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Which Law Applies?

A recent Bahraini case highlights the relevance of forum to choice of law

Market participants looking to engage in sales and trading transactions, such as swaps and repos, with emerging market counterparties rightly investigate whether the close-out and netting provisions in their contracts will be recognised and given effect in the jurisdiction of the relevant counterparty.

A recent Bahraini case is a timely reminder that, while the effectiveness of netting is certainly an important element to due diligence, it is by no means the only aspect to investigate. In particular, if the forum before which the case is likely to be heard will not recognise and apply the parties' choice of law, the claim may never get as far as close-out and netting.

The Bahraini case involved a claim brought by a bank in court proceedings in Bahrain to enforce payment of the amount due following operation of the close-out provisions of an ISDA Master Agreement entered into by it with a Bahraini corporate counterparty.

The facts were that:

- the counterparty had failed to make a payment;
- the bank had followed the procedure set down in the ISDA Master Agreement for calling an event of default and designating an Early Termination Date
- the bank had then delivered to the counterparty a notice specifying the amount payable by the counterparty and requiring the counterparty to pay it;
- the counterparty having failed to pay, the bank sought enforcement of the counterparty's payment obligation in proceedings in Bahrain; and
- the relevant ISDA Master Agreement was expressed to be governed by English law.

While the defendant raised a number of defences to the claim against it, we focus here on two particular points of note.

Although the defendant challenged the validity of provisions of the contract, the Bahraini court accepted that there was a valid contract between the parties and, indeed, accepted that the defendant was indebted to the bank.

However, the Bahraini court did not apply the contractually agreed choice of English law as the governing law of the contract. Instead, the court determined that Bahraini law applied and, therefore, that the validity and effect of the terms of the contract fell to be determined in accordance with Bahraini law rather than English law.

This resulted in the court concluding that, while there was a valid contract and while the bank was entitled to payment of the unpaid amounts which had already fallen due under the contract, nevertheless the bank was not entitled to claim in respect of the amounts representing sums that would have become payable in the future.

Indeed, the Bahraini court regarded the amount claimed in respect of future payments – the close-out amounts - as a penalty. As a result, the Bahraini court was not willing to order the defendant to pay the sum which the bank had determined to be due on close-out.

This case shows the importance - and the difficulties - of choice of forum and choice of law in emerging markets contracts, and the care that must be taken over these clauses, despite the temptation to treat them as part of the boilerplate.

In a similar situation, a bank could, for example, try to sue its Bahraini counterparty in the English courts on the basis of the standard jurisdiction provision in the ISDA Master Agreement. In these circumstances, the English courts would have applied the parties' choice of English law and, all other things being equal, would

Key issues

- Choice of forum is critical as forum will determine which law to apply
- Choice of English law as governing law of ISDA Master Agreements not applied by Bahraini courts
- Application of Bahraini law as governing law results in close-out provision not being effective
- Choice of forum clauses should be selected by parties in light of local law advice

have given judgment for the sum due as a result of the designation of the Early Termination Date. However, enforcing an English judgment in Bahrain would be a challenge. As a result, if the counterparty refused to pay the judgment debt voluntarily and had no assets in a location where an English judgment is enforceable (eg in the UK or other EU member states), the judgment would have been a worthless, if rather costly, piece of paper.

In these circumstances, the Bahraini courts are the obvious forum in which to pursue the claim. However, as the case shows, there are risks in doing so, and here the consequence has been the loss of much of the value in the contract because of the Bahraini courts' decision to apply their local law instead of English law.

There are other possible solutions to this dilemma. For example, taking collateral to support the counterparty's obligations and providing a resource out of which to be paid without the need to sue would be one option, although of course that approach would require investigation of the possibility of taking effective security and the practicality of enforcement. With impending regulatory requirements for margin for uncleared derivatives, this is an investigation which will presumably need to be more vigorously pursued in many cases in the future.

An alternative might be an arbitration clause, providing for arbitration in a jurisdiction that will uphold the parties' choice of law (eg London or Singapore). Bahrain is a party to the New York Convention on the recognition and enforcement of arbitral awards, and so an arbitration award against a Bahraini counterparty should in principle be enforceable in Bahrain. Of course even with arbitration, the local experience in enforcing arbitral awards is worth investigating, but at least the arbitrators should respect the parties' choice of law.

The bottom line is that the boilerplate provisions relating to dispute resolution are important, and parties are clearly better off if they can ensure that dispute resolution must take place in a forum that will uphold the parties' choice of law and give a judgment or award that is capable of enforcement against the counterparty's assets. And, as we said at the outset, if a claim is heard in a forum that does not recognise and apply the parties' choice of law, then a netting provision in the contract, no matter how robustly drafted, may prove of little value.

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