

## LEGAL ISSUES REGARDING NETTING IN THE CROATIAN LEGAL SYSTEM - *DE LEGE LATA* AND PERSPECTIVES

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*The concept of netting as a risk management tool opens up many issues in the Croatian legal system. In general, netting in the context of the EU is the cancellation of reciprocal obligations, the valuation of terminated obligations and its replacement by a single payment obligation. The main issue which was put forth and is still before the Croatian legislator is the recognition of netting enforceability in a so-called close-out netting insolvency context. In spite of its widespread use in developed financial markets since the 1980s, it only appeared in Croatia in 1996. Since then the hyperproduction of legal rules in the Croatian legal system regarding netting has been quite obvious. Although this situation has produced a lot of legal uncertainties for participants in the Croatian financial market, this process has made its impact on the development of the Croatian financial market. In the first part of this paper, the author analyses the meaning of the netting concept from a comparative law perspective, its differentiation from set-off and the forms of netting in the financial market. The author also examines the role of ISDA in the harmonisation of the legal treatment in different legislations in the world. ISDA stresses the main economic purposes of netting and its impact on the financial market. In the second part, the author further debates whether it is necessary to relax the criteria for enforceability of netting agreements and identifies various legal uncertainties in the enforceability of netting in the Croatian legal system together with ideas on how to overcome them.*

*Key words: derivatives, insolvency, ISDA Master Agreement, netting, set-off*

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## I. INTRODUCTION

Netting as a contractual arrangement first appeared in the 1980s in developed financial markets<sup>1</sup>, but in the Croatian legal system it still raises a number of legal issues. The business community, led by the International Swaps and Derivatives Association, Inc. (ISDA), recognized the importance of this tool for financial risk management on the financial market and through its efforts contributed to the periodic harmonisation of the legal treatment of netting internationally. The European Union had an important role in this as well, by accepting netting as a legally valid institution (the right to claim for non-performance) and by giving it an advantage in relation to the preemptory rules of insolvency law.

This entire process largely influenced the Croatian legal system and contributed to the evolution of the Croatian legislator's awareness of the matter. In the Croatian legal system of the 1990s it was unthinkable in the event of initiating insolvency proceedings for a debtor to voluntarily set-off outstanding and future claims in such manner so as to offset the net amount of these claims on the day before the opening of the very insolvency proceedings.<sup>2</sup> Proponents of this rigid treatment defended their positions stating that they were protecting the rights of creditors and that netting was contrary to the mandatory rules of the insolvency proceedings which derogates the freedom of the debtor to the circumstance of managing their own assets after opening the insolvency proceeding.<sup>3</sup> In time the Croatian legislator relented to pressure by the EU and the business community.<sup>4</sup> This was mainly due to Croatia's impending accession to the EU and the obligation to implement the EU *acquis* which regulates matters of capital markets in Croatian positive law.<sup>5</sup>

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<sup>1</sup> Jovanović, T., *Pravna priroda ugovora o netiranju i preduslovi njegove izvršnosti*, Bankarstvo, No. 3-4, 2010, p. 39. For more details about the historical development of netting, see also: Roe, M. J., *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, Stanford Law Review, Vol. 63, 2011, p. 556.

<sup>2</sup> For more details see *infra ad* 3.1.

<sup>3</sup> Jovanović, *op. cit.* note 1, p. 47.

<sup>4</sup> See: ISDA, *Support for reform of netting and collateral legislation in Croatia*, London, 2011, p. 5, <http://www2.isda.org/regions/emerging-markets-across-europe-the-middle-east-and-africa/> (6.2.2017). For more details see also *infra ad* 3.1.

<sup>5</sup> E.g. Financial Collateral Arrangements Directive 2002/47/EC (Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements OJ L 168, 27.6.2002), Settlement Finality Directive 98/26/EC (Directive 98/26/EC of the European Parliament and of the Council of 19 May

The aim of this paper is to determine the legal issues with regards to netting in the Croatian legal system and to offer a solution on how to overcome them. The paper first discusses netting from a comparative perspective and points out the substantial differences between netting and set-off. This is followed by presenting the most important forms of netting and the economic purpose of netting in a global and Croatian context. The central part of this paper is dedicated to a systematic analysis of the legal treatment of netting from 1996 to today, and presents perspectives and critical observations that have so far been lacking in Croatian legal literature. The concluding part presents a general assessment of the legal treatment of netting in the Croatian legal system and offers guidelines for the prevention of further hyperproduction of regulations in this area which would have a positive impact on the Croatian financial market.

## 2. NETTING FROM A COMPARATIVE PERSPECTIVE

### 2.1. Defining and explaining the concept of netting

Even though netting first appeared in the EU during the 1980s<sup>6</sup>, today it is still the subject of much discussion in comparative legal systems.<sup>7</sup> Netting implies a set-off of mutual arrears and/or undue claims in case of occurrence of contractual events (e.g., initiating liquidation or insolvency proceedings against one of the contractual parties, loss of business license, etc.), and then calculating a single net amount that one party is to pay the other party.<sup>8</sup> The legal basis for netting arises from the framework contract in which the contracting parties define the general terms and conditions for a large number of future transactions. In addition to the aforementioned, the framework contract contains a clause on netting which foresees the termination of the framework contract should any of the agreed resolutive conditions occur and

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1998 on settlement finality in payment and securities settlement systems, OJ L 166, 11.6.1998), and Winding-up Directive for Credit Institutions 2001/24/EC (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 OJ L 125, 5.5.2001).

<sup>6</sup> See: Jovanović, *op. cit.* note 1, p. 39.

<sup>7</sup> Zobl, D.; Werlen, T., *Rechtsprobleme des bilateralen Netting*, Schulthess Polygraphischer Verlag, Zürich, 1994, p. 84; Skeel, D. A.; Jackson, T. H., *Transaction Consistency and the New Finance in Bankruptcy*, Columbia Law Review, Vol. 112, No. 1, 2012, pp. 159 – 162; Roe, *op. cit.* note 1, p. 581.

<sup>8</sup> Zobl, Werlen, *op. cit.* note 7, p. 3.

that all outstanding claims between the parties will be set-off and the remaining net amount calculated.<sup>9</sup> For the purposes of this paper, netting implies a contractual tool for terminating a financial agreement in the event of opening the insolvency proceedings by which all mutual claims between the parties are terminated reducing them to a single net amount which one party subject to the agreement must pay, that is, the other party should receive.<sup>10</sup>

The etymology of the word netting specifies another important factor in defining this term. The root word means 'to net', namely to calculate the value of the mutual claims existing on the date a termination of the agreement occurs, or with a breach of contractual terms by the other party. If the premise is that netting takes its root word from the word *netto*, it would be logical that any alignments in the event of netting are based on the net value of mutual claims on the day the agreement was terminated, and not the gross value of the mutual claims.<sup>11</sup>

In comparative legal systems, the issue of netting is largely tied to the question of execution of netting as a result of the opening of liquidation or insolvency proceedings (so-called close-out netting).<sup>12</sup> The question is whether priority should be given to the freedom of contract or to the mandatory rules of insolvency proceedings. Through an analysis of comparative legal systems it can be concluded that three groups of legislation have been formed to date with regards to netting. On the one hand there are laws that do not allow netting.<sup>13</sup> Such laws are generally representative of less developed financial

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<sup>9</sup> According to Foy, when a resolute condition occurs, this results in the termination of the framework contract, followed by the calculation of the value of the mutual claims of the parties and ultimately to set-offs and the calculation of a single net amount that one party pays and the other receives. Foy, A., *The Capital Markets: Irish and International Laws and Regulations*, Round Hall, Dublin, 1998, p. 372.

