

UPDATE

Netting & Set-Off: Enforceability in the Cayman Islands and BVI

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Recent turmoil in the financial markets due to the COVID-19 pandemic has brought with it a wave of margin calls against counterparties to margin loan financings, swap and repurchase agreements and various other equity linked transactions. Measures introduced by governments to curtail the pandemic (including stay-at-home orders and travel restrictions) continue to feed market turbulence and the increasingly global economic slow-down means counterparties are increasingly at risk of default under outstanding trades. In this environment, finance parties may wish to consider steps that can be taken on default to mitigate exposure to financially vulnerable counterparties. Amongst a range of statutory and contractual measures are the application of netting and set-off provisions.

This briefing outlines the enforceability of netting and set-off clauses in such transactions upon the onset of insolvency in the Cayman Islands and the BVI.

Cayman Islands

The Companies Law (2020 Revision) of the Cayman Islands (the **Companies Law**) operates to ensure that written agreements for the netting or set-off of claims between an exempted company incorporated in the Cayman Islands (the **Cayman Company**) and any other person (or if the written agreement is multi-lateral, persons) are, as a matter of Cayman Islands law, effective, including on a winding up of the Cayman Company (subject to the rights of secured and preferred creditors and to any agreement to subordinate any claim) pursuant to section 140 of the Companies Law.

Section 140 of the Companies Law states that:

- (1) *Subject to subsection (2), the property of the company shall be applied in satisfaction of its liabilities *pari passu* and subject thereto shall be distributed amongst the members according to their rights and interests in the company.*
- (2) *The collection in and application of the property of the company referred to in subsection (1) 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 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.*

Order 16, Rule 9 of the Companies Winding Up Rules (2018 Revision) of the Cayman Islands (the **Winding Up Rules**) confirms that in respect of a Cayman Company, "*any contractual right of set-off or non-set-off or netting arrangement agreed between the company and any creditor prior to the commencement of the liquidation (including both bilateral and multi-lateral set-off or netting arrangements)... are binding upon the company in liquidation and shall be enforced by the official liquidator*". As such, the validity and

enforceability of standard netting and set-off arrangements are, as against a Cayman Company, further enhanced in the Cayman Islands through the operation of the Winding Up Rules.

Pursuant to the Exempted Limited Partnership Law (2018 Revision) of the Cayman Islands, section 140(2) of the Companies Law also applies to the insolvency of an Exempted Limited Partnership registered in the Cayman Islands and, equally, the Limited Liability Companies Law (2020 Revision) of the Cayman Islands operates to generally apply the sections of Part V of the Companies Law (which incorporates section 140 of the Companies Law) to the winding up of a Limited Liability Company in the Cayman Islands.

British Virgin Islands

The overall position in the BVI is similar to the Cayman Islands, but the approach is by no means identical and there are key differences.

Pursuant to the Insolvency Act (2003) of the British Virgin Islands (the **Insolvency Act**), written agreements for the netting or set-off of claims pursuant to a "*financial contract*" between a BVI business company incorporated in the BVI (the **BVI Company**) and another person are, as a matter of BVI law, enforceable (including on a winding up of the BVI Company), notwithstanding any other provisions of the Insolvency Act or the Insolvency Rules (2005) of the BVI (the **Rules**), (subject to fraud, misrepresentation or any similar ground).

A *financial contract* under the Insolvency Act is a contract 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. They include, among other things, currency, cross currency or interest rate swap agreements; basis swap agreements; futures or options, cap, collar or floor transactions; credit derivatives such as credit default swaps, credit default basket swaps, total return swaps and credit default options; equity derivatives, such as equity or equity index swaps, equity options and equity index options, and any other agreement similar to any such agreement or contract.

Section 435 of the Insolvency Act states that:

- (1) *Notwithstanding anything contained in the Insolvency Act or the Rules or in any rule of law relating to insolvency,*
 - (a) ***the provisions relating to netting, the set off of money provided by way of security, the enforcement of a guarantee and the enforcement of a collateral arrangement and the set off of the proceeds thereof, as contained within a netting agreement or a guarantee provided for in such an agreement shall be legally enforceable against a party to the agreement and, where applicable, against a guarantor or other person providing security, and***
 - (b) ***the provisions relating to set off of the net amounts due under netting agreements, the set off of money provided by way of security, the enforcement of a guarantee and the enforcement of a collateral arrangement and the set off of the proceeds thereof, as contained within a master netting agreement or a guarantee provided for in such an agreement shall be legally enforceable against a party to the agreement and, where applicable, against a guarantor or other person providing security.***
- (2) *Nothing in subsection 1:*
 - (a) *prevents the application of the Insolvency Act, any other enactment or rule of law which would prevent the legal enforceability of netting, set off, or enforcement in any particular case, on the grounds of fraud or misrepresentation or on any similar ground; or*
 - (b) *permits the enforceability of netting, set off, or enforcement if any provision of an agreement between the two parties concerned would make netting, set off, enforcement and realization void whether because of fraud or misrepresentation or any similar ground.*

The Insolvency Act also requires that a netting agreement or master netting agreement, to be enforceable in the manner described above, must be between two parties. This is a key difference between the BVI and Cayman Islands regime and, as such, netting arrangements involving a BVI Company should be structured as bilateral contracts only and not as multi-lateral contracts.

The Insolvency Act also provides that, in circumstances prior to the liquidation of a BVI Company, where there have been mutual credits, mutual debts or other mutual dealings between a BVI Company and a

creditor claiming or intending to claim in an insolvency proceeding, then the amounts due from one party shall be set-off against the amounts due from the other party and only the balance of that account (if any), may be claimed in the insolvency proceeding or is payable to the BVI Company, as the case may be.

Closing

In the current financial circumstances, and facing further COVID-19 generated headwinds, counterparties to products such as margin lending facilities, swaps and repurchase agreements may face a range of challenges such as margin calls, collateral issues and mark-to-market calculations upon defaults which can be difficult to quantify. In these circumstances, the benefits of the respective Cayman Islands and BVI legislative frameworks, which expressly recognise and largely uphold contractual netting and set-off rights between counterparties upon insolvency, are invaluable. They also serve to demonstrate one of the many benefits of utilising Cayman Islands and/or BVI vehicles for parties wishing to enter into structured finance transactions whilst ensuring creditor protections are maximised.

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