

GUIDE TO THE USE OF DERIVATIVES IN THE ISLE OF MAN AND THE ENFORCEABILITY OF NETTING AGREEMENTS WITH ISLE OF MAN COUNTERPARTIES

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PREFACE

This Guide presents an overview of the use of derivatives in the Isle of Man, both in terms of the products available and the types of derivatives transactions Isle of Man counterparties typically enter into with foreign financial institutions. It also discusses the legislative landscape in the Isle of Man *vis-à-vis* derivatives products and the ability of certain Isle of Man entities to enter into such transactions. In particular, we discuss the enforceability of netting agreements adopting the International Swaps and Derivatives Association's (**ISDA**) Master Agreement form.

Appleby, as counsel to ISDA since the introduction of the 1992 ISDA Master Agreement, is well versed in advising global financial institutions on the enforceability in the Isle of Man of netting agreements, particularly in the insolvency of the Isle of Man counterparty. This Guide serves as an introduction to each of the post-insolvency netting analyses that can apply depending on the type of Isle of Man counterparty, e.g. companies, protected cell companies, insurance companies, partnerships and trusts. Thus, various themes are covered in terms of how a netting agreement should be structured in order to ensure that the anticipated contractual effect of the agreement is given the same practical and commercial effect in the insolvency of the Isle of Man counterparty. Various other practical issues regarding enforcement of contracts in the Isle of Man and collateral arrangements are also discussed.

Decisions of the English courts, particularly the Supreme Court and the Court of Appeal, whilst not binding on the courts of the Isle of Man, are of highly persuasive authority and are followed unless there is some provision to the contrary in Manx statute or a decision to the contrary, or, exceptionally there is some local condition which would give good reason for not following the particular English decision. The Judicial Committee of the Privy Council of the United Kingdom is the final court of appeal from the Isle of Man courts.

It is recognised that this Guide will not completely answer the detailed questions that clients and their advisers may have. It is intended to provide a sketch of the Isle of Man's legal and regulatory environment in relation to derivatives and the enforceability of netting agreements. This Guide is therefore designed as a starting-point for a more detailed and comprehensive discussion of the issues.

Whilst this Guide speaks of Isle of Man law, Appleby can advise on the laws of all the offshore jurisdictions listed at the end of this Guide and the effect that such laws can have on derivatives and netting agreements.

Whilst we have made every effort to ensure the accuracy of the statements made herein, we accept no liability for any errors. In all cases expert legal advice from a qualified practitioner of Isle of Man law should be obtained. If any such questions arise in relation to the contents, they should be addressed to any member of the team, using the [contact information](#) provided at the end of this Guide.

Appleby

Isle of Man

February 2015

1. THE DERIVATIVES MARKET AND LEGISLATIVE LANDSCAPE IN THE ISLE OF MAN

1.1 Current Markets Overview

The Isle of Man is a relatively small domestic market for derivatives products. There are now around twenty banks in the Isle of Man and most of these enter into derivatives transactions with customers. More importantly however, Isle of Man counterparties frequently enter into derivative transactions with foreign financial institutions.

All derivative transactions with Isle of Man counterparties are arranged bilaterally, whether with a local bank or a foreign financial institution. There is no public exchange of standardised derivatives.

The bulk of the derivatives transactions take place between an Isle of Man counterparty and a non-Isle of Man financial institution, usually based in either London or New York. There are no regulatory restrictions or prohibitions on the types of derivative transactions that are entered into by Isle of Man counterparties. Both domestic and cross-border transactions typically involve, for example, Credit Default/Total Return/Asset Swaps, Credit Linked Notes/Trusts, Interest Rate Swaps/Caps/Floors/Collars, Currency Options or Foreign Exchange Contracts.

There have been no indications of any significant threats or adverse changes to the Isle of Man's present market for derivatives. On the contrary, it is likely that a comprehensive statutory netting provision will be introduced in the near future either embodied in new insolvency legislation or as a discrete statute.

1.2 Current Legal Framework Overview

There are as yet no specific statutes governing derivatives in the Island. There is general freedom of contract, and any party may enter into a derivative with any other party irrespective of its place of incorporation.

There are no foreign exchange issues between an Isle of Man counterparty and a financial institution.

The economic and contractual effect of certain provisions of a typical ISDA Master Agreement are also affected by certain laws of the Isle of Man, but such laws are incidental and are not intended to regulate derivatives per se. This is discussed further below.

