PROTECTION FOR BILATERAL INSOLVENCY SET-OFF AND NETTING AGREEMENTS UNDER EC LAW

A REPORT BY THE

EUROPEAN FINANCIAL MARKET LAWYERS GROUP

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NOTICE

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REPORT ON PROTECTION FOR BILATERAL INSOLVENCY SET-OFF AND NETTING AGREEMENTS UNDER EC LAW

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EXECUTIVE SUMMARY

Various Community legal acts have sought to offer greater legal certainty to financial market participants on the enforceability of bilateral contractual set-off and netting agreements. These acts include in particular:

- Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings[2] (the 'Insolvency Regulation');
- Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions[3] (the 'Banks Winding-up Directive');
- Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings[4] (the 'Insurance Undertakings Winding-up Directive'); and
- Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements[5] (the 'Collateral Directive').

In this report the European Financial Market Lawyers Group (EFMLG) identifies various legal uncertainties on the enforceability of contractual set-off and netting agreements that result from certain provisions of the Insolvency Regulation, the Banks Winding-up Directive and the Collateral Directive. To resolve these uncertainties, we believe there is a pressing need for legislative clarification on the scope of protection for insolvency close-out netting arrangements under Community law.

The main reason for such legislative clarification is that it is deeply uncertain whether the set-off protection in Article 6 of the Insolvency Regulation encompasses close-out netting. As a result, the enforceability of close-out netting arrangements in insolvency proceedings concerning non-financial

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1 This report sets out the views of the European Financial Market Lawyers Group (EFMLG) on the interpretation of certain provisions in Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, OJ L 160, 30.06.2000, p. 1; Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, OJ L 125, 5.5.2001, p. 15, and Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L 168, 27.06.2002, p. 43. This report is not a formal legal opinion. Specific advice should be sought on specific matters and circumstances.

2 OJ L 160, 30.06.2000, p. 1.

3 OJ L 125, 5.5.2001, p. 15.

4 OJ L 110, 20.04.2001, p. 28.

5 OJ L 168, 27.06.2002, p. 43.

counterparties is unclear in many EU Member States[6]. Financial market participants and regulators consider it essential to have a high degree of certainty on the enforceability of contractual set-off and netting agreements in case a counterparty should default. The Community and the Basel Committee on Banking Supervision share this concern for certainty in view of the implications of the legal enforceability of set-off and netting agreements for the prudential supervision of credit institutions and the stability of the international financial system. Ensuring legal certainty would guarantee the necessary level of legal protection for key financial instruments, which play a vital role in modern financial markets. This would make transactions and the legitimate expectations of parties more certain in an area where any doubt creates severe risk of systemic damage and impaired market efficiency.

The protection for close-out netting provisions in the Collateral Directive is not sufficient to overcome this uncertainty, since the Collateral Directive applies only to close-out netting provisions in a financial collateral arrangement or an arrangement of which a financial collateral arrangement forms part. In addition, Member States may opt to exclude from the scope of the Collateral Directive financial collateral arrangements in which the collateral taker and the collateral provider do not both belong to one of the listed categories of financial institutions and public authorities. This potential exclusion could further reduce the protection for close-out netting provisions in financial collateral arrangements with non-financial counterparties.

Clarification is also required because the Community *acquis* on the enforceability of bilateral set-off and netting agreements is incoherent, due to the divergent approaches taken by the Community legislator to overcoming legal uncertainties on their enforceability. The main legal risks affecting the enforceability of set-off and netting agreements arise under the insolvency law applicable to a defaulting counterparty, rather than the governing law of the contract. The Collateral Directive correctly sought to overcome these risks by requiring Member States to ensure the enforceability of close-out netting provisions in financial collateral arrangements. By contrast, the Insolvency Regulation and the Banks Winding-up Directive sought to overcome the same risks by creating special conflict-of-law rules designed to circumvent the insolvency law applicable to the defaulting counterparty by ensuring that the governing law of the contract should determine the enforceability of set-off and netting agreements. We consider this conflict-of-law approach to overcoming legal risks unsatisfactory without general legislative recognition of such agreements. Indeed, this approach can create surprising results that are contrary to the expectations of parties, thus replacing one form of legal uncertainty with another. We consider that the Collateral Directive's approach to the enforceability of insolvency set-off and netting agreements is conceptually preferable to the approach in the Insolvency Regulation and the Banks Winding-up Directive.

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[6] This report focuses on the EU Member States before the accession of the 10 new members on 1 May 2004. The legal situation regarding netting and the respective legislative background in the new Member States is the subject of a separate specific analysis by the EFMLG.

Ideally, we would support an EU legal act on close-out netting. Such a legal act would deal with inconsistencies between the considerable body of netting legislation that exists at the level of the Member States by providing criteria by which a Member State can assess whether its own netting legislation is adequate against EU standards. However, we recognise that this proposal might not be feasible at present in view of the legislative agenda of the Commission following the Financial Services Action Plan (FSAP). We note, however, that a possible review of the conflict-of-law provisions in Article 9 of the Collateral Directive in the light of the Hague Convention of 13 December 2002 on the law applicable to certain rights in respect of securities held with an intermediary, might offer an opportunity to address this issue as well. We would urge the Commission to take advantage of such a review process, which will involve discussions in the European Parliament and the EU Council, to also amend and expand the Collateral Directive's close-out netting provisions.

Without prejudice to other possible legislative solutions, including a possible EU legal act on close-out netting, we recommend that the definition of 'close-out netting provision' in Article 2(1)(n) of the Collateral Directive be amended as follows:

> '(n) "close-out netting provision" means a provision of a**n[**]arrangement, **whether** or **not such** arrangement **forms part** of[ ]a financial collateral arrangement[,] or, in the absence of any such provision, any statutory rule by 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.'

Also, consistent with this amendment, we recommend that recital 14 of the Collateral Directive be amended as follows:

> 'The enforceability of bilateral close-out netting should be protected, not only as an enforcement mechanism for title transfer financial collateral arrangements including repurchase agreements but more widely[]. Sound risk management practices commonly used in the financial markets should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of **any** []collateral **provided**.'

I. Introduction

1. Contractual set-off and netting agreements play a vital role in reducing risks and enhancing efficiency in the increasingly integrated European, and indeed global, financial markets. The reduction of parties' gross exposures allows the more effective use of regulatory capital for regulated entities, extends the transaction volumes one party is prepared to assume towards another, increases the number of counterparties with whom a party may be prepared to transact and contributes to increasing access to, and accordingly the liquidity of, the wholesale financial markets.

