# Research Topic : Legal Aspect of Netting

Student : PAUL WONG CHI YUEN (SLW)

Netting is a way of discharging obligations by mutual debts owed one to another. 'Netting is the process by which, where two or more parties owe each other obligations, instead of each of themperforming the whole of his side of the agreement and also receiving the whole of the performance from his counterparty, the two "gross" obligations are set off against one another, and only the net balance of obligations are performed by one of the parties."

Generally netting can take place in three different ways. The first one is 'payment netting' Parties may have mutual obligations arising from different contracts with various payment due dates. Instead of paying the gross amount due to one another, the parties may stipulate that only the net sum after debiting and crediting the obligations should be paid. This is also the major benefit of netting or set-off, because what others owe you can discharge what you owe themin turn and thus cash flow can be more smooth. Set-off is said to possess the benefit of performing security function. Netting is also the case.

The second type is 'netting by novation' The parties keep a running account in which every new balance made by each payment into the account constitutes a new single obligation either against or in favour of each party. Previous obligations are deemed to be satisfied and to be replaced by the new balance. The Central Clearing and Settlement System (CCASS) is a typical example of netting by novation. (see also 'Proprietary Interests in Fungible Shares' Journal of International Banking Law 2002 Issue 1 Legal Analysis (Paul Wong ChiYuen)

The third type is 'netting by close out.' The netting agreement provides that if certain events happen (e.g insolvency of either party), the outstanding obligations (whether monetary or not) between the parties will be netted to a single monetary sum. The special aimof this device is to prevent the liquidator from'cherry-picking' Upon insolvency a liquidator generally has the power to 'disclaim' any 'onerous' contracts and the non-default counterparty is left with a right to proof the damage suffered as an unsecured creditor. The liquidator in the course of his duty to maximize the assets of the insolvent probably selects to performany profitable contacts to the company and refuses to performany unprofitable contracts, i.e. 'Cherry-picking'. If the counterparty cannot net all the obligations from unprofitable contracts to profitable contracts, he will run the risk of having to pay the full amount due to the liquidator but having left with only a dividend for the amount due from the insolvent to him. Participants to any sort of netting agreements are therefore very concerned with the enforceability of the netting agreements which is a factor affecting commercial decisions. Financial dealers usually adopt a 'master agreement' to link all transactions with the same counterparty to net off all obligations. The following diagrambriefly explains this:

Without a master agreement, Liquidator A can cherry-pick Transaction 1,2 or 3. However, when the master agreement is used, Liquidator B is Left with all-or-nothing to assume or reject all the transactions with a netted value.

香港城市大學 City University of Hong Kong