under all Master Agreements and may result in a forbearance agreement or workout arrangement in lieu of termination, but the most likely situation in which a party will want to terminate transactions immediately under a Master Agreement is when its counterparty has become insolvent.[17] The Master Agreement provides that a party can elect to terminate all of the underlying transactions and calculate the close-out amount upon the insolvency of its counterparty.

A party looks to the Netting Opinion to provide due diligence that the right to terminate all of the underlying transactions with an insolvent counterparty will be enforceable. A primary concern is that the early termination of the transactions could be stayed automatically by a filing or court order, or by an insolvency trustee, receiver, or other insolvency administrator (collectively a "Trustee").

There are several reasons why this termination right is important in an insolvency. First, a party wants to avoid additional losses from fluctuations in the market value of the transactions after its counterparty has become insolvent. For example, a transaction may continue to move in favor of a non-defaulting party after its counterparty has become insolvent, increasing the eventual total loss for the non-defaulting party. In addition, this could expose the non-defaulting party to potential future losses after the commencement of the insolvency proceeding, and these losses might be unrecoverable if post-filing losses are disallowed under relevant insolvency law.

Second, a party looks to a Netting Opinion for assurances as to when it can replace the trades to be terminated. Upon the insolvency of its counterparty, an end-user of derivatives, for example, will need to replace the terminated transactions with its insolvent counterparty in order to continue to hedge that party's assets or liabilities that the now "terminated" transactions were meant to hedge. In the case of a dealer or market-maker, the dealer will need to either replace the terminated transactions or unwind or modify offset-

ting positions that were entered into to hedge the now terminated transactions.

For either a dealer or end-user, assuming that the transactions were in-the-money, the party will want to use the early termination payments from the insolvent counterparty to cover its losses and costs of replacing the transactions or unwinding or modifying its hedges. Assuming instead that the dealer or end-user was out-of-the-money, the party does not want to pay more to the insolvent counterparty than any profit realized in replacing the transactions or unwinding or modifying its hedges. In either scenario, time will be of the essence in replacing, terminating, unwinding, or modifying its positions upon the insolvency of its counterparty.

Just as importantly, to avoid any potential losses from the collateral declining in value after an insolvency and termination of the transactions, a party will want to exercise its rights and remedies to foreclose on any pledged collateral as soon as possible. Similarly, a party will want to enforce any guaranties that guarantee the terminated transactions and/or the Master Agreement.

Because of a concern in the early history of Master Agreements about the legal uncertainty of the enforceability of early termination and close-out netting provisions, the drafters of these Master Agreements attempted to minimize these legal risks by allowing parties to elect "automatic early termination" in the Master Agreement.[18] By electing automatic early termination, the transactions are deemed to terminate immediately prior to the occurrence of certain insolvency events.

The conceptual idea behind automatic early termination is that, because a counterparty is not yet subject to an insolvency proceeding when an automatic termination is deemed to take effect, the termination and close-out of the transactions would not be stayed, triggering termination of the trades automatically and permitting the solvent party to determine a close-out netting amount. Whether it could file suit to collect the amount due or foreclose on any collateral securing the trades is a separate question, since a post-filing enforcement proceeding or foreclosure may be subject to a stay. In the Netting Opinion, local bankruptcy counsel would opine or conclude whether the "Automatic Early Termination" provisions of the ISDA Master Agreement would be enforceable.

Unfortunately, the enforceability of automatic early termination has been a concern for parties, lawyers and commentators since ISDA introduced the concept in 1987.[19] There are few judicial precedents that are helpful in resolving this legal uncertainty from one jurisdiction to the next.[20] In addition, there are several policy issues, practical concerns, and risks surrounding the election. Accordingly, attorneys are often reluctant to opine that automatic early termination should be elected in Netting Opinions.