2. These advantages explain the widespread use of contractual set-off and netting agreements by European financial market participants, including various master agreements governed by the laws of England,[7] France,[8] Germany,[9] Spain[10] and other jurisdictions inside and outside the EU

[7] English law-governed master agreements include the International Swaps and Derivatives Association (ISDA) Master Agreement, which may also be governed by New York law; The Bond Market Association (TBMA)/ International Securities Markets Association (ISMA) Global Master Repurchase Agreement; several master agreements for foreign exchange transactions sponsored by the New York Foreign Exchange Committee, in association with the British Bankers' Association, the Canadian Foreign Exchange Committee and the Tokyo Foreign Exchange Market Practices Committee (i.e., the International Foreign Exchange Master Agreement (IFEMA); the International Currency Options Master Agreement (ICOM) and the International Foreign Exchange and Options Master Agreement (FEOMA), which agreements may also be governed by Japanese or New York law); several master agreements for securities lending transactions sponsored by the International Securities Lending Association (ISLA) (i.e., the Global Master Securities Lending Agreement (GMSLA), the Overseas Securities Lender's Agreement (OSLA), the Master Equity & Fixed Interest Stock Lending Agreement (MEFISLA) and the Master Gilt Edged Stock Lending Agreement); and the multi-jurisdictional, multi-lingual and multi-product Master Agreement for Financial Transactions (EMA) sponsored by the Banking Federation of the European Union, in cooperation with the European Savings Banks Group and the European Association of Cooperative Banks.

[8] French law-governed master agreements include the Association française des banques (AFB) Convention-Cadre relative aux Opérations de Marché à Terme (master agreement for foreign exchange and derivative transactions); the Association du Forex et des trésoriers de banque (AFTB) Convention-Cadre relative aux Opérations de Pension Livrée (master agreement for repurchase transactions); the Association française des professionels de titres (AFTI) Contrat Cadre de Prêts de Titres (master agreement for securities loans); and the multi-jurisdictional, multi-lingual and multi-product Convention-Cadre relative aux Opérations sur Instruments Financiers (Master Agreement for Financial Transactions) sponsored by the Banking Federation of the European Union, in cooperation with the European Savings Banks Group and the European Association of Cooperative Banks.

[9] German law-governed master agreements include several master agreements sponsored by the representative German banking associations, such as the Rahmenvertrag für Finanztermingeschäfte (master agreement for financial derivative transactions); the Rahmenvertrag für Pensionsgeschäfte (master agreement for repurchase transactions) and the Rahmenvertrag für Wertpapierleihgeschäfte (master agreement for securities loans); and the multi-jurisdictional, multi-lingual and multi-product Rahmenvertrag für Finanzgeschäfte (Master Agreement for Financial Transactions) sponsored by the Banking Federation of the European Union, in cooperation with the European Savings Banks Group and the European Association of Cooperative Banks.

[10] Spanish law-governed master agreements include the Associación Española de Banca Privada (AEB) Contrato Marco de Operaciones Financieras (master agreement for financial transactions); and the multi-jurisdictional, multi-lingual and multi-product Contrato Marco Europeo (CME) para Operaciones Financieras (Master Agreement for Financial Transactions) sponsored by the Banking Federation of the European Union, in cooperation with the European Savings Banks Group and the European Association of Cooperative Banks.

(e.g., New York[11]). Indeed, an enormous volume of financial market transactions, including swap, derivative, foreign exchange, repurchase and securities lending transactions, are documented under agreements containing such contractual set-off and netting arrangements.

3. In spite of the widespread use of contractual set-off and netting agreements, however, the enforceability of contractual set-off and netting rights is sometimes uncertain. This is mainly because the law governing insolvency proceedings may, as a matter of policy or tradition, refuse to recognise such rights. If this occurs, the benefits of set-off and netting agreements are undermined in circumstances when they are most needed. The insolvency law policy of several Member States is unfavourable to set-off and netting agreements. Many have reflected the special role of set-off and netting in the financial markets by introducing special exceptions to their normal insolvency rules. Such protective provisions are not, however, universal, nor are those that exist identical in scope and operation.

4. Financial market participants and regulators consider it essential to have a high degree of legal certainty on the validity and enforceability of contractual set-off and netting agreements in case a counterparty should default. The EU and the Basel Committee on Banking Supervision share this concern for legal certainty in view of the implications of the legal enforceability of set-off and netting agreements for the prudential supervision of credit institutions and the stability of the international financial system. Consistent with the approach of the Basel Capital Accord,[12] Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions[13] provides that the national authorities competent to supervise credit institutions may recognise bilateral agreements between a credit institution and its counterparty for contractual netting as risk-reducing only under the following conditions:

   (i) a credit institution must have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, so that, in the event of a counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the credit institution would have a claim to receive or an

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[11] New York law-governed master agreements used by financial market participants in the EU include the International Swaps and Derivatives Association (ISDA) Master Agreement; and the master agreements for foreign exchange transactions sponsored by the New York Foreign Exchange Committee (i.e., the International Foreign Exchange Master Agreement (IFEMA), the International Currency Options Master Agreement (ICOM) and the International Foreign Exchange and Options Master Agreement (FEOMA)).

[12] See Basel Committee on Banking Supervision, Basel Capital Accord: Treatment of Potential Exposure for Off-Balance Sheet Items (Publication No. 18, April 1995), published at http://www.bis.org/publ/bcbs18.htm.

[13] Annex III (The treatment of off-balance sheet items), Part 3 (Contractual netting (contracts for novation and other netting agreements)), OJ L 126, 26.05.2000, p. 1.

obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions;

(ii) a credit institution must have made available to the competent authorities written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (i), find that the credit institution's claims and obligations would be limited to the net sum, as described in (i), under: - the law of the jurisdiction in which the counterparty is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located, - the law that governs the individual transactions included, and – the law that governs any contract or agreement necessary to effect the contractual netting; and

(iii) a credit institution must have procedures in place to ensure that the legal validity of its contractual netting is kept under review in light of possible changes in the relevant laws.

5. Extensive legal opinions are commissioned by financial market participants (acting collectively through trade bodies) to achieve greater certainty and regulatory recognition on the enforceability of contractual set-off and netting agreements under the laws of all the original 15 Member States of the EU. Similar legal opinions have been commissioned under the laws of some of the 10 new Member States, and it may be reasonably expected that an extensive collection of legal opinions will be commissioned in all the new Member States.

6. Various Community legal acts have sought to offer greater legal certainty to financial market participants on the enforceability of contractual set-off and netting agreements; in particular, the Insolvency Regulation, the Banks Winding-up Directive, the Insurance Undertakings Winding-up Directive and the Collateral Directive.

7. In this report the EFMLG identifies various legal uncertainties on the enforceability of contractual set-off and netting agreements that have been created by certain provisions of the Insolvency Regulation, the Banks Winding-up Directive and the Collateral Directive. We consider that the best means of resolving these uncertainties would be legislative clarification at Community level.

