

Close-out netting and set-off provisions for BVI, Cayman, Guernsey, Jersey and Lux counterparties

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Introduction

The current geo-political climate is contributing to the rapid rise to inflation rates in many countries around the world. Governments have reacted with an inevitable increase to interest rates to try and offer some form of counterbalance to rising costs in an effort to stymy localised, and more widespread, economic recessions.

As a result, financial institutions are reacquainting themselves with protectionist financial contracts, for example, interest rate hedging and swap contracts. Such documentation has, for the last few years at least, not been overly necessary due to record low interest rates (for example in the UK).

Ogier is counsel to the International Swaps and Derivatives Association, Inc. (**ISDA**) in Guernsey and Jersey and provides netting and collateral opinions which are available to members from ISDA's website and updated on an annual basis. We are often asked to advise on the enforceability of close-out netting and set-off provisions under ISDA and other standard form agreements (including prime brokerage agreements and interest rate hedging agreements) against counterparties incorporated or registered in the BVI, the Cayman Islands, Guernsey, Jersey or Luxembourg. This involves an analysis of the extent to which local laws recognise the enforceability of such provisions in pre and post-insolvency circumstances. The relevant legislation from each jurisdiction is summarised in general terms below. Upon request, we are able to provide opinions in respect of specific counterparties/types of counterparties and agreements.

British Virgin Islands

The Insolvency Act 2003 of the British Virgin Islands (the **IA**) provides that the netting of

financial contracts is legally enforceable notwithstanding any provisions of the IA or the Insolvency Rules. Significantly, this means that where an insolvent entity that is party to a financial contract goes into liquidation, what might otherwise be a voidable transaction will be upheld if carried out pursuant to a netting agreement.

In order to be legally enforceable in this way, the netting agreement governing the financial contracts must be an agreement between two parties only. Therefore, it is critical that netting agreements are structured as bilateral contracts rather than multilateral contracts.

Financial contracts are contracts pursuant to which payment or delivery obligations that have a market or an exchange price are due to be performed at a certain time or within a certain period of time. Examples include currency or interest rate swap agreements, futures or options, and equity or credit derivatives.

As regards insolvency set-off, section 150 (1) of the IA provides that where, before the liquidation of a company, there have been mutual credits, mutual debts or other mutual dealings between the company and a creditor claiming or intending to claim in the insolvency proceeding, the sums due from one party shall be set-off against the sums due from the other party and only the balance of the account, if any, may be claimed in the insolvency proceeding or is payable to the company, as the case may be.

Section 150 (2) goes on to say that a creditor is not entitled to claim the benefit of a set-off if it had actual notice that the company was insolvent:

- at the time it gave credit to the company or received credit from the company, or
- at the time it acquired any claim against the company or any part of or interest in such a claim

Cayman Islands

The Companies Act (Revised) (**Companies Act**) requires, in section 140 (1), that on the winding up of a company, whether voluntary or compulsory, the property of the company be applied in satisfaction of its liabilities *pari passu* and subject thereto be distributed amongst the members according to their rights and interests in the company. However, this requirement is subject to section 140 (2) which provides that that collection in and application of the property of the company is without prejudice to, and after taking into account and giving effect to, the rights of preferred and secured creditors and to any agreement between the company and any creditors, that the claims of such creditors shall be subordinated or otherwise deferred to the claims of any other creditors, and to any contractual rights of set off or netting of claims between the company and any other person or persons (including, without limitation, any bilateral or any multi-lateral set-off or netting arrangements between the company and any person or persons) and subject to any agreement between the company and any person or persons to waive or limit

the same.

The equivalent of section 140 (2) of the Companies Act is also provided for in section 38 (2) of the Limited Liability Companies Act (Revised) (**LLC Act**) and therefore applies to the collection and application of the property of a limited liability company as between its creditors and members on a winding up of that limited liability company.

By virtue of section 36 (3) of the Exempted Limited Partnership Act (Revised), section 140 of the Companies Act applies to the winding up of an exempted limited partnership, voluntary or compulsory, as if references therein to a company were references to an exempted limited partnership, and limited partners are treated as if they were members of a company.

Accordingly, contractual bilateral and multi-lateral netting arrangements are effective on the winding up of a company, limited liability company or an exempted limited partnership in the Cayman Islands.

