Feature

KEY POINTS

- Although French insolvency law is more debtor-friendly than English insolvency law, a number of exemptions and exceptions in relation to financial matters in French law mean that parties to a French ISDA Master Agreement can expect similar treatment to that in relation to an English ISDA Master Agreement.
- Netting is fully recognised and enforced under French law and its scope has been widened to accommodate market participants.
- The reform of French contract law does not generate uncertainty for parties to an ISDA contract.
- Good faith duties will not disturb derivative transactions as they are already present in ISDA documentation and welcome in the OTC market to a limited extent.
- French law is fully compatible with the ISDA documentation and adopting the French Master Agreement does not require abandoning other pivotal documents (such as the Definitions Booklets) or necessarily submitting them to different laws (although that is a possibility).
- French judges have considerable expertise in derivatives contracts and new specialist courts have been established to deal with financial matters.

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The choice of French law for the new ISDA Master Agreement: Part 2[1]

Brexit and its consequences has led ISDA to release a new French Law ISDA Master Agreement. Foreign lawyers have voiced criticism of civil law and French law in particular. This article examines and qualifies the alleged disadvantages of the French legal system with regard to the ISDA Master Agreement and the OTC market.

CRITICISING CIVIL LAW SYSTEMS AND FRENCH LAW

Arguments typically levied against the effectiveness of the new French law Master Agreement relate to the uncertainty of French law and the lack of expertise of French judges. In this article, the author examines these arguments in the context of the ISDA documentation.

FRENCH LAW

Parties are willing to adopt a Master Agreement when they believe it will be enforced in a market-friendly manner. This depends on corporate law (for netting and insolvency considerations) and contract law (as there is no general and uniform law of derivatives). Participants in the OTC market and foreign lawyers have expressed some concern as to whether French law can deliver. For instance, they have questioned whether French law respects the relationship between the ISDA Master Agreement and other ISDA documentation.

NETTING IN FRENCH LAW?

Netting as an English law concept is difficult to translate and many jurisdictions lack the adequate terminology. Close-out netting consolidates the various cross claims of the parties into a net figure, owed by one party (the party out of the money) to another (the party in the money) if the contract is terminated early. Set-off resembles the French concept of *compensation* (Art 1347 of the French Civil Code), but the concepts of set off and *compensation* have almost contradictory domains of application. *Compensation* is not appropriate to effect close-out netting as close-out netting is not technically a mechanism of *set-off* but rather a means of evaluating the contractual damage and indemnity due to one of the parties (and then novating the contracts to reflect the new balances due). Close-out netting (or *default netting*) is either not reflected in its entirety or translated as *compensation-resiliation* (ie set-off and termination), while netting of payments often becomes *compensation des paiments*. The main difference is that netting does not operate by novation in French law. This is because netting is seen as a *means of payment* in French law that aims at *reducing* pre-existing obligations.

No changes have been made to the close-out netting mechanism of the ISDA Master Agreement to reflect how netting operates under French law (see Art 6 of the French Master Agreement). Indeed, netting is recognised and enforced, irrespective of the risk that any of the trades may fail subsequently, as shown in cases involving documentation from the French Banking Federation (FBF).[2] In fact, netting law has been *deregulated* in French law, whether it concerns lifting restrictions on the enforceability of close-out netting or increasing the potential application of close-out netting.

Before the Financial Collateral Directive, netting would only be enforced if it was provided for by way of a Master Agreement "from the market/financial centre".[3] Since the Financial Collateral Directive, the use of a Master Agreement from professional bodies (ISDA, FBF etc) is no longer a condition for the enforceability of netting even if in practice, parties feel more reassured by the Master Agreement.

One issue brought to light during the drafting of the French law ISDA concerned the restrictive scope of netting measures (some transactions did not benefit from the close-out netting regime such as those involving Foreign Exchange spot, quotas, as well as those relating to the sale, purchase and delivery of gold etc). This was solved by broadening the scope of netting under French law,[4] codified at Art L. 211-36 French Monetary and Financial Code.

Thus, netting under French law has become looser and can operate transaction by transaction or multi-transactionally.