II. Insolvency Regulation

8. The Insolvency Regulation applies to collective insolvency proceedings which entail the partial or total divestment of a debtor and the appointment of a liquidator, but does not apply to insolvency proceedings concerning insurance undertakings, credit institutions, investment undertakings that provide services involving the holding of funds or securities for third parties, or to collective investment undertakings.[14] The Insolvency Regulation is directly applicable in all Member States except Denmark.[15]

9. Under the Insolvency Regulation the law of the Member State in which insolvency proceedings are opened - the *lex concursus* - governs the insolvency. The courts of the Member State where the centre of a debtor's main interests is situated has jurisdiction to open insolvency proceedings.[16]

10. Article 4(1) of the Insolvency Regulation lays down the general rule that the law applicable to insolvency proceedings and their effects shall be that of the Member State within the territory of which such proceedings are opened, referred to as the 'State of the opening of proceedings'.

11. Article 4(2) of the Insolvency Regulation states that the law of the State of the opening of proceedings shall determine the conditions for the opening of those proceedings, their conduct and their closure. Article 4(2) sets out a non-exhaustive list of specific matters to be determined by the law of the State where proceedings are opened. These include (Article 4(2)(d)) 'the conditions under which set-offs may be invoked'.

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[14] See Insolvency Regulation, Article 1. For the purposes of the Regulation, insolvency and winding-up proceedings mean the proceedings listed in Annexes A and B of the Regulation, which identify the specific insolvency proceedings covered by the Regulation in 13 of the 15 EU Member States. See Insolvency Regulation, Article 2(a) & Annexes A & B.

[15] As noted in the thirty-third recital of the Insolvency Regulation, in accordance with Articles 1 and 2 of the Protocol on the position of Denmark annexed to the Treaty on European Union and the Treaty establishing the European Community, Denmark is not participating in the adoption of the Regulation, and is therefore not bound by it nor subject to its application. In accordance with Article 44(3) of the Insolvency Regulation, the Regulation shall not apply: (a) in any Member State, to the extent that it is irreconcilable with the obligations arising in relation to bankruptcy from a convention concluded by that State with one or more third countries before the entry into force of the Regulation; or (b) in the United Kingdom of Great Britain and Northern Ireland, to the extent that is irreconcilable with the obligations arising in relation to bankruptcy and the winding-up of insolvent companies from any arrangements with the Commonwealth existing at the time the Regulation enters into force.

[16] See Insolvency Regulation, Articles 3(1), 4(1). Secondary proceedings may be opened in other Member States in which the debtor possesses an establishment. See Insolvency Regulation, Article 3(2), (3).

12. 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 15 of the Insolvency Regulation.[17] The exception relevant for the purposes of this report is that set out in Article 6, 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).'

13. It is clear from the opening words of Article 4 of the Insolvency Regulation ('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 summarised 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 rules governing contractual obligations.[18]

14. As noted above, the protection of rights of set-off and netting from being undermined in insolvency proceedings in EU Member States provides vital support to financial markets and the financial system. Yet there is a risk that the value of the protection will be impaired by doubts about its scope. The key questions about the scope of the set-off protection in the Insolvency Regulation are linked to 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 party can convert 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.

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[17] 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.

[18] The Rome Convention on the Law Applicable to Contractual Obligations.

15. Doubts about whether close-out netting is fully protected by the Insolvency Regulation 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 therefore covered by the protection for set-off in the Insolvency Regulation. This argument involves, or is accompanied by, the argument that set-off and netting are two distinct legal concepts, and that the lack of specific protection for netting in the Insolvency Regulation indicates that it did not intend to protect close-out netting.

16. This report attempts to set out those arguments which, in our view, are relevant to whether set-off protection under the Insolvency Regulation encompasses close-out netting. Following the techniques deployed by the European Court of Justice (ECJ), these arguments are derived from the text of the Insolvency Regulation itself, the text of other Community legal acts, the recitals of the Insolvency Regulation and the *travaux préparatoires* (preparatory work) on the Insolvency Regulation.

II.1 Textual and comparative law interpretation of the term 'set-off' as used in Article 6 of the Insolvency Regulation

17. The term 'set-off' as used in Article 6 of the Insolvency Regulation is not defined. Consistent with the case-law of the ECJ, in the event of doubt, a particular provision of Community law should be interpreted and applied in the light of the versions existing in the various languages.[19] In this regard, it has been recognised, in the specific context of the interpretation of the Insolvency Regulation, that it is certainly appropriate, where key concepts are concerned, that they are considered in alternative language versions.[20] Therefore we have reviewed the term 'set-off' as used in the original 11 equally authentic language versions of the Insolvency Regulation to ascertain whether the concept of insolvency set-off in the Insolvency Regulation encompasses the technique of insolvency close-out netting. In this regard, we have also taken into account corresponding terms used in related provisions of Community law.

18. In addition to considering the different linguistic versions of Article 6 of the Insolvency Regulation and related provisions of Community legal acts, we have made a comparative

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[19] See, e.g., Case 9/79 *Koschninske* v *Raad van Arbeid* [1979] ECR 2717, 2724; Case 372/88 *Cricket St Thomas* v *Milk Marketing Board of England and Wales* [1990] ECR 1345, 1376; Case 64/95 *Lubella* v *Hauptzollamt Cottbus* [1996] ECR 5105, 5133; see also, e.g., Case 29/69, *Stauder* v *Stadt Ulm*: [1969] ECR 419, 424; Case 55/87, *Moksel* v *BALM* [1988] ECR 3845, 3871; Case 372/88 *Cricket St Thomas* v *Milk Marketing Board of England and Wales* [1990] ECR 1345, 1376.

[20] See The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide (G. Moss, I. Fletcher & S. Isaacs, eds., 2002), p. 26.

national legal analysis of the various texts as an aid to interpreting Article 6 of the Insolvency Regulation. Where Community law uses terms or concepts that are well known in national laws, without itself defining them, ascertaining an autonomous Community meaning of a legal term or concept may involve a comparison of the relevant national laws.[21]

Danish text

19. In recital 26 and Article 6 of the Danish version of the Insolvency Regulation, set-off has been translated as *modregning*. In Community legal acts the term *netting* has been consistently translated using the English word netting, including in connection with other words, e.g., *slutafregning* (close-out netting), rather than *modregning*.

20. From the perspective of Danish law, as established in case law and as provided in the general provisions of the Danish Insolvency Act, the concept of *modregning* is in certain respects wider and in certain respects narrower than the concept of *netting*. In particular, *modregning* is not necessarily based on a contractual agreement, whereas *netting* is. t can be argued that close-out netting agreements are a specific type of agreed *modregning* under Danish law. However, insofar as there is a difference in the Danish Insolvency Act between the right to set-off (*modregning*) and the right to terminate a contract, it could also be argued that the concept of *modregning* does not encompass insolvency close-out netting.

21. In conclusion, it is difficult to reach a definitive legal conclusion on the proper meaning of the term *modregning* as used in the Danish version of Article 6 of the Insolvency Regulation. A comprehensive treatment of this issue is set out in Annex 1 to this report.

