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Derivatives and insolvency: a British Virgin Islands perspective on the *Metavante* decision and the ISDA Master Agreement

KEY POINTS

- The *Lehman Metavante* judgment has led to renewed speculation among commentators as to the enforceability of the termination, suspension and netting provisions of the ISDA Master Agreement.
- While the British Virgin Islands has insolvency safe harbours similar to the US bankruptcy code which would probably not cover s 2(a)(iii) of the ISDA Master Agreement, English common law and British Virgin Islands insolvency law nevertheless uphold the s 6(a) right of a Non-defaulting Party not to terminate and the s 2(a)(iii) right of a Non-defaulting Party to suspend payments.
- The s 5(a)(vii) bankruptcy Events of Default of the ISDA Master Agreement cover intended BVI insolvency events in respect of standard companies though some care is needed when dealing with segregated portfolio companies or partnerships.

On 15 September 2009 the judge responsible for the Lehman bankruptcy proceedings in the US held that *Metavante* Corporation ('*Metavante*') could not rely on s 2(a)(iii) of the ISDA Master Agreement to suspend payments to Lehman Brothers Special Financing, Inc ('LBSF') (*re Lehman Brothers Holdings Inc, Case No 08-13555 (JMP) (Bankr SDNY 15 Sept, 2009)*). Specifically, Judge Peck held that the safe harbour provisions in the US bankruptcy code protected a Non-defaulting Party's contractual rights to liquidate, terminate or accelerate swaps and to net termination values, but did not provide a basis to withhold performance under a swap if it did not terminate. Judge Peck essentially held that a party must either elect to terminate or not, but, if they elected not to terminate, the contractual right to withhold performance by the Non-defaulting Party was not protected from the ordinary provisions of US bankruptcy law.

The *Metavante* judgment has led to renewed speculation among commentators as to the enforceability in other jurisdictions of the termination, suspension and netting provisions of the ISDA Master Agreement. We consider here the position of the ISDA Master Agreement in the British Virgin Islands ('BVI'), and seek to confirm the historic view that a court in the BVI would uphold the contractual provisions of ss 2(a)(iii) and 6(a) on the occurrence of a s 5(a)(vii) bankruptcy Event of Default in respect of a BVI counterparty. Before doing so, however, we take a look at the insolvency proceedings available to a company and its creditors in the BVI and seek to ascertain the extent to which they would trigger Events of Default under the ISDA Master Agreement.

The US ruling in the *Metavante* case that s 2(a)(iii) of the ISDA Master Agreement could not be relied upon contrasted with that in a 2003 Australian case relating to the collapse of Enron which upheld the right to suspend payments. In the context of increased speculation as to the enforceability of termination and suspension provisions of the ISDA Master Agreement, this feature takes a brief look at British Virgin Islands insolvency proceedings and their relationship with the bankruptcy triggers in s 5(a)(vii) and considers the enforceability of ss 2(a)(iii) and 6(a) on the occurrence of a s 5(a)(vii) bankruptcy event in respect of a British Virgin Islands counterparty in the light of recent litigation.

BVI INSOLVENCY PROCEEDINGS

The right of a party to terminate an ISDA Master Agreement on the basis of a counterparty's insolvency is contingent on the occurrence of a bankruptcy Event of Default under s 5(a)(vii) in accordance with the chosen governing law. However, s 5(a)(vii) invariably interrelates with national insolvency laws insofar as determining whether the relevant proceedings under national insolvency laws constitute any of the events listed in s 5(a)(vii). In the BVI this analysis is somewhat complicated by the wide range of corporate structuring options created by the BVI legislature to promote the jurisdiction for use in formation of investment funds and structured finance vehicles.

Before considering insolvency proceedings in the BVI we should first consider the use of the term 'insolvent'. In the BVI 'insolvent' is defined in the Insolvency Act for most purposes as meaning: (i) it has failed to comply with a statutory demand; (ii) execution or process issued on a judgment, decree or order of a BVI court in favour of a creditor is returned wholly or partly unsatisfied; (iii) the value of the company's liabilities exceed its assets (the 'balance sheet test'); or (iv) the company is unable to pay its debts as they fall due (the 'cash flow test').

The only insolvency proceedings to which a BVI company is subject in the BVI are: (i) insolvent voluntary liquidation; (ii) supervised creditors' arrangements; (iii) administration; (iv) receivership and administrative receivership; and (v) liquidation. Of these, administration has not yet been brought into force. Since the English administration regime on which the BVI regime was based has developed since the introduction of the BVI Insolvency Act in 2004, and in the absence of any clear indication from the BVI legislature, it

seems unlikely that administration will be introduced in the BVI in its current form.

There are a number of additional statutory reorganisational processes in the BVI which are not related to the insolvency of the party. These are: (i) solvent voluntary liquidation; (ii) striking-off and dissolution; (iii) reorganisation; and (iv) continuation out of the BVI.

Insolvency proceedings (as well as the balance sheet test) are modified in respect of licensed BVI insurance companies, but other licensed entities such as banks, trust companies and investment funds are subject to the same proceedings as standard BVI companies though usually subject to requirements to notify the relevant regulator.

