

Netting, contractual subordination and non-petition provisions under Cayman Islands Law

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Background

As financing transactions have become more sophisticated over time, it has been common for parties to a transaction to agree in advance matters relating to:

- The manner in which respective debts and credits between the parties will be calculated upon the happening of a defined event so that a single payment is to be made from one party to another (**Netting**). In particular, Netting provisions play a large part in the standard Master Agreements produced by the International Swap and Derivatives Association Inc.
- The order in which parties will have the priority in respect of claims against another person (**Contractual Subordination**).
- The circumstances under which one or more parties may take an action to have another party wound-up (**Non-petition**). The rating agencies often require debt issuing special purpose vehicles in capital markets transactions to have the protection of Non-petition provisions as part of the 'bankruptcy remoteness' analysis.

This client briefing contains an overview of Cayman Islands law in respect of such matters.

This client briefing is intended to provide a general summary of the position in law as at the date shown above, and is not to be taken as specific legal advice applicable to particular issues or circumstances. If such advice is required, please contact your usual Ogier contact or one of our partners listed here.

Netting and set-off

The Companies Act (Revised) (**Companies Act**) requires, at 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) of the Companies Act which provides that the collection in and application of the property of the company... is without prejudice to, and after the taking into account and giving effect 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.

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 shareholders of a company. Accordingly, contractual bilateral and multi-lateral set-off or Netting arrangements are effective on the winding up of a company or an exempted limited partnership in the Cayman Islands. It should also be noted that preferential debts under the Companies Act are payable out of assets of a 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.

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 both companies and exempted limited partnerships.

Contractual Subordination

Contractual Subordination is recognised in the Cayman Islands and, indeed, Cayman Islands companies and exempted limited partnerships are regularly party to Contractual Subordination arrangements. Contractual Subordination can be achieved within any form of contractual arrangement, but it is common for a standalone subordination deed or intercreditor deed to be used, pursuant to which one or more parties agree, among other things, to subordinate certain claims to another party's claims.

Section 140(2) of the Companies Act preserves contractual subordination arrangements at law, by stating that on a winding up of a company the realisation of its assets shall be applied after taking into account and giving effect 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... thereby reinforcing the validity of Contractual Subordination as a matter of Cayman Islands law.

Non-petition

In respect to limited partnerships, based on the partnership law principle that partners of a

limited partnership are free to negotiate the method by which a partnership ends, limited partnership agreements that seek to prevent limited partners from winding-up the partnership are effective. This was recently upheld by the Cayman Islands Court of Appeal, which affirmed that section 95(2) of the Companies Act, which provides that the court shall dismiss a winding up petition or adjourn the hearing of a winding up petition on the ground that the petitioner is contractually bound not to present a petition against the company, also applies to exempted limited partnerships.

Flexibility

The fact that Netting, set-off, Contractual Subordination and Non-petition matters are all addressed by legislative provisions in the Cayman Islands evidences the Cayman Islands' understanding of the importance of such matters to parties looking to structure their finance transactions. This continues to make the Cayman Islands an attractive offshore jurisdiction across the banking and finance industry.

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