We are not aware of any efforts being undertaken locally to: (a) replicate the UK Banking Act 2009, which provides, amongst other things, a new insolvency regime for banks; or (b) adopt the EU Directive on Financial Collateral Arrangements (2002/47/EC), which aims to create a uniform EU legal framework to limit credit risk in financial transactions through the provision of securities and cash as collateral. The Isle of Man is not a Member State or part of a Member State of the European Union.

It is likely, however, that the Vickers Report in the UK and the implementation of its main proposals will result in the introduction of a compatible banking regime in the Isle of Man.¹

2. GENERAL ASPECTS OF CROSS-BORDER OVER THE COUNTER DERIVATIVES DOCUMENTATION AND ENFORCEABILITY IN THE ISLE OF MAN

Cross-border over-the-counter derivatives between an Isle of Man counterparty and a foreign (non-Isle of Man) counterparty would typically be documented using one of the ISDA Master Agreement formats. Both the 1992 and 2002 versions (including optional amendments relating to how section 2(a)(iii) should operate) (in this Guide, **ISDA Master Agreements**) are in use. There appears to be no pattern of use of one form versus the other dependent on the type of entity. There is no local Isle of Man form.

¹ The Independent Commission on Banking: The Vickers Report & the Parliamentary Commission on banking standards Final Report 12 September 2011

The principal procedural matters for an Isle of Man entity will be to ensure the proposed derivative transaction is within its powers, as contemplated by its constitutional documents. Thus, an Isle of Man company must act within the terms of its memorandum and articles of association; partnerships will need to comply with the terms of their deeds of partnership; and trusts with the terms of the settlement of the trust, including the trust deed and any applicable instructions to the trustee of the relevant trust. Generally, the directors, managers or trustees of the entity concerned would also need to adopt board, management or trustee resolutions expressly authorising the transaction.

Isle of Man entities will also be regulated to the extent they are authorised or licensed under specific legislation, such as the Insurance Act 2008, the Financial Services Act 2008 or the Collective Investment Schemes Act 2008. In order to remain authorised or licensed, an Isle of Man entity may, in a given case, be restricted to engaging in certain types of business. Such restrictions or conditions will figure on the relevant authorisation, permit or licence. Although not a common occurrence, an entity may be restricted, or specific consents may be required from the Insurance and Pensions Authority or the Financial Supervision Commission in order to engage in derivatives transactions.

In the case of a Governmental entity, for example the Treasury of the Isle of Man Government (a Government department) or Manx Utilities (a statutory board), capacity and authority would be determined by reference to the statute which created that entity, the Government Departments Act 1987 or the Statutory Boards Act 1987. Generally, however, there is no restriction on an Isle of Man Government department or statutory board conducting cross-border derivatives transactions.

During the solvency of the Isle of Man counterparty, the terms of a derivatives contract are generally enforceable in accordance with their terms, including terms relating to netting or automatic early termination. Further, in the event of an insolvency, the economic effect of a derivatives contract can usually be preserved, particularly where credit support has been taken. However, in certain circumstances the Isle of Man's Bankruptcy Code 1892 will take precedence over contractual provisions relating to netting and set-off and, accordingly, the close-out mechanism may not operate according to the precise terms of the relevant contract.

In addition, the post-insolvency netting analysis may be affected by Isle of Man legislation where the counterparty is registered under, for example, incorporated cell legislation, protected cell legislation or the Insurance Act 2008, although with the appropriate drafting of the relevant agreement the thrust of the economic intentions of the netting provisions can be preserved, even in the insolvency of the Isle of Man counterparty. This is discussed in greater detail below.

3. **SPECIFIC ASPECTS OF ENFORCEABILITY OF ISDA PROVISIONS IN THE ISLE OF MAN**

Enforceability² of the ISDA Master Agreements is considered in relation to two main areas, namely (a) Set-off, Netting and Close-out Netting and (b) the Early Termination provisions of the ISDA Master Agreement.

There is no distinction between Isle of Man domestic and cross-border transactions in terms of contractual enforcement.

Under the laws of the Isle of Man, the provisions relating to the above areas are generally enforceable in the context of cross-border over the counter derivatives transactions between a local party and a foreign party. This is so even in the event of insolvency, though a number of qualifications arise in such a case.

The term "Bankruptcy", as broadly defined in the ISDA Master Agreements, would encompass (among other things) the liquidation of companies, the appointment of a receiver by the court or under private

² The term "enforceable" in this context means that the obligations of the Isle of Man counterparty are of a type that the Isle of Man courts will enforce. It does not mean that such obligations will necessarily be enforced in all circumstances in accordance with their terms where, for example, enforcement may be limited by general principles of equity or where claims for enforcement may be barred under statute.

instrument and bankruptcy proceedings commenced in respect of natural persons. For practical purposes, Bankruptcy usually refers to the liquidation of a company. For that reason, the discussions below concerning Bankruptcy and insolvency refer to and contemplate company liquidation.