CLOSE-OUT NETTING

After gaining assurances with respect to the enforceability of terminating transactions upon the insolvency of its counterparty, a party will also look to a Netting Opinion for assurances that upon termination of the transactions, it will be permitted to net the in-the-money and out-of-the-money termination amounts together, referred to as close-out netting.[21] The principal concern is that insolvency law could permit a Trustee to "cherry-pick" transactions subject to a Master Agreement and over-ride the close-out netting

provisions of the Master Agreement. Two simplified examples help illustrate the issue of cherry-picking.

EXAMPLE 1—ENFORCING CLOSE-OUT AMOUNT NETTING

To illustrate the concern, assume that Party A has entered into an ISDA Master Agreement with Party B. Assume further that Party A and Party B have entered into two OTC derivative transactions. Upon the insolvency of Party B, Party A would like to net the in-the-money early termination amount of $10,000,000 of Transaction 1 (i.e., Party B owes Party A) with the out-of-the-money early termination amount of $11,000,000 of Transaction 2 (i.e., Party A owes Party B). If the close-out netting provisions are enforced and the two termination amounts are netted together, Party A would only pay to Party B the net close-out amount of $1,000,000.

Cherry-picking can result from a Trustee disclaiming contracts that are in-the-money to the solvent party (i.e., where the party is owed a payment by the insolvent counterparty) but then enforcing and collecting amounts under transactions that are out-of-the-money to the solvent party (i.e., where the party owes a payment to the insolvent counterparty). For example, it could occur if the Trustee were to assume the solvent party's out-of-the-money transactions for the benefit of the insolvent party's estate and reject the solvent party's in-the-money transactions, leaving the party with losses that cannot be netted against gains it would otherwise have realized had the party been permitted to terminate them and net them together.

EXAMPLE 2—CHERRY-PICKING

To illustrate the concerns of cherry-picking, assume the same facts as in Example 1, except that in this Example 2, upon the bankruptcy of Party B, the Trustee disclaims the in-the-money Transaction 1 (Party B owes $10,000,000 to Party A) and assumes the out-of-the-money Transaction 2 (Party A owes $11,000,000 to Party B). In this case, Party A would be required to pay $11,000,000 to the Trustee. Party A would then be a creditor of Party B's insolvency estate with respect to the in-the-money Transaction 1 amount of $10,000,000 (Party B owes Party A). Party A now runs the risk that it will have paid $11,000,000 to the bankruptcy estate of Party B but potentially will only collect pennies on the dollar with respect to the $10,000,000 termination amount owed by Part B to Party A with respect to Transaction 1.

There is also a concern that with respect to cherry-picking that a Trustee could also assign the assumed transactions to third parties,[22] thereby benefiting by capturing the termination value of the assigned transactions for the debtor's estate. This would be in spite of the fact that Trustee would not have a contractual termination right.[23]

EXAMPLE 3—ASSIGNMENT OF THE SOLVENT PARTY'S OUT-OF-THE-MONEY TRADES

To illustrate the concerns of an assignment of the out-of-the-money trades (amounts owed by Party A to Party B), assume the same facts as in Example 1, except that in this Example 3, upon the bankruptcy of Party B, the Trustee assigns the out-of-the-money trade of $11,000,000 of Transaction 2 (Party A owes Party B) to a third

party ("Third Party") and disclaims the in-the-money Transaction 1 of $10,000,000 (Party B owes Party A). In this case, the Trustee would realize $11,000,000 from the assignment (i.e., sale) of the out-of-the-money Transaction 2 to the Third Party. Party A would then be a creditor of Party B's insolvency estate with respect to the in-the-money Transaction 1 amount of $10,000,000 (Party B owes Party A), possibly only collecting pennies on the dollar. Party A would also now be a party to the continuing Transaction 2 with the Third Party. Party A will have lost any benefit of netting the termination amounts of Transactions 1 and 2 together.