Dutch text

22. The equivalent Dutch term for set-off as used in Article 6 of the Insolvency Regulation is *verrekening*.

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[21] See, e.g., Case 3/54, *ASSIDER* v *High Authority*: [1954-56] ECR 63, opinion of Advocate General Lagrange; *Case 29/76, LTU* v *Eurocontrol*: [1976] ECR 1541, opinion of Advocate General Reischl; Case 814/79; *Netherlands* v. *Rüffer*: [1980] E.C.R. 3807, opinion of Advocate General Warner.

23. Set-off has traditionally been translated in Dutch as *schuldvergelijking* and netting by *verrekening*. While this might imply that 'set-off' as used in Article 6 of the Insolvency Regulation should be understood as 'netting', there are several strong arguments, based on Belgian and Dutch law as well as the Dutch versions of Community legal acts, supporting the conclusion that, in Dutch, the terms *verrekening* (netting) and *schuldvergelijking* (set-off) may be used interchangeably.

24. As a matter of both Dutch and, more clearly, Belgian law, while the terms netting and set-off express the same legal concept, this concept is different from close-out netting, which includes an additional element of termination.

25. In conclusion, it does not appear that the reference to *verrekening* in the Dutch text of Article 6 of the Insolvency Regulation covers insolvency close-out netting. A more comprehensive treatment of this issue is set out in Annex 2 to this report.

English text

26. The English text of the Insolvency Regulation refers to the term 'set-off' in Article 6.

27. The English text of the Collateral and Winding-up Directives provide some support for the view that the term 'set-off' is broad enough to describe the acceleration and net settlement of claims that forms part of the close-out netting procedure. However, the English text of the Collateral Directive also supports the view that the overlapping concepts of close-out netting and set-off are in certain respects distinctive legal concepts. From one perspective the English text of the set-off and netting provisions of the Banks Winding-up Directive offers some support for the interpretation that set-off provides the general legal framework within which the contractual technique of netting operates. From another perspective, however, these provisions could also be seen as distinguishing between the concepts of insolvency set-off and insolvency close-out netting.

28. The contractual technique of insolvency close-out netting used in some master agreements (e.g., the TBMA/ISMA Global Master Repurchase Agreement) is constructed on the basis of the traditional legal concept of set-off known to English law for centuries. As a matter of English law, insolvency set-off can thus be properly regarded as providing the general legal framework within which financial market participants deploy the particular contractual technique of

insolvency close-out netting in these master agreements to reduce the effective level of their obligations following counterparty insolvency. However, in the case of executory contracts to deliver property or money, insolvency close-out netting has been said to involve a legal process beginning with the rescission or termination of all open or unmatured contracts with the insolvent counterparty followed by the set-off of the resulting losses and gains over the whole series of mutual contracts. Also, for other master agreements insolvency close-out netting is more properly analysed on the basis of a 'flawed assets' theory under English law, rather than on the traditional basis of insolvency set-off. From this perspective, the net obligation derived from applying the close-out netting provisions of certain master agreements (e.g., the ISDA and EMA forms of master agreement) can be viewed as a product of mere accounting, and not the result of a set-off of claims resulting from those transactions.

29. Irish law conceives of netting as a broader legal concept than set-off, encompassing a three-step process: (1) the termination of financial contracts; (2) assessing the termination values of those contracts; and (3) setting off these termination values to arrive at a net amount due by one party to the other.

30. In conclusion, based on Community legal acts and applicable national laws, a credible argument can be made that 'set-off' as used in the English version of Article 6 of the Insolvency Regulation should be interpreted to encompass insolvency close-out netting arrangements. However, counter-arguments can be made, and it is difficult to predict with legal certainty how the concept of 'set-off' referred to in the English version of Article 6 of the Insolvency Regulation should be interpreted. A comprehensive treatment of this issue is set out in Annex 3 to this report.

Finnish text

31. The Finnish term used as an equivalent to the English term 'set-off' in Article 6 of the Insolvency Regulation is *kuittaus*.

32. The consistent usage of the terminology '*kuittau*' for 'set-off' and *nettoutus* for 'netting' in different Community legal acts may imply that these two terms are treated as two different concepts. However, the preparatory works of the new Finnish Bankruptcy Act make it fairly clear that the Finnish legislator appears to treat netting (*nettoutus*) as a special form of set-off (*kuittaus*), which relates to claims referred to in the Finnish Netting Act. So, in this context 'set-off' and 'netting' are practically synonymous.

33. In conclusion, based on Finnish insolvency law it would appear that *kuittaus* as used in Article 6 of the Finnish version of the Insolvency Regulation may be properly interpreted to encompass insolvency close-out netting. A comprehensive treatment of this issue is set out in Annex 4 to this report.

French text

34. The equivalent French term for 'set-off' as used in Article 6 of the Insolvency Regulation is *compensation*.

35. The consistent usage of the term *compensation* to refer to the related English concepts of set-off and netting in the French versions of various Community legal acts may imply that the reference to *compensation* in Article 6 of the Insolvency Regulation covers both insolvency set-off and insolvency close-out netting. However, from the perspective of French, Belgian and Luxembourg law, close-out netting appears to embrace two, if not three, distinctive concepts or stages. The first stage in the close-out process involves termination (*résiliation*), which may be accomplished through explicit termination clauses (*clauses résolutoires expresses*). The second stage involves valuation (*évaluation*). The third stage involves set-off (*compensation*). Based on this analysis, the concept of *compensation* may not be construed to cover the entire close-out netting procedure.

36. In conclusion, the reference to *compensation* in the French text of Article 6 of the Insolvency Regulation does not appear to cover insolvency close-out netting. A comprehensive treatment of this issue is set out in Annex 5 to this report.

German text

37. The German term used as the equivalent to the English term 'set-off' in Article 6 of the Insolvency Regulation is *Aufrechnung*.

38. A comparison between the usage of *Aufrechnung* in German and Austrian law and relevant Community legal acts seems to imply that *Aufrechnung* is used in a broader sense in Community law than it is used in national legislation. Statutory legislation in Germany uses

Aufrechnung (or the correspondent terminology (*Kompensation*) in Austria) as being limited to statutory set-off, although under the principles of contractual freedom and party autonomy, the term also appears to recognise contractual set-off arrangements (Aufrechnungsvereinbarungen), which do not necessarily have to comply with statutory limitations. The borderlines between contractual set-off arrangements and netting might be fluid. The Community law usage is covering a broad range of legal concepts. Yet the Community law references to *Aufrechnung* are not entirely consistent between the various legal acts (in particular the Settlement Finality Directive, the Collateral Directive and the Banks Winding-up Directive) and may denote 'traditional' statutory set-off as well as various categories of contractual set-off arrangements and netting (netting agreements, close-out netting, settlement netting), depending on the specific context.

39. In conclusion, an analysis of Community legal acts in their German version does not enable us to establish an unambiguous meaning of set-off/*Aufrechnung* that would allow us to determine whether, in the context of the Insolvency Regulation, the use of set-off/*Aufrechnung* encompasses close-out netting or not. A comprehensive treatment of this issue is set out in Annex 6 to this report.