GLOBAL NETTING UNDER FRENCH LAW?

Global netting is the concept of set-off applied between several Master Agreements.

Global netting can be achieved either via the inclusion of a clause in the principal Master Agreement that "creates a 'bridge' to the other agreements in the event of a close-out" (such as the 2001 ISDA Cross-Agreement Bridge clause) or via a Master Master Agreement (or Master Netting Agreement), such as the one produced by the Securities Industry and Financial Markets Association. There also exists special cross-product Master Agreements that provide for the netting of different products together. Unlike close-out netting, global netting can be viewed as a true *compensation* mechanism.

French Law has already welcomed global netting, recognising the possibility of tying several Master Agreements together.[5] Certain conditions (Art L. 211-36-1-I of the French Monetary and Financial Code) have to be satisfied (the presence of an event of default, a specific global netting clause, its application to only some operations and to only the parties to the Master Agreements). As in practice global netting has been implemented between ISDA and FBF Master Agreements, there is no reason to think it would not be achievable between various ISDA Master Agreements submitted to different laws including French law. In such a scenario, parties whose counterparties have assets in the EU may find it useful to submit their Master Master Agreement to French law.

A PRO-DEBTOR INSOLVENCY LAW?

English insolvency law is viewed as being more creditor-friendly than French law. It is true that there is more room to deny creditors an ability to enforce contracts (Art L. 622-13 or L. 631-14 of the French Commercial Code, depending on the specific insolvency procedure) and to deny netting (despite the looser application referred to above) (Art L. 611-10-1 of the French Commercial Code). Insolvency practitioners have a greater ability to cherry pick the contracts they wish to continue on behalf of the debtor, selecting those that create a net balance for the debtor (Arts L. 622-13, L. 631-14 and L. 641-11-1-II of the French Commercial Code). In addition, delays and grace periods can be granted (Art L. 611-10-2 and L. 611-7 of the French Commercial Code), whilst early payments are prohibited once insolvency proceedings have begun (Art L. 622-7-I of the French Commercial Code).

Although mandatory insolvency law is more intrusive in French law, it has gradually been pushed back with regard to the use of Master Agreements as shown by a succession of laws[6] and ordinances[7] on the subject. Article L. 211-40 French Monetary and Financial Code creates a safe harbour (permitting termination and netting of derivatives contracts post an insolvency petition), thus promoting the certainty of financial markets. As highlighted in Part 1,[8] French law arrives at similar results to English law for international financial contracts but by utilising specific branches of the law. This is contrary to English law that utilises general law on many aspects (interpretation, netting, insolvency proceedings etc).

UNCERTAINTY DUE TO THE REFORM OF FRENCH CONTRACT LAW?

French Contract Law was recently reformed.[9] However, concerns as to the reform were not expressed during the drafting of the French Law ISDA mainly because the more "uncertain" provisions are not applicable to an ISDA relationship. Two examples illustrate this.

French Contract Law reform introduced a form of economic frustration that had never previously been permitted.[10] Economic frustration has never received recognition by the English courts[11] although the doctrine of impracticality (where performance is physically possible but economically too burdensome) is applied in the US. The ISDA Master Agreement 2002 and the French ISDA does include impracticability within the Force Majeure Event clause in Art 5(b)(ii). Regardless of the arguments against or in favour of a form of economic frustration (moral fairness versus legal certainty put simply) Art 1195 of the French Civil Code is explicitly excluded from financial contracts (Art L. 211-40-I of the French Monetary and Financial Code). For contracts drafted after the reform but before the exclusion came into force, it is possible to exclude the application of Art 1195 of the French Civil Code in the Confirmations.

The reform also introduced a new form of unfair contract terms into *general contract law* (previously this only existed in French consumer and commercial law). This is a very intrusive form of judicial rewriting of the parties' bargain motivated by the inequality between the two contracting parties. Contracts that are characterised as *adhesion contracts* will be subject to this intrusive norm (Art 1171 of the French Civil Code). To avoid being characterised as an *adhesion contract* both parties must have the opportunity to negotiate the contract (Art 1110 of the French Civil Code). In practice, parties to an ISDA contract will negotiate many key terms (especially economic-related ones) and the content is neither drafted nor imposed by one of the parties. For instance, hedge funds are often said to negotiate defensively by trying to restrain the circumstances allowing their counterparty (the dealer) to terminate their contracts early (and thus close-out trades). In fact, the existence and use of the Schedule constitutes proof of the *negotiability* of the Master Agreement. Thus, Art 1171 will not apply to ISDA contracts.