<sup>10</sup> Netting is not synonymous with a netting agreement. Jovanović, *op. cit.* note 1, p. 41.

<sup>11</sup> Jovanović *op. cit.* note 1, pp. 38 – 52; Corbi, A., *Netting and Offsetting: Reporting Derivatives under U.S. GAAP and under IFRS*, ISDA, London, 2012, p. 10.

<sup>12</sup> For more details see: Wood, P. R., *Set-off and netting, derivatives, clearing system*, Sweet & Maxwell, London, 2007, p. 25; Johnston, W.; Werlen, T., *Set-Off Law and Practice*, Oxford University Press, Oxford, 2006, p. 42.

<sup>13</sup> E.g., China. See: *Memorandum on Enforceability of Close-Out Netting in China*, ISDA, February 25, 2014, [http://www2.isda.org/news/memorandum-onenforceability-of-close-out-netting-in-china\(6.2.2017\)](http://www2.isda.org/news/memorandum-onenforceability-of-close-out-netting-in-china(6.2.2017)). In Argentina, Chile, Georgia, Morocco, Pakistan, Serbia, Seychelles and Ukraine, netting legislation is still under consideration. See: [http://www.isda.org/docproj/stat\\_of\\_net\\_leg.html](http://www.isda.org/docproj/stat_of_net_leg.html) (7.2.2017). Many countries have changed the rules of insolvency proceedings and recognized netting as a legally

markets. They give primacy to the mandatory rules of the insolvency proceeding which derogates from the freedom of contract of the insolvency debtor to foresee the termination of the agreement due to the opening of the liquidation or insolvency proceeding. The second group of laws are those that limit netting to *ratio personae* and allow it to be contracted only by certain legal entities, or those that limit it to *ratio materiae* and allow it only for certain types of financial transactions.<sup>14</sup>

Austria has limited the transactions of both parties which are either public entities, central banks, credit and financial institutions, clearing systems, and trustees in the context of securities offerings.<sup>15</sup> According to Austrian law, any claims that arise by reason of termination of financial transactions are explicitly declared to be subject to set-off even on the day after opening of the bankruptcy proceedings.<sup>16</sup> Germany refers only to corporate cash deposits with credit institutions as a security for transactions dealing with financial instruments.<sup>17</sup> France has a broader scope of the application of *ratio materiae* because it allows netting even after opening of insolvency proceedings for all financial obligations resulting from transactions on financial instruments to the extent that none of the parties to the transaction is a natural person and that at least one of the parties is a qualifying entity, and financial obligations resulting from any agreement giving right to a cash payment and/or delivery of financial instruments to the extent that all parties are qualifying entities,

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valid act introducing a separate *lex specialis* regulation which allows netting in case of a clearly identifiable obligation at the time of opening the liquidation or insolvency proceedings. In most middle-income countries these reforms have helped in recognizing the legal termination of a framework contract and the execution of netting in the event of liquidation or insolvency (e.g., Croatia, Czech Republic, Slovakia, Hungary and Romania). It can be concluded from an overview of the current situation that the perceived trend in the world is that less developed countries long refused to legally recognize netting, justifying that it is contrary to the rules of insolvency law, while developed very quickly adopted all the benefits of netting and thus became more competitive in the financial markets.

<sup>14</sup> E.g. Austria, Slovakia, Sweden, Belgium, Canada, the United States. In France there is a specific concept of limiting netting that permits netting only to financial institutions, and exceptionally to non-financial institutions when the borrower is a financial institution or investment fund (e.g., Jovanović, *op. cit.* note 1, p. 47).

<sup>15</sup> Johnston, Werlen, *op. cit.* note 12, p. 42.

<sup>16</sup> *Ibid.* See also Art. 4 and 5 of the Austrian Financial Collateral Act, Federal Law Gazette I No. 117/03.

<sup>17</sup> *Ibid.* p. 174. Art. 3 par. 1 of the German Financial Collateral Act/2003.

as well as financial obligations resulting from any agreement entered into the context of an inter-bank settlement system or a system of settlement and delivery of financial instruments.<sup>18</sup>

The third group of laws are the more liberal ones which do not limit netting by any criteria and fully recognize it among all legal entities and for all types of transactions.<sup>19</sup> In such laws there are no restrictions for netting either in terms of *ratio personae*, or *ratio materiae* limitations.

Netting is often associated and compared with the institute of set-off, but there is a significant fundamental difference between them.<sup>20</sup> It is an undeniable fact that netting is a manifested form of a set-off of claims, but it represents much more than just a simple set-off. The legal consequences of the institute of set-off usually occur with the fulfilment of legal assumptions (e.g., reciprocity, concurrency, maturity and actionability and declaration of set-off), while netting is a type of contractual arrangement in which the set-off does not need the fulfilment of legal consequences as those sought by the legislator with set-offs, but the occurrence of contractual assumptions.<sup>21</sup>

In relation to the contractual compensation, netting of a contractually based set-off of mutual claims also includes termination of the agreement in which the netting was contracted. Termination of the agreement is a prerequisite for netting.<sup>22</sup> Another difference is that netting in countries with developed financial markets enjoys a much better legal treatment in the event of the consequences of opening a liquidation or insolvency proceeding. Namely, the efforts of professional associations have resulted in many laws recognizing the deviation from the mandatory rules of insolvency rights and allowing for a set-off even before the opening of a liquidation or insolvency proceeding, even though in the regular course of things it would be prohibited and would lead to prohibited actions by the debtor to the detriment of creditors before opening of the insolvency proceeding.

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<sup>18</sup> *Ibid.* p. 166 and 168.

<sup>19</sup> For example, the UK, Japan. In the UK courts have been applying close-out netting since the 17<sup>th</sup> century, which has been recognized by the law since 1705. In the UK the set-off of future outstanding receivables in insolvency is mandatory. See: Goode, R., *Legal Problems of Credit and Security*, Sweet & Maxwell, London, 2003.

<sup>20</sup> Directive 2001/24/EC uses the notions set-off and netting agreement separately.

<sup>21</sup> Wood, *op. cit.* note 12, p. 4.

<sup>22</sup> Jovanović, *op. cit.* note 1, p. 41.

