



Jackson, Etti & Edu

**AN ASSESSMENT OF NETTING PROVISIONS UNDER  
THE COMPANIES AND ALLIED MATTERS ACT 2020**

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## INTRODUCTION

The Companies and Allied Matters Act 2020 (**'the Act'**), which repealed the Companies and Allied Matters Act, 1990, introduced several innovative developments to aid ease of doing business in Nigeria and improve the Nigerian financial market. One of such innovative developments is the introduction of provisions on netting in financial transactions.

Netting is a mechanism by which amounts payable between contracting parties are consolidated into a single payment from one party to another. As a reconciliation tool in structured finance, netting provides contracting parties, usually in derivative transactions, a means of mitigating credit and settlement risks by aggregating two or more obligations to achieve a reduced net obligation. Mutual payment obligations are aggregated so that the party owing the greater aggregate amount makes a net payment to the party owing the lesser aggregate amount.

There are different forms of netting; however, the forms mainly used in financial transactions are 'settlement netting' and 'close out netting'. Settlement netting provisions are used where contracting parties have mutual payment obligations under an executory contract to reduce the parties' payment obligations into one payment balance and discharge a single net payment obligation from one party to the other. The objective of settlement netting is to reduce settlement risk by netting off obligations so that the only obligation of the party with outstanding payment obligations is to pay a net balance. Settlement netting is only possible in respect of payments due in the same currency (or delivery of the same commodity) and on the same date.

Close-out netting provisions provide for the termination of all unmatured open executory contracts, valuation of the parties' respective liabilities, the gains and losses arising from the valuation are then aggregated and set off against each other to produce a single amount payable by one party to the other. The objective is to reduce exposures on open or executory contracts should one party become insolvent before the value date.

## BENEFITS OF NETTING

One crucial benefit of netting is the reduction or elimination of credit risk. This can be done by reducing an institution's capital adequacy costs related to funded credit protection exposures by enabling its regulatory capital requirements to be measured against the net rather than gross exposures.

Another benefit is the reduction of liquidity risk. As stated above, a close-out netting provision in an executory contract would typically provide for the termination of the contract before its value or settlement date. This can be used when an event of default occurs, such as the insolvency of one of the parties.

Other benefits are a reduction of settlement risk and a reduction of systemic risk. A robust netting system generally gives rise to a thriving derivatives market.



## THE LEGAL FRAMEWORK FOR NETTING IN NIGERIA

### Netting prior to the Enactment of the Act

Before the Act, there was no legislative framework or specific provisions for netting, and there were no judicial authorities on the subject. Nevertheless, parties to derivative contracts would typically rely on contractual provisions in their transactions containing netting mechanisms, hoping that the courts would enforce such provisions.

However, this did not provide enough comfort to the market as there were uncertainties with respect to the enforceability of netting provisions in contracts with Nigerian counterparties. Enforcement of close-out netting arrangements in the context of insolvency of a Nigerian party was challenging as the close-out netting provisions were subject to the mandatory provisions such as, the rules on fraudulent preference<sup>1</sup>, the discretion of the liquidator as to which contracts to honour or otherwise<sup>2</sup> and *pari passu* distribution under the repealed CAMA. These challenges slowed down the growth of the derivatives market in Nigeria.

### The Framework for Netting Under the Act

With the introduction of netting provisions under Chapter 28 of the Act, statutory backing is given to netting, particularly the enforcement of contractual provisions on netting.

Under the Act, the netting provisions are, to an extent benchmarked against the International Swaps and Derivative Association (ISDA) Master Agreement.

Netting is defined under the Act<sup>3</sup> as the occurrence of the following:

- (a) Termination, liquidation, or acceleration of any payment or delivery obligation or entitlement under one or more qualified financial contracts entered into under a netting agreement;
- (b) Calculation or estimation of a close-out value, market value, liquidation value, or replacement value in respect of each obligation or entitlement or group of obligations or entitlements terminated, liquidated, or accelerated under paragraph (a);
- (c) Conversion of any values calculated or estimated under paragraph (b) into a single currency; and
- (d) Determination of the net balance of the values calculated under paragraph (b), as converted under paragraph (c), whether by operation of set-off or otherwise.

A netting agreement is defined in the Act<sup>4</sup> as any:

- (a) 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 by the parties to the agreement (a "master netting agreement");

<sup>1</sup> Section 495 (1) of the Companies and Allied Matters Act 1990

<sup>2</sup> Section 499 of the Companies and Allied Matters Act 1990

<sup>3</sup> Section 718 of the Act

<sup>4</sup> *ibid*



- (b) Master agreement between two parties that provides for netting of amounts due under two or more master netting agreements (a "master-master netting agreement); and
- (c) Collateral arrangement related to or forming part of one or more of the foregoing.

### **Enforceability of Netting Arrangements**

Based on the definitions above, a key criterion for the enforcement of netting provisions under the Act is that the transaction in question must be a qualified financial contract within the scope of the Act.

The Act defines a 'qualified financial contract' to mean any form of financial contracts for which payment or delivery obligations are due to be performed at or within a certain time, including futures, forwards, options, swaps, collateral arrangement, amongst others<sup>5</sup>, and any other agreement, contract or transaction a financial regulatory authority designates as such.<sup>6</sup>

The implication of this is that the definition will also accommodate other forms of financial derivatives contracts not listed in the Act, and any other form of financial contract that may be developed in the future by financial regulatory authorities such as the Central Bank of Nigeria, the Securities Exchange Commission, the National Insurance Commission and other financial services sector regulators.

The Act also expands the categories of persons who may be covered under the provisions of the Act on the enforcement of netting provisions by broadening the scope of the definition of who a person and a party is to capture natural, corporate and statutory bodies, foreign entities, supranational and international organisations.

To ensure the enforceability of netting arrangements made under qualified financial contracts in the event of insolvency of one party, the Act<sup>7</sup> has accorded netting provisions in qualified financial contracts precedence over any action of a liquidator, any provision of law relating to bankruptcy, reorganisation, composition with creditors, receivership or any other insolvency proceeding or provision of law an insolvent party may be subject to, which may seek to prevent the enforcement of netting provisions. This is a departure from what was previously obtainable before the enactment of the Act.

Therefore, the provisions of the law in relation to the prohibition of payment of a net sum after the commencement of winding up<sup>8</sup>, the right of the liquidator to choose contracts to honour and which contracts to set aside<sup>9</sup>, provisions against preference and fraudulent transfers<sup>10</sup>, and the *pari passu* principle of insolvency, are now subject to the provisions on netting under the Act. Specifically in relation to fraudulent preference or transfer, section 721(6) of the Act provides that the liquidator of an insolvent party may not avoid (a) any transfer, substitution or exchange of cash, or collateral or any other interests under a netting agreement from the insolvent party to the non-insolvent party; or (b) any payment or delivery obligation incurred by the insolvent and owing to the non-insolvent party under a netting

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<sup>5</sup> *ibid*

<sup>6</sup> Section 719 of the Act

<sup>7</sup> Section 721(1) of the Act

<sup>8</sup> Section 576 of the Act

<sup>9</sup> Section 663 of the Act

<sup>10</sup> Section 658 of the Act



agreement on the grounds of it constituting a preference by the insolvent party to the non-insolvent party.

However, the exception to this general rule is that a liquidator may avoid the enforcement of such netting arrangement if there is clear and convincing evidence that the non-insolvent party made such transfer or incurred such obligation 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 that such transfer was made or such obligation was incurred.

## **CONCLUSION**

The statutory backing provided to netting mechanisms by the Act is a positive development. It is believed that the innovations introduced by the provisions of the Act will cure critical legal deficiencies that previously impacted the development of the derivatives market. The Act will stimulate a more robust and efficient derivatives market in Nigeria, a much-desired development, which will provide, amongst others, a wide range of risk management opportunities, enhanced market liquidity, improved price discovery, reduced risk capital charges, and transaction costs as well as increased financial markets stability.<sup>11</sup>

### ***Authors***

Folakemi Mogbojuri  
Okey Nnebedum

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<sup>11</sup> FMDQ, CAMA 2020 Netting Provisions: Game Changer for FMDQ Derivatives and Central Counterparty Agenda, Positions Nigerian Financial Market for Radical Transformation

## Key Contacts



**Fola Olusanya**  
Partner  
e: [folaulusanya@jacksonettiandedu.com](mailto:folaulusanya@jacksonettiandedu.com)



**Okey Nnebedum**  
Senior Associate  
e: [okeynnebedum@jacksonettiandedu.com](mailto:okeynnebedum@jacksonettiandedu.com)

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RCO Court 3-5, Sinari Daranijo Street,  
Victoria Island, Lagos, Nigeria.

t: +234 (1) 4626841/3, +234 (1) 2806989f: +234 (1) 2716889  
e: [jacksonettiedu@jacksonettiandedu.com](mailto:jacksonettiedu@jacksonettiandedu.com) [www.jacksonettiandedu.com](http://www.jacksonettiandedu.com)