The vast majority of these concerns have been resolved through statutory and regulatory reforms. The U.S. Congress passed federal bankruptcy legislation that provides safe harbor protections such as close-out netting.[24] Concerns about the application of state insolvency law to insurance companies, for example, which are governed by state regulators or commissioners, have also largely been addressed through statutes and regulations.[25]

Industry trade groups have also been active in providing model netting acts that governments in foreign jurisdictions could consider enacting to ensure that close-out netting would be enforceable in their particular jurisdictions.[26] These model netting acts were drafted to ensure that Netting Opinions could be easily delivered if the netting acts were enacted. Emerging markets and jurisdictions with favorable tax or regulatory frameworks, anxious to attract trading activity beneficial to their markets, have frequently enacted these model statutory netting provisions, with Netting Opinions provided almost immediately or soon thereafter.[27] These Netting Opinions would then provide market participants with the confidence to trade with counterparties from these jurisdictions.

REGULATORY CAPITAL REQUIREMENTS AND NETTING

Regulated financial institutions in the United States are required by their regulators to meet minimum regulatory capital requirements and overall capital adequacy standards ("Regulatory Capital Rules").[28] Similar regulatory capital requirements are also in place in other jurisdictions.[29] These Regulatory Capital Rules and related calculations can be complex and may require a party to make complex calculations such as the determination of its "risk-weighted assets."[30] Essentially, these rules require a financial institution to reserve a certain amount of regulatory capital against the possibility that the financial institution will not collect amounts owed to it by a distressed or insolvent counterparty, whether from loans, derivatives or other exposures.[31]

In general, a financial institution prefers to minimize the amount of regulatory capital that it is required to reserve against its exposures. In banking vernacular, bankers generally refer to the actual and potential amounts that would or could be owed to a bank by a counterparty as the bank's "exposure" to that counterparty.[32] The bank is "exposed" to its counterparty because in the event that the counterparty fails to meet its obligations, the bank could potentially suffer a loss on the defaulted obligations. A bank is required under the Regulatory Capital Rules to reserve regulatory capital against its counterparty exposures in order to mitigate the bank's losses from nonperforming loans, derivatives, and other exposures, helping to keep the bank solvent.

A fundamental issue in determining the amount of regulatory capital to be reserved in the case of OTC derivatives exposures is whether the calculations are determined on the gross amount of exposure that a party has to its counterparty or on the "net" amount of exposure.[33] In order to determine the amount of regulatory capital to be reserved on a net basis for derivatives, a party would need to establish that the close-out netting provisions of the Master Agreement would be enforceable. Two simplified examples help illustrate the importance of close-out netting with respect to minimizing the amount of regulatory capital that needs to be reserved.

EXAMPLE 4—CALCULATION OF EXPOSURE FOR REGULATORY CAPITAL REQUIREMENTS FOR ONE TRANSACTION

Assume that Party A, a U.S. bank, has entered into an ISDA Master Agreement with Party B. Assume further that Party A and Party B have entered into only one OTC derivative transaction. Party A has an exposure of $10,000,000 under Transaction 1 to Party B. In other words, upon the early termination of Transaction 1, Party B would owe Party A $10,000,000. If there was just one transaction, Party A would need to reserve regulatory capital in the relevant percentage against the entire $10,000,000 exposure that Party A has to Party B.

EXAMPLE 5—CALCULATION OF EXPOSURE FOR REGULATORY CAPITAL REQUIREMENTS FOR TWO TRANSACTIONS

Assume the same facts as in Example 4, except that Party A (a U.S. bank) and Party B have entered into an additional transaction. In Transaction 2, Party B is exposed to Party A in the amount of $9,000,000. In other words, upon the early termination of Transaction 2, Party A would owe Party B $9,000,000. If Party A is permitted under the Regulatory Capital Rules to net the respective $10,000,000 and $9,000,000 exposures of Transactions 1 and 2, Party A would only need to reserve regulatory capital against a net exposure amount of $1,000,000 ($10,000,000 - $9,000,000).

Example 5 illustrates the importance to a bank of being permitted to net the parties' respective exposures together for regulatory capital purposes. If a bank were unable to net the exposures under Transactions 1 and 2 together, it would need to reserve regulatory capital against its gross exposure of $10,000,000 in Transaction 1 and would not receive any relief by offsetting the $9,000,000 amount it owes to its counterparty.

