A comparative Law and Economics perspective in Derivatives contract in Brazil and Germany. (Comparison between master agreement contract).

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Abstract. The present article will discuss about The Economic Analyses of Law. How this matter arises and the impact in the contracts. It is a mix between Economics and Law and the main goal of the article is to identify different treatment in the agreement. The base for this paperwork will be a comparative analysis of the Derivative contracts based in Brazil and a similar contract in Germany. The focus will be to understand the different treatment related to clauses mentioned on that. The study will start with an introduction about The Economic Analysis of Law, how the Law and Economics arises and the impact in contracts. Second topic, a definition about derivatives and an investigation about the main difference in Master agreements in Brazil and Germany. Going further in the analysis of default clauses and the economic impact. How both countries protect themselves with this kind of contract and what is the goal of the Economic analyses versus the Law analyses. The research is based on articles, books, personal experience on the job and some jurisdiction to compare both scenarios. The main conclusion is that Brazil grantee more protection in their contracts, main related to culture behaviour, as Brazil do not have the same law protection that guarantee German law.

Keywords. Derivatives, law and economics, contract, regulation

1. Introduction

The Economic Analysis of Law began in the United States in the 1970s with the work of Richard Posner, Guido Calabresi and Ronald Coase. Even though the USA is a country based on Common Law, these studies are relevant for countries like Brazil and Germany that use Civil Law. Law and Economics (LE) began in the Chicago school, and Ronald Coase introduced the topic with an article called “The Problem of Social Costs”, where he presented transaction costs in a revolutionary way through Coase’s theorem, which aimed at the efficient allocation of resources. With the emergence of (LE), the study demonstrates how economic theories can relate to the legal world, directly impacting contracts.

The purpose of this article is to analyse the issue of the Derivatives contract in Brazil and Germany, focusing on the Default part of both documents. Seek the difference with each jurisdiction and how the protection of each of them works from an economic and legal point of view.

2. Derivative Contract

2.1 Definition

Derivative contracts are financial instruments that allow fixing a certain rate in order to not be exposed to fluctuations in this interest rate or exchange rate variation. A relatively new instrument, since it began in the 70s. Even recently, it has been used by large corporations for the purpose of protecting their assets. In Brazil, there was a considerable increase in these instruments, as shown in the chart below **Fig 1**:

The Brazilian Derivatives Market (2006-2013) - Source: BM&FBOVESPA and CETIP).

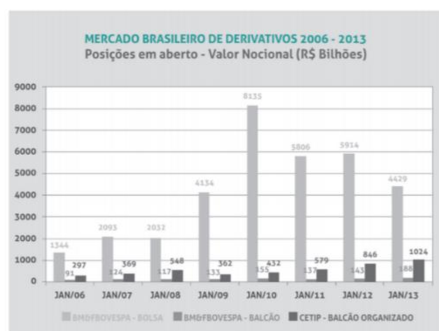

Fig. 1 – Brazilian Market Derivatives

2.2 Diference between Brazil and Germany – Master Contracts in Derivatives

The operations carried out in the market by the companies or consumers relationship, aim to allocate the products and services in the best possible way in order to have more efficiency and effectiveness in the processes. In order for these voluntary operations to be clearer and safer, contracts are instruments that guarantee operations, leaving both parties more relaxed about their business. If formal contracts did not exist, a part of the relationship could be subject to opportunism, mistrust and have its business damaged on a large scale. Considering that the market does not always works efficiently, it is necessary to establish a contract between the parties. Economists suggest that there is a correlation between the clauses that are defined in a contract with the behavior of people and companies. Because of this, this behavior may vary according to the culture and particularity of each country, requiring a more specific and non-general contract on the subject. In other words, the contract used in Germany as the DRV can even be used as a model for the contract in Brazil, but hardly a company will accept to use this pure contract. Although the instrument to be used is the same, market conditions change and the German contract may have a little more risk in Brazil when compared to the backing that can be established in CGD. An efficient contract is capable of maximizing the well-being between companies. In the event of a dispute, the aggrieved party has greater speed in guaranteeing its rights if the operation is concluded within a formal contract between the parties.

3. Analysis of the default clauses, indentifying Economic impact

Anbima's 2010 version of the derivatives agreement has twenty-one pages, of which at least two pages are specific to deal with events of default. The German Bankenverband model contract has four pages, the terms in the credit clauses being much more succinct and often not being as specific as the Brazilian contract regarding the clauses. The German model DRV, was first published in 1993 replacing the Master Agreement for SWAP Transactions of 1990. The DRV remained as a model document for derivative operations in the German market. The DRV does not distinguish between termination events and default events. Additionally, the DRV does not establish a specific list of default events. The DRV model is based on the German legal concept of a material cause (“wichtiger Grund”), which allows a termination for a material cause. However, according to German law, continuing obligations contracts (“Dauerschuldverhältnis”) cannot be terminated for material reasons, except for those mentioned in the contract. With this difference in contracts, it can be concluded that the behavior and risks of Brazilian companies are seen by banks as more prone to a default operation. For this reason, the need for a more robust and “secure” contract. In addition to the fact that in Brazil there is no law that protects contracts for the continuous provision of services as in Germany. It is also necessary to take into account State interference in contracts, which can generate instability in jurisprudence. In fact, this point also affects the country's economic issue, as many foreign investors are not encouraged to invest in Brazil due to instability and uncertanties.

