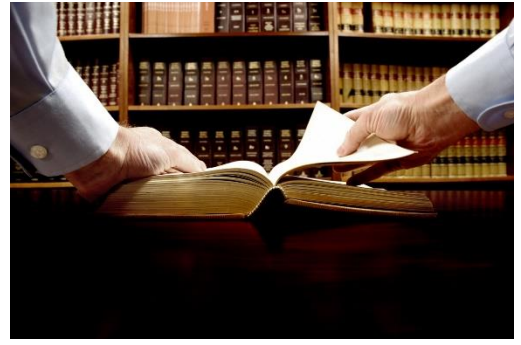


inBrief



The New Netting Law

By Rahat Dar | 03 January 2025

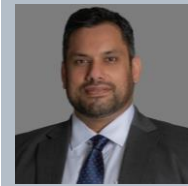
A new netting law was published on 1 October 2024 as Federal Decree-Law No. 31 of 2024 on Netting (the **Netting Law**) and came into effect on 2 January 2025, repealing Federal Decree-Law 10 of 2018 on Netting (the **Old Law**). The Netting Law provides further clarification on both the legal recognition and enforceability of various financial contracts, and the ability to implement close-out netting (*i.e.*, netting of obligations following an event of default or termination event), particularly following the insolvency of the UAE counterparty. The Netting Law applies to all qualified financial contracts, netting agreements and related collateral arrangements entered into by a person or entity in the UAE (other than persons and entities located in financial free zones, being the Dubai International Financial Centre (**DIFC**) and the Abu Dhabi Global Market (**ADGM**), which have their own netting regimes). As with the Old Law, the Netting Law is closely modelled on the 2006 and 2018 ISDA Model Netting Acts (as published by the International Swaps and Derivatives Association (**ISDA**)).

Why is netting important?

Close-out netting is essentially the process where, following a default under a contract (usually a master agreement, such as an ISDA Master Agreement), the non-defaulting party can request the termination of all transactions between the parties under the contract. The parties then determine the value of the unperformed obligations under all “open” transactions and then aggregate the obligations owed by each party to the other, resulting in a net sum (or close-out amount) owed by one party to the other. Effective close-out netting (particularly in post-insolvency situations) can provide a clear and reliable mechanism for parties to settle payments and/or obligations (including collateral transfers) across multiple transactions, thereby minimising the overall credit and settlement risk and, in the case of financial institutions, reducing the amount of collateral required to secure the counterparty’s obligations under contracts.

Financial institutions rely on close-out netting as a key tool for managing and mitigating credit risk associated with a variety of financial contracts, particularly over-the-counter derivatives trading. Financial institutions will use post-insolvency risk of a counterparty to set credit limits, thus if the counterparty is in a jurisdiction where the insolvency laws recognise netting arrangements then the credit limit will be calculated on the basis of net exposure, whereas, if the counterparty is a jurisdiction where the insolvency laws do not recognise netting arrangements (a non-netting jurisdiction), the credit limit will be based on gross exposure.

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Therefore, entering into financial contracts with a counterparty in a non-netting jurisdiction can result in the financial institution becoming subject to very high capital adequacy requirements and increase the costs and collateral requirements for the counterparty.

Whilst the UAE Bankruptcy Law (Federal Decree-Law No. 51 of 2023 Promulgating the Financial Reorganisation and Bankruptcy Law) recognises the set-off on a net basis, this is limited to agreements and arrangements under the Old Law. Consequently, it is not clear whether the adoption of the Netting Law means that the UAE is currently a non-netting jurisdiction.

Key Concepts Under the Netting Law

Netting

The Netting Law allows parties to enter into netting agreements for the purposes of netting off their payment and delivery obligations under qualified financial contracts (netting). A netting may include the following features:

- a. any termination, liquidation and/or acceleration of payment/delivery rights or obligations under qualified financial contracts entered into under a netting agreement or to which a netting agreement applies;
- b. calculation, estimation or adoption of an index of close-out or termination value, market value, liquidation value or any other relevant value, which may arise from a party's failure to enter into or perform a transaction under a netting agreement, where the rights and/or obligations of the parties under such netting agreement have been terminated, liquidated and/or accelerated under point (a) above;
- c. conversion of the values calculated or estimated under point (b) above into a single currency;
- d. determination of the net balance of values calculated under point (b) above to be paid or in respect of which an obligation may arise, as converted under point (c) above, whether by exemption, replacement or otherwise; and
- e. entry into an arrangement whereby the net amount calculated under point (b) above becomes payable directly or as part of either the (i) consideration for a specific asset or (ii) damages for non-performance of such transaction.