The Regulatory Capital Rules will generally allow a party to calculate the amount of regulatory capital to be reserved on a net basis if it can demonstrate through the requisite level of due diligence that the relevant Master Agreement qualifies for netting under the rules. This due diligence can generally be satisfied by obtaining a sufficiently strong Netting Opinion and ensuring that the provisions of the Master Agreement are consistent with the Netting Opinion and the Regulatory Capital Rules.

The Regulatory Capital Rules governing netting for national banks and federal savings associations illustrate the role of legal due diligence in Netting Opinions. National banks are permitted to calculate a "net credit exposure" for purposes of reserving regulatory capital provided that the transaction exposures to be netted are

governed by a "qualifying master netting agreement."[34]

In addition to permitting banks to net exposures under a qualifying master netting agreement for purposes of determining regulatory capital, banking regulations also permit a bank to further reduce its regulatory capital if financial collateral was pledged by its counterparty.[35] The regulation recognizes "the credit risk mitigation benefits of financial collateral that secures an OTC derivative contract or multiple OTC derivative contracts subject to *a qualifying master netting agreement*."[36] The bank would need to meet the same level of due diligence for the enforceability of the collateral as it would for netting the exposures, which has prompted ISDA and other trade associations to obtain collateral opinions that cover collateral documentation in addition to obtaining Netting Opinions.

The definition of a qualifying master netting agreement is found in the capital adequacy standards of the relevant regulations.[37] The definition provides that it must be a "legally enforceable agreement" that provides "the right to accelerate, terminate and close-out on a net basis all transactions under the agreement."[38] These are all rights and remedies provided under a Master Agreement.

The regulations however require that a bank establish that it has performed the necessary legal due diligence to ensure that the Master Agreement is enforceable. The regulation is specific as to the due diligence required:

> (d) Qualifying master netting agreement. In order to recognize an agreement as a qualifying master netting agreement as defined in § 3.2, a national bank or Federal savings association must:
>
> (1) Conduct sufficient legal review to conclude with a well-founded basis (and maintain sufficient written documentation of that legal review) that:
>
> (i) The agreement meets the requirements of paragraph (2) of the definition of qualifying master netting agreement in § 3.2; and
>
> (ii) In the event of a legal challenge (including one resulting from default or from receivership, insolvency, liquidation, or similar proceeding) the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions; and
>
> (2) Establish and maintain written procedures to monitor possible changes in relevant law and to ensure that the agreement continues to satisfy the requirements of the definition of qualifying master netting agreement in § 3.2.[39]

Although the regulation does not expressly require that a bank obtain a Netting Opinion in order to establish a well-founded basis that a Master Agreement qualifies, market participants generally agree that a Netting Opinion solicited by an industry trade group such as ISDA would meet this requirement so long as the bank's legal counsel has reviewed the Netting Opinion and is satisfied with its analysis and conclusions.

The due diligence requirement first requires that the bank conduct a "sufficient legal review." Although the regulation does not set out the scope of such a review, such a review would need to include a review of any relevant statutory, regulatory or judicial authorities that would govern the particular transactions contemplated with the counterparty with respect to the required netting requirements set out in the definition of a qualifying master netting agreement.[40] As discussed above, a Netting Opinion will specifically set out the authorities reviewed, the type of

transactions contemplated, and the type of counterparty entering into the agreement.

After a bank has conducted a sufficient legal review, it must "conclude with a well-founded basis" that the Master Agreement meets the definition of a qualifying master netting agreement. The regulation does not define what is meant by "well-founded basis." Presumably this would be a conclusion or opinion that is delivered without reservations, qualifications or limitations (other than what is customary practice) and would conclude or opine that the agreement was enforceable.[41] In particular, the legal review would need to opine that if the enforceability of the netting provisions were challenged, "the relevant court and administrative authorities would find the agreement to be legal, valid, binding, and enforceable under the law of the relevant jurisdictions."