3.1 Validity and Enforceability of Set-off, Netting, and Close-out Netting Provisions

During Regular Performance or Triggered by an Event of Default or a Termination Event, other than Bankruptcy

The Set-off, Netting and Close-out Netting provisions typical to the ISDA Master Agreements can be validly entered into by local entities. The provisions are enforceable and there are no requirements peculiar to the law of the Isle of Man that must be reflected in the actual agreement to ensure their validity and enforceability. This is so both in terms of the regular day-to-day performance of the agreement, and in a case where an Event of Default or Termination Event has occurred, other than a Bankruptcy (discussed in the following section).

Triggered by Bankruptcy

Subject to the discussion below, the Set-off, Netting and Close-out Netting provisions typical to an ISDA Master Agreement are enforceable in a Bankruptcy event. In particular, these provisions are enforceable in the Isle of Man in the event of insolvency³, solvent or insolvent liquidation, and receivership by order of the court or under the terms of a private instrument.

The provisions of the ISDA Master Agreements provide for the netting of termination values in determining a single lump-sum termination amount upon the insolvency of a counterparty. Such a provision is enforceable under the law of the Isle of Man. Provided there are no issues of fraudulent preferences or fraudulent assignments, Isle of Man insolvency law will not intervene if the Early Termination Date is prior to the commencement of the insolvent winding up of the Isle of Man counterparty. Even if the Early Termination Date is after the commencement of an insolvent liquidation of the Isle of Man counterparty, a court would enforce the ISDA Master Agreements on their terms in an insolvent liquidation in the Isle of Man provided it can be said that there are “mutual debts” between the parties pursuant to section 22 of the Bankruptcy Code 1892 (discussed below). As the ISDA Master Agreements themselves provide for the substitution of a single net balance owing by one party or the other for the rights and obligations under individual Transactions, arguably the computation of the single net balance is a matter of simple accounting between the parties and is consistent with insolvency set-off.

Even if the position were to be determined by application of insolvency set-off, the commercial result would be substantially (albeit not precisely) in accordance with the terms of the ISDA Master Agreements. Pursuant to Section 248 of the Companies Act 1931 which applies to companies incorporated in the Isle of Man under the Companies Acts 1931-2004 and the Companies Act 2006 (the **Companies Acts**), the rules that prevail under the law of bankruptcy with respect to the rights of secured and unsecured creditors, debts provable and the valuation of future and contingent liabilities also apply in the winding up of an insolvent company. Among these rules is Section 22 of the Bankruptcy Code 1892 which provides:

“Where there have been mutual credits, mutual debts or other mutual dealings, between a debtor against whom an order of adjudication shall be made under this Act, and any other person proving or claiming to prove a debt under such order, an account shall be taken of what is due from the one party to the other in respect of such mutual dealings, and the sum due from the one party shall be set off against any sum due from the other party, and the balance of the account, and no more, shall be claimed or paid on either side respectively; but a person shall not be entitled under this section

³ In this guide, “insolvency” and “insolvent” means the inability to pay debts in accordance with the Isle of Man law, taking into account contingent and prospective liabilities.

to claim the benefit of any set off against the property of a debtor in any case where he had, at the time of giving credit to the debtor, notice of an act of bankruptcy committed by the debtor and available against him."

It is not possible to contract out of these statutory provisions: they will override the provisions of the ISDA Master Agreements to the extent of any inconsistency. The statutory provisions provide for mandatory set-off and are generally applied and construed quite broadly. Whilst there are subtle differences (which local counsel can advise on), there is no substantive inconsistency between set-off in an insolvent liquidation pursuant to these provisions and the provisions for netting under the ISDA Master Agreements when entered into with an Isle of Man company incorporated under the Companies Acts.

Notwithstanding that insolvency set-off as described above should generally coincide with the netting provisions under the ISDA Master Agreements, certain differences in terms of calculations and timing are possible. For example, there is the requirement that calculation of foreign currency claims in an insolvent liquidation must be made as at the date of the winding up order against the insolvent company, even if the ISDA Master Agreements might select a different date.

In the context of insolvency set-off, a potential issue may arise as to the obligation to deliver commodities. Such an obligation cannot be brought into the insolvency set-off account. The ISDA Master Agreements envisage that such an obligation would be converted into a purely monetary obligation. While there is some uncertainty on this point, a court is likely to recognise the conversion of the delivery obligation into a monetary obligation, in which event the monetary obligation will be brought into the mandatory insolvency set-off account.