Netting Agreements

Under the Netting Law, netting agreements include:

- a. any agreement between two parties for netting of present or future rights to or obligations for payments or delivery, or transfer of title arising in connection with one or more qualified financial contract between the parties (a master agreement) or between parties to whom the agreement applies;
- b. any agreement providing for the netting of amounts due under two or more master netting agreements (a master netting agreement);
- c. any collateral arrangements such as credit support annexes or documents relating to or forming part of a master netting agreement or master agreement;
- d. any Shari'ah compliant agreement or arrangement which is intended

The Netting Law provides legal recognition for all qualified financial contracts, netting agreements and related collateral arrangements entered into by a person or entity in the UAE (other than persons and entities located in the DIFC and the ADGM, which have their own netting regimes).

to have a similar effect as the agreement or arrangements under points (a) through (c) above or any other netting agreement; and

- e. any agreements, contracts or transactions which fall within the definition of a qualified financial contract.

A netting agreement and all qualified financial contracts to which it applies will constitute a single agreement.

Qualified Financial Contracts

The Netting Law currently identifies 26 categories of agreements as qualified financial contracts (which create either a right to receive or an obligation to make a payment or delivery or to transfer title to assets/commodities for consideration) including (a) all types of swaps (in relation to currencies, interest rates, basis rates or commodities), forward rate agreements, currency or interest rate futures, currency or interest rate options, derivatives (relating to bonds, energy, bandwidth, freight, emissions and property index), securities contracts, collateral arrangements, commodities related contracts, (b) derivatives, agreements, contracts or digital asset transactions of the types under the other categories of qualified financial contracts, (c) any voluntary carbon credit derivatives, agreements, contracts or transaction or other types of carbon credit from the types of transactions under the other categories of qualified financial contracts, and (d) any Shari'ah compliant arrangement having an equivalent of the type of agreements and transactions under the other categories of qualified financial contracts.

The list of qualified financial contracts under the Netting Law may be reduced or expanded by the UAE Central Bank. This is a change from the Old Law, which contemplated the establishment of a Committee for Designation of Qualified Financial Contracts which would, amongst other things, determine the type of transactions that would constitute qualified financial contracts.

Collateral Arrangements

The Netting Law recognises collateral arrangements, including title transfer collateral arrangements (such as under repo transactions). Collateral arrangements are identified as mechanisms whereby collateral (including cash, securities, guarantees, letters of credit, repayment obligations and any other assets that are commonly used as security in the UAE) as security relating to or forming part of a netting agreement or qualified financial contracts including (a) security interest over collateral, (b) a collateral title transfer arrangement or (c) any obligation to provide collateral, letter of credit or repayment from one party to another party under a qualified financial contract.

The Netting Law provides that:

- a. Any sale, acquisition or liquidation of collateral under a collateral arrangement shall be enforceable without the need for any notice or consents from any person unless (i) the parties have agreed to such notice or consent requirements or (ii) UAE requires the sale, acquisition or liquidation to be effected in a fair commercial manner. The Netting law provides no guidance on what constitutes "fair commercial manner".
- b. Any direct transfer of collateral under a collateral title transfer arrangement shall be concluded in accordance with its terms and shall not be characterised as an insurance arrangement.

Financial institutions rely on close-out netting as a key tool for managing and mitigating credit and settlement risk associated with a variety of financial contracts, particularly over-the-counter derivatives trading.

No Gharar

Under UAE law, futures, margin trading and derivatives transactions were often viewed as potentially unenforceable due to perceived gharar, an unacceptable level of risk or uncertainty that undermines contract formation. In the past, UAE courts had held in some instances, that derivatives are unenforceable “contracts of risk,” even when used to manage risk (as in hedging contracts) rather than to create risk or to speculate. Even for Shari’ah compliant hedging products in the market (for example, the ISDA/IIFM Tahawwut Master Agreement), which are supported by fatwas confirming that such products are Shari’ah compliant and free of gharar, there was no certainty on how the courts would hold. The Old Law had minimised, if not entirely eliminated, these uncertainties by providing that qualified financial contracts shall not be void, unenforceable, or not final by reason of gharar under the UAE Civil Code – the Netting Law has retained this earlier position. Further, under the Netting Law if a party pledges that a qualified financial contract or any agreement relating to a qualifying financial contract is Shari’ah compliant, then the pledging party cannot refuse to perform its obligations under such qualified financial contract, on the basis that the qualified financial contract is no longer Shari’ah compliant, whether on account of a change in the interpretation of Shari’ah rules and principles or otherwise. This provision may have been added as a consequence of recent cases in the UAE, where issuers of Shar’ah compliant financial products (mostly Sukuk) refused to perform their obligations on the basis that these products (or the transitions thereunder) were no longer Shari’ah compliant.