The bank is also required to "maintain sufficient written documentation of that legal review." This means more than simply maintaining a working file of the legal authorities reviewed. This particular requirement would indicate that there must be some form of formal memorandum of law or opinion that summarizes, concludes, or opines that the Master Agreement in question was a qualifying master netting agreement as defined in the regulations. Presumably the regulators intend that this documentation would be available for review by a regulator to determine compliance with the regulations. Again, a Netting Opinion solicited by an industry trade group and delivered to its members, or a Netting Opinion solicited directly by a bank, should meet this requirement, provided that the Master Agreement itself has been reviewed to ensure that its provisions are consistent with the Netting Opinion and the Regulatory Capital Rules.

Once a Netting Opinion has been obtained and a review of the Master Agreement has been conducted, the bank has an ongoing obligation to "establish and maintain written procedures" requiring it to monitor any changes in law that would affect the opinion or conclusion. To meet their obligations to monitor changes in law and keep their due diligence up to date, banks rely on industry trade groups such as ISDA to monitor changes to insolvency laws that affect netting in the various jurisdictions and solicit updated Netting Opinions when necessary.[42] In the case of Netting Opinions that a bank has solicited on its own, the bank will need to maintain arrangements with law firms to monitor changes in relevant law and update their opinions.

CONCLUSION

Netting Opinions have proven to be an invaluable form of due diligence for parties entering into capital market transactions such as OTC derivatives, whether on a cross border basis or in their home jurisdiction. Parties rely on these Netting Opinions to support credit approvals, to provide assurances that the termination and close-out netting provisions of Master Agreements are enforceable in insolvency proceedings, and to meet regulatory capital requirements that allow banks to net down their derivatives exposures provided they have the requisite legal foundation and regulatory compliance procedures.

Because of the cost and administrative burden of obtaining and updating Netting Opinions, especially in emerging market jurisdictions, parties frequently rely on Netting Opinions solicited by

industry trade associations such as ISDA. This minimizes the cost and effort required for market participants to solicit opinions on their own. An additional advantage is that industry trade groups will also make arrangements with law firms to monitor changes in relevant laws and keep their Netting Opinions current.

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ENDNOTES:

[1]ISDA solicited the first Netting Opinion with respect to the United States in 1987.

[2]12 C.F.R. 3.3(d)(1)(ii).

[3]A party may also solicit a Netting Opinion for a counterparty in its own jurisdiction if the enforceability of the netting provisions for that particular type of counterparty (i.e., entity) are uncertain. For example, historically parties in the U.S. have been concerned about the enforceability of netting provisions with respect to a state regulated insurance company which has resulted in the solicitation of Netting Opinions for particular states in the U.S.

[4]Parties also often require legal opinions that deal with collateral, protocols and a variety of other legal issues. See, e.g., ISDA, Opinions Library, https://www.isda.org/opinions-library/.

[5]Other capital market industry trade groups also publish Master Agreements as well that provide for termination and close-out netting provisions. These include the Global Master Repurchase Agreement by the International Capital Market Association (ICMA) as well as the Global Master Securities Lending Agreement published by the International Securities Lending Association (ISLA).

[6]See, e.g., 12 C.F.R. 3.3(d)(2) ("establish and maintain written procedures to monitor possible changes in relevant law").

[7]Trade groups may even restrict reliance on Netting Opinions to certain classes of members. Although ICMA provides access to its Netting Opinions to its associate members, "the opinions are not addressed to associate members and therefore they cannot rely on them." https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/legal-documentation/icma-gmra-legal-opinions/

[8]ISDA, 2021 ISDA Opinion Updates, https://www.isda.org/2021-isda-opinion-updates/.