Segregated portfolios (previously only available to insurance companies) were introduced for use with funds in 2004 under the BVI Business Companies Act. Additional provisions relate to the insolvency of segregated portfolio companies. A liquidator of a segregated portfolio company is for example bound to maintain the segregation of the portfolios through insolvency. Certain insolvency related proceedings are provided for in respect of individual segregated portfolios and, for example, the company, its directors, any creditor, any holder of shares attributable to that segregated portfolio or the British Virgin Islands Financial Services Commission may apply to the court for a portfolio liquidation order in respect of a specific segregated portfolio. Provisions have also been enacted for administration orders in respect of individual segregated portfolios but these are subject to the bringing into force of the general administration provisions of the BVI Insolvency Act which, as indicated above, appears a distant prospect. Although individual segregated portfolios are explicitly not separate legal entities, the effect of these provisions is that for the purposes of liquidation a liquidator treats a segregated portfolio much as if it was.

SECTION 5(A)(VII) BANKRUPTCY EVENTS IN THE CONTEXT OF BVI INSOLVENCY

While, strictly speaking, construction of the ISDA Master Agreement is a matter for the governing law, it is clear that certain of the proceedings outlined above will fall comfortably within the list in s 5(a)(vii). The institution of a supervised creditors' arrangement, the appointment of a receiver, administrative receiver or liquidator, voluntary liquidation whether solvent or insolvent and dissolution would each constitute an Event of Default under s 5(a)(vii). It is probable that merely being struck-off the register of companies (as a result of failing to pay fees) would not be an Event of Default under s 5(a)(vii), though given that the business of a struck-off company is supposedly frozen it is likely to subsequently generate a performance related Event of Default. A reorganisation would also not necessarily be an Event of Default under s 5(a)(vii) though, depending on the facts, might cause an Event of Default under s 5(a)(viii). Continuation out of the BVI is completed in the BVI by striking-off the register and, as with a reorganisation, would probably not amount to an Event of Default if it did not constitute a merger without assumption under s 5(a)(viii).

The position with entities other than simple BVI Business Companies is not so clear. Whether or not analogous events in

respect of specific segregated portfolios are caught by s 5(a)(vii) is complicated by the fact that the segregated portfolio itself is not a legal entity. Even if the party is carefully described as being the segregated portfolio of the company, questions will arise as to whether the s 5(a)(vii) bankruptcy Events of Default apply to the company itself or to the segregated portfolio. When dealing with segregated portfolio companies, it is therefore recommended to explicitly include analogous events in respect of the segregated portfolio as bankruptcy Events of Default or Additional Termination Events and to specify the company, the segregated portfolio and, for cross-default, the other segregated portfolios as Specified Entities for the purposes of s 5(a)(vii).

Issues also arise in the BVI when dealing with partnerships. While provision has been made in the BVI Insolvency Act for the promulgation of insolvency rules for partnerships, this has not been done and the only effective way to formally wind up a partnership in the BVI is to proceed separately against the partners. In the context of s 5(a)(vii), the most effective bankruptcy triggers are the partners themselves and they (or at least, in the case of limited partnerships, the general partners) should ordinarily be included as Specified Entities for the purposes of s 5(a)(vii).

BVI companies are not generally required to prepare accounts. For this reason it is not always easy to ascertain the point at which a company becomes insolvent on a balance sheet test. This exacerbates a number of issues under the ISDA Master Agreement. For example, where Automatic Early Termination is elected, because s 5(a)(vii) includes as a trigger insolvency itself as well as insolvency proceedings (which by their nature are easier to identify), it may be difficult to specify retrospectively when a Termination Date resulting from a s 5(a)(vii) Event of Default has occurred. Typically where a debt due from a BVI company is unpaid, a statutory demand would be served and failure to have the statutory demand set aside would constitute formal insolvency. Notwithstanding the fact that, for example, significant volatility in underlying prices might cause a party to suspect that its counterparty is balance sheet insolvent, in order to demonstrate insolvency by serving a statutory demand a due debt is needed. However, as many derivative contracts have infrequent scheduled settlement dates, in the short term a debt may not become due and payable until termination following an Event of Default. There is therefore a circularity which may delay close-out, and, even where Automatic Early Termination has not been selected, uncertainty as to whether a s 5(a)(vii) Event of Default has occurred may affect the actions taken by the Non-defaulting Party. In this context we return to the question of the enforceability of the Non-defaulting Party's right not to terminate and right to suspend payments.

ENFORCEABILITY OF SS 2(A)(III) AND 6(A) FOLLOWING A S 5(A)(VII) BANKRUPTCY EVENT

The ruling in the *Metavante* case referred to at the beginning of this article contrasted with that in a 2003 case heard in Australia relating to the collapse of Enron (*Enron Australia v TXU Electricity* [2003] NSWSC 1169). In the *Enron* case Austin J took a diametrically opposing view to Judge Peck in the *Metavante* decision and

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supported the right of a Non-defaulting Party to suspend payments. Specifically, it was held that Australia's bankruptcy laws did not permit the court to deprive the counterparty of its contractual rights. The court therefore upheld the contractual right not to designate an Early Termination Date and the right under s 2(a)(iii) to suspend performance indefinitely, and thereby effectively applied the English common law position accepting the right to terminate a contract after the happening of a designated event by giving express notice.