IS GOOD FAITH INCOMPATIBLE WITH COMMERCIAL CONTRACT LAW?

One recurring criticism is that Civil Law is uncertain because it applies vague moral standards such as good faith (Art 1104 French Civil Code) and *équité* (Art 1194 French Civil Code) that are incompatible with English Law and the commercial perspective of the market.

Another, less moral and more economical, vision defines good faith as simply a duty to abstain from anything that would hinder the contractual performance/goal. The standard of diligence required varies per contract. Thus, in simple exchanges (ordinary sale, etc), the duty of good faith takes a negative shape in civil law, ie a duty *not* to interfere or prevent the performance of the contract. Although English law does not recognise such a duty, it arrives at a similar result indirectly via piecemeal solutions such as economic duress, misrepresentation, undue influence, promissory estoppel, implication, unjust enrichment and many remedies in equity.

In contracts that require a certain co-operation (franchise, consortiums, joint ventures) or where parties hold

identical interests (partnerships, companies, associations), the duty of good faith requires positive action. Here, instead of simply abstaining from certain behaviours, the parties are required to act in their common (co-operation contracts – franchises, consortiums, joint ventures) or identical (organisation contracts – partnerships, companies, associations) interests. It is in the cooperation types of contracts that some English cases have caused a stir by rallying to a general duty of good faith (*Yam Seng Pte Ltd v International Trade Corp Ltd* [2013] EWHC 111). Instead of linking this to a distinction between the nature of the contractual operation (exchange, co-operation or organisation), English judges prefer the idea of a *relational contract*. According to Macneil relational contracts are based on trust and the parties' relationship as opposed to contracts solely focused on the performance of a specific (often spot) operation. Good faith duties could be implied in relational contracts (*Al Nehayan v Kent* [2018] EWHC 333), although once again the case concerned a co-operation contract (joint venture).

GOOD FAITH IS WELCOME IN ISDA CONTRACTS

ISDA documentation has always utilised vague moral standards. The 1992 Master Agreement relied on good faith to calculate the close-out amount and a party closing a 2002 Master Agreement must satisfy the commercial reasonableness test (*Lehman Brothers Special Financing Inc v National Power Corporation* [2018] EWHC 487). In several other instances, the ISDA Master Agreement holds the parties to a duty of good faith, mainly regarding the calculation of amounts due and the selection of third parties that intervene in the contract, etc. Amendment templates, such as the articles governing the agreement to reconcile portfolio data, also make explicit reference to good faith.

The presence of such duties can be explained and theorised by the fact that OTC trading relationships often rely on long (some swaps last up to 15 years) open-ended contracts. In such transactions, behavioural norms are both useful and necessary as shown for instance in *Re Lehmans* [2016] EWHC 2417 (Ch) where the court had to determine what the requirements to determine the Default Rate, Non-default Rate and Termination Rate in good faith rationally entailed. Indeed, such norms can mitigate the risk of fact-specific litigation.

CONCLUSION ON GOOD FAITH

What counts is not the general admission of a duty of good faith but whether such a duty would be relevant in *certain practices*. Through this angle, both English Law and ISDA participants are actually open to good faith. The latter more so than the former.

In order to reassure OTC participants and the financial markets, it is possible to summarise current practices towards good faith and to formulate certain propositions.