[9]The International Capital Market Association has also solicited Netting Opinions for approximately seventy jurisdictions for its members dealing with repo transactions. ICCMA, 2021 GMRA Legal Opinions, https://www.icmagroup.org/Regulatory-Policy-and-Market-Practice/repo-and-collateral-markets/legal-documentation/icma-gmra-legal-opinions/. The International Securities Lending Association has solicited and obtained Netting Opinions from approximately sixty (60) jurisdictions for its members dealing with securities lending transactions. ISLA, 2021 ISLA Opinions - Jurisdictions & Counterparty Coverage, https://www.islaemea.org/wp-content/uploads/2020/03/ISLA_Legal_Opinions_Coverage_Jurisdictions_September_2021.pdf. Other Netting Opinions are also available from other trade groups for other types of transactions. For example, SIFMA has also solicited Netting Opinions on behalf of its members with respect to the Master Repurchase Agreement, the Master Securities Loan Agreement, and the Master Securities Forward Transaction Agreement. See, https://www.sifma.org/resources/general/legal-opinions/.

[10]For examples and discussions of legal opinions in business transactions generally, see Legal Opinions, Business Law Section of the American Bar Association (August 4, 2021), https://www.americanbar.org/groups/business_law/publications/the_business_lawyer/find_by_subject/buslaw_tbl_mci_legalopinions/.

[11]For example, the ISDA Netting Opinion with respect to U.S. law was delivered by Mayer

Brown and the ISDA Netting Opinion with respect to England & Wales was delivered by Allen & Overy.

[12]Over 25 different examples of the potential types of transactions that could be covered by a Netting Opinion can be found in the definition of a qualified financial contract in ISDA's 2018 Model Netting Act. See ISDA, 2018 ISDA Model Netting Act and Guide, at 44-45 (2018).

[13]These would include, for example, the 1987 ISDA Interest Rate and Currency Exchange Agreement, the 1992 ISDA Master Agreement (both Local Currency-Single Jurisdiction and Multi-Currency - Cross Border), and the 2002 ISDA Matser Agreement. See ISDA Books (Master Agreement), www.isda.org/books/.

[14]For a discussion of insolvency rules and Master Agreements, see Johnson & Zeigler, Deciphering Insolvency Events in Master Agreements and Similar Finance Agreements, 41 Futures & Derivatives Law Report 14 (June 2021).

[15]ISDA, User's Guide to the 1992 ISDA Master Agreement (1993 Edition), at 18.

[16]See, e.g., 2002 ISDA Master Agreement § 5(a)(vii); 2011 GMRA ¶ 10.

[17]In the author's experience, in spite of the number of termination events and events of default set out in the Master Agreement, it is much more likely that a termination will occur because of an insolvency than, for example, the failure to make a payment or the occurrence of a "credit event upon merger."

[18]For a thorough discussion of Automatic Early Termination, see Johnson & Zeigler, supra note 14.

[19]See ISDA User's Guide, supra note 15, at 21-22.

[20]See Brookfield Asset Management, Inc. f/k/a Hees International Bancorp Inc. and Brysons International, Ltd., f/k/a Bryons International Bank v. AIG Financial Products and American International Group, Inc., Case No. 09-cv-8285 (U.S. District Court); Lehman Brothers Special Financing Inc. v. Federal Home Loan Bank of Cincinnati, 13-01330 (US District Court for the S.D.N.Y.); Lehman Brothers Finance SA (in liquidation) v. Sal Oppenheim jr. & cie. KGAA [2014] EWHC 2627 (Comm); Dentons, Calculations on ISDA Close-out (Aug 19, 2014), https://www.dentons.com/en/insights/alerts/2014/august/19/calculations-on-isda-close-out.

[21]For a discussion of termination, see Bergman, Bliss, Johnson and Kaufman *Netting, Financial Contracts, and Banks: The Economic Implications*, Research in Financial Services, Fall 2003, available at SSRN: http://ssrn.com/abstract=505965

[22]This would be done in spite of the Master Agreement's anti-assignment clause, which may be unenforceable against a Trustee absent safe harbors like those in the U.S. bankruptcy code. 2002 ISDA Master Agreement, § 7 (" . . . neither this Agreement nor any interest or obligation in or under this agreement may be transferred . . . by either party without the prior written consent of the other party, . . . ").

[23]Only the non-defaulting party has this right under the typical Master Agreement.

[24]See, e.g., 11 U.S.C.A. § 560 (contractual right under federal bankruptcy code to liquidate, terminate or accelerate a swap agreement).