Greek text

40. The Greek term used as the equivalent for the English term 'set-off' in the Insolvency Regulation is *sympsiphismos* («συμψηφισμός»).

41. The term *sympsiphismos*, as used in Greek law and the relevant Community legal acts, covers both the related English legal concepts of insolvency set-off and insolvency close-out netting.

42. In conclusion, based on Greek law and the Greek versions of various Community legal acts, it would appear that the term *sympsiphismos*, as used in Article 6 of the Greek version of the Insolvency Regulation, may be properly interpreted as encompassing insolvency close-out netting. A comprehensive treatment of this issue is set out in Annex 7 to this report.

Italian text

43. The equivalent Italian term for 'set-off' as used in Article 6 of the Insolvency Regulation is *compensazione*.

44. The same word - *compensazione* - is used to describe both set-off and netting in the Italian version of the Insolvency Regulation. While the Collateral Directive also implies that the Italian term *compensazione* is understood to embrace both netting and set-off, the Banks Winding-up Directive indicates that netting in the Italian language text of the Banks Winding-up Directive has an overlapping, yet in certain respects distinctive, meaning as compared to set-off, since set-off is translated as *compensazione*, and netting encompasses both *compensazione* and *novazione*, which are distinctive legal concepts under Italian law.

45. Italian insolvency law appears to distinguish between the termination of transactions against an insolvent party and the calculation of the close-out amounts and consequential set-off or *compensazione* of those amounts.

46. In conclusion, from an Italian insolvency law perspective, the reference to *compensazione* in Article 6 of the Insolvency Regulation would not appear to encompass the full process of insolvency close-out netting, beginning with the termination of the agreement following default or insolvency, continuing with the calculation of the close-out amount and culminating in the set-off of the resulting amounts. A more comprehensive treatment of this issue is set out in Annex 8 to this report.

Portuguese text

47. The corresponding Portuguese term for 'set-off' in Article 6 of the Insolvency Regulation is *compensação*.

48. A comparison between the usage of the terms *compensação* in Portuguese law and relevant Community legal acts seems to imply that the term *compensação* is used in a rather vague and imprecise manner both in Community law and in national legislation. The related English concepts of set-off and netting find expression in the single word *compensação* under Portuguese law, but it is not always clear to which type of set-off (legal or contractual) this word refers.

49. In conclusion, as regards the Portuguese text of Article 6 of the Insolvency Regulation, the mere wording of this article does not enable us to interpret the reference to '*compensação*' restrictively as referring exclusively to either one of the types of set-off (legal or contractual).

That would have to be determined in each specific case, with recourse to teleological interpretation. A comprehensive treatment of this issue is set out in Annex 9 to this report.

Spanish text

50. The equivalent Spanish term for 'set-off' as used in Article 6 and in recital 26 of the Insolvency Regulation is *compensación*.

51. While the term *compensación* is consistently used throughout the Spanish texts of various Community legal acts to describe both set-off and netting, netting agreements are referred to in Spanish law as *acuerdos de compensación contractual*.

52. Taking account of Spanish insolvency legislation, the term *compensación* (including *compensación convencional*) only refers to the traditional concept by which various debts arising from different agreements can be set off against each other. The fact that the word *compensación* is also used in the equivalent Spanish concept of netting agreements (*acuerdos de compensación contractual*) does not mean that set-off and netting are overlapping legal concepts under Spanish insolvency law. From a Spanish insolvency law perspective the concepts of set-off (*compensación*) and netting agreements (*acuerdos de compensación contractual*) may be properly understood as distinct, rather than overlapping, legal concepts.

53. In conclusion, the term *compensación* as used in the Spanish text of Article 6 of the Insolvency Regulation does not encompass close-out netting agreements.[22] A more comprehensive treatment of this issue is set out in Annex 10 to this report.

Swedish text

54. In Article 6 of the Swedish version of the Insolvency Regulation, 'set-off' is translated as *kvittning*. In Community legislation, 'set-off' is consistently translated in Swedish as *kvittning* and 'netting' is translated as *nettning* or *avräkning*.

[22] This conclusion relates only to the interpretation of the Spanish text of Article 6 of the Insolvency Regulation. This conclusion should not be understood as suggesting that under applicable Spanish law regulating Spanish insolvency proceedings for undertakings there is any uncertainty regarding the protection accorded to close-out netting agreements.

55. The preparatory work to Swedish netting legislation indicates that netting is a contract-based construction between two or more parties with effects that are similar to those of set-off. However, claims based on close-out netting provisions in an agreement seem to have a wider protection in the case of the insolvency of one of the parties than claims based on set-off, which may only be recognised under certain specified conditions. This would imply that insolvency set-off and insolvency close-out netting are distinct concepts under Swedish law.

56. In conclusion, the term *kvittning* as used in the Swedish text of Article 6 of the Insolvency Regulation does not appear to encompass close-out netting agreements. A comprehensive treatment of this issue is set out in Annex 11 to this report.

Conclusion

57. On balance, a textual review of the term 'set-off' as used in many of the original 11 equally authentic language versions of the Insolvency Regulation (Dutch, French, Italian, Spanish and Swedish, and arguably also Danish and English), in conjunction with a review of terminology used in related Community legal acts and a consideration of the underlying concepts known to national laws in many of the original 15 Member States (Belgium, France, Ireland, Luxembourg, the Netherlands, Spain, Sweden, and arguably also Denmark and England), indicates that the concept of insolvency set-off in Article 6 of the Insolvency Regulation does not encompass the technique of insolvency close-out netting. The terms used for 'set-off' in these language versions of Article 6 of the Insolvency Regulation may not be interpreted to cover insolvency close-out netting. This is either because set-off does not encompass the full process of close-out netting (starting with the termination of the agreement following default or insolvency, continuing with the calculation of the close-out amount and culminating in the set-off of the resulting amounts), and/or because set-off and contractual close-out netting are regarded as overlapping but distinct legal concepts.

58. However, the terms used for ‘set-off’ in some of the original 11 language versions of Article 6 of the Insolvency Regulation may be properly interpreted to encompass insolvency close-out netting, either because the corresponding term used covers both set-off and close-out netting (Greek) or because close-out netting can be regarded as a specific form of set-off under the laws of certain Member States (Finland, and arguably also Denmark and England).

59. Finally, it is difficult to reach any clear conclusion on the proper meaning of the terms used for 'set-off' in some of the original 11 language versions of Article 6 of the Insolvency Regulation (German and Portuguese).

60. In these circumstances our review of the term 'set-off' as used in the original 11 equally authentic language versions of the Insolvency Regulation, with a review of terminology used in related Community legal acts and a consideration of the underlying concepts known to national laws in the original 15 Member States, fails to clearly resolve whether the concept of insolvency set-off in Article 6 of the Insolvency Regulation encompasses the technique of insolvency close-out netting.