Issues may also arise where a counterparty to the ISDA Master Agreements is a company registered as an incorporated cell company, a protected cell company or authorised to carry on insurance business. Further issues also arise where the counterparty is a partnership or a trust, since in some circumstances the mutuality requirement under insolvency set-off may not consistently be satisfied in respect of the partnership or the trustee (see further discussion of these entities below).

3.2 Validity and Enforceability of Early Termination Provisions

(a) Triggered by an Event of Default or a Termination Event, other than Bankruptcy

Under Isle of Man law the Early Termination provisions typical to the ISDA Master Agreements, including Additional Termination Event provisions, can be validly entered into by local entities, and are enforceable. The parties are generally free to stipulate the conditions upon which a contract or obligations under it will terminate. There are no requirements peculiar to the law of the Isle of Man that must be reflected in the actual agreement to ensure their validity and enforceability. This is so both in terms of the regular day-to-day performance of the agreement, and in a case where an Event of Default or Termination Event has occurred, other than a Bankruptcy (discussed in the following section).

(b) Triggered by Bankruptcy

The Early Termination provisions typical to the ISDA Master Agreements can be validly enforced when triggered by a Bankruptcy event. This is so notwithstanding the broad scope of the definition of "Bankruptcy" under the ISDA definitions. In particular, these Early Termination provisions are enforceable in the Isle of Man in the event of insolvency, solvent or insolvent liquidation, receivership by order of the court, or under the terms of a private instrument.

3.3 Cherry-Picking in the Event of a Bankruptcy

Section 252 of the Companies Act 1931 (which applies to all companies incorporated under the Companies Acts) provides that a liquidator may, with the leave of the court, disclaim any right under a contract which in his opinion is onerous for the company to hold or is unprofitable or not readily

saleable. On the basis that all Transactions concluded under a single ISDA Master Agreement constitute a single contract, a liquidator of the Defaulting Party should not be in a position to “cherry pick” between Transactions under a single ISDA Master Agreement terminating some derivative agreements and repudiating or leaving standing others. The liquidator could only disclaim the ISDA Master Agreement as a whole, whereby the Non-defaulting Party would be entitled to prove in liquidation for the amount of its loss or damage.

In the case of multiple ISDA Master Agreements between two parties, a liquidator could not exercise his rights to disclaim under Section 252 in respect of the ISDA Master Agreements where its provisions operate automatically to terminate the agreements upon the occurrence of an insolvency, or where the Non-defaulting Party exercises an option to terminate in those circumstances. At that time, there would be no ongoing obligations to disclaim.

Section 252 of the Companies Act 1931 is rarely invoked except in the case of land and most likely does not have practical application in a case involving ISDA Master Agreements.

In the absence of such a disclaimer power, a liquidator does not have any effective mechanism for cherry-picking among Transactions, whether they be a single ISDA Master Agreement between two counterparties, or where there are multiple ISDA Master Agreements between two counterparties.

(a) **Validity and Enforceability of Foreign Law and Foreign Jurisdiction Provisions**

Under Isle of Man law, the Governing Law and Jurisdiction provisions typical to the ISDA Master Agreements, both pertaining to the applicability of New York law or English law and the irrevocable submission to English courts and the courts of the State of New York, as the case may be, can be validly entered into by local entities, and they are enforceable.

There are no requirements peculiar to the law of the Isle of Man that must be reflected in the actual agreement to ensure their validity and enforceability. This is so both in terms of the regular day-to-day performance of the agreement, and in a case where an Event of Default or Termination Event has occurred, including a Bankruptcy.

In particular, where the parties’ intention is manifested in an express term which selects the law of the contract, a court in the Isle of Man seized of the action would ordinarily give effect to that choice, provided that such choice of law is bona fide, legal, valid as a matter of the chosen law and there is no reason for avoiding it on the grounds of public policy. It is essential, too, that the choice of law provision is expressly pleaded in any action before a court in the Isle of Man. In the absence of any such pleading, the court will apply Isle of Man law. In our opinion, the courts in the Isle of Man would uphold the choice of law to govern the ISDA Master Agreements.⁴

Further, the submission by a counterparty to the jurisdiction of foreign courts is not contrary to Isle of Man law and would be recognised by the courts of the Isle of Man as a legal, valid and binding submission, if such submission is legal, valid and binding under the laws of the place selected.