Bankruptcy

Effective close-out netting can limit a party’s exposure to the insolvency of its counterparty, thus allowing sums owing to an insolvent party to be netted-off against sums owed by the insolvent party to the other party. Under the UAE Bankruptcy Law, a debtor and creditor may only set off obligations (i) if the conditions for exercising the setoff are satisfied before initiating procedures under the UAE Bankruptcy Law, (ii) if conducted as part of the implementation of a preventative settlement or restructuring procedure or (iii) as approved by the court.

The Netting Law provides that the provisions of a netting agreement shall be deemed final and enforceable (including against a third-party security provider, even if such third party becomes insolvent), even following the insolvency and/or bankruptcy of one of the parties thereto. The arrangements under a netting agreement may not be suspended, delayed or made conditional merely by the appointment of a liquidator or the initiation of bankruptcy proceedings or under any other law applicable to insolvent parties. Insolvency and/or bankruptcy proceedings will not affect the netting arrangements under a netting agreement or a qualified financial contract (or any other financial contract) to which a netting agreement applies. Similarly, the provisions of a netting agreement shall not be affected by any limitations on setoff or netting imposed under any insolvency or bankruptcy laws.

In case of procedures under the UAE Bankruptcy Law, the liquidator or trustee of a party to a netting agreement (the insolvent party) may annul, stop or refuse the performance of a transaction constituting a preference to a non-insolvent third party (the third party). For example, such a transaction could be the transfer of cash, assets, property or collateral from the insolvent party to the third party under a netting agreement. However, the liquidator or trustee may do so only on the basis of clear and convincing evidence that such third party entered into the transaction with the intention to prevent,

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hinder, delay debt recovery by a current or future creditor of the insolvent party or defraud the creditors of the insolvent party or any party that becomes a creditor as a result of the relevant netting agreement or qualified financial contract. There is no definition of “clear and convincing evidence” (a term that has no antecedent in UAE law), but the concept would appear to present a higher hurdle than a mere preponderance of evidence. Significantly, there are no other grounds in the netting law for a liquidator or trustee to fail to implement netting.

Multi-branch netting

In line with the 2018 ISDA Model Netting Act and Guide, the Netting Law has recognised multi-branch netting agreements (the MBNA) as netting agreements between two or more parties, one of whom must be a foreign party (*i.e.*, a party that is established, registered or regulated outside the UAE) under which a party can enter into qualified financial contracts through its home office (*i.e.*, the office in the country where it is established, registered or regulated (home country)) and one of its branches or agencies in countries other than its home country.

In the event of the insolvency of a foreign party’s branch/agency (the branch), its liability (or the liability of its liquidator in the UAE) to the non-insolvent counterparty (the solvent counterparty) shall be calculated on the date of the termination of the qualified financial contract under the MBNA and limited to the lesser of (i) the foreign party’s net payment obligations (as adjusted by any payments to the solvent counterparty and the fair market value of any collateral provided by the foreign party under the MBNA) or (ii) the branch’s net payment obligation. The foreign party’s net payment entitlement from the solvent counterparty (as adjusted by any payments made to the liquidator of the foreign party and the fair market value of any collateral provided by the solvent counterparty under the MBNA) shall be netted against the solvent counterparty’s net payment entitlement from the foreign party. The solvent counterparty may liquidate any collateral (provided under, and in accordance with the terms of, the MBNA) and apply the proceeds against settlement of sums due from the foreign party under any related qualified financial contracts. Any excess collateral shall be returned.

Conclusion

The Netting Law is a sign of the UAE’s continued desire to participate fully in international markets for financial services. The addition of agreements relating to digital asset transactions and carbon credit derivatives as qualified financial contracts also demonstrates the UAE’s commitment to stay at the forefront of market developments and allow UAE counterparties to take advantage of the full range of financial products available in the international markets.

Whilst the Netting Law provides that it shall override any conflicting laws, it remains to be seen how the Netting Law will be implemented by the courts in certain circumstances, including the sale or title transfer of collateral under a collateral arrangement, where the relevant collateral is subject to a conflicting security interest in favour of a third party (including security interest perfected through registration on the EIRC movables security register or otherwise). We will continue to report as these and other issues are addressed in the coming years. ■

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Afridi & Angell

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