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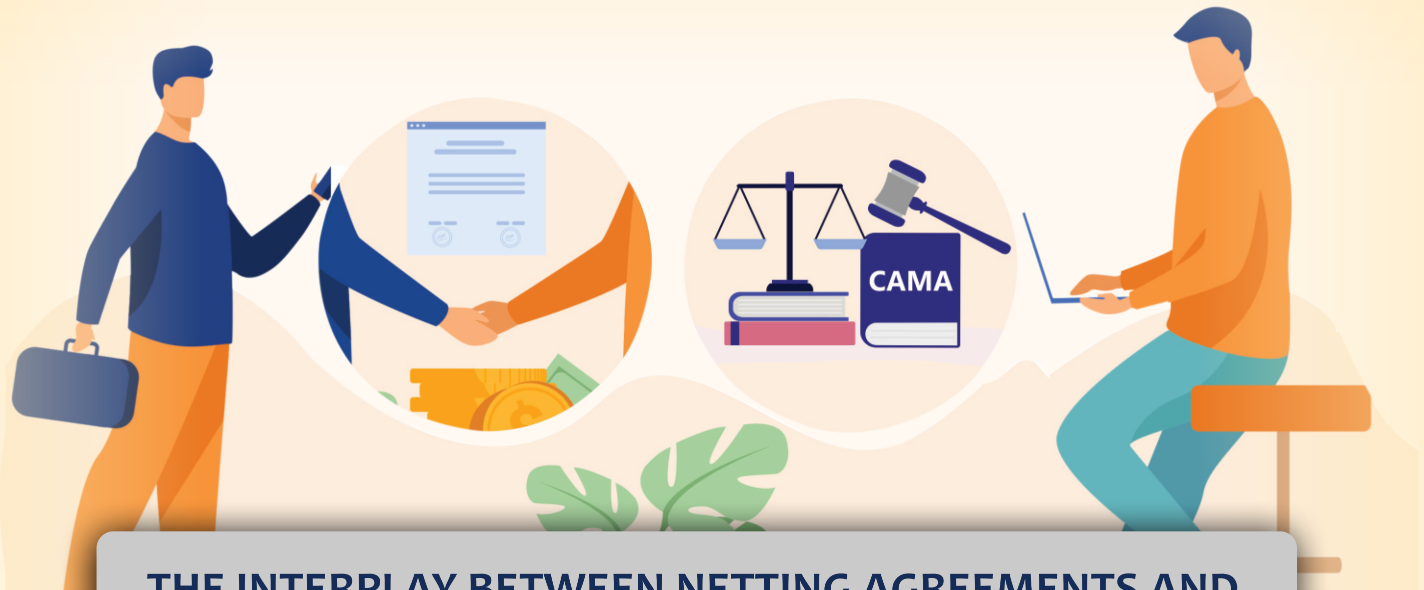

THE INTERPLAY BETWEEN NETTING AGREEMENTS AND INSOLVENCY UNDER THE COMPANIES AND ALLIED MATTERS ACT 2020

INTRODUCTION

The Companies and Allied Matters Act 2020 (**CAMA**) has been hailed for some of its key innovations and bringing Nigerian company law into the 21st century. One of the innovations brought about by CAMA was the introduction of provisions in relation to netting agreements and carving such agreements out of the general company insolvency regime.

Netting is the consolidation of multiple positions or payments being owed between two or more parties so that a net balance payment is simply owed from one of the parties to the other. A netting agreement is simply an agreement that provides for or documents the netting arrangement or terms. However, as will be further discussed, the regime for netting agreements under CAMA is special and is limited to netting agreements in relation to specific types of contracts.

Netting agreements are commonly used in the context of derivatives and the International Swaps and Derivative Association (**ISDA**) Master Agreement which is a globally recognised template for the documentation of derivative transactions makes express provisions for netting. Netting serves to reduce counterparty credit and settlement risk.

Countries with more developed financial markets have for years exempted netting arrangements in relation to specific types of financial contracts from their general insolvency regime. Prior to CAMA, there were no specific statutory provisions regarding netting under Nigerian law and recourse was always had to general principles of contract. Under that old regime, while parties were generally free to enter into netting agreements under Nigerian law, they ran the risk of not being able to take advantage of their netting agreements in the case of their contract counterparty's insolvency.