(b) **Known Local Issues with the Validity and Enforceability of Collateral Arrangements and Guarantees**

Under Isle of Man law, the typical collateral arrangements and guarantees accompanying ISDA Master Agreements can be validly entered into by local entities, and they are enforceable.

There are no requirements peculiar to the law of the Isle of Man that must be reflected in the actual agreement to ensure their validity and enforceability. This is so both in terms of the regular day-to-day performance of the agreement, and in a case where an Event of Default or Termination Event has occurred, including a Bankruptcy.

⁴ *Vita Foods Products Inc. v. Unas Shipping Co., Limited* [1939] 1 All ER 513 (P.C.), a decision of the Judicial Committee of the Privy Council.

Charges over the assets of Isle of Man companies wherever situated, and charges on assets situated in the Isle of Man granted by companies incorporated outside the Isle of Man but having a place of business there, are capable of being registered in the Isle of Man under Part III of the Companies Act 1931 and Part VIII of the Companies Act 2006. Registration under this legislation is the only method of registration of charges over the assets of Isle of Man companies and foreign companies having a place of business in the Isle of Man (except charges over real property in the Isle of Man or ships or aircraft registered in the Isle of Man). Failure to register a charge against a company under the Companies Acts will result, if not rectified, in the security provided by the charge being void as against a liquidator and any creditor.

The English form of ISDA Credit Support Annex stipulating an absolute transfer of title may create issues in insolvency in that the transferee of the asset will have no right akin to a right of redemption. That could give rise to two possibilities; if the transfer is at an undervalue (the value of the asset transferred exceeds the value of the claims the asset was meant to secure) this could give rise to claw-back remedies; if on the other hand the title transfer is re-characterised as a security interest, non-registration could render the arrangement void.

Guarantees of the kind typical in respect of the ISDA Master Agreements should not give rise to any issues of enforceability under the laws of the Isle of Man.

4. SPECIAL AREAS OF CONSIDERATION IN THE ISLE OF MAN

4.1 General Tax Considerations

The Isle of Man is a tax neutral jurisdiction so no significant tax issues should arise in respect of the ISDA Master Agreements or cross-border payments made under a derivatives agreement.

4.2 Currency

The Isle of Man currency is the Manx pound, which by law has parity with the pound sterling. The pound sterling is also legal tender in the Island.

Under the laws of the Isle of Man, the conversion of foreign currency for the purpose of determining the value of net claims in an insolvent liquidation against a company are to be calculated at the date of the winding up order.⁵ Under the definition of "Termination Currency Equivalent" referred to in the ISDA Master Agreements, a different date for converting foreign currencies may apply. Conversion will have to be calculated by reference to the date of the winding up order if the contractual rate is different, not only for the purposes of filing any proof of claim in respect of a liability of an Isle of Man counterparty, but also therefore, for the purposes of calculating rights of set-off.⁶

4.3 Interest

Notwithstanding a first instance case of the Isle of Man High Court⁷, it is considered that, in an insolvent liquidation, interest is computed to the date of a winding up order (or special resolution to wind up a company in the case of a voluntary winding up) not to the date of presentation of a winding up petition, as this is consistent with the convergence of all other claims for the purposes of proof at that date.

4.4 Others

As stated above, the post-insolvency netting analysis can be affected by Isle of Man legislation where the counterparty (being a corporate entity) is registered under, for example, the Incorporated Cell

⁵ *Re. Dynamics Corporation of America* [1976] 2 All ER 669; *Re. Lines Brothers Limited* [1983] Ch.1.

⁶ This paragraph assumes that termination under the ISDA Master Agreement occurs as a direct result of the liquidation of the Defaulting Party. The result would be different if close-out took place prior to and unconnected with any subsequent liquidation. Close-out under such circumstances should give rise to a valid settlement based on the contractual conversion rate because creditors' rights in liquidation become crystallised as at the date of the winding up order and valid transactions up to that point are unaffected by the liquidation.

⁷ Application of *Kay re Kaupthing* CHP 2010.

Companies Act 2010, the Protected Cell Companies Act 2004, Part VII of the Companies Act 2006 (protected cell companies) or the Insurance Act 2008. Further, the account provided above only takes into consideration a corporate Isle of Man counterparty. What follows, therefore, is an outline of the impact that certain applicable legislation may have on the post-insolvency netting analysis described above (where Isle of Man insolvency law is applied), together with an analysis of the enforceability of the netting provisions of the ISDA Master Agreements when entered into with partnership and trust counterparties.