- The duty of good faith should not lead to the creation of obligations that would contradict express terms (*Good Hill Master Fund L.P. v Deutsche Bank AG*, Index No. 600858/2010, 2016 N.Y. Misc. LEXIS 2317).
- Good faith cannot be used to challenge the validity of a contract without basis or to interpret a contract beyond its terms (CA Paris, 3/04/2014, n° 13/03780).
- Duties of good faith will not prevent parties from protecting their own interests, as this is explicitly stated, for instance in s 9.1(b)(iii) of the 2003 ISDA Credit Derivatives Definitions.
- Most behaviour will not be challenged unless it is obvious a party acted in bad faith. In a balancing test, the judge must remember that certainty often trumps justice. This can be observed in the short delay a party has to correct a mistake made regarding an exchange rate (when using a rate published that was incorrect). The short delay is understandable because one calculation will impact a series of subsequent trades of the concerned party (perhaps hedging this "mistaken" trade with a series of different positions) and the market more generally. The possibility to undo or modify one trade would thus have a ripple effect within the market.

It is true that the French ISDA Master Agreement distinguishes itself by subjecting the enforceability of all rights and obligations of the parties to "equity (*équité*) and good faith (*bonne foi*) principles of general application […]" in s 3(v). As shown, this is not necessarily a threat to legal certainty.

COMPATIBILITY ISSUES?

Aside from the Master Agreement, parties utilise several other documents that are provided for by ISDA (eg Credit Support Annexes are used to guarantee the transactions) which have been written by common law lawyers.

Not only has the French Master Agreement been drafted in such a way as to be entirely compatible with the ancillary documentation but ISDA documentation does not need to be adapted as it is not meant to work with a specific legal system. Most derivative contracts take effect via the payment of a sum paid by the party out of the money to the party in the money. All the calculations, per contract, rest on economic and mathematical concepts that are legally neutral. For example, parties can conclude a swap where the variable rate due is calculated via a formula indexed on the difference in the exchange rate between the dollar and the Swiss franc.[12] Therefore, most ISDA documentation can work seamlessly with any legal system. Only Credit Default Swaps and the Credit Support Annex deviate from this legally neutral structure.

CREDIT DEFAULT SWAPS

Credit Default Swaps are derivatives that enable users to protect themselves against an event (eg an event of default) by transferring the risk associated with the event to another party. Pay-outs in Credit Default Swaps depend on one of three conditions: payment default, insolvency or restructuring. These terms are taken from English law. They cannot easily be understood out of that legal context.

Parties can, under French law (Art 3.1 Rome I), submit different parts of the contract to different laws (*dépeçage*). The courts respect such *dépeçage*.[13] Sometimes parties sign an FBF Master Agreement (French law) and use ISDA Credit Derivative terms (template Confirmations and 2014 Definitions) whilst providing that English law will govern the terms of the underlying transaction.

Thus, parties could adopt a French Master Agreement, agree on a Credit Default Swap but apply English law for the interpretation of the Definitions booklet. Parties find this structure useful should the mark-to-market pricing of their transactions evolve, and for liquidity purposes, as relying on English law allows them to trade the Credit Default Swap more easily if needed.

Although possible and enforceable, parties must be careful of splitting up their contracts in this way as they need to preserve the coherence of their documents (for enforceability reasons). Furthermore, it is not always wise to have different parts of the same contract submitted to different laws and/or different courts.

CREDIT SUPPORT ANNEX

Given the importance of collateral in derivative trading, certain specific collateral-related documents, have been subject to a redraft for the French and Irish templates. No rights *in rem* stem directly from the Credit Support Annex. It is concerned with relational aspects and sets out how and when collateral and guarantees will be provided by the parties (eg margin requirements).

As made possible by ISDA since 1999,[14] parties can submit certain collateral arrangements to a different law, such as the *lex rei sitae* (the law of the country where the collateral is located). However, for legal and/or judiciary consistency, market users may wish to submit both their contract and collateral arrangement to the same law, which can now be French law.

FRENCH JUDGES

Parties to derivative contracts want their litigation to be handled in a market-friendly way by a professional with technical understanding. This is why the UK has developed a financial list of expert judges and why ISDA has developed alternatives to the judiciary such as Determinations Committees and Arbitrage clauses.

Determinations Committees have been set up with the aim to "apply the terms of market-standard credit derivatives contracts to specific cases, and make factual determinations on Credit Events, Successor Reference Entities and other issues (…)".[15] They have made a few decisions concerning for instance the existence of a payment default or the level of eligible debt. This form of market arbitration has always been present in ISDA with the possibility of calculating indemnities due via market quotations.