Preferential debts under the Companies Act are payable out of assets of a company, limited liability company or exempted limited partnership available to satisfy unsecured creditors after effect has been given to contractual netting arrangements under section 140 (2) of the Companies Act or section 38 (2) of the LLC Act, as applicable.

However, any such netting arrangement will be subject to the provisions of the Companies Act relating to fraudulent preferences and dispositions at an undervalue, which apply on the winding up of companies, limited liability companies and exempted limited partnerships.

Guernsey

Guernsey does not have a separate modern netting law but it is considered that netting will be effective in Guernsey by operation of contract law and a positive opinion has been issued to ISDA and its members in relation to the ISDA Master Agreements.

In respect of set-off, The Law of Property (Miscellaneous Provisions) (Guernsey) Law, 1979 provides that where there is for the time being in force an agreement (whether written or oral and whether express or implied) whereby, in respect of mutual dealings between them, any "debt" (see below) from one party is to be set off against any debt from the other party, the effect of that agreement is, unless the parties have expressly or by implication agreed to a different effect, that the only action which may be taken at any time in relation to what would otherwise be those mutual debts (whether by or at the instance of either party or any third party, and whether by way of enforcement, assignment, arrest, restraint or otherwise) is in respect of the balance (if any) then due after that set-off. This provision is subject to:

- in a case where the affairs of one party have been declared to be in a state of *désastre* at a meeting of his arresting creditors held before a Jurat as Commissioner of the Royal Court,

then where the Jurat presiding at such a meeting has reasonable cause to believe that any such agreement was entered into by the party whose affairs have been declared to be in a state of *désastre* (the **debtor**) less than six months before the date of the meeting, the matter of the agreement shall be referred to the Royal Court and where the Royal Court is satisfied that the agreement was entered into with a view of giving to the other party a preference over the other creditors of the debtor, the Royal Court may make an order directing that the agreement shall be treated as being fraudulent and void as against the other creditors of the debtor

- in ascertaining the balance due as described above, if a contingent liability is to be taken into account the contingency is to be treated as having occurred, and if a future liability is to be taken into account it is to be treated as if presently payable

For the purposes of the above provisions the The Law of Property (Miscellaneous Provisions) (Guernsey) Law, 1979 provides that "debt" includes all debts and liabilities, present or future, certain or contingent, but does not include demands in the nature of unliquidated damages arising otherwise than by reason of contract or breach of trust.

In respect of set-off it is also to be noted that the provision of the Companies (Guernsey) Law, 2008, as amended, which provides that a company's assets in a winding up shall be realised and applied in satisfaction of the company's debts and liabilities *pari passu* is subject, amongst other matters, to any agreement between the company and any creditor thereof as to set-off.

Jersey

On 5 April 2005, the States of Jersey passed the Bankruptcy (Netting, Contractual Subordination and Non-Petition Provisions) (Jersey) Law 2005 (the **Law**) which came into force on 12 August 2005. The Law ensures certainty to parties entering into agreements involving netting and set-off provisions.

Pursuant to Article 2 of the Law, notwithstanding any enactment of rule of law to the contrary, any close-out netting provision or set-off provision in any agreement is enforceable in accordance with its terms. This will be the case regardless of the bankruptcy of a party to the agreement or of any other person or the lack of any mutuality of obligation between a party to the agreement and any other person. The Law provides that such provisions will be enforceable against any of the parties to the agreement, any guarantor or person providing security for a party to the agreement and any creditor of a party to the agreement.

The definition of an "agreement" is widely drafted to include any agreement between two or more parties, a series of inter-related agreements between two or more parties (whether pursuant to a master netting agreement or otherwise) or an agreement made between parties whether or not acting through multiple branches and whether operated through a clearing house system or otherwise.

The Law defines "netting" as the conversion, into one net claim or one net obligation, of all claims and obligations arising under the agreement to the effect that only a net claim can be demanded or a net obligation is owed.

A "close-out netting provision" means so much of an agreement as relates to:

- there ceasing to be any time allowed for the performance of an obligation specified in the agreement on the occurrence of an event specified in the agreement, including its automatic termination (such as provided in the ISDA Master Agreement)
- an obligation in an agreement to pay a specified amount but not immediately becoming an obligation to pay an amount determined pursuant to the agreement, or
- any combination of the above, whether through the operation of netting or otherwise

A "set-off provision" means so much of any agreement, other than a close-out netting provision, as relates to the netting of amounts due from one party to the agreement to any other party to it.