(a) **Incorporated Cell Companies**

Formation and nature

The Incorporated Cell Companies Act 2010 (**ICC Act**) provides that an Isle of Man company may be incorporated as an incorporated cell company under the Companies Acts 1931-2004 (**1931 legislation**) or the Companies Act 2006 (**2006 legislation**) if it is a company limited by shares (**ICC**). In each case, the 1931 legislation or the 2006 legislation apply, such that Isle of Man company insolvency law is applicable. Currently, an ICC may only carry on insurance business within the meaning of the Insurance Act 2008. An ICC is a legal person. Further, a company may be incorporated as an incorporated cell under the 1931 legislation or the 2006 legislation (**IC**). Again, in each case, the 1931 legislation or the 2006 legislation apply, such that Isle of Man company insolvency law is applicable. An IC is also a legal person and is not a subsidiary of its ICC by virtue only of the fact that it is an incorporated cell of its incorporated cell company. A protected cell company and a company incorporated under the 1931 legislation or the 2006 legislation may be converted into an ICC. An IC may be converted into a company incorporated under the 1931 legislation or the 2006 legislation independent of its ICC. An IC may be transferred from one ICC to another ICC. An IC may be expelled from an ICC by the Department of Economic Development, the ICC or the liquidator of the ICC.

Assets and liabilities

The directors of an ICC and its ICs must keep the assets and liabilities of the ICC and each IC separate and separately identifiable. An ICC can only transact for itself and not for any IC. Similarly an IC can only transact for itself and not for any other IC or the ICC. The ICC Act provides that a winding up of an ICC is precluded from prejudicing the affairs, business and property of its ICs. During its winding up, the ICC may continue to carry on business to the extent necessary for the continuance of its ICs.

Prior to an insolvency, transactions which are entered into by an ICC or an IC and which would be regarded as a single contract under the governing law of the relevant ISDA Master Agreement, providing for the payment of one net sum and not a series of contracts, would be so regarded in Isle of Man law.

Provided that the provisions of the ICC Act are followed and the ICC or each IC (as the case may be) contracts for itself, all Transactions to be included for the purposes of Close-out Netting in respect of an ISDA Master Agreement executed by an ICC or an IC should be attributed solely to that ICC or IC and the assets and liabilities of any non-contracting ICC or IC should be excluded.

The insolvency of an ICC (the meaning of which is the same as for other Isle of Man companies, see note 3) as well as the insolvency of any relevant IC is pertinent to the discussion. Insolvency of an ICC may trigger the need for the conversion of an IC (even though that IC itself might be solvent) into a company.

An ICC or an IC, where properly constituted, may be treated for the purposes of insolvency set-off as companies incorporated under the 1931 legislation or the 2006 legislation (as the case may be) to which section 248 of the Companies Act 1931 (application of bankruptcy rules in

winding up of insolvent companies) applies, subject to the particular requirements for mutuality in respect of insurance companies referred to in 4.4(c), below.

(b) **Protected Cell Companies**

The Protected Cell Companies Act 2004 and Part VII of the Companies Act 2006 provide that an Isle of Man company may incorporate as, or convert to a protected cell company (**PCC**) for the purpose of segregating and protecting cellular assets.⁸ A PCC may be converted into an incorporated cell company in accordance with the Incorporated Cell Companies Act 2010.

To the extent that liabilities of a PCC are contractually attributed to a cell, any creditors will be afforded a restricted recourse against any assets, and will be entitled to make their recoveries only as against assets attributed to the specific cell to which their respective contracts are also attributed. Such creditors will not be legally entitled to make recovery against assets attributed and credited to any other cell of the PCC, or against the non-cellular assets, being those assets which have not been attributed to any other cell of that PCC. Where there is no contractual attribution of liability solely to a particular cell, the default position is that the cellular assets attributable to the particular cell are primarily liable until they are exhausted after which non-cellular assets are secondarily liable.

Prior to an insolvency, transactions which are attributed to the same cell and which would be regarded as a single contract under the governing law of the relevant ISDA Master Agreement, providing for the payment of one net sum and not a series of contracts, would be so regarded in Isle of Man law.

To avoid mutuality difficulties, all Transactions to be included for the purposes of Close-out Netting in respect of an ISDA Master Agreement executed with a PCC in respect of a cell should be attributed solely to that cell and the liability of non-cellular assets should be excluded.