ISDA has also included arbitration clauses in its Master Agreement – and specialist panels, such as P.R.I.M.E FINANCE, have been created.

France was quick to understand the need for a specialist forum with the creation of the International Chambers of the Courts of Paris. The International Chambers are well developed, supported by the legal committee for the financial markets of Paris. It is based on a previous international chamber that was established in 1995. Two chambers now co-exist, one within the commercial Tribunal of Paris and one within the Court of Appeal of Paris for appeals.

JURISDICTION

Protocols signed by the two chambers with the Paris Bar indicate, in their first article, that the International Chambers will be competent in all disputes concerning operations and transactions on financial instruments, standard master agreements, and financial contracts, instruments, and products.

The only difficulty is that the International Chambers are competent for *international* or *transnational* disputes. There may be doubt as to whether they will adjudicate purely domestic transactions (which would be contrary to market expectations). However, this concern can be dissipated as the International Chambers are competent for disputes that involve "international commercial interest" and any adjudication on an ISDA document will interest the entire market regardless of the parties' nationality. Furthermore, the protocol clearly states that "(market) standard master agreements" fall within the competence of the International Chambers. Finally, the International Chambers' competence stems from the jurisdiction clause although this clause needs to be correctly understood.

In reality, the International Chambers are not technically a jurisdiction. They are a special formation within existing courts, which means the Chambers cannot be directly designated by a jurisdiction clause. Clause 13(b) of the French ISDA Master Agreement designates the Commercial tribunal of Paris and the Court of Appeal of Paris. By virtue of an unchallengeable administrative judiciary measure, the International Chambers should receive all disputes mentioned in the protocols. A further recommendation is to keep the existing jurisdiction clauses but to insert in brackets the designation of the International Chambers after the jurisdiction language.

EXPERTISE

Recent decisions indicate that Parisian commercial judges are very respectful of freedom of contract and the need for certainty in the financial markets.[16] This can also be observed in disputes regarding the validity of an FBF governed contract where French judges rarely bind the swap to the fate of the underlying terminated loan (unless otherwise stipulated), considering that they both pursue different aims.[17]

Article 14 of the FBF Master Agreement, giving competence to the Paris courts, is always upheld.[18] Consequently, Paris courts have developed a considerable expertise in financial Master Agreements which can now be put to good effect on the French ISDA. FBF litigation includes payment netting,[19] determining amounts due,[20] the validity of the Master Agreement and specific related transactions[21] and termination rights.[22]

FAMILIARITY

As the International Chambers have adopted processes relating to witnesses, experts, proof, fast track and amicus brief, participants in the OTC market, used to the approach of the English courts, will find proceedings quite familiar.

Although procedural acts are drafted in French the protocol allows parties to submit their documents in English without translation. Foreign parties, their experts, witnesses and counsel can express themselves in English. This allows ISDA and experts (such as members of P.R.I.M.E. Finance) to intervene and present their perspective on a particular issue as in some English cases.[23]

Feature

Biog box

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There is also simultaneous translation and only English-speaking judges are selected for the International Chambers (ten for the Tribunal and three for the court). Judgments are issued in French with a sworn English translation.

One element of concern is that only foreign lawyers are allowed to plead in English. This facility should extend to French lawyers as parties (especially non-French) will presumably prefer pleadings in English. Not only does this favour foreign lawyers over French but it does not necessarily benefit the parties as French lawyers would be better versed in the applicable law.

THE FUTURE OF THE FRENCH ISDA MASTER AGREEMENT?

The future of the French ISDA Master Agreement is potentially three-fold.

First, the French ISDA will have an impact on the domestic market which currently uses English ISDAs or French FBFs. FBF documentation is used for simpler operations than ISDA. In practice, parties using an FBF Master Agreement often include a bridge clause to ISDA definitions (such as the ISDA Credit Derivatives Definitions). Market participants may wish to simplify their documentation management by relying only on ISDA for both their international and domestic needs. The French ISDA may, thus, outcompete the FBF Master Agreement in the domestic market.

