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Dear Sirs

EU Insolvency Regulation - Position Paper for the International Swaps & Derivatives Association on the Treatment of Set-Off

This paper sets out our views on the interpretation of the European Union Regulation on Insolvency Proceedings. The paper was commissioned by ISDA and considers how the protection for set-off in the Regulation should be interpreted, having regard to the policy behind the Regulation amongst other matters. However, the paper is not a formal legal opinion and should not be construed as representing any view on how the Regulation would, in fact, be interpreted by any court. Accordingly, specific advice should be sought in relation to particular matters and circumstances.

1. INTRODUCTION

1.1 It is difficult to overstate the significance of set-off rights for the wholesale financial markets. Contractual set-off arrangements play a vital role in reducing risk. Almost equally important is their contribution to increasing efficiency. The reduction of parties' gross exposure allows the more effective use of regulatory capital for regulated entities, extends the gross "credit" or exposure one party is prepared to assume to another; expands the number of counterparties with whom a party may be prepared to transact; and contributes to increasing the access of companies to, and accordingly the liquidity of, the wholesale financial markets.

1.2 These advantages explain the pervasive use of contractual set-off rights in financial market transactions and the steps that regulators and EU and national legislators have over many years taken to encourage and promote such use.

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1.3 In spite of these advantages, however, the enforceability of contractual set-off rights is not always beyond doubt. This is principally because the law governing insolvency proceedings may as a matter of policy refuse to recognize such rights. If this occurs, the benefits of set-off are removed in precisely the circumstances in which they are most needed.

1.4 The insolvency law policy of a number of EU countries is unfavourable to set-off. Some of the countries concerned have reflected the special role of set-off in the financial markets by introducing special protections from their normal insolvency rules. Such protective provisions are not, however, universal, nor are those that exist identical in scope and operation. Extensive legal opinions are sought to try to achieve a measure of certainty regarding the enforceability of set-off provisions.

1.5 The European Union Regulation on Insolvency Proceedings (*the “EUIR”*) and the Directives relating to the winding-up of insurance companies and of credit institutions (*“the Directives”*) offer a solution to these difficulties. They provide special protection for rights of set-off in the context of insolvency proceedings in cases where the set-off applies to a claim of the insolvent debtor which is governed by the law of a country other than the law of the State of the opening of the insolvency proceedings (*“the lex concursus”*). Where the law applicable to the insolvent debtor’s claim permits set-off, then it should be unnecessary to consider whether the *lex concursus* is favourable or unfavourable to rights of set-off.

1.6 This protection of rights of set-off from being undermined in EU insolvency proceedings provides vital support to the systemic and market benefits of set-off explained above. There is however a risk that the value of the protection will be impaired by doubts about its scope.

1.7 The key questions about the scope of the protection centre on the technique of “close-out netting”. Close-out netting provisions are routinely included in master agreements between financial market counterparties. Their purpose is to ensure that, if one party defaults, the other can crystallize its current and prospective exposures under a range of open transactions with the defaulting party into a single net amount owing from one party to the other.

1.8 Doubts about whether close-out netting is fully protected centre on the argument that the process of close-out involves elements in addition to set-off, such as early termination and acceleration of claims, which may themselves be contrary to mandatory insolvency law rules, and which are not covered by the protection. This argument involves, or is accompanied by, the argument that set-off and netting are two distinct concepts, and that the lack of protection specifically for netting indicates that close-out netting was not intended to be protected.

1.9 We believe these arguments to be misconceived. They would effectively remove protection from key financial instruments which play a vital role in modern financial

markets. If the arguments were correct, the EUIR and the Directives would fail to promote certainty of transactions and to protect the legitimate expectations of parties in an area where any doubt creates severe risk of systemic damage and impaired market efficiency. This result would be plainly at odds with the rationale underlying the set-off protection¹. Moreover, the arguments are in our view not supported by the wording of the EUIR and relevant preparatory materials².

1.10 The purpose of this paper is to set out those arguments which, in our view, support the case for the set-off protection in the EUIR encompassing close-out netting. These arguments are derived from the text of the EUIR itself and the preparatory materials for the EUIR, in particular the Virgos/Schmit report. As the EUIR was, in effect, an implementation of the Convention on Insolvency Proceedings, the Virgos/Schmit report should provide assistance in the interpretation of the EUIR³.