Section 2(a)(iii) was also considered by the English courts in October 2009 in relation to a dispute relating to forward freight agreements governed by the ISDA Master Agreement (*Marine Trade SA v Pioneer Freight Futures Co Ltd BVI* [2009] EWHC 2656 (Comm)). Pioneer Freight Futures Company Limited ('Pioneer'), in fact a BVI company, conceded during the case that it was subject to a s 5(a)(vii) bankruptcy Event of Default. In his judgment, Flaux J upheld the contractual right of the Non-defaulting Party under s 2(a)(iii) not to make payment where an Event of Default had occurred. In the absence of termination no amount was therefore payable to Pioneer for the purposes of netting under s 2(c).

"The s 5(a)(iii) Event of Default provisions ... adequately cover most insolvency related proceedings ..."

While technically insolvent and therefore subject to a s 5(a)(vii) Event of Default, Pioneer was not subject to actual insolvency proceedings. Since BVI insolvency law was not therefore a focus in the Pioneer judgment, the Pioneer judgment speaks only to the enforceability of s 2(a)(iii) as a matter of contract. However, in both the *Metavante* case and the *Enron* case, the question was not over the validity of s 2(a)(iii) as a contractual provision, but whether or not that provision was affected by national bankruptcy laws. Both the *Metavante* case and the *Enron* case also related to transactions where Automatic Early Termination was not selected. Were Automatic Early Termination to be selected, since s 2(a)(iii) relates to pre-termination payments under s 2(a)(i), questions as to its enforceability would not arise.

THE BVI POSITION ON TERMINATION AND SUSPENSION OF PAYMENTS

English common law has been extended to the British Virgin Islands by statute and judgments of the English courts therefore create precedent in the BVI. While a court in the BVI is not obliged to follow Australian judgments, absent BVI case law or BVI statute that suggested otherwise, it would also find judgments of courts in English common law jurisdictions persuasive. There is no BVI case law that contradicts the *Enron* judgment and so the *Enron* decision would be likely to be followed to the extent that BVI and Australian bankruptcy regimes are comparable in this regard.

Indeed, in a further case involving Pioneer heard in the BVI (*Pioneer Freight Future Company Limited v MAP Marine Limited, BVIHCV 2009/308*), Bannister J strictly upheld the provisions of the ISDA Master Agreement in relation to calculations under s 6(d)(i) (although it was the insolvency of the party other than Pioneer that was an issue on this occasion). The question remains therefore whether BVI insolvency law, like the US bankruptcy code, might defeat the contractual effect of ss 2(a)(iii) and 6(a).

The commencement of liquidation in the BVI triggers operation of statutory set-off of amounts due from one party to the other prior to the commencement of liquidation. However, when considering a financial markets transaction under an ISDA Master Agreement, the effect of insolvency set-off is generally subsumed by Pt XVII of the BVI Insolvency Act. Part XVII contains provisions based on the ISDA Model Netting Act which are designed to uphold contractual terms in financial markets contracts relating to termination through the insolvency of a BVI counterparty. Specifically Part XVII protects '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 proceeds thereof, as contained within a netting agreement'. While an ISDA Master Agreement will nearly always constitute a netting agreement for the purposes of these provisions, much like the US bankruptcy code safe harbour provisions it must be doubtful whether these provisions would protect a term such as s 2(a)(iii) allowing a Non-defaulting Party to withhold performance as withholding performance is not ostensibly related to netting, set-off, guarantees or collateral.

If s 2(a)(iii) is not protected by the Part XVII financial markets exclusions, the question remains as to whether there is anything under BVI insolvency law or English common law that would invalidate such a term. BVI insolvency law is now largely enshrined in the BVI Insolvency Act 2003, which contains many of the features of the original 1986 English Insolvency Act. As with English insolvency law, BVI insolvency law does not put a liquidator in a stronger position than the insolvent company: where the company would not have been in a position to force a counterparty to perform when an express contractual provision permits them to withhold performance, the liquidator will similarly not be in a position to compel performance. The reasoning in the *Enron* case was therefore in accordance with BVI law and is consistent with case law upholding the enforceability of 'flawed asset' arrangements in the event of insolvency.

CONCLUSIONS

The s 5(a)(iii) Event of Default provisions as found in the 1992 (Multicurrency – Cross Border) ISDA Master Agreement and the 2002 ISDA Master Agreement adequately cover most insolvency related proceedings to which a company might be subject in the BVI.

Whether or not Automatic Early Termination has been selected, there is no reason to change the historical view that the close-out provisions of the ISDA Master Agreement will be enforceable in the BVI on the occurrence of a s 5(a)(vii) bankruptcy Event of Default in respect of a BVI counterparty. ■