3.1 Credit Clauses in the derivatives contract in Brazil

E.g.“Cases of Default. The occurrence, at any time, of any of the cases mentioned below with respect to one of the Parties and/or the Guarantor, as the case may be, shall constitute a case of default (a “Case of Default”) with respect to the Party involved: (a) Non-Payment or Non-Delivery. Failure to comply, at maturity, with any pecuniary obligation or obligation to deliver the underlying asset, as the case may be, under the terms of this Agreement; (b) Breach of Contract. (i) Failure to comply with, omit or fail to comply with any term, covenant, agreement or obligation set forth in this Agreement and/or the Confirmations, including, but not limited to, the falsehood of any statements, information or documents that have been, respectively, executed, rendered or delivered by one Party or by its Guarantor in favor of the other Party; or (ii) the Party or its Guarantor denies, waives or rejects, in whole or in part, or contests the validity of this Agreement and/or the Confirmations; (c) Default of the Instrument for the Establishment of Guarantee. (1) non-compliance or non-compliance, by the Party or by any Guarantor, of any agreement or obligation to be observed or complied with in accordance with any Guarantee Instrument; (2) the expiration or termination of such Guarantee Instrument, without the Party or the Guarantor, as the case may be, replacing the guarantee with another one under conditions acceptable to the Party benefiting from the original guarantee; (3) if the Guarantee Instrument, or any real or fiduciary right granted by a Party or a Guarantor, as the case may be, to the other Party, ceases to produce effects, ceases to be considered valid, has a defect not remedied by the

respective Party or Guarantor, as the case may be, or is declared null and void prior to the fulfillment of all obligations of the respective Party to which such Guarantee Instrument is related; or (4) the Party or such Guarantor denies, waives or rejects, in whole or in part, or contests the validity of such Guarantee Instrument"; Insolvency. If the Party, any legal entity of its respective Economic Group, or the respective Guarantor: (1)(a) requests judicial or extrajudicial reorganization, civil insolvency or bankruptcy or (b) a lawsuit has been filed or instituted against it seeking bankruptcy, insolvency civil, judicial or extrajudicial liquidation, dissolution or any other renegotiation that may affect the credit rights of the other Party, and such process or petition is not extinguished or suspended within a period of up to 15 (fifteen) calendar days of its protocol; (2) is submitted to an intervention process, temporary special administration regime –or performs any type of assignment, reorganization or composition with or for the benefit of its creditors; and (e) Dissolution. In the event that any of the Parties or any Guarantor ceases to exist validly and legally in accordance with the laws of the place of incorporation (for reasons other than merger, incorporation or spin-off). 5.2 Party B expressly agrees that Party A may, in addition to the cases provided for in Clause 5.1 above, consider the following cases as Cases of Default by Party B and/or the Guarantor, as the case may be: (a) Change in Economic Situation. The occurrence of a change in the economic and financial state that causes or may cause any damage to the ability to perform the obligations of Party B or the Guarantor assumed in this Agreement; (b) Default of Other Obligations. The occurrence or existence of a default, event of default, or other similar condition or event (however described) in relation to Party B, any legal entity of its respective Economic Group or any Guarantor of Party B, with respect to one or further payments due to (1) Party A or any person in its respective Economic Group that cause a material decrease in the financial capacity of Party B to honor its obligations under this Agreement; or (2) any interested third party, in an aggregate amount not less than _______ 9 (______); (c) Early Maturity of Other Obligations. The declaration, by any interested third party, of the early maturity of any contracts or instruments entered into by Party B, any person of its respective Economic Group or any Guarantor of Party B, in an aggregate amount not less than _______ (______)";

3.2 Credit Clauses in the derivatives contract in Germany

E.g. "The DRV does not distinguish between termination rights and events of default. More importantly, it does not set out an extended list of specific events resulting in a termination or giving a party a right to terminate the agreement. Rather, the DRV differentiates between contractual termination rights (termination for cause) on the one hand and automatic early termination (AET) on the other. With regard to termination rights, the DRV relies on the German legal concept of material cause ("wichtiger Grund") by permitting only a termination for material cause. Under German law, the right to terminate contracts for the performance of continuing obligations ("Dauerschuldverhältnis" - the master agreement qualifying as such) for material cause cannot be contractually waived. It is, however, possible to circumscribe its scope and reach (i.e. by including positive examples of events constituting a material causes triggering the termination right in an agreement). The DRV only sets out one specific (albeit very relevant) example of such a material cause, namely failure to pay or deliver following notification and a cure period (5 Bank Working Days under the DRV 1993/2001 and 3 Bank Working Days under the DRV 2018). A further express example of a material cause (failure to post collateral in time) is addressed in the standard collateral addenda (collateral addendum of 2001 and VM-collateral addendum) to the master agreement. However, these examples of material causes are non-exhaustive so that any other event qualifying as material cause (taking into account the relevant case groups developed over time by the courts) grants the affected party the right to terminate the agreement for cause".

4. Conclusion

The objective of the article was to analyse and understand the impact of default clauses in Derivatives contracts. Because contracts in Brazil can have greater protection in credit clauses and what were the reasons and consequences when compared to a contract with the same purpose but originating in another country. Law in general seeks in its contracts an effectiveness of clauses. However, the economic vision aims at efficiency. With this, it can be concluded that these clauses have a high impact on contracts, especially in Brazil, which does not have the same protection as German law. As a result, Brazil keep more robust and complex document to be safe.

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