1.11 Like any significant new EU measure, particularly one in an important area not covered by existing EU legislation, the EUIR will inevitably leave scope for differences of interpretation until case law of the European Court of Justice has been built up. There may also be a risk, as a practical matter, that courts in different member states will tend to be influenced by the traditional policy approaches of their respective domestic insolvency laws, and that as a result the uniform effect which on fundamental grounds the EUIR should have throughout the Community will to some extent be undermined for a time. This possibility does not however lessen – indeed it underlines – the need to ascertain the correct interpretation of the EUIR, having regard to its wording, its purpose and the relevant preparatory materials. That is the purpose of this paper.

2. THE PROTECTION FOR SET-OFF

2.1 Under the EUIR the law of the State in which the main insolvency proceedings are opened (the *lex concursus*) governs the insolvency (Article 4). The State of the opening of proceedings will be the State where the debtor has its centre of main interests⁴.

2.2 Article 4 lays down the general rule that the *lex concursus* governs the insolvency proceedings and their effects, including “*the conditions for opening the proceedings, their conduct and their closure*”.

¹ See paragraph 3 below.

² See paragraph 4 below.

³ The European Court of Justice has referred to preparatory materials to assist in the interpretation of directive provisions (see, for example, *J.R. Bowden, J.L. Chapman and J.J. Doyle v Tuffnells Parcel Express Limited*. Case C-133/00, [2001] ECR I-7031).

⁴ Secondary proceedings may be opened in other States in which the debtor has an establishment.

2.3 Article 4(2) provides a non-exhaustive list of specific matters to be determined by the law of the State of the opening of proceedings. These include (Article 4(2)(d)) “*the conditions under which set-offs may be invoked*”.

2.4 The general application of the law of the State of the opening of proceedings is subject to certain exceptions set out in Articles 5 to 11 and 13 to 15⁵. The exception relevant for the purposes of this paper is that set out in Article 6, which provides as follows:

“1. *The opening of insolvency proceedings shall not affect the rights of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor’s claim.*

2. *Paragraph 1 shall not preclude actions for voidness, voidability or unenforceability as referred to in Article 4(2)(m).”*

2.5 It is clear from the opening words of Article 4 (“Save as otherwise provided in this Regulation”) that Article 6 qualifies the general rule on set-off in Article 4(2)(d). The relation between the two provisions can therefore be summarized as follows –

- (a) Article 4(2)(d) lays down the basic rule on the law governing insolvency set-off;
- (b) Article 6(1) then qualifies this rule to the extent that the insolvency set-off rules of the *lex concursus* would preclude a creditor from invoking a right of set-off in a case where set-off is permitted by the law applicable to the insolvent debtor’s claim. The reference here to the law applicable to the insolvent debtor’s claim is clearly a reference to the *contractual* governing law, which will be ascertained under the normal conflict of laws rules⁶⁷.

2.6 By way of example, if the insolvent debtor is an English company⁸ then the *lex concursus* will be English law. Rule 4.90 of the Insolvency Rules 1986 will therefore

⁵ Article 5 – Third parties rights in rem; Article 6 – Set-off; Article 7 – Reservation of title; Article 8 – Contract relating to immoveable property; Article 9 – Payment systems and financial markets; Article 10 – Contracts of employment; Article 11 – Effects on rights subject to registration; Article 13 – Detrimental acts; Article 14 – Protection of third-party purchasers; Article 15 – Effects of insolvency proceedings on lawsuits pending.

⁶ Within the EU, this will be determined by the Rome Convention on the Law Applicable to Contractual Obligations.

⁷ Although Article 6 provides a protection for set-off where this is permitted by the contractual governing law this should not be construed as limiting the protection only to contractual set-off. Article 6 should protect other forms of set-off where these are permitted by the law applicable to the insolvent debtor’s claim (for example, equitable set-off under English law). The focus of this paper is, however, on the protection for contractual set-off.