If assets, rights, obligations and liabilities which relate to the Transactions under an ISDA Master Agreement are not successfully segregated by contract to a particular cell of a PCC (following a failed attempt so to do) the Close-out Netting provisions of the ISDA Master Agreement between the counterparties could still be enforceable. Following a rare failed attempt to segregate, the liabilities and rights in relation to a given Transaction will fall into the non-cellular assets and liabilities. As regards all claims by and against the non-cellular assets, the netting process will operate as before. Only assets which are not segregated (i.e., the non-cellular assets of the PCC only) will be available to apply towards the settlement of any net sum which the PCC is liable to pay as the result of the netting (provided that the governing instrument, be it an ISDA Master Agreement or Confirmation (or other evidence of a Transaction) so permits).

The insolvency of a PCC (the meaning of which is the same as for other Isle of Man companies, see note 3) as well as the insolvency of any relevant cell is pertinent to the discussion. Insolvency of a PCC may trigger the winding up of a cell (even though that cell itself might be solvent). In addition, the cell itself may be insolvent where the cellular assets attributable to a particular cell, when account is taken of the PCC's non-cellular assets, unless there are no creditors in respect of that cell entitled to have recourse to the PCC's non-cellular assets, are or are likely to be insufficient to discharge the claims of creditors in respect of that cell. A cell may therefore be insolvent where the PCC itself is still solvent. Where a PCC carries on insurance business, regard should be had to the particular requirements of mutuality referred to below.

(c) **Insurance Companies**

⁸ In the case of a company incorporated under the Companies Acts 1931-2004, a company incorporated as, or converting to a PCC under the Protected Cell Companies Act 2004 must carry on insurance business within the meaning of the Insurance Act 2008 or such other class or description of business as may be prescribed by The Treasury of the Isle of Man Government (currently certain international schemes established under the Collective Investment Schemes Act 2008). Part VII of the Companies Act 2006 however, allows any type of company to incorporate or convert to a PCC.

For this analysis, by “insurer” we mean a company incorporated under the Companies Acts 1931-2004 which is by far the most common form of vehicle authorised by the Isle of Man Insurance Supervisor under the Insurance Act 2008 to carry on insurance business in or from the Isle of Man. From a netting perspective, insurers can be categorised into three types in the Isle of Man: general business insurers, long-term business insurers (life and annuity products, for example) and composite business insurers, (i.e. insurers that carry on both general and long-term business). For the purposes of the analysis of the enforceability of the netting provisions of an ISDA Master Agreement post-insolvency of an insurer, general business insurers are treated like Isle of Man companies, while long-term and composite insurers are treated differently.

A long-term business insurer must maintain its accounts in respect of that long-term business separate from any accounts it has in respect of any other business. All receipts must be carried to, and form part of, a special fund referred to as the “long-term business fund”. No payment from a long-term business fund may be made directly or indirectly, other than for a purpose of the insurer’s long-term business; except insofar as such payment can be made out of any surplus certified by the insurer’s approved actuary to be available for distribution otherwise than to policyholders. Accordingly, composite insurers must keep their general business capital, assets and liabilities segregated from their long-term business capital, assets and liabilities.

Insolvency set-off in relation to composite insurers is more complicated than it is for general insurers or those carrying on only long-term business. Pursuant to Schedule 3 of the Insurance Act 2008, on the winding up of a long-term or composite insurer, net balances owing by the insurer may only be paid out of the long-term business fund if all of the transactions entered into under the ISDA Master Agreement are attributable to the long-term business of the insurer. If the transactions are not attributable to the long-term business fund, then the net claim against the insurer may only be paid out of the assets which are not included in its long-term business fund. Accordingly, mutuality issues can arise as those transactions entered into under an ISDA Master Agreement may only be netted and paid out of the fund to which those transactions are attributed, be it the long-term business fund or the other assets (the general account) of the (composite) insurer.

(d) **Partnerships**

The basic problem in applying the insolvency set-off principles set out above to (usually limited) partnerships in the Isle of Man is the requirement for mutuality in relation to debits and credits sought to be set-off. Only claims owed by and against each general partner (typically an Isle of Man company) may be set off if the mutuality requirement is satisfied in respect of each partner (or group of the same). This mutuality requirement will be affected by changes in respect of partners of the partnership, brought about either by agreement amongst the partners (e.g., admissions or withdrawals), or by operation of law as a result of the dissolution, bankruptcy or death of a partner. Appropriate mechanisms can, however, be built into the deed of partnership whereby assets and liabilities of the partnership prior to any change are assigned and novated, respectively, to the partnership as constituted after the change, so that mutuality between the parties is maintained.