## 2.2. Types of netting

Depending on the number of parties, netting is divided into bilateral and multilateral netting. While bilateral netting is the calculation of the net amount between the two parties with the set-off of mutual debts and claims, multilateral netting represents a more complex form of netting which occurs in two ways: either through direct determination of the multilateral net position or indirectly through the calculation of the net bilateral position which serves as the basis for the “net-net” positions of both parties in the calculation procedure.<sup>23</sup>

With respect to the legal context and relations in which netting takes place, differentiation is made between payment netting and default netting. Payment netting takes place between liquid parties and is essentially the calculation of the accrued amounts from the current account between the parties in bilateral or multilateral agreements on a certain day and in a certain value.<sup>24</sup> According to Wood, this is a risk mitigation tool which essentially represents an agreement on the anticipated set-off on the day of settlement of mutual claims regarding the same funds. It is not contentious from a legal aspect as in most countries it implies common payment transactions.<sup>25</sup>

In contrast, netting of outstanding receivables opens up a number of legal issues. It is a type of netting agreement by which a diligent contracting party, in the event of the occurrence of a resolutive condition, gains the right to revoke or terminate all existing agreements with the counterparty which did not fulfil its obligations and which then results in the netting of claims and debts of all mutual legal relations. The manifestation of netting of outstanding receivables is known as netting by novation and close-out netting. As close-out netting is the most disputable from a legal aspect, its most important determining factors are set out hereinafter without going into an analysis on the remaining forms of netting of outstanding receivables.

With close-out netting the outstanding and undue claims between the parties are automatically calculated in the event of the occurrence of liquidation,

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<sup>23</sup> In comparative literature it is also present division on the basis of the legal nature of mutual netting transactions: payment-system netting, foreign-exchange netting, derivatives-contracts netting, etc. See: Mäntysaari, P., *The Law of Corporate Finance: General Principles and EU Law 2*, Springer, Heidelberg, Berlin, 2012, p. 276; Jovanović, *op. cit.* note 1, p. 40.

<sup>24</sup> Corbi, *op. cit.* note 11, p. 11.

<sup>25</sup> Wood, *op. cit.* note 12, p. 153.

insolvency or breach of contract. Close-out netting is a contractual tool which allows for unilateral termination and always includes three phases: termination of the agreement, calculation of the value of mutual claims of the contracting parties and set-off, and finally calculation of a single net value of the mutual obligations.<sup>26</sup> The most common reasons that in practice lead to termination of the framework contract with undue claims are difficulty in paying, refusal to execute obligations, seizure of license for operating a financial institution, opening of a liquidation or insolvency proceeding and similar.

Finally it should be noted that a sufficient degree of harmonisation has not been carried out on an international level and national legislation in terms of close-out netting creates many legal uncertainties with respect to the recognition of the validity of close-out netting and recognition of the execution of close-out netting for the reason that the national provisions on close-out netting are in contrast with mandatory insolvency rules.

### 2.3. ISDA and ISDA Master Netting Agreement

It is not possible to have a more serious discussion on the issue of netting without taking a look at the effect of the ISDA.<sup>27</sup> ISDA is the most influential international organisation of the financial industry in the world. It was founded in 1985 in London with the aim of creating an internationally harmonized and secure legal treatment of over-the-counter derivatives (OTC derivatives) which include a wide variety of financial products such as interest rate, currency, commodity, credit, equity swaps, options and forwards, caps, floors, swaptions and other products.<sup>28</sup>

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<sup>26</sup> Foy, *op. cit.* note 9, p. 374.

<sup>27</sup> The first international document that promoted the need to establish a uniform international legal treatment regarding the execution of netting was the Angell Report on Netting Schemes of 1989. In addition to this, an important international contribution to the popularisation of netting was the Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries in 1990. This report states that legal certainty and a good legal basis for carrying out a set-off is one of the prerequisites for establishing minimum standards for conducting net settlement systems and netting mechanisms. In recent years, one of the most important impacts on the harmonisation of national legislation was from the Basel Committee on Banking Supervision: Consultative Proposal: *The Supervisory Recognition of Netting for Capital Adequacy Purposes of 1993*, <http://www.bis.org> (2.8.2017). Today a new Basel agreement on convergence of capital from 2006 is in force.

<sup>28</sup> Today ISDA has more than 830 members from the ranks of the world's largest

The main mission of ISDA is to promote fair business practices of risk mitigation in international financial markets and the strengthening of legal certainty through consultation and participation in conducting legal reforms in countries that substantially diverge in their compliance with international and European standards in the market with respect to OTC derivatives.<sup>29</sup>

To date ISDA has adopted a series of documents by which it has continually warned legislators on the latest trends and requirements of financial market participants. As some national legislators were slow to adapt to new conditions while the requirements of the market grew all the more, in 2006 ISDA adopted the second Memorandum on the Implementation of Netting Legislation: A Guide for Legislators and Other Policy-Makers.<sup>30</sup> This memorandum describes in detail the legal requirements and elements of netting, and how to implement them in national legislation.

The ISDA Master Netting Agreement (ISDA MNA) played a key role in the harmonisation of documentation and the creation of legal certainty with regards to the occurrence, duration and termination of netting in different legal systems. It represents a legal basis for netting as it contains a so-called clause on the right to set-off all outstanding and/or undue claims between the parties to the contract in the event of the occurrence of a particular event or resolutive condition from the contract.<sup>31</sup>

The ISDA and ISDA MNA are standardized contracts that are used as standard forms in almost all international transactions of OTC derivatives world-wide. They were created in 1985 by adopting the ISDA Code of Standard Working, Assumptions and Provisions for Swaps. The version from 2002

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banks, governmental agencies and other financial institutions. For more details on ISDA's mission see: Support, *op. cit.* note 4, pp. 21 – 22.

<sup>29</sup> With ISDA's expertise and logistic support the EU has created a legal framework which is closer to the national legislation of EU member states and a legal framework for the execution of netting in case of insolvency. See: Support, *op. cit.* note 4, p. 22.

<sup>30</sup> Memorandum on the Implementation of Netting Legislation: A Guide for Legislators and Other Policy-Makers, <http://www.isda.org/docproj/pdf/Memo-Model-Netting-Act.pdf>, 21.1.2017.

<sup>31</sup> In practice, the netting process is almost always carried out in two phases. The first phase represents the conclusion of the ISDA MNA, a so-called single master contract on netting which contains a provision on set-off of all due and/or undue claims between the parties to that contract. The second phase starts later and implies the conclusion of individual contracts in which the parties elaborate the essential ingredients of each legal transaction in detail.

is currently in force. According to it, the parties basically agree on the general conditions and common content of future long-term contracts (e.g., the meaning of specific terms, timeframe for fulfilment, place of performance, consequences of delay, applicable law, jurisdiction for resolving disputes, actions to be taken in case of non-fulfilment of some of the contractual provisions between the parties and third parties, calculation of mutual obligations of the parties and similar).<sup>32</sup>

The main purpose of the ISDA MNA is to prevent legal consequences (e.g., losing the right to claim for non-performance), in case of default due to liquidation or insolvency proceedings, initiating disputes on set-off of debts, changes in tax regulations and the like.<sup>33</sup> By concluding the framework contract, the parties agree only on the general rules of business transactions that will apply to all future contracts that will be concluded soon after, while the essential components of individual legal relations will be consequently determined when concluding the individual contracts (specified transaction).<sup>34</sup>

The ISDA MNA falls in the legal category of standard contracts, i.e., standardized contract forms. These are unnamed framework contracts with general business transaction rules which aim to respond to complex challenges that arise in financial markets and thereby establish order and increase legal certainty. In legal texts the legal nature of these agreements is controversial because

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<sup>32</sup> These rules do not only contain provisions concerning netting but apply to all financial derivatives that the parties hereto conclude within the framework of mutual long-term agreements. It introduces the possibility that any of the parties to such a framework contract, in case of OTC derivative transactions that have not yet matured, “connect” (net) all their market values on the date of their early termination, if there is a violation of contractual provisions of the counterparty (default) or other agreement of certain events. For details about the content of the ISDA MNA, see: Corbi, *op. cit.* note 11, p. 10; Slakoper, Z.; Beroš Božina, M., *Ugovor o valutnom i kamatnom swapu*, Zbornik Pravnog fakulteta Sveučilišta u Rijeci, Vol. 30, No. 2, 2009, pp. 966 – 968.