[25]See, e.g., Iowa Code 2018, § 507C.28A (Qualified financial contracts under Iowa law)

[26]See, e.g., ISDA, Netting Related Material: 2018 Model Netting Act and Guide, https://www.isda.org/2018/10/15/2018-model-netting-act-and-guide/.

[27]See Habib Motani, Quiet Reformation, https://www.isda.org/a/kVITE/IQ-ISDA-Quarterly-article-by-Habib-Motani-on-Close-out-Netting-February-2021.pdf (exploration of "ISDA's ongoing work to promote netting certainty in emerging markets.").

[28]See, e.g., 12 C.F.R. Part 3 (Capital Adequacy Standards for national banks and federal savings associations); 12 C.F.R. Part 217 (Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks).

[29]Oliver Abel Smith, Credit Risk Mitigation

and Legal Opinions (April 14, 2016), https://www.fieldfisher.com/en/insights/credit-risk-mitigation-and-legal-opinions.

[30]A complete discussion of the Regulatory Capital Rules and the calculation of risk-weighted assets is beyond the scope of this discussion.

[31]For an early discussion of the origin of these rules, see Matthews, Capital Adequacy, Netting and Derivatives, 2 Stan. J.L. Bus. & Fin 167 (1996).

[32]See Bank Exposure Definition, Law Insider, https://www.lawinsider.com/dictionary/bank-exposure.

[33]See, e.g., 12 C.F.R. 3.34 Derivative Contracts (calculating exposure amounts for derivative contracts).

[34]12 C.F.R. 3.34(b)(2).

[35]Similar legal due diligence is also required to determine if an agreement qualifies as an *eligible master netting agreement* under the margin rules. 12 C.F.R. § 349.2(4) ("conduct sufficient legal review"). The failure of an agreement to qualify as an eligible master netting agreement may have significant impact on the calculation of margin and the exchange of margin on net or a gross basis under the variation and initial margin rules. A discussion of the margin rules is beyond the scope of this discussion.

[36]12 C.F.R. 3.3(c) (emphasis added)

[37]12 C.F.R. 3.2 (definition of a "qualifying master netting agreement").

[38]Id. (clause (2) in the definition). The regulation is specific in what is required with respect to netting.

Qualifying master netting agreement means a written, legally enforceable agreement provided that:

(1) The agreement creates a single legal obligation for all individual transactions covered by the agreement upon an event of default following any stay permitted by paragraph (2) of this definition, including upon an event of receivership, conservatorship, insolvency, liquidation, or similar proceeding, of the counterparty; and

(2) The agreement provides the national bank or federal savings association the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set-off collateral promptly upon an event of default, including upon an event of receivership, conservatorship, insolvency, liquidation, or similar proceeding, of the counterparty, provided that, in any such case:

(i) Any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions, other than:

(A) In receivership, conservatorship, or resolution under the Federal Deposit Insurance Act, Title II of the Dodd-Frank Act, or under any similar insolvency law applicable to GSEs, or laws of foreign jurisdictions that are substantially similar to the U.S. laws referenced in this paragraph (2)(i)(A) in order to facilitate the orderly resolution of the defaulting counterparty; or

(B) Where the agreement is subject by its terms to, or incorporates, any of the laws referenced in paragraph (2)(i)(A) of this definition; and

(ii) The agreement may limit the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set-off collateral promptly upon an event of default of the counterparty to the extent necessary for the counterparty to comply with the requirements of part 47, subpart I of part 252, and part 382, of this title 12, as applicable.

[39]12 C.F.R. 3.3(d)

[40]For these requirements, see endnote 38.

[41]See Legal Opinions Committee, ABA Business Law Section, Cross-Border Closing Opinions of U.S. Counsel, 71 Bus Law. 139 (2016-2016); Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section Business Law, American Bar Association, 47 Bus. Law. 167 (Nov 1991).

[42]ISDA has updated the Netting Opinion for the United States approximately 24 times since the original Netting Opinion for the United States was delivered in 1987.