It is now possible for Isle of Man partnerships to register a declaration upon formation to elect “legal personality”. An Isle of Man partnership (general or limited) that registers such a declaration is a legal person separate from its partners with power to own and deal with its separate property in accordance with the partnership agreement and has unlimited capacity at law. Once made, the “legal personality” election is irrevocable. In addition, and subject to any agreement between the partners, such a partnership is not dissolved by a change in the constitution of the partnership. Thus, the complications set out above in relation to Transactions with Isle of Man partnerships regarding mutuality are obviated and the Transaction can be analysed as if the counterparty were an Isle of Man company.

(e) **Trusts**

Commercial trusts are invariably constituted by a trust deed. A trust has no separate legal capacity; it acts through its trustee or trustees, typically an Isle of Man company in the case of an Isle of Man trust. Isle of Man trusts cannot become subject to corporate insolvency laws nor can they commit “acts of bankruptcy”; however, the trustee, the trust fund or the beneficiaries of a trust may become insolvent.

The basic problem in applying the termination and closeout provisions of the ISDA Master Agreement in relation to the trustee as contracting counterparty is the requirement of mutuality in relation to debits and credits sought to be netted. Where the trustee of an Isle of Man trust is an Isle of Man company, the commercial result of the netting and set-off provisions contained in the ISDA Master Agreement will only be achievable in an insolvency of the Isle of Man company if (i) the Isle of Man company is the ultimate beneficial owner of the claims against the other party thereto that arise pursuant to the ISDA Master Agreement and is the party ultimately liable to the other party in respect of each Transaction entered into pursuant thereto; and (ii) in entering into each Transaction under such ISDA Master Agreement, each party is acting in the same right and capacity. In other words, the law of insolvency set-off under the law of the Isle of Man looks through agencies and trusts and analyses set-off as between parties having the relevant beneficial entitlements under the relevant ISDA Master Agreement (with a right of indemnity from the trust fund). Plainly, a trustee, as a fiduciary for underlying beneficiaries, whilst personally liable does not hold any rights or assets for itself but as trustee and accordingly acts in a different capacity from a person acting for its own account.

The insolvency of the trustee itself may not substantially affect the rights of the parties under an ISDA Master Agreement. A liquidator is likely to be appointed to administer the ISDA Master Agreement or to novate the obligations of the trustee to a third party where the trust itself is solvent. To avoid or reduce complications in this regard, the trustee should be required to transfer his functions to a new trustee nominated by the non-Isle of Man counterparty, to transfer all documents and assets to the new trustee and to take all other steps as may be necessary to accomplish this.

Aside from the solvency of the trustee, there is the question of the solvency of the Isle of Man trust itself (as indicated, an Isle of Man trust does not have legal personality). In these circumstances, an additional trigger for termination can be introduced in the ISDA Master Agreement, by reference to the financial position of the trust fund. The provision would entitle the counterparty to Early Termination in the event that the liabilities of the trust fund (contracted through the trustee, who has a right of indemnity from it) exceeded its realisable assets (or some such test) before any formal insolvency proceedings in respect of the trust.

The enforceability of the ISDA Master Agreements relating to an Isle of Man trust where a party to the ISDA Master Agreement is an Isle of Man company and acts in its capacity as trustee of the relevant Isle of Man trust is likely to be the same as described above in relation to an Isle of Man company. That is to say, the provisions of the ISDA Master Agreements providing for the netting of termination values in determining a single lump-sum termination amount upon the insolvency of the Isle of Man trust or the Isle of Man company acting as trustee of an Isle of Man trust are enforceable under the law of the Isle of Man. Whilst there is no clear case law on the application of the statutory law of set-off in insolvency to commercial trusts, we consider that the High Court of Justice in the Isle of Man will seek an equitable resolution of claims consistent with the trustee’s substantive right to seek indemnity from a trust fund for personal liability and for rights held on trust to be applied as to reduction or extinguish such liability since the statutory position, whilst applicable only to individuals and Isle of Man companies, is a statutory codification of law having its origin in equitable principles.

(f) **Banks**

Generally, Isle of Man banks have the capacity to enter into derivatives transactions on the terms of an ISDA Master Agreement. Nevertheless, regard must be had to compliance with banks' capital requirements. In respect of the enforceability of an ISDA Master Agreement with an Isle of Man bank, both pre- and post-insolvency, the position is as described above for an Isle of Man company (at the date of this publication). Certain special considerations may arise where the Isle of Man bank is part of a group of foreign affiliates, entering into a multi-branch ISDA Master Agreement.

For more specific advice on derivatives in the Isle of Man, we invite you to contact one of the following:

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For the convenience of clients in other time zones, a list of contacts available in each of our jurisdictions may be found [here](#).

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