<sup>33</sup> As this is about agreements that exist in different legal systems (common law and civil law systems), the ISDA MNA raises a number of substantive and procedural questions whose answers must be sought in the relevant laws. This often causes difficulties due to the fact that ISDA MNA with its content and terminology belongs to common law legal logic which is problematic when it is subsumed under the terminology of civil law countries. For more details, see: *ibid.*

<sup>34</sup> In terms of content, the ISDA MNA can be divided into three parts: the standard framework contract, Schedule to the Master Agreement (a form in which data is entered on the provisions of the framework contract to be changed and/or supplemented), and the specified transaction which is referred to in separate certificates (special contracts with essential segments for certain activities). For more details, see: Corbi, *op. cit.* note 9, p. 11.

some authors refer to them as general terms and conditions. This view however is not entirely true given the fact that the ISDA MNA is not prepared by only one contractual party but by both, and that its application should be explicitly stipulated while for the general business conditions it is sufficient that the other party knew or should have known of the existence of the general terms and conditions.<sup>35</sup>

The adoption of the ISDA MNA unified documentation and standards in terms of netting, which formed a legally recognized legal basis for the implementation of netting in different legal systems.

#### 2.4. Economic purpose of netting

Netting, as a financial technique of calculating claims, represents one of the most effective instruments of risk reduction in the financial market of OTC derivatives. Risk reduction relates primarily to reduction of credit risk, which ultimately leads to the reduction of systemic risk in an individual financial market. This domino effect is logical because the credit risk reduction of one participant in the financial market has a positive effect on the other participants, which contributes to the stability of the financial market. By using netting participants of unsecured financial markets ensure the recoverability of their claims should resolute conditions occur (e.g., insolvency or winding-up) which leads to better placement of their capital (i.e., adequacy of capital) and reduces the demands of credit institutions in determining the conditions of credit security.<sup>36</sup>

The role of netting nowadays becomes particularly relevant in times of economic crisis. Reducing systemic risk has a positive influence both on the payment system and settlement system for securities, which is also associated with reduced business risk because it thereby reduces the number of insolvent participants in the financial market and increases their competitiveness. As netting is an action that does not create a new, but rather calculates the net of the existing claims, it also helps reduce the costs in determining the cost of capital. Cost savings occur as netting is carried out on the net amounts, rather than on the gross amounts, which reduces the burden of the parties and their capital which is in circulation.<sup>37</sup>

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<sup>35</sup> From the point of view of Croatian law, see: Slakoper, Beroš Božina, *op. cit.* note 32, p. 966.

<sup>36</sup> See: Mäntysaari, *op. cit.* note 23, p. 276; Corbi, *op. cit.* note 9, pp. 11–12.

<sup>37</sup> Mäntysaari, *op. cit.* note 23, p. 276.

Proponents of the special treatment of netting legislation have emphasised that the securities and derivatives markets are too complex to be treated in the same way as other contracts<sup>38</sup>, namely that the status of securities professionals is more that of middlemen rather than true parties interested in securities transactions<sup>39</sup>, and subjecting them to the stay and the trustee's powers of preference would magnify the volatility and delay the growth of the market<sup>40</sup> and the need to keep system risk in check by avoiding a domino effect while taking other participants in the derivatives down with it.<sup>41</sup>

Detecting the economic benefits of netting gives rise to its popularisation and wider international application of OTC derivatives and ISDA framework contracts. In this way one can speak of a kind of international standardisation of documentation and legal regulations regarding netting in different legal systems. Uniformity in legislation and predictability in the execution of netting leads to legal certainty regardless of the legal environment and economic power of the financial markets.<sup>42</sup>

The economic purpose of netting is not only about the calculation of mutual claims in the case of non-fulfilment of mutual obligations or insolvency claims.<sup>43</sup> It can also be used in the absence of legal conditions for implementing netting. In the absence of reciprocity, claims, homogeneity, or if a statement on netting is not given, a framework contract in which netting is contracted can serve as a legal basis for netting mutual claims.<sup>44</sup>

Numerous EU instruments have tried to draw attention in different ways to the benefits of netting. The European Commission in its report on the evaluation of implementation of the Directive on Financial Collateral warned of the importance of future harmonisation of netting in the European area.<sup>45</sup>

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<sup>38</sup> Skeel, Jackson, *op. cit.* note 7, p. 160.

<sup>39</sup> *Ibid.*, p. 159.

<sup>40</sup> *Ibid.*, p. 160.

<sup>41</sup> *Ibid.*, p. 162.

<sup>42</sup> See: Support, *op. cit.* note 4, p. 22.

<sup>43</sup> *Ibid.*

<sup>44</sup> In Croatian legislation netting is regulated by the Obligations Act, OG [Official Gazette of the Republic of Croatia] 35/05, 41/08, 125/11, 78/15, Art.195-202.

<sup>45</sup> The importance of netting was confirmed in the report of the Basel Committee/FSB Cross-Border Bank Resolution Group, which was adopted in March 2010. It states that netting is a successful instrument for overcoming global economic crises for all market participants as in the case of the insolvency of a contracting party which has concluded a transaction with OTC derivatives, credit risk is reduced due to the

This had a positive effect on the legal framework and in identifying the economic purposes of netting in Croatia. From 1996 to the present the Croatian legal treatment of netting has evolved to such an extent that one can speak of a kind of legal revolution. In the initial adjustments of Croatian legislation to European *acquis*, Croatia basically allowed netting, but the modalities of its implementation were vague and contradictory.

Taking into account that discrepancies between the provisions of the Bankruptcy Act/1996 (OG 44/96), Financial Collateral Act/2007 (OG 76/07) and Credit Institutions Act/2008 (OG 117/08) will be elaborated in more detail in the chapters that follow, in order to highlight the importance of netting in Croatia, the efforts of ISDA, which in 2011 directed its support to the Croatian legal reform regarding legislation on netting and financial collateral, will be indicated here. In its address to the Ministry of Finance ISDA stated five groups of benefits that would contribute to the effectiveness and enforceability of netting in the Republic of Croatia.<sup>46</sup> Some of the then mentioned benefits, despite the above-mentioned evolution of Croatian law, are still current. For example: reducing the cost of determining the price of derivatives, increasing the comparative advantages that would be manifested in the form of setting lower capital adequacy requirements by credit institutions, increased predictability in terms of execution, uniformity with the international business community and the need for greater legal security. In conclusion despite the recognized economic benefits of netting, the Republic of Croatia has not yet in the full sense created an effective legal framework for its actualisation and implementation.