II.2 Contextual and purposive/teleological interpretation of the term 'set-off' as used in Article 6 of the Insolvency Regulation

61. While the ECJ has authority to consider the various language versions to interpret Community law, the ECJ will have regard to a contextual and purposive (or teleological) interpretation where linguistic analysis fails to resolve the interpretation of a provision. The ECJ has held, in the context of an examination of the different language versions of a Council Regulation, that '[i]n the case of divergence between the language versions the provision in question must be interpreted by reference to the purpose and general scheme of the rules of which it forms a part.'[23] Indeed, the contextual and purposive interpretation of Community law is of critical importance. As noted by the ECJ, '[e]very provision of Community law must be placed in its context and interpreted in the light of the provisions of Community law as a whole, regard being had to the objectives thereof and to its state of evolution at the date on which the provision in question is to be applied.'[24]

62. The most important aid to establish the purpose underlying Article 6 of the Insolvency Regulation is the statement of reasons on which the Regulation is based, as recorded in the recitals of the Insolvency Regulation.[25]

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[23] Case 100/84 *Commission* v *United Kingdom* [1985] ECR 1169, 1182; see also Case 30/77, *Regina* v *Bouchereau* [1977] ECR 1999, 2010; Case 372/88, *Cricket St Thomas* v *Milk Marketing Board of England and Wales* [1990] ECR 1345, 1376.

[24] Case 283/81, *CILFIT* v *Italian Ministry of Health* [1982] ECR 3415, 3430; see also, e.g., Case 294/83, *Parti Ecologiste 'Les Verts'* v *European Parliament* [1986] ECR 1339; Case 302/87, *European Parliament* v *Council* [1988] ECR 5616.

[25] See The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide (G. Moss, I. Fletcher & S. Isaacs, eds., 2002), p. 27.

63. In addition, the ECJ may consider the *travaux préparatoires* (preparatory work) that preceded the adoption of the Insolvency Regulation in establishing the purpose of Article 6.[26] The Insolvency Regulation was, in effect, an implementation of the Convention on Insolvency Proceedings, signed in Brussels on 23 November 1995. After the Convention lapsed due to the failure of one contracting State to sign the Convention in due time, all the provisions of the Convention, with one exception, were transformed into the text of the Insolvency Regulation.[27] As a result, the explanatory report on the Convention drawn up by Professor Virgos and Mr. Schmit (the 'Virgos/Schmit report')[28] should, consistent with the case law of the ECJ on the use of *travaux préparatoires*, help with the interpretation of the Insolvency Regulation.[29] The Virgos-Schmit report was produced during the concluding phase of the negotiations for the Convention on Insolvency Proceedings under the auspices of the EU Council. The report was never formally adopted or officially published by the EU Council after the Convention lapsed, so technically it lacks the status of *travaux préparatoires*. However, because of the close identity of substance between the provisions of the Insolvency Regulation and the Convention on Insolvency Proceedings, and because the recitals of the Insolvency Regulation were drafted by extracting propositions from the Virgos-Schmit report, the Virgos-Schmit report is generally acknowledged as an important aid to interpreting the Insolvency Regulation.[30]

64. To establish the proper teleological interpretation of Article 6 of the Insolvency Regulation, it should also be interpreted by reference to the purpose and general scheme of the rules of which it forms a part. Clearly this means that any other relevant provisions of the Insolvency Regulation should be taken into account.[31]

65. Finally, Article 6 of the Insolvency Regulation must be interpreted in the light of the provisions of Community law as a whole, including related provisions on set-off and netting in other Community legal acts (e.g. the Banks Winding-up Directive and the Collateral Directive). In

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[26] See The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide (G. Moss, I. Fletcher & S. Isaacs, eds., 2002), pp. 27-28.

[27] See Jean-Pierre Deguée, Advisor – Belgian Banking and Finance Commission, Directive 2001/24/EC on the reorganisation and winding up of credit institutions, which finally establishes uniform private international law for banking insolvency proceedings, International Conference on Bankruptcy Reform, Siena, 6-7 December 2000, p. 2, footnotes 6 & 7.

[28] Report on the Convention on Insolvency Proceedings by Professor Miguel Virgos, Universidad Autonoma of Madrid, and Etienne Schmit, Magistrate, Deputy Public Prosecutor, Luxembourg, Brussels, 8 July 1996, reproduced in The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide (G. Moss, I. Fletcher & S. Isaacs, eds., 2002), pp. 261-327.

[29] See, e.g., Case 133/00, *J.R. Bowden, J.L. Chapman and J.J. Doyle* v *Tuffnells Parcel Express Limited.* [2001] ECR I-7031, 7065.

[30] See The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide (G. Moss, I. Fletcher & S. Isaacs, eds., 2002), pp. 4 n.10, 13-14, 28, 261.

[31] See The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide (G. Moss, I. Fletcher & S. Isaacs, eds., 2002), p. 27.

this context the current state of evolution of Community law in this area must be considered, as well as the evolution of the market techniques that the law is aimed at.

Recitals of and travaux préparatoires on the Insolvency Regulation

66. Recital 24 of the Insolvency Regulation explains the purpose for the exceptions to the primacy of the *lex concursus* (the law of the State of the opening of the insolvency proceedings) 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.' So the purpose of the exceptions is to protect the legitimate expectations of a party which has entered into transactions with another entity that has since become insolvent. The former 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 those expectations should not subsequently be defeated by the insolvency law of another State.

67. The Virgos/Schmit Report states the purpose behind the exceptions to the primacy of the *lex concursus* slightly more expansively: 'The application by the State of the opening of proceedings 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.'32

68. Recital 26 of the Insolvency Regulation applies the general principle explained in recital 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.'

69. The use in recital 26 of the Insolvency Regulation of the phrase 'a kind of guarantee function' indicates that the function of set-off is viewed as analogous to that of security, thus meriting

32 Virgos/Schmit report, paragraph 21.

similar 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.'33; 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'34.

70. Both in recital 26 of the Insolvency Regulation itself and in the Virgos/Schmit report, the word in the French text corresponding to the English word 'guarantee' is '*garantie*'.35 Similarly, the Italian, Portuguese and Spanish texts of the Insolvency Regulation use the terms '*garanzia*', '*garantia*' and '*garantía*', respectively. Unlike the English word, which would ordinarily refer to a merely personal obligation, the French, Italian, Portuguese and Spanish words would naturally be taken in a wider sense as including proprietary rights of security.

71. It therefore appears from the purpose of the set-off protection, as evidenced by both the recitals of the Insolvency Regulation and the Virgos/ Schmit report, that set-off should be regarded as akin to security. A party to a contract is entitled to rely on 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, i.e. a net obligation.

72. The concern that Article 6 of the Insolvency Regulation may not protect close-out netting provisions rests mainly on the argument that such provisions include elements which are not covered by the English term 'set-off' and which may themselves be contrary to the mandatory insolvency rules of some EU Member States. So the argument is that set-off is simply one element of close-out netting, and that the protection in Article 6 covers the setting-off of mutual claims or obligations, but does not cover the early termination or acceleration and valuation of claims, which often precede set-off in a close-out mechanism. 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'. So the Article 6 protection appears to be intended to allow for

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33 Virgos/Schmit report, paragraph 97.