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[1]S. 718 CAMA; [2]S. 718 CAMA; [3]S. 719 CAMA

SCOPE OF CONTRACTS COVERED UNDER CAMA FOR NETTING AGREEMENTS

CAMA makes it clear which contracts will be subject to its provisions on netting agreements. The CAMA specifically defines a netting agreement as an *"...agreement between two parties that provides for netting of present or future payment or delivery obligations or entitlements arising under or in connection with one or more **qualified financial contracts** entered into under the agreement...*[1]" 'Qualified financial contracts' is defined[2] as covering derivate transactions, collateral arrangements including credit derivatives, equity derivatives, currency swaps, commodity swaps etc. There is flexibility for more contracts than specifically stated in CAMA to be regarded as *qualified financial contracts* as a financial regulatory authority is empowered, pursuant to CAMA, to designate any agreement, contract or transaction as a *qualified financial contract*[3]. The financial regulatory authorities are the Central Bank of Nigeria, the Securities and Exchange Commission, the National Insurance Commission, the National Pension Commission and any other financial regulatory authority established by an Act of the National Assembly. This flexibility means that as the financial markets in Nigeria develop, financial regulators can assess if other types of contracts should be able to benefit from the CAMA provisions on netting agreements without waiting for legislative action through the amendment of CAMA.

Even where a netting agreement covers qualified financial contracts and non-qualified financial contracts, the qualified financial contracts covered by the netting agreement will still benefit from CAMA's special regime for netting agreements[5].

In addition, a netting agreement which is to benefit from the CAMA provisions should not have a natural person as a party to the agreement as the definition of a 'person' in relation to the netting provisions of CAMA seems to cover only non-natural persons[6].

SPECIAL REGIME FOR ENFORCEABILITY OF NETTING AGREEMENTS

While it is relatively easier to enforce an agreement in accordance with its terms against a solvent party, insolvency law has provisions which would usually mean that the solvent party might find itself unable to enforce all the terms of the relevant contract against its insolvent counterparty. Under CAMA, the provisions of a netting agreement are enforceable in accordance with its terms even if one of the parties is insolvent[7]. CAMA provides that the enforceability of netting agreements shall not be limited by any insolvency proceedings in relation to a party, or any provision of law applicable to an insolvent party[8]. Therefore, insolvency law provisions which allow "cherry picking" by the insolvent party's liquidator[9], disallow fraudulent preference[10] and generally require *pari passu* distribution of the insolvent party's assets will typically not be applicable to a netting agreement. However, CAMA still allows a liquidator of an insolvent party to avoid a netting agreement where there is clear evidence that the obligation incurred, or transfer made, by the insolvent party to the non-insolvent party was incurred or made "*with actual intent to hinder, delay or defraud any entity to which the insolvent party was indebted or became indebted, on or after the date such transfer was made, or such obligation was incurred*"[11].

WHY EXEMPT NETTING AGREEMENTS FROM THE GENERAL INSOLVENCY REGIME?

The main reason for countries exempting netting agreements in relation to financial contracts from their general insolvency regime is to avoid the systemic risk that arises when a company, particularly one in the financial industry, goes insolvent with a large number of open contracts. Due to the likely domino effect if all those open contracts could not benefit from netting agreements, and counterparties were forced to pay the full amount of what they owed the insolvent party with no guarantee that the insolvent party would be able to pay its own obligations, the

[4]S. 718 CAMA; [5]S. 721(8) CAMA; [6]S. 718 CAMA; [7]S. 721 CAMA; [8]S. 721 CAMA; [9]S. 663 CAMA; [10]S. 658 CAMA; [11]S. 721(6) CAMA

risk of the insolvent company's counterparties and the other parties' counterparties becoming insolvent increases. Due to the interconnectedness of the global financial market, this could have drastic consequences as we saw from the global financial crisis of 2007 to 2008.

The policy reasons for seeming to give this preference in insolvency in relation to netting agreements particularly as it concerns financial institutions is that financial institutions are typically seen as too "big" or too important to fail given the impact such failure would have on the economy.

Also, a framework for netting agreements in relation to insolvency has the effect of encouraging investments in relation to the covered contracts in the relevant jurisdiction as market participants like certainty and provisions that generally minimise their risk.

CONCLUSION

It is yet to be seen if the CAMA provisions on netting agreements have led or will immediately lead to an appreciable increase in the number of derivate transactions in the Nigerian financial market. However, CAMA definitely provides more certainty to participants regarding the enforceability of netting agreements under Nigerian law generally, and more specifically where a counterparty to a netting agreement is insolvent. While this is laudable, Nigerian regulators should study, and to the extent relevant, implement, the additional measures other countries and associations such as ISDA have put in place to manage systemic risk in relation to derivative transactions in an increasingly interconnected global financial market.

[12]This can be seen in how the Asset Management Corporation of Nigeria was set up to take over the bad loans of Nigerian banks and the various bridge banks that were set up and sold to avoid the collapse of ailing Nigerian banks.