⁸ i.e., in this context, a company whose centre of main interests is in England.

govern the conditions for the application of insolvency set-off. If the English company has an agreement, which is governed by French law, with a French company, then French law will govern the contractual set off in a case where such a set-off is prohibited by Rule 4.90 but permitted under French law.

2.7 Conversely, if the insolvent debtor were the French company then Rule 4.90 would have no application, since the *lex concursus* would be French law. If the agreement were under English law, however, any rule of French insolvency law which would normally have precluded the English company from asserting a right of set-off available under the general rules of English law will not apply⁹ 10.

3. THE RATIONALE BEHIND THE ARTICLE 6 PROTECTION FOR SET-OFF

3.1 The preamble to the EUIR explains the rationale for the exceptions to the primacy of the *lex concursus* as follows:

*“Automatic recognition of insolvency proceedings to which the law of the opening State normally applies may interfere with the rules under which transactions are carried out in other Member States. To protect legitimate expectations and the certainty of transactions in Member States other than that in which the proceedings are opened, provisions should be made for a number of exceptions to the general rule.”*¹¹

3.2 The purpose of the exceptions is therefore to protect the expectations of a party which has entered into transactions with another entity which has since become insolvent. Such a party should be able to rely on the legitimate expectations as to its rights and obligations which it forms when it enters into a transaction, and should not have those expectations defeated by the subsequent application of the insolvency law of another State.

⁹ This conclusion is obviously dependent to an extent upon the issue considered by this paper, namely the scope of the set-off protection. The example is given to illustrate the relation between Article 4(2)(d) and Article 6(1).

¹⁰ Article 26 of the EUIR allows Member States to refuse to recognise insolvency proceedings opened in another Member State, or to enforce judgments handed down in the context of such proceedings, where the effects of such recognition or enforcement would be manifestly contrary to that State’s public policy. Unless the creditor obtained a judgment in insolvency proceedings in another Member State to uphold a contractual right of set-off, it is difficult to see that the *lex concursus* could rely upon this Article to defend its approach to set-off. However, it is possible that some Member States may regard Article 26 as the basis for a more general public policy argument to preserve their own approach to set-off. For the reasons set out in this paper we do not believe that such an interpretation of Article 6 is justifiable in the light of the policy and purposes of the EUIR.

¹¹ Preamble to the EUIR, paragraph 24.

3.3 Paragraph 26 of the preamble applies the general principle explained in paragraph 24 to the specific case of rights of set-off in the following terms:

“If a set-off is not permitted under the law of the opening State, a creditor should nevertheless be entitled to the set-off if it is possible under the law applicable to the claim of the insolvent debtor. In this way set-off will acquire a kind of guarantee function based on legal provisions on which the creditor can rely at the time when the claim arises.”

3.4 The Virgos/Schmit Report states the rationale behind the exceptions slightly more expansively:

“The application by the State of the opening of its law and the automatic extension of the effects of those proceedings to all Community Member States may interfere with the rules under which local market transactions are carried out in other States. For this reason, in the provisions governing the main proceedings, the Convention gives due attention to important local interests: protection of legitimate expectations and security of transactions.”¹²

3.5 The use in paragraph 26 of the preamble to the EUIR of the phrase “a kind of guarantee function” indicates that set-off is viewed as having a function analogous to that of security, and therefore as meriting a like degree of protection. This is reflected in the Virgos/Schmit Report, which uses the word “guarantee” both in relation to rights in rem -

“Rights in rem have a very important function with regard to credit and the mobilization of wealth. They insulate their holders against the risk of insolvency of the debtor and the interference of third parties. They allow credit to be obtained under conditions that would not be possible without this type of guarantee.”¹³;

and in relation to set-off –

“... set-off becomes, in substance, a sort of guarantee governed by a law on which the creditor concerned can rely at the moment of contracting or incurring the claim”¹⁴.

3.6 It is relevant to note that, both in paragraph 26 of the preamble to the EUIR itself¹⁵ and in the Virgos/Schmit report, the word in the French text corresponding to the English word

¹² Virgos Schmit report, paragraph 21.

¹³ Virgos/Schmit report, paragraph 97.

¹⁴ Virgos/Schmit report, paragraph 107.