## 2.5. Policy justifications for the prohibition of netting in insolvency

For a comprehensive analysis of the institution of netting it is necessary to look back at the argument that criticises the special treatment of netting in insolvency proceedings. Opponents of the special treatment point out that the special regulation of netting is actually the result of strong financial lobbies that put pressure on the political elite.<sup>47</sup> For example, Schwarcz and Sharon

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net amount between the parties, and it can even amount to zero in the case where there has been a transfer of security to cover the net exposure, <http://www.bis.org/publ/bcbs169.htm> (6.11.2016).

<sup>46</sup> See: Support, *op. cit.* note 4, p. 4.

<sup>47</sup> Schwarcz, S. L.; Sharon, O., *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, Washington & Lee Law Review, Vol. 71, No. 3, 2014, p. 1724;

call attention to the fact that such rights and protection are a result of a series of enacting steps that were lobbied for and which serve as corroboration for subsequent steps, without a careful and systematic vetting of the consequences.<sup>48</sup> They further emphasise how the characteristics of the derivatives market contributed to the idea that should a derivatives counterparty collapse, this might trigger a complete meltdown and that trading in derivatives is concentrated among relatively few major firms.<sup>49</sup>

Apart from them, Roe criticises the superpriority undermining market discipline in managing their dealings with the debtor because the rules reduce their concern for the risk of counterparty failure and bankruptcy.<sup>50</sup> According to Roe, there is no need for such treatment as the stronger counterparties will be paid even if their derivatives or repo counterparty fails.<sup>51</sup> Roe believes that the key problem is that the major superpriority vehicles come packaged with systemically dangerous consequences, because systemically central institutions disproportionately use the bankruptcy-safe package<sup>52</sup> meaning that in the end the risk is transferred but not eliminated.<sup>53</sup> Roe states that the counterparties often have the required skills, but inadequate incentives<sup>54</sup> while exposed creditors have incentives, but inadequate skills.<sup>55</sup> It is important to note that netting could be valuable for the non-bankrupt counterparty even if the obligation to the bankrupt party is equal in size to that from the bankrupt party.<sup>56</sup> Roe points out that “the blanket exceptions and superpriorities for the derivatives and repo markets are overly broad and can let counterparties drop their guard”.<sup>57</sup>

Taking the mentioned criticisms into consideration, what needs to be noted is that they are primarily related to the US capital market (which is on a much higher level of development and much more liberal than the European

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Mokal, R., J., *Liquidity, Systemic Risk and Financial Contracts*, Journal of Corporate, Financial & Commercial Law, Vol. 10, 2015, p. 96.

<sup>48</sup> Schwarcz, Sharon, *op. cit.* note 47, p. 1715.

<sup>49</sup> *Ibid.*, p. 1743.

<sup>50</sup> Roe, *op. cit.* note 1, pp. 539 and 541.

<sup>51</sup> *Ibid.*, pp. 539 and 542.

<sup>52</sup> *Ibid.*, pp. 539 and 543.

<sup>53</sup> *Ibid.*, pp. 539 and 545.

<sup>54</sup> *Ibid.*, pp. 539 and 555.

<sup>55</sup> *Ibid.*, pp. 539 and 556.

<sup>56</sup> *Ibid.*, pp. 539 and 573.

<sup>57</sup> *Ibid.*, pp. 539 and 589; Mokal, Brook, *op. cit.* note 47, p. 95.

and Croatian ones) and therefore the same arguments cannot be fully accepted in the context of the European and the Croatian capital markets. There is no doubt that the preferential treatment of netting within the framework of the EU is the result of lobbying by strong financial subjects in the capital market. Despite this, the harmonisation efforts of the EU in terms of netting legislation are very useful because they have contributed to the development of the internal market through harmonisation of the situation on the capital markets in different EU countries and greater legal security with respect to the enforceability of the ISDA MNA contract in the event of insolvency.

Analysing such opposing arguments shows that in the context of European and Croatian capital markets the arguments of those opposing special treatment of netting in insolvency proceedings can not be accepted for now. It follows that the benefit of the established legal certainty that the internal market gained from the harmonisation of netting legislation in combination with the reduction of credit, settlement, liquidity and systemic risk outweighs the fact that it favoured certain financial lobbies.<sup>58</sup> In the future, the EU and Croatia should pay attention to the arguments of opponents of netting and watch that the special treatment of netting in insolvency does not become a legitimate tool in the hands of those in power and which does not help the development of the capital market but rather the interests of strong financial lobbies.

### 3. REGULATION OF NETTING IN THE CROATIAN LEGAL SYSTEM

#### 3.1. (R)evolution of the Croatian normative framework – legal reforms of netting from 1990 to 2015

In the period from 1990–1996, netting was not legally regulated in the Republic of Croatia. Looking at it chronologically from 1990–1991, on the territory of Croatia at that time the Socialist Federal Republic of Yugoslavia's (SFRY) Law on Forced Settlement, Bankruptcy and Liquidation (OG of SFRY 84/89)<sup>59</sup> was in force, namely from 1991–1996 the Law on Forced Settlement, Bankruptcy and Liquidation (OG of the Republic of Croatia 53/91, 54/94)

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<sup>58</sup> The Regulation of Close-Out Netting in the New Member States of the European Union, *A Report by the European Financial Market Lawyers Group EFMLG from 2005*, p. 3., <http://www.efmlg.org/> (9.2.2016).

<sup>59</sup> This law is fully taken up in the Croatian legal system with its enactment from the date 28.6.1991 as the Law on Forced Settlement, Bankruptcy and Liquidation (OG 53/91, 54/94).

which did not contain any provisions on netting. The concept of netting was introduced for the first time into the Croatian legal system only in 1996 with Article 111 of the Bankruptcy Act/1996. With the passing of the Bankruptcy Act/1996 and up to the present the Republic of Croatia has made considerable effort with regards to the complete legal recognition of netting. The reason for this is the attempt to harmonise Croatian law with EU acquis regulating the capital market. This is primarily related to the implementation of the following EU directives: Financial Collateral Arrangements Directive 2002/47/EC, Settlement Finality Directive 98/26/EC, and the Winding-up Directive for Credit Institutions 2001/24/EC.