Second, looking to the future, both regarding European and international usage, the Irish Law Master Agreement may prove to be more popular because the language is the same, the law is very similar and English cases have a *persuasive force* in Irish law.

However, the research behind this article indicates that French law and the French courts will be able to provide the framework that markets seek. Furthermore, there is already market interest in the new French ISDA Master Agreement with endorsement from major asset managers associations (AFG). Some parties have already begun the transition towards the French Master Agreement. In particular certain financial associations have declared that there are no legal or operational arguments to justify using the English law ISDA for parties that are not British.[24]

Third, the new French Master Agreement is affecting more than the OTC derivatives market. The French Master Agreement is having a wider knock-on effect as parties are now considering undertaking credit and structured finance operations in French law given its' market-friendliness.

THE DYNAMISM OF THE OTC MARKET

ISDA is not concerned with which Master Agreement is used but with market certainty. Introducing different templates is counterintuitive as this creates *fragmentation risk* but ISDA's hand was forced by Brexit.

Although French law is market-friendly, users first have to decide to change, something which may take more persuasion – and regulatory and political pressure. French law has also been reformed to make it more attractive on the *prudential* side. A recent decree[25] formalised the Interdealer Exemption outlined in the AMF-ACPR letter (12 February 2019), with effect from 29 June 2019.

But a template alone may not drive change as, from the perspective of the OTC market, what really counts is the enforceability of netting and collateral (as they impact capital ratios) and clearing arrangements. Therefore, however contractually sound a Master Agreement may be, a prudential and regulatory analysis is necessary to judge its real efficacy as prudential and regulatory developments will be the main drivers behind any change to derivative documentation. ■

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2 eg TGI Paris, 9e ch. 1re sect., 23/03/2016, n° 12/14157.

3 Article L. 431-7 French Monetary and Financial Code in force between 16 May 2001 and 25 February 2005.

4 *Ordonnance* n° 2019-75 *du 6 février 2019 relative aux mesures de préparation au retrait du Royaume-Uni de l'Union européenne en matière de services financiers.*

5 *Loi n° 2001-420 du 15 mai 2001 relative aux nouvelles regulations. économiques.*

6 N° 93-1444 of 1993 and n° 96-597 of 1996.

7 N° 2005-171 of 2005 for example.

8 (2019) 10 JIBFL 658.

9 *Ordonnance* n° 2016-131 *du 10 février 2016 portant réforme du droit des contrats, du régime général et de la preuve des obligations*).

10 Civ., 6/03/1876, *De Galifet c/Cne de Pelissanne.*

11 *Blackburn Bobbin Co Ltd v TW Allen & Co* [1918] 1 KB 540.

12 TGI Paris, 9e ch. 3e sect., 29/01/2015, n° 11/09601.

13 Civ. 1re, 30/05/2000, n° 98-16104.

14 ISDA User's Guide to the ISDA Credit Support Documents under English Law 1999.

15 https://www.cdsdeterminationscommittee.org

16 T. com. Paris, 4/7/2019, n° RG 2019031042, *Foncière Euris v Société Générale & BNP Paribas.*

17 Cass. com., 24/05/2018, n° 17-14.697.

18 CA Aix-en-Provence, 8e ch. a, 19/10/2017, n° 17/08999.

19 T. com. Paris, 6e ch., 21/01/2016, n° 2013077037.

20 CA Paris, pôle 5 – ch. 6, 16/02/2018, n° 16/08968.

21 CA Paris, 3/04/2014, n° 13/03780.

22 T. com. Paris, 6e ch., 10/02/2012, n° 2009068390.

23 *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372.

24 AFTE declaration on the 22 February 2019.

25 *Décret n° 2019-655 du 27 juin 2019 pris en application de l'article L. 532-48 du code monétaire et financier.*

Further Reading:

- The choice of French law for the new ISDA Master Agreement: Part 1 (2019) 10 JIBFL 658.
- ISDA hedges its bets over Brexit (2019) 1 JIBFL 51.
- LexisPSL: Banking & Finance: Practice note: European derivatives master agreements.