“guarantee” is “garantie”. Unlike the English word, which would ordinarily refer to a merely personal obligation, the French word would naturally be taken in a wider sense as including proprietary rights of security.

3.7 It is therefore clear from the literal wording of the set-off protection in the EUIR, and the rationale for that protection in both the preamble and the Virgos/ Schmit report, that set-off should be regarded as akin to security. A party to a contract is entitled to rely upon a contractual right to set off its obligations against those of the debtor in the event of the debtor’s insolvency. Just as a secured creditor should not face the prospect of its security being ignored, a contracting party should not face the prospect of owing a gross obligation where the contract provides for set-off.

3.8 The need to protect the certainty of transactions and the legitimate expectations of parties, and in particular to respect the security function of rights of set-off, is particularly acute in the context of the financial instruments which typically incorporate close-out netting provisions. The gross underlying amounts outstanding under such instruments at any given time are so enormous that any doubts about the efficacy of the net calculation of exposures (which is dependent on the validity of close-out netting) would give rise to risks of systemic importance. Any doubt on this point would also be likely severely to damage the depth and liquidity of financial markets (because credit limits would be exhausted far more quickly), to increase dealing costs (because of the cost of capital and of providing alternative collateral) and to exclude weaker counterparties altogether from access to these products (since institutions may be unwilling to extend significant unsecured credit to weaker counterparties, and such counterparties may have no collateral capable of substituting, either in quality or in value, for effective rights of set-off). This would in turn have damaging consequential effects on the wider economy.

3.9 These concerns explain the adoption by supervisors of regulatory capital regimes which permit the net calculation of exposures if appropriate assurance that the relevant arrangements are legally robust is provided, and the enactment in a number of countries, and by the EU itself, of legislation specifically directed at providing a satisfactory level of legal certainty for close-out netting in key market instruments. It would therefore be extremely surprising if the EU, in incorporating into the EUIR and the Directives provisions for the protection of set-off expressly stated to be directed at reinforcing certainty of transactions and the legitimate expectations of parties, nevertheless worded the protections so as not to extend to close-out netting. A purposive approach to the interpretation of the EUIR and the Directives therefore points strongly to the conclusion that close-out netting is indeed covered by the protection.

¹⁵ *“La compensation devient ainsi une sorte de garantie regie par une loi par dont le créancier concerné peut se prévaloir au moment de la naissance de la créance.”*

4. CONTINGENT AND PROSPECTIVE CLAIMS: EARLY TERMINATION AND ACCELERATION

4.1 The concern that Article 6 of the EUIR may not protect close-out netting provisions rests principally on the argument that such provisions include elements which are not covered by the term “set-off” and which may themselves be contrary to mandatory insolvency rules of some EU member states. The argument is, therefore, that -

- (a) set-off is simply one element of close-out netting;
- (b) the protection in Article 6 covers the setting-off of mutual claims, but does not cover the early termination or acceleration and valuation of claims which often precede set-off in a close-out mechanism.

4.2 In our view, this approach is not correct, and the fact that items are at the onset of insolvency payable only at a future time, or subject to a contingency, does not deprive them of the protection of Article 6 where under the terms of the governing contract they become payable by virtue of the insolvency.

4.3 The issue is one of interpretation of the EUIR. We consider that the view expressed in paragraph 4.2 above is supported -

- (a) by the ordinary meaning of the words used and general principles of law;
- (b) by the views expressed in the Virgos/Schmit report, on the specific case of contingent and future claims;
- (c) by a comparison with other Community instruments; and
- (d) by consideration of the policy objective of Article 6.

4.4 “Set-off” in its ordinary meaning is a broad term, and there is nothing unnatural or stilted about a reference to the net settlement of reciprocal future or contingent claims as “set-off”. For example, insolvency set-off under English law expressly extends to items which are future or contingent claims at the time of the commencement of insolvency proceedings¹⁶.

4.5 In discussing the rationale for the protection for set-off, the Virgos/Schmit report provides an example of why set-off might not be permitted by the *lex concursus*: “*since it requires both claims to be liquidated, matured and payable prior to a certain date*”. The

¹⁶ Rule 4.90 of the Insolvency Rules 1986 and *Stein v Blake* [1996] AC.

Article 6 protection is therefore clearly intended to allow contractual set-off of contingent and future obligations where the law applicable to the insolvent debtor's claim permits this.

4.6 Support for the view that the term "set-off" is broad enough to describe the acceleration and net settlement of claims is also provided by the Directive on Financial Collateral Arrangements, which defines "close-out netting provision" as a financial collateral arrangement:

"which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise:

- (i) the obligations of the parties are accelerated so as to be immediately due and expressed as an obligation to pay an amount representing their estimated current value, or are terminated and replaced by an obligation to pay such an amount; and/or*
- (ii) an account is taken of what is due from each party to the other in respect of such obligations, and a net sum equal to the balance of the account is payable by the party from whom the larger amount is due to the other party."*

This clearly contemplates that "the operation of set-off" may include the acceleration of the parties' obligations. Set-off is not separated into two parts, acceleration and set-off, but is a process incorporating both elements.

4.7 There is, therefore, good justification for interpreting the set-off protection in Article 6 broadly to include all elements of close-out netting (and there is nothing inherent in Article 6 which would preclude this interpretation). Given this position, we believe that the correct interpretation is that which best gives effect to the purpose of the protection as outlined in the preamble to the EUIR and in Virgos/Schmit. The contractual mechanism for closing-out transactions and setting off the resulting sums acts precisely as a form of security. The taking of collateral, for example, by way of title transfer operates as a form of security only because the collateral taker knows that it can set off its obligation to redeliver collateral against the obligations of the other party should that party become insolvent. Consequently, and consistently with the interpretation of the Convention, set-off in the EUIR should in our view be interpreted as a single process incorporating early termination and acceleration of claims.

5. "SET-OFF" AND "NETTING"

5.1 A connected argument against the proposition that the Article 6 protection for set-off covers close-out netting is that set-off and netting are two distinct concepts; and that the absence of specific protection for "netting" in the EUIR indicates that close-out netting is not protected.

5.2 The Banks Winding-up Directive is referred to in support of this argument. In addition to the protection for set-off conferred by Article 23 of the Banks Winding-up Directive (which is in substantially the same terms as Article 6 of the EUIR), Article 25 provides that –

“Netting agreements shall be governed solely by the law of the contract which governs such agreements.”.

5.3 Were close-out netting intended to be protected by the EUIR, so the argument runs, a similar specific protection would have been included in the EUIR.

5.4 In so far as this argument relies solely on the meanings of the terms “set-off” and “netting”, we consider it difficult, and dangerous, to draw any firm conclusions from the various uses of the two terms. “Netting” is a newer term than set-off and, at least until recently, was primarily a commercial rather than a technical legal term. It is moreover clear that there is, at the least, substantial scope for overlap between the two terms.

5.5 In so far as it relies on the Banks Winding-up Directive, the argument is in our view fundamentally flawed. It implies the propositions that –

- (a) as a matter of interpretation of the Banks Winding-up Directive, the presence of the protection for “netting agreements” in Article 25 supports the conclusion that “set-off” in Article 23 has a narrow meaning¹⁷; and
- (b) a comparison between the two instruments supports the conclusion that the reference to “set-off” in Article 6 of the EUIR must have a similarly narrow meaning, even in the absence in the EUIR of a provision corresponding to Article 25 of the Banks Winding-up Directive.

5.6 The first of these propositions seems to us to be, at best, weak. There are a number of possible explanations for the inclusion of an additional protection for netting agreements. It is, for example, possible that the particular spur for the inclusion of Article 25 of the Banks Winding-up Directive was the desire to confer express protection on the class of netting arrangements, such as netting by novation, which would not otherwise be covered by the

¹⁷ It seems that, if the argument were carried to its logical conclusion, this would be a meaning that encompassed only those forms of set-off that would not be covered by the term “netting agreement” – essentially, therefore, non-contractual forms of set-off. This seems inconsistent with the wording of Article 6, which, by using the words “the law applicable to the insolvent debtor’s claim”, seems clearly to imply that contractual set-off is intended to be included. This is certainly the view of Virgos/Schmit – see paragraph 110: “The same rationale on which Article 5 is based explains that in the event of a contractual set-off agreement covering different claims between two parties, the law of the Contracting State applicable to that agreement will continue to govern the set-off of claims covered by the agreement and incurred prior to the opening of the insolvency proceedings”.

protection for set-off – a desire that would be natural when account is taken of the prevalence of netting by novation as a mechanism in the foreign exchange markets and the key role played by banks in those markets. But in any event, the argument that Article 25 shows that the draftsman intended a narrow scope for Article 23 loses all its force when one reflects that it is equally probable – in our view, indeed, a great deal more probable – that the draftsman inserted Article 25 out of caution and was unconcerned about the scope of any overlap or redundancy, since its effect would only be that provisions which were intended to be protected were clearly protected, whether under one or both articles.

5.7 The second proposition is in our view still more dubious. It offends against the fundamental principle that a legislative provision should be interpreted as a whole, and suffers from the additional defect that the provision which is alleged to be relevant to the meaning of the EUIR was enacted almost a year after it.

6. PROTECTION UNDER ARTICLE 13

6.1 Even if the argument were accepted that close-out netting consists of elements, such as early termination and acceleration, which are not covered by Article 6, we believe that there is a further argument that those provisions should be protected by the operation of Article 13. This states that:

“Article 4(2)(m) shall not apply where the person who benefited from an act detrimental to all the creditors provides proof that:

- the said act is subject to the law of a Member State other than that of the State of the opening of proceedings; and

- that law does not allow any means of challenging that act in the relevant case.”

6.2 The rationale behind Article 13 set out in the Virgos/Schmit report is similar to that for set-off itself, namely *“to uphold the legitimate expectations of creditors or third parties of the validity of the act [i.e. the act which would otherwise be declared void or unenforceable under Article 4(2)(m)] in accordance to the normally applicable national law, against interference from the lex concursus.”*

6.3 Accordingly, if the law of the State of the opening declares that contractual terms providing for early termination and acceleration of claims are unenforceable then, where those provisions are governed by and valid under the law applicable to the contract, a creditor should be able to advance Article 13 as a protection against claims of voidness or unenforceability (assuming also, of course, that there is nothing in the circumstances of the

specific case to allow the early termination or set-off to be challenged under the law applicable to the contract¹⁸).

6.4 If the narrow view of the Article 6 set-off protection were adopted, Article 13 would protect the legitimate expectations of the creditor who had signed up to a contractual agreement allowing the early termination and acceleration of claims.

7. THE EFFECT OF ARTICLES 6(2) AND 4(2)(M)

7.1 It is worth mentioning one further argument which is sometimes put forward for narrowing the protection accorded to set-off in the EUIR¹⁹. This centres on the effect of Article 4(2)(m), which provides that the *lex concursus* shall determine:

“the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all creditors”

7.2 As mentioned above, Article 6(2) provides that the protection for set-off in Article 6(1) will not preclude actions for voidness, voidability or unenforceability as referred to in Article 4(2)(m).

7.3 The argument goes thus: if, according to the *lex concursus*, a contractual set-off is void, Article 6(2) preserves the ability of the *lex concursus* to declare the provision void notwithstanding the protection in Article 6(1).

7.4 This argument is in our view misconceived, for two reasons.

7.5 First, it would render Article 6(1) largely, if not completely, devoid of application, since any rule of the *lex concursus* restricting the availability of set-off will, almost by definition, be a rule doing so on the basis that it constitutes “a legal act detrimental to all creditors”.

7.6 Since this result is clearly repugnant on any sensible purposive interpretation, it will in our view be adopted only if there is no plausible alternative explanation of the purpose and function of Article 6(2). In fact, however, there is no difficulty in formulating an alternative and much more reasonable explanation, namely that, in the absence of Article 6(2), a creditor who entered into an agreement with the insolvent debtor for the set-off of claims might argue that as a result he had absolute protection under Article 6(1) even where the agreement creating the right of set-off was itself vulnerable as a preference, for example

¹⁸ For example if the agreement itself were open to challenge on grounds of fraud or misrepresentation.

¹⁹ This argument narrows the protection for set-off further than simply distinguishing between set-off and netting. In fact, the effect of the argument is to remove the protection for set-off altogether.

because it was entered into in respect of pre-existing debts during a “suspect” period and with the intention on the part of the debtor of improving the position of the creditor.