Luxembourg

Close-out netting provision is defined in article 1(2) of the Luxembourg law of 5 August 2005 on financial collateral arrangements (the Luxembourg Financial Collateral Law) as a contractual arrangement, or, in the absence of any such arrangement, any statutory rule, pursuant to which the occurrence of an enforcement event may lead either to the effective realisation of the collateral provided under a financial collateral arrangement or to the netting of the parties' respective claims or positions in financial instruments, whether through the operation of netting or set-off or otherwise and triggers the following effects:

- the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; or
- an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party

The core provisions in respect of set-off and recognition of the validity of contractually agreed close-out netting provisions absent a security interest between reciprocal or multilateral payment obligations are to be found in articles 18 and 19 of the Luxembourg Financial Collateral Law.

Automatic early termination

Under article 19 of the Luxembourg Financial Collateral Law termination clauses entered into

with a view to set-off assets (that is, financial instruments, contractual claims and cash) are valid and binding against third parties, administrators, insolvency receivers and liquidators or other similar officeholders and are effective:

- notwithstanding the commencement or continuation of a reorganisation measure or liquidation proceedings, irrespective of the time at which such clauses have been agreed upon or enforced; and
- notwithstanding any civil, criminal or judicial attachment or criminal confiscation as well as any purported assignment or other disposition of or in respect of such rights

The Luxembourg Financial Collateral Law applies (and article 19 comes into play), irrespective of the status of the parties involved (i.e. whether they are regulated or unregulated entities, whether they are residents or not in Luxembourg), each time where set-off between assets is made with respect to transactions that are covered by bilateral or multilateral clauses between two or more parties.

Close-out netting

According to article 18 of the Luxembourg Financial Collateral Law, set-off between assets (that is, financial instruments, contractual claims and cash) operated in the event of reorganisation measures, liquidation proceedings or any situation of competition between creditors, is valid and binding against third parties, administrators (commissaires), insolvency receivers and liquidators or other similar officeholders, irrespective of the maturity date, the subject matter or the currency of the assets, provided that set-off is made in respect of transactions which are covered by bilateral or multilateral set-off provisions between two or more parties.

Exclusion of insolvency risk

With the exception of the Luxembourg legal provisions on over-indebtedness (surendettement), which are only applicable to natural persons, both Luxembourg and foreign provisions relating to bankruptcy, liquidation, reorganisation, other situations of competition between creditors or similar measures are not applicable to set-off contracts and do not affect the enforcement of such contracts (article 20(4) of the Luxembourg Financial Collateral Law).

Based on article 21 of the Luxembourg Financial Collateral Law, termination and close-out netting clauses and contracts entered into on the day of commencement of a reorganisation measure or winding-up proceeding, but before the Court decision ruling the opening of such proceedings or before such measure becomes effective, are valid and enforceable against third parties. However, netting agreements or financial collateral arrangements entered into on the day of, but after the moment of the commencement of, winding-up proceedings or reorganisation measures, may only be legally binding and enforceable against third parties if the collateral taker can prove that he was not aware nor should have been aware, of the

commencement of such proceedings or measures.

Moreover, netting agreements and financial collateral arrangements are not vulnerable to being set aside by reason of any pre-bankruptcy hardening period (période suspecte) (article 20 (4) of the Luxembourg Financial Collateral Law).

The Luxembourg Financial Collateral Law aims to ensure that collateral arrangements and netting agreements are enforceable in a prompt and efficient manner without hindrance, notwithstanding any civil, criminal or judicial forfeiture or attachments, escrow completed by a Luxembourg or foreign judicial decision incurred subsequently to the entry into such arrangements.

The Luxembourg legislator intends to maintain this legal continuity in order to further secure lenders' rights. Such aim is reflected in various recent bills of law such as the Bill of Law N°7933 amending, inter alia, the Luxembourg Financial Collateral Law and Bill of Law N°6539A modernising Luxembourg insolvency proceedings.

About Ogier

Ogier is a professional services firm with the knowledge and expertise to handle the most demanding and complex transactions and provide expert, efficient and cost-effective services to all our clients. We regularly win awards for the quality of our client service, our work and our people.

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