



**A Safe Harbour for
Derivatives Closeout
Netting in Brazilian
Judicial Reorganisations**
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The enforceability of close-out netting provisions is a long-standing concern for the over-the-counter (OTC) derivatives industry. It is critical to allowing parties to mitigate and manage credit risk associated with such trades and the insolvency of their counterparties and, more broadly, to managing the systemic risk of the financial system.

To use a well-understood definition, “close-out netting provision” means a contractual provision in which, upon the occurrence of an event pre-defined in the provision in relation to a party to the contract, the obligations owed by the parties, whether or not they are at that time due and payable, are reduced to or replaced by a single net obligation either automatically or at the discretion of one of the parties, whether by way of novation, termination or otherwise, representing the aggregate value of the combined obligations, which is thereupon due and payable by one party to the other.¹

Most of the leading countries in the financial industry support netting and many have explicit legislation providing for safe harbours.² Regulators in general are also supportive of close-out netting,³ along with the taking of collateral, as measures to reduce and manage the risk of the counterparty’s insolvency. The International Swaps and Derivatives Association (ISDA) has also had a significant role in promoting netting and engagement to ensure the enforceability of netting arrangements, particularly in emerging markets.⁴

Although Brazil is recognised as a jurisdiction that has adopted netting,⁵ it is necessary to explore this further. First, with respect to listed derivatives, section 7 of Law 10,214/2001 provides the necessary legal framework to ensure multilateral netting of listed derivatives

¹ Principle 2 of the UNIDROIT Principles on the Operation of Close-Out Netting Provisions, 2013 (<https://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf>).

² See <https://www.isda.org/2020/07/03/status-of-netting-legislation/>.

³ See, e.g., Recommendation 8 of the Bank for International Settlements, *Report and Recommendations of the Cross-border Bank Resolution Group*, March 2010, p. 36 *et seq.* (<https://www.bis.org/publ/bcbs169.pdf>); the Basel Committee on Banking Supervision, the Financial Stability Board (FSB). Key Attributes of Effective Resolution Regimes for Financial Institutions, 15 October 2014 (https://www.fsb.org/wp-content/uploads/r_141015.pdf); and the Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision and the UNIDROIT Principles on the Operation of Close-Out Netting Provisions (<https://www.unidroit.org/english/principles/netting/netting-principles2013-e.pdf>).

⁴ See, e.g., ISDA Quarterly Article, Quiet Reformation, February 2021 (<https://www.isda.org/a/kVITE/IQ-ISDA-Quarterly-article-by-Habib-Motani-on-Close-out-Netting-February-2021.pdf>)

⁵ See <https://www.isda.org/2020/07/03/status-of-netting-legislation/>.

A Safe Harbour for Derivatives Closeout Netting in Brazilian Judicial Reorganisations

subject to clearinghouses. This provision is further enhanced by sections 193 and 194 of the Brazilian Bankruptcy Law, which deal with netting for listed derivatives, collateral and margin posted at clearinghouses.

Previously, the situation regarding protection for the close-out netting of OTC derivatives in the case of judicial reorganisations was not as clear. However, the latest reform of the Brazilian Bankruptcy Law targeted this issue⁶ and it is reasonable to expect that courts would not rule otherwise. The reform included the following new section, inspired by the safe harbours specifically extended to derivatives and repurchase agreements in the United States:

Section 193-A. The judicial reorganization request, the granting of such request or the confirmation of the judicial reorganization plan shall not affect or suspend, pursuant to the applicable law, the exercise of rights of early termination and netting within the context of repurchase and derivatives transactions, so such transactions may be subjected to early termination, provided it is so agreed in the contracts between the parties or provided for in a rulebook. Measures that result in any form of reduction of the guarantees/security interests or their foreclosure conditions, the restriction of the exercise of rights, including the right of early termination due to default, and [of] the netting provided contractually or in a rulebook shall be prohibited.

Paragraph One. Due to the early termination of repurchase and derivatives transactions pursuant to the head of this section, the credits and debits arising from such transactions shall be netted and shall extinguish the obligations to the extent that they net off.

Paragraph Two. In the event an outstanding balance remains against the debtor, it shall be considered a credit subject to the judicial reorganization, unless a fiduciary sale or assignment exists.

This new provision is a very positive development for legal certainty and avoiding the risk of judicial decisions challenging or suspending close-out netting arrangements.

The change addresses the fact that while the Brazilian Bankruptcy Law included provisions admitting *ipso facto* provisions alongside netting arrangements within Brazil's national financial system in connection with *bankruptcy* liquidations, *it was silent with respect to judicial reorganisations*.⁷ Even though a series of arguments would support the conclusion that netting

⁶ Federal Law No. 14,112, dated 24 December 2020, which amended the Brazilian Bankruptcy Law (Law No. 11,101 of 9 February 2005).

⁷ The netting of OTC derivatives in *extrajudicial* reorganisations should not pose challenges, as this sort of reorganisation (similar to a prepackaged reorganisation) is expected to trigger customary early termination provisions (in particular, those referring to arrangements and compositions with or for the benefit of creditors), and thus trigger netting before a court is requested to confirm the extrajudicial reorganisation plan.

A Safe Harbour for Derivatives Closeout Netting in Brazilian Judicial Reorganisations

was already enforceable at that time, the omission regarding *judicial reorganisations* turned into a source of legal controversy and, ultimately, a risk that caused mixed results in case law.

As a cautionary tale, it is worth recalling that in the judicial reorganisation of Brazilian telecommunications carrier Oi S.A., the presiding judge granted an order to suspend the close-out netting of financial agreements in addition to the typical interconnection agreements and executory agreements. The suspension order was essentially based on preserving the company's business and the social function of the contracts, which allegedly barred *ipso facto* provisions. Only after further consideration was the netting of the existing derivatives carved out of the suspension order.

In sum, Brazilian Bankruptcy Law now affords express legal protection to the netting of OTC derivatives in judicial reorganisation and bankruptcy liquidation proceedings. This is an important step forward for fostering the OTC derivatives market in Brazil and ensuring greater legal certainty for parties transacting in the market.

This article is for informational purposes only and should not be taken as legal advice.

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