7.7 This explanation is reinforced, if that were necessary, by a comparison with Article 5, which includes an identical qualification clearly designed to make it clear that a disposition giving rise to a right in rem is capable of being attacked as a preference.

7.8 Even if, contrary to our view, the wide interpretation of the effect of Article 6(2) suggested above were correct, it would still be overruled in cases where Article 13 applied.

7.9 Accordingly, if Article 4(2)(m) were held to result in a contractual set-off governed by the law of another Member State being declared void by the *lex concursus*, Article 13 would then operate to protect the set-off, provided that the set-off in the particular case could not be challenged under the law governing the set-off. In our view the circular nature of this process (protection under Article 6(1), removal under Article 4(2)(m) and reinstatement by Article 13) provides an additional argument against the broad interpretation of Article 6(2), since it introduces an element of complexity which surely cannot have been intended.

8. TO WHICH RULES OF THE CONTRACTUAL GOVERNING LAW DOES ARTICLE 6 REFER?

8.1 Article 6 uses the phrase “the law applicable to the insolvent debtor’s claim” without expressly stating whether this refers to the general rules of that law on set-off or refers to, or includes, that law’s insolvency rules.

8.2 In view of the rationale for the Article 6 protection as explained in paragraph 26 of the preamble, with its emphasis on the protection of rights acquired before insolvency, one would naturally expect the reference to be to general rules of law. This is supported in particular by the reference in paragraph 26 to set-off as having “*a kind of guarantee function based on legal provisions on which the creditor can rely at the time when the claim arises*²⁰.” Since at that time there will be no insolvency proceeding in prospect and therefore no question of the application of special rules of insolvency law, the clear implication is that the rules contemplated in Article 6 are those to which the creditor would have regard at that time, i.e. those of the general law.

8.3 This view is supported by paragraph 108 of the Virgos/Schmit report, which opens with the words –

²⁰ Underlining added. The phrase underlined is rendered in the French text as “*au moment de la naissance de la créance*” thereby making it clear that it refers to the time when the claim is incurred, rather than when it becomes due and payable (if later). This is reflected in the Virgos/Schmit report, which refers (paragraph 107) to “the moment of contracting or incurring the claim”.

“Set-off is a part of the law of obligations governed by the relevant rules of private international law regarding the law applicable to obligations.”²¹

8.4 It is, therefore, surprising that paragraph 109 of the Virgos/Schmit report refers to the Convention as “permitting the set-off according to the conditions established for *insolvency* set-off by the law applicable to the insolvent debtor’s claim” [emphasis added].

8.5 The only definite conclusion to be made on this point is that the law is unclear. In our view, however, the above reference – which seems to us to be inconsistent both with paragraph 26 of the preamble and with paragraph 108 of the Virgos/Schmit report itself – does not provide any good ground for questioning the view that the rules referred to in Article 6 are the general law rules of the contractual governing law of the debtor’s claim, not those of its insolvency law²²²³.

9. IS ARTICLE 6 TO BE READ AS CONFINED TO THE LAW OF A MEMBER STATE?

9.1 A further, and related, issue is the extent to which the “law applicable to the insolvent debtor’s claim” (ie the contractual governing law) must be the law of a Member State. If, for example, a debtor with its centre of main interests in a Member State has entered into an agreement containing a set-off provision governed by New York law will that law or the *lex concursus* govern the conditions for the applicability of set-off?

9.2 Unlike the other exceptions from the applicability of the *lex concursus* in Articles 5 to 15, Article 6 does not contain an express reference to the law of a Member State. It merely requires that “set-off is permitted by the law applicable to the insolvent debtor’s claim”. The applicability of non-Member State law would be consistent with the policy objectives for the set-off protection: namely to uphold the legitimate expectations of the parties at the time they

²¹ The paragraph then goes on to consider whether, given the existence of two claims that may have different contractual governing laws, the right of set-off should be regarded as stemming from the cumulative application of both laws or only from the law applicable to the insolvent debtor’s claim (the “passive” claim in a case where set-off is being asserted by the solvent counterparty). It notes that the latter alternative is adopted by [what was then] the Convention, but does not at that point consider the insolvency law rules of either of the two laws.

²² Of course, the general law rules of the contractual governing law may, as a matter of public policy, restrict the availability of set-off in a case where the debtor is insolvent, even where there are no insolvency proceedings governed by that law. Possibly an unspoken assumption that mandatory restrictions on the availability of set-off in relation to an insolvent counterparty will have this wider application explains the reference in paragraph 109 of the report.

²³ This is subject to one caveat. The insolvency rules of the law applicable to the insolvent debtor’s claim will be relevant where the insolvent debtor is subject to insolvency proceedings in the country the law of which is the contractual law governing set-off. In this case the general law will include the country’s insolvency rules. So, for example, where the law applicable to the insolvent debtor’s claim is French law and the insolvent debtor is subject to insolvency proceedings in France then French insolvency rules will apply.

enter into a contract. This position would also be consistent with the fact that the Rome Convention makes clear that a “contract shall be governed by the law chosen by the parties²⁴”, which need not be the law of a signatory to the Convention²⁵.

9.3 However, notwithstanding the absence of explicit reference to the law of a Member State, the Virgos/Schmit Report seems clear that Article 6 must be construed in a similarly restrictive way:

“The exceptions to the application of the law of the State of the Opening (Article 4) are referred to in Articles 5 to 15 of the Convention. Apart from Articles 6 and 14, which by systemic arguments must be interpreted in the same way, the exception is made in favour of the law of a “Contracting State”.”²⁶

9.4 The Report goes on to state that this does not necessarily mean that the law of the State of the opening must therefore apply in default of a Member State contractual governing law. However, in such a case the applicable law is not determined by the EUIR, but is left to Member States “to decide which rules they deem most appropriate”²⁷.

9.5 This position probably underlies the statements in paragraph 24 of the preamble to the EUIR:

“Automatic recognition of insolvency proceedings to which the law of the opening State normally applies may interfere with the rules under which transactions are carried out in other Member States. To protect legitimate expectations and the certainty of transactions in Member States other than that in which proceedings are opened, provisions should be made for a number of exceptions to the general rule.” [emphasis added].

9.6 It is arguable that a transaction may be regarded as being “in a Member State”, or carried out under the rules of a Member State, even if the governing law is that of a third country. The statement in Virgos/Schmit, would seem to suggest, however, that these phrases should be interpreted as limiting the protection for set-off in the EUIR to circumstances where the contractual governing law is also the law of a Member State. Notwithstanding the Virgos/Schmit statements there are clear policy reasons in favour of not

²⁴ Article 3(1) Convention on the Law Applicable to Contractual Obligations.

²⁵ Article 2 Convention on the Law Applicable to Contractual Obligations.

²⁶ Virgos Schmit Report, paragraph 93.

²⁷ Virgos Schmit Report, paragraph 93.

limiting the protection for set-off only to cases where the contractual governing law is that of a Member State²⁸.

10. CONCLUSION

10.1 Set-off rights are of particular significance to transactions in the financial markets. Indeed, it is arguable that there is no commercial sector where such rights are as important. Close-out netting rights are the most important of all forms of set-off in the financial markets, and perform a key role in promoting the stability and efficiency of those markets.

10.2 A narrow interpretation of Article 6, which distinguishes close-out netting from set-off and regards those elements of close-out netting, such as early termination and acceleration of claims, as outside Article 6 will rob the set-off protection of virtually any effect in financial market transactions.

10.3 There is nothing in the EUIR itself, or in the Virgos Schmit report, which compels this narrow interpretation. On the contrary, the broader interpretation is supported by the natural meaning of set-off, general principles of law and the views expressed in the Virgos/Schmit report. Most importantly, however, the broad interpretation is the one which best achieves the objectives of the Article 6 protection. The significance of this protection for a vital area of European Union commerce is, in our view, a powerful reason to accept the broad view of Article 6.

Yours faithfully



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²⁸ There appears to be a growing consensus amongst commentators for the view that the equivalent protection for set-off in Article 23 of the Winding-up Directive for Credit Institutions is not so limited.