34 Virgos/Schmit report, paragraph 109, fourth para.

35 The French version of recital 26 to the Insolvency Regulation states as follows: "*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.*"

the contractual early termination and set-off of contingent and future obligations where the law applicable to the insolvent debtor's claim permits this.

73. Moreover, the Virgos/Schmit report appears to contemplate the set-off of a range of such obligations documented under a bilateral contractual agreement, with the law applicable to the agreement governing all transactions entered into before the opening of insolvency proceedings - 'Article 6 covers only rights to set-off arising in respect of mutual claims incurred prior to the opening of the insolvency proceedings…. [I]n 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.'[36]

74. So there is good justification, based on the recitals of the Insolvency Regulation and the Virgos/Schmit report, for interpreting the set-off protection in Article 6 of the Insolvency Regulation broadly to include all elements of close-out netting. Given this position, it may be legitimately argued that the correct interpretation is that which best achieves the purpose of the protection as outlined in the recitals of the Insolvency Regulation and in the Virgos/Schmit report. The contractual mechanism for closing-out transactions and setting off the resulting sums acts as a form of security. For example, the taking of collateral by 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. Accordingly, set-off in the Insolvency Regulation may be properly interpreted as a single process incorporating early termination and acceleration of claims.

75. The Insolvency Regulation's objective 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 important 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 substantial that any doubts about the reliability of the net calculation of exposures (which depends on the validity of close-out netting) would create risks of systemic importance. Any doubt on this point would also be likely to severely 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 these

[36] Virgos/Schmit report, paragraph 110.

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.

76. These concerns explain why supervisors have adopted regulatory capital regimes which permit the net calculation of exposures as long as they are assured that the relevant arrangements are legally robust, and why several countries, and the Community itself, have enacted legislation specifically to establish a satisfactory level of legal certainty for close-out netting in key market instruments.[37] So it would be unfortunate if the Community, in incorporating into the Insolvency Regulation provisions for the protection of set-off that expressly aim to reinforce certainty of transactions and the legitimate expectations of parties, had worded the protections to exclude close-out netting. A purposive or teleological approach to the interpretation of the Insolvency Regulation may therefore strongly point to the conclusion that the protections are intended to include close-out netting.

77. The ECJ has held that a legal provision must be interpreted in such a manner that its implementation is effective and useful (*l'effet utile*).[38] Set-off rights are of particular significance to transactions in the financial markets. 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. It can be argued that a narrow interpretation of Article 6 of the Insolvency Regulation, which distinguishes close-out netting from set-off and regards elements of close-out netting, such as early termination and acceleration of claims, as outside Article 6, would rob the set-off protection of virtually any effect in financial market transactions, contrary to the principle of *l'effet utile*.

Protection under Article 13 of the Insolvency Regulation

78. 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 of the Insolvency Regulation, it is also arguable that those provisions should be protected under Article 13 of the Insolvency Regulation. Article 13 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

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[37] See, e.g., Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, Annex 3 (The Treatment of Off-Balance Sheet Items), Part 3 (Contracts for Novation and Other Netting Agreements), OJ L 126, 26.05.2000, p. 1.

[38] See, e.g., Case 25/59, *The Netherlands* v *High Authority*: [1960] ECR 355; Case 34/62, *Germany* v *Commission*: [1963] ECR 131; Case 41/74, *Van Duyn* v *Home Office*: [1974] ECR 1337; Case 31/87, *Beentjes* v *The Netherlands*: [1988] ECR 4635.

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.'

79. The aim of 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 a different lex concursus.'[39]

80. Accordingly, if the law of the State of the opening of proceedings declares that contractual terms providing for early termination and acceleration of claims are invalid or 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 contract).

81. If the narrow view of the Article 6 set-off protection were adopted, it could be argued that 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.

Effect of Articles 6(2) and 4(2)(m) of the Insolvency Regulation

82. A further argument has been suggested for narrowing the protection accorded to set-off in the Insolvency Regulation.40 This centres on the effect of Article 4(2)(m), which states that the law of the State of the opening of proceedings (*lex concursus*) will determine 'the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all creditors'.

83. 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). It could be argued that if, according to the *lex concursus*, a contractual set-off is void, Article 6(2)

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[39] Virgos/Schmit report, paragraph 138, first para.

[40] 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.

preserves the ability of the *lex concursus* to declare the provision void despite the protection in Article 6(1).

84. We suggest this argument is misconceived. It would make Article 6(1) largely, if not completely, devoid of application, since any rule of the *lex concursus* restricting the availability of set-off would, almost by definition, do so on the basis that it constitutes 'a legal act detrimental to all creditors'. This would be contrary to the principle endorsed by the ECJ that a legal provision must be interpreted so that its implementation is effective and useful (*l'effet utile*).[41] Since this result is clearly repugnant on any sensible purposive interpretation, it would, in accordance with the principle of *l'effet utile*, 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 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 creditor's position. This explanation is reinforced by a comparison with Article 5(4) of the Insolvency Regulation, which includes an identical qualification clearly designed to clarify that a disposition giving rise to a right *in rem* is capable of being attacked as a preference.

85. Even if, contrary to this 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. 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 protect the set-off, provided that the set-off in the particular case could not be challenged under the law governing the set-off. We suggest that 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 that surely cannot have been intended.

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[41] See, e.g., Case 25/59, *The Netherlands* v *High Authority*: [1960] ECR 355; Case 34/62, *Germany* v *Commission*: [1963] ECR 131; Case 41/74, *Van Duyn* v *Home Office*: [1974] ECR 1337; Case 31/87, *Beentjes* v *The Netherlands*: [1988] ECR 4635.

The Banks Winding-up Directive and the Collateral Directive

86. Article 6 of the Insolvency Regulation must be interpreted in the light of the provisions of Community law as a whole, including related provisions regarding set-off and netting contained in other Community legal acts (e.g., the Banks Winding-up Directive and the Collateral Directive).

87. Article 23 of the Banks Winding-up Directive states, in substantially the same terms as Article 6 of the Insolvency Regulation, that: '1. The adoption of reorganisation measures or the opening of winding-up proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the credit institution, where such a set-off is permitted by the law applicable to the credit institution's claim. 2. Paragraph 1 shall not preclude actions for voidness, voidability or unenforceability laid down in Article 10(2)(l).'[42]

88. Article 25 of the Banks Winding-up Directive states: 'Netting agreements shall be governed solely by the law of the contract which governs such agreements.'

89. The reference to 'netting agreements', rather than simple 'netting', in Article 25 of the Banks Winding-up Directive indicates that netting is conceived as a contractual technique. This is consistent with the fact that close-out netting arrangements are most often established under the terms and conditions of master agreements that are widely deployed by financial market participants to reduce the effective level of their obligations in case a counterparty becomes insolvent. By contrast, the reference to 'set-off' rather than 'set-off agreements' implies that set-off is regarded as a general legal concept forming the legal framework within which netting agreements operate.