Even though the situation with regards to netting has much improved, with the adoption of Article 111 of the Bankruptcy Act/1996 the concept of netting in the Republic of Croatia has still not been widely regulated. Article 111 of the Bankruptcy Act/1996 only states that if the parties entered into a framework agreement with a clause on netting and if insolvency proceedings are opened over one of the counterparties, the other party has the right to unilaterally terminate all transactions with the first party to the contract and claim compensation for non-fulfillment.<sup>60</sup> The key problem was that the value of such compensation for non-fulfillment was determined on the basis of the value of transactions on the second business day after the opening of the insolvency proceedings (but not prior to the opening of insolvency proceedings).<sup>61</sup> An additional weakness was the fact that the other party could actualise such compensation for non-fulfillment of the contract only as a bankruptcy creditor.<sup>62</sup>

However it should be noted that with this Article for the first time at least partial freedom of contract had priority before the strict rules of the bankruptcy law. Specifically, financial transactions and financial transactions with a set deadline were allowed to deviate from the prohibition of set-off in case of opening of insolvency proceedings from Articles 103-105 of the Bankruptcy Act/1996. Namely, Article 103 of the Bankruptcy Act/1996 stipulated that the opening of insolvency proceedings did not affect the statutory or contractual right of set-off if the creditor in bankruptcy had that right at the time of opening the insolvency proceedings. Thus, in accordance with Article 104 of the Bankruptcy Act/1996, in case of insolvency proceedings, it could not apply the rule that accrued and contingent claims with the opening of insolvency

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<sup>60</sup> See: Art. 111 par. 5 of the Bankruptcy Act/1996.

<sup>61</sup> Compare: Art. 111 with Art. 103-105 of the Bankruptcy Act/1996.

<sup>62</sup> See: Art. 111 par. 5 of the Bankruptcy Act/1996.

proceedings become due (Article 73 of the Bankruptcy Act/1996), and unconditional claims (Article 74 of the Bankruptcy Act/1996) in terms of netting were actually allowed. In addition, Article 111 of the Bankruptcy Act/1996 in some ways deviated from the rules that set-off would occur only when the suspensive conditions are fulfilled if the claims that are put in set-off are still under deferment or not yet due or claims have not been managed to the same kind of obligation.<sup>63</sup> In fact, Article 111 of the Bankruptcy Act/1996 allowed for claims reimbursement in the case of bankruptcy for instance for failure to fulfill obligations even if not yet mature or if it was under suspensive condition. Another exception was that Article 105, paragraph 1 of the Bankruptcy Act/1996 prescribed that set-off was not allowed if the obligations of the bankruptcy creditors under the bankruptcy estate came after the insolvency proceedings, which according to Article 111 was now allowed.

Even though from 1996 to 2007 Article 111 of the Bankruptcy Act/1996 was the only legal source which regulated netting in the Republic of Croatia, it was not recognised in the full sense of the word.<sup>64</sup> From today's perspective, it can be concluded that through Article 111 of the Bankruptcy Act/1996 netting was only seemingly implanted in the Croatian legal system. What was lacking was a clear definition of netting, and the question of its viability in the event of insolvency was, to say the least, legally tentative. An extra burden on legal certainty was the fact that apart from Article 111 of the Bankruptcy Act/1996, no other regulation up to 2007 contained a clear provision on financial collateral in terms of the Directive on Financial Collateral. This set out that the legal treatment of netting as financial collateral also needs to be considered together with all the transactions covered by the framework contract at the time of calculating a single net amount.

The situation improved somewhat in 2008 with the entry into force of the Financial Collateral Act/2007 (OG 76/07), which introduced the concept of financial collateral in accordance with the Financial Collateral Arrangements Directive 2002/47/EC.

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<sup>63</sup> See: Art. 103 of the Bankruptcy Act/1996. Set-off was excluded if the claim which should make the set-off becomes unconditional and due before clearing becomes possible.

<sup>64</sup> In a broader sense the provisions of the Obligations Act could be applied to netting, in particular the provisions on contractual compensation, and the rules of the Bankruptcy Act/1996 that regulate set-off in case of insolvency. However, due to the specific nature of netting, a legal analogy would not be applicable.

Despite the aforementioned implementation of internationally recognized standards into Croatian law, ISDA warned of the newly created discrepancies between Article 111 of the Bankruptcy Act/1996 and Article 8 of the Financial Collateral Act/2007. According to ISDA, the key problem lay in the fact that the two regulations sought to regulate the same legal issue, but each regulation did so in a completely different way.<sup>65</sup> An additional degree of legal uncertainty stemmed from the lack of relevant practice in relation to the enforceability of netting in the case of insolvency of Croatian entities.<sup>66</sup>

Summing up this issue, it may be concluded that the fundamental discrepancies were in that Article 111 of the Bankruptcy Act/1996 provided that netting and calculation of the net amount would be reached the second day after the opening of insolvency proceedings, while conversely the Financial Collateral Act/2007 stated that the fulfilment of the obligations under the financial collateral agreement would be fulfilled according to the contract regardless of the consequences of opening insolvency and liquidation proceedings or carrying out reorganisation measures (which was in line with the terms of the framework contract as a rule prior to the date of the resolute condition). Therefore, it was not clear by which law the date of termination of the framework contract the contract netting would be determined, nor the exact day of calculating the net amount in the case of a framework contract with a clause on netting between the parties.

In the mentioned period the Financial Collateral Act/2007 generally recognized the freedom of contract netting and calculation of the net amount in the case of opening insolvency and liquidation proceedings or reorganisation measures, but what was still problematic was if the mandatory provisions of public law from the Bankruptcy Act/1996 could be derogated, since it provided that the claim for non-performance went into force the second business day of the opening of insolvency proceedings, and not the way it was agreed on between the parties.

In this period, netting was also regulated in Article 7 paragraph 2 of the Act on Settlement Finality in Payment and Financial Instruments Settlement Systems/2008 (OG 117/08), which implemented the Settlement Finality Directive 98/26/EC. The aim of the adoption of Directive 98/26/EC on settlement finality in payment and securities settlement systems was to ensure that transfer orders and their netting should be legally enforceable under the laws of all

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<sup>65</sup> See: Support, *op. cit.* note 4, p. 27.

<sup>66</sup> *Ibid.*, p. 28.

Member States and binding on third parties<sup>67</sup>, and that the rules on close-out netting before implementation of the set-off should not obstruct verification in the system whether the orders that had entered the system are in accordance with the rules of that system and then enable implementation of the settlement of that system.<sup>68</sup> This aim was achieved in Croatian legislation in Article 7 paragraph 2 of the Act on Settlement Finality in Payment and Financial Instruments Settlement Systems/2008 where netting was defined as the conversion of assets and liabilities resulting from transfer orders which a participant or participants gave or received from one or more other participants in one net claim or one net obligation, with the result that only the net amount is being sought or owed.<sup>69</sup>

An additional problem appeared with Croatia's accession when EU law became an integral part of Croatian positive law. On the day of accession, the Credit Institutions Act/2008 (OG 117/08, 74/09, 153/09, 108/12, 54/13, 159/13) came into force in which netting is regulated in Article 353. This Article stipulates that with respect to credit institutions from Croatia or other EU member states, during the implementation of reorganisation measures or the opening of liquidation, insolvency proceedings contracts on set-off and netting are the relevant law applicable to such contracts.

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<sup>67</sup> Introductory par.11 of the Settlement Finality Directive.

<sup>68</sup> Introductory par.12 of the Settlement Finality Directive.

<sup>69</sup> In accordance with Art. 2 item (k) of the Settlement Finality Directive, netting is defined as the conversion into one net claim or one net obligation of claims and obligations arising from transfer orders which a participant or participants either issue or receive from one or more other participants which results in only a net claim or net debt. Transfer orders and netting are legally enforceable, even in the event of insolvency proceedings against a participant, and shall be binding on third parties, provided that the transfer orders entered into the system before the opening of the insolvency proceedings. When transfer orders exceptionally enter the system after the opening of insolvency proceedings or were carried out on the day of opening of such proceedings, they are legally enforceable and binding on third parties only if, after settlement, the settlement agent, the central party or the clearing house can prove that they did not know, or could have known of the opening of such proceedings (Art. 3, par. 1 of the Directive). Also, Art. 3 par. 2 of the Directive stipulates that no law, regulation, rule or practice of cancelling of contracts and transactions concluded before the opening of insolvency proceedings can lead to set-off. The moment a transfer order enters into the system defines the rules of that system. If the national law regulating the above system lays down conditions relating to the moment of entry, the rules of the system must comply with these conditions (Art. 3, par. 3 of the Directive).

This formulation caused confusion in the Croatian legal system with regards to netting as it was unclear how to determine the applicable law. Was the applicable law the one that is applied to contracts on netting; was it the bankruptcy law which is relevant for the legal entity against which the insolvency proceedings have been opened; or was it the law the parties agreed on in their framework contract in which the clause on netting was contracted?<sup>70</sup> The Croatian legislator should adopt the latter solution as this would recognise the essential purpose of netting and give priority to the freedom of contract.

The next step in the evolution of Croatian law was the amendment to the Financial Collateral Act/2007/2012 (OG 76/07, 59/12) which contained a substantive definition of netting for the first time in Croatian law. In Article 2 paragraph 14 of the Financial Collateral Act/2007/2012, netting is defined as the calculation of present or future payments, calculation of the obligation to deliver or calculation of rights arising from one or more agreements on specific financial business by which the calculation could mean termination or cancellation, or early maturity of the obligation to pay and delivery, or the acquiring of any other rights. According to the aforementioned Article, the settlement includes calculation or estimation of the unique, market, liquidation or replacement value in connection with one or more obligations or rights, but can also mean the conversion to a single currency and/or determining the net amount of the obligation, either through set-off or in any other way. According to Article 8 paragraph 1 of the Financial Collateral Act/2007/2012, netting is fulfilled according to that agreement notwithstanding the initiation of insolvency or liquidation proceedings or reorganisation measures against the financial collateral provider or financial collateral taker.

By analysing the observed period, we can conclude that the Croatian derivatives market was largely limited which undermined the competitiveness of the Croatian financial market and its participants. The net exposure of financial institutions and investors could not be calculated with certainty towards Croatian contracting parties; there was great uncertainty as to the execution of netting during the opening of insolvency proceedings with regards to the moment early termination of the contract would be in force, as well as the day on which the net value of mutual claims would be calculated.<sup>71</sup> This led to higher prices of derivatives and restricted access to the Croatian derivatives market.<sup>72</sup>

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<sup>70</sup> *Ibid.*

<sup>71</sup> See: Support, *op. cit.* note 4, p. 29.

<sup>72</sup> *Ibid.*, p. 10.

Nevertheless, it is evident that within one decade Croatia managed to evolve in terms of netting. Besides having netting recognized as a legally valid way of calculating mutual claims, the need to have it implemented in the Croatian legal system was also recognized. The legislator recognized that there was progress in terms of the derivatives market which required a deviation from the basic principles of insolvency law<sup>73</sup> (protection of creditors and maturity of obligations) and that netting was an internationally recognized principle that was knocking on the legislator's door. Faced with these facts, the Croatian legislator attempted to implement netting in the Croatian legal order by a hyperproduction of regulations. However this was done in an insufficient quality. It failed to fully ensure legal certainty during the said implementation in terms of applying netting and modifying Article 111 of the Bankruptcy Act/1996 by stating that the fulfilment of the obligations under the financial collateral agreement would be fulfilled according to the contract regardless of the consequences of opening insolvency and liquidation proceedings or carrying out reorganisation measures (which was in line with the terms of the framework contract as a rule prior to the date of the resolutive condition) and not on the second day after the opening of insolvency proceedings.

### 3.2. *De lege lata*

Full legal security in the Croatian legal system with regards to netting was introduced after the adoption of the Bankruptcy Act/2015 (OG 71/15). This meant that a high degree of harmonisation of the Croatian legal framework regarding netting with international and European standards on the derivatives market had been achieved.

A kind of revolution in the legal treatment of netting in Croatia was completed in 2016 with the entry into force of Article 182 of the Bankruptcy Act/2015. The articulation of the aforementioned Article resolved legal uncertainties and doubts that were actuated in Article 111 of the Bankruptcy Act/1996. Article 182 of the Bankruptcy Act/2015 has indisputably recognized the possibility of calculating fees for failure to fulfil obligations in accordance with the content of the framework contract containing a clause on netting, and not on the basis of the difference between the contracted price and the market or stock price which on the next business day after the opening of the insolvency proceedings in the place of its fulfilment, is applicable for

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<sup>73</sup> *Ibid.*, p. 5.

contracts with a contracted period of fulfilment. It introduced the possibility of the other party realizing its claim on such fee only as an insolvency creditor.

In analysing the existing legal framework, netting in Croatia is regulated by Article 182 of the Bankruptcy Act/2015, Article 353 of the Credit Institutions Act/2008/2013, Article 2 paragraph 14 of the Financial Collateral Act/2007/2012, and Article 3 paragraph 11 of the Act on Settlement Finality in Payment and Financial Instruments Settlement Systems/2012/2016 (OG 59/12, 44/16). The mentioned regulations are aligned and allow for the contracting of netting in Croatia and its realisation even in the event of liquidation or insolvency proceedings or reorganisation measures. With such a set of laws, Croatia has sided with the legislation that restricts netting to *ratio personae* and *ratio materiae* ratio, namely it considers it as a privilege that is only allowed for certain financial institutions and with regards to individual financial transactions.

On the one hand, according to Article 3 paragraph 1 of the Financial Collateral Act/2007/2012, entities to which the netting legislation apply are taxatively numbered. Some of these are financial institutions such as credit institutions as legal persons taking deposits or other repayable funds from natural and legal persons and approval of loans for their account, investment firms, financial institutions, insurance undertakings, Central counterparties, settlement agents and clearing houses.<sup>74</sup> In Croatia, parties to the financial collateral agreement may also be other entities and natural persons, but only if they conclude financial collateral agreements with entities to which the netting legislation applies.<sup>75</sup>

On the other hand, Article 182 paragraph 7 of the Bankruptcy Act/2015 provides that qualified financial contracts to which netting rules can be applied are only financial contracts in which one of the parties is a credit institution, financial institution, investment firm, leasing company, management fund, alternative investment management fund, pension fund management company or insurance company, for which arising obligations must be fulfilled at a given time or during a specified period, regardless of whether they are concluded under condition or not.<sup>76</sup>

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<sup>74</sup> The Republic of Croatia will also be treated as a financial entity. See Art. 3 par. 2 of the Financial Collateral Act/2007/2012.

<sup>75</sup> See: Art. 3 par. 3 of the Financial Collateral Act/2007/2012.

<sup>76</sup> These in particular are contracts with financial instruments within the meaning of the Capital Market Act 2007/2012, repurchase agreements and other contracts for

It can be concluded that Croatia today has adopted a broader model of *ratio personae* netting limitations unlike Austria and Germany.<sup>77</sup> This can be currently accepted as a good solution, but will need to be monitored in the future so that the existing solution does not become subject to abuse (e.g., unauthorised persons falsely concluding financial dealings only to avoid the strict rules of the insolvency proceedings and thereby causing damage to insolvency creditors). Such a conclusion can not be performed for the *ratio materiae* restriction, which is much stricter than the *ratio personae* netting restriction. As the capital market develops rapidly and it is not possible to foresee all the changes on the market, it would be pragmatic in the future to expand the *ratio materiae* restrictions on all types of transactions relating to OTC derivatives and avoid their taxative numeration in the law. However, one should take into account the possible abuses that could serve as a legitimate means of achieving legal actions of the debtor and third parties to the detriment of creditors.

It should be noted that in terms of netting regarding finality settlement in financial systems and settlement systems of financial instruments there have been no substantive changes to the meaning of netting, but rather only renumbering so that netting is now regulated in Article 3 paragraph 11 of the Act on Settlement Finality in Payment and Financial Instruments Systems/2012/2016 which implements Directive 2009/44/EC.<sup>78</sup>

Another note to be made is that the opening of pre-bankruptcy proceedings or restructuring should not affect the enforceability of netting. If netting is allowed in insolvency proceedings it should also be allowed in pre-bankruptcy proceedings and in the process of restructuring.<sup>79</sup>

According to the current regulation of the Bankruptcy Act/2015, it emerges that in the event of opening pre-bankruptcy proceedings against a party of the ISDA MNA which is not a financial institution (provided that the other party to such agreement is a financial institution) it should not affect the enforcea-

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financial security in terms of the Financial Collateral Act/2007/2012, the use of financial instruments, including loans and borrowings as well as ancillary services in terms of the Capital Market Act, agreements on balance sheet accounting (netting) pursuant to the regulations governing the operations of credit institutions and transactions buying and selling foreign currencies. See: Art. 182 par. 7 of the Bankruptcy Act/2015.

<sup>77</sup> *Supra ad p. 5.*

<sup>78</sup> Directive 2009/44/EC of the European Parliament and of the Council of 6 May 2009, OJ L 146, 10.6.2009.

<sup>79</sup> Wood, *op. cit.* note 12, p.60.

bility of netting and should be permitted. The justification for such conclusion arises from Article 3 paragraph 6 of the Bankruptcy Act/2015, which stipulates that pre-bankruptcy proceedings can not be performed over a financial institution, and it would be logical that in such case in practice the issue of netting would not even arise as pre-bankruptcy proceedings can not be carried out over a financial institution. On the other hand, if pre-bankruptcy proceedings are opened over a party that is not a financial institution (even if it is a legal person), and the other party of the ISDA MNA is a financial institution, it emerges that netting could then occur in accordance with the Bankruptcy Act/2015.<sup>80</sup>

Despite the undisputed progress, some legal issues with regards to netting still remain open. Below is an overview of the open issues and possible perspectives.

#### 4. CONCLUSION: THE PERSPECTIVES OF NETTING IN THE CROATIAN LEGAL SYSTEM

Chronologically speaking, it can be concluded that Croatian legislation on netting was always reparatory but not to prevent legal problems. What is positive is that the reform of the legal treatment of netting in the past twenty years has resulted in the harmonisation of national legislation. Despite this, the Croatian legislator has not learned much from the previous period and in the future we can expect further amendments to relevant legislation. Such defects can be expected in the future as there was no pragmatic research and reform of the Croatian legal system with regards to netting, which would have a positive impact on the Croatian financial market and Croatian financial entities. A recommendation to the Croatian legislator would be to monitor trends on the developed markets and to consult with practitioners where the emphasis should be placed on the specific features of the Croatian capital market. It is necessary to examine whether the existing legal framework in respect of netting regulations is sufficient or if it has become a legitimate platform for abuse (e.g., legal actions of the debtor to the detriment of creditors). Therefore, in proposing future *de lege ferenda* solutions it should first of all take into consideration the particularities of the Croatian capital market and to test future solutions in accordance with the commercial reality and degree of development in Croatia.

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<sup>80</sup> Compare with Art. 8 par. 1 of the Financial Collateral Act/2007/2012.

In addition, it has been shown that the existing *ratio personae* limitation is good, but that the *rationis materiae* restrictions are not a smart choice because business practice and financial innovation in relation to the Croatian legislator in the future lead to an overproduction of regulations that can be expected in order to remain in step with the times and market requirements. Therefore it would be pragmatic to extend *ratio materiae* restrictions on all types of transactions relating to OTC derivatives and avoid their taxative enumeration in the law. But one should take into account the possible abuse that could serve as a legitimate means of achieving legal actions of the debtor and third parties to the detriment of creditors. Furthermore, in Article 186 of the Bankruptcy Act 2015 it should be clearly set out that netting can be carried out even in the case of opening of pre-bankruptcy proceedings on a non-financial institution.

Finally, Croatian legislation should clearly define the method of determining the applicable law in a netting agreement. What is uncertain is whether the applicable law is the one that applies to insolvency proceedings or the one that has been chosen by the parties in their framework contract. The Croatian legislator should consider adopting the latter solution as this would recognize the essential purpose of netting and give priority to the freedom of contract.

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## Sažetak

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**PROBLEMATIKA NETIRANJA U HRVATSKOM PRAVNOM  
SUSTAVU *DE LEGE LATA* I PERSPEKTIVE**

*Koncept netiranja, kao sredstvo upravljanja rizicima, otvara mnoga pravna pitanja u hrvatskom pravnom sustavu. U kontekstu EU-a podrazumijeva način prestanka uzajamnih obveza obračunavanjem dospjelih i/ili nedospjelih tražbina u slučaju nastupa ugovorenog događaja i izračunavanje jedinstvenog netoiznosa koji jedna strana treba platiti drugoj. Iako je ovaj institut na razvijenim financijskim tržištima prisutan od osamdesetih godina prošlog stoljeća, u RH se pojavio tek 1996. godine. Od tada je u RH vidljiva hiperprodukcija propisa koji su se bavili regulacijom netiranja, što je imalo za posljedicu razvoj našeg financijskog tržišta. Unatoč tomu, u hrvatskom pravnom sustavu još su sporna pojedina pravna pitanja koja se tiču provedivosti toga instituta.*

*U prvom dijelu rada autorica analizira pojam netiranja iz poredbenopravne perspektive te ga razgraničava od prijeboja i drugih srodnih instituta koji se pojavljuju na financijskom tržištu. Zatim se ispituje uloga ISDA-e u harmonizaciji nacionalnih zakonodavstava u pogledu netiranja. U drugom dijelu raspravlja se o tome je li potrebno smanjiti uvjete za njegovu provedivost u hrvatskom pravnom sustavu. Završni dio rada predlaže smjernice za prevladavanje uočenih nelogičnosti u hrvatskom pravnom sustavu.*

*Ključne riječi: financijski derivati, insolventnost, ISDA-ina master ugovori, netting, netiranje, prijeboj*

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