90. However, it can also be argued that the absence of specific protection for 'netting agreements' in the Insolvency Regulation indicates that close-out netting agreements are not protected. If the Insolvency Regulation had been meant to protect close-out netting, it could have included specific protection similar to Article 25 of the Banks Winding-up Directive.

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[42] Article 22 of the Insurance Undertakings Winding-up Directive contains a provision on the set-off of claims against the claims of insurance undertakings that is drafted in substantially the same terms as Article 23 of the Banks Winding-up Directive. However, the Insurance Undertakings Directive does not contain a provision equivalent to Article 25 of the Banks Winding-up Directive on netting.

91. One possible explanation as to why Article 25 of the Banks Winding-up Directive included special protection for 'netting agreements' as distinct from 'set-off' is that the purpose of Article 25 of the Banks Winding-up Directive is to protect a particular class of netting arrangements, namely netting by novation, which is not otherwise covered by the protection for set-off. This explanation finds some support in the French, Italian, Portuguese and Spanish versions of Article 25 of the Banks Winding-up Directive. The equivalent for 'netting agreements' in the French, Italian, Portuguese and Spanish texts of Article 25 is *les conventions de compensation et de novation* ('netting agreements'*)*, *convenções de compensação e de novação*, *convenções de compensação e de novação* and *acuerdos de compensación y de novación*, respectively, which in each case can be literally translated as 'set-off and novation agreements'. Netting by novation is a particularly common mechanism in the foreign exchange markets, and involves a contractually agreed process where each new foreign exchange contract is automatically consolidated with existing contracts to produce a new contract (novation), a single net indebtedness replacing the previous contracts. Because the netting by novation takes place as each new contract is made and is not deferred until the time of payment, it follows that when payment falls due only a single sum is involved on one side or the other, and no question of set-off arises, including insolvency set-off.[43]

92. If Article 25 of the Banks Winding-up Directive was intended to protect netting by novation agreements, the question arises why netting by novation arrangements with banks should be accorded special protection. One possibility is that the significance of banks in foreign exchange markets justifies a specific reference to netting agreements to ensure that arrangements which operate by novation, as opposed to set-off, are clearly protected.

93. Another possible explanation as to why Article 25 of the Banks Winding-up Directive included special protection for 'netting agreements' as distinct from 'set-off' is that legislative references to close-out netting have a relatively modern origin. The concept of close-out netting does not appear to have been reflected in any Community legal texts before the implementation of EU Directives giving effect to the 1988 Basel Capital Accord.[44] This relatively modern evolution of legislative references to close-out netting is consistent with the increasing use by market participants of master agreements containing close-out netting provisions during the 1990s. Because the Insolvency Regulation was, in effect, an implementation of the Convention on

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[43] See Roy Goode, Commercial Law, pp. 514-15 (2nd ed. 1995).

[44] See Council Directive 89/299/EEC of 17 April 1989 on the Own Funds of Credit Institutions, O.J. L 124/6; Council Directive 89/647/EEC of 18 December 1989 on a Solvency Ratio for Credit Institutions, O.J. L 386/14 (since replaced by Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, O.J. L 126/1); Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions, O.J. L 141/1.

Insolvency Proceedings, signed in Brussels on 23 November 1995,[45] the drafting of which began in 1989,[46] it could be seen as natural that the English version of the text would refer to the more traditional concept of set-off, rather than the modern contractual technique of close-out netting. By contrast, the Banks Winding-up Directive was adopted in 2001.[47] The ever-increasing use of master agreements by this time may explain why a reference in a Community legal text to the general legal concept of set-off was also accompanied by a more specific reference to the more modern evolution of master agreements containing close-out netting provisions.

94. However, we should consider the current state of evolution of Community law in the area of set-off and netting, as well as the evolution of the market techniques at which Community law is aimed, rather than the historical circumstances when the Insolvency Regulation was adopted, to establish the proper teleological interpretation of the set-off protection in Article 6. The most recent provisions of Community law regarding set-off and netting are contained in the Collateral Directive adopted in 2002.[48] The Collateral Directive provides some support for the view that the term 'set-off' may be broad enough to describe the acceleration and net settlement of claims. However, the Collateral Directive also supports the view that the overlapping concepts of close-out netting and set-off in the Collateral Directive are in certain respects distinct legal concepts.

95. Article 2(1)(n) of the Collateral Directive defines 'close-out netting provision' as 'a provision of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any statutory rule by 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'.

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45 See Jean-Pierre Deguée, Advisor – Belgian Banking and Finance Commission, Directive 2001/24/EC on the reorganisation and winding up of credit institutions finally establishes uniform private international law for banking insolvency proceedings, International Conference on Bankruptcy Reform, Siena, 6-7 December 2000, p. 2, footnotes 6 & 7.

46 The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide (G. Moss, I. Fletcher & S. Isaacs, eds., 2002), pp. 1-14.

47 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, OJ L 125, 5.5.2001, p. 15.

48 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements, OJ L 168, 27.06.2002, p. 43.

96. This definition of close-out netting provisions 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. However, the definition of a 'close-out netting provision' under the Collateral Directive also considers that close-out netting may be accomplished through 'the operation of netting or set-off or otherwise', implying that insolvency set-off and netting are overlapping, but in certain respects distinct, legal concepts.

97. In particular, the kind of close-out netting provision contemplated by the Collateral Directive, where the obligations of the parties are 'terminated and replaced by an obligation to pay' an amount representing the estimated current value of the terminated obligations, would not technically require any set-off of the resulting single replacement obligation.[49] For example, the ISDA master agreement forms, governed by English or New York law, under which an enormous number of swap and derivatives transactions are documented, explicitly make performance of payment and delivery obligations in respect of individual transactions subject to the condition that an 'early termination date' in respect of all outstanding transactions has not occurred or been effectively designated.[50] The obligation to pay or deliver in respect of an individual transaction may thus be regarded as a conditional obligation, and the occurrence or effective designation of an early termination date may be regarded as the permanent failure of one of the conditions to the parties' respective rights and obligations under the terms of individual transactions. Based on this so-called 'flawed assets' analysis,[51] the parties' obligations under individual transactions would, when an early termination date occurs or is designated, be replaced with a single net obligation calculated in accordance with the insolvency close-out netting provisions of the ISDA Master Agreement.[52] This net obligation is a product of mere accounting and not the result of a set-off of claims determined in respect of those transactions.[53]

98. In conclusion, the evolution of Community law provisions relating to set-off and netting may be seen as distinguishing between the concepts of insolvency set-off and insolvency close-out netting. In particular, a powerful argument can be made that the absence of specific protection for 'netting agreements' in the Insolvency Regulation indicates that close-out netting

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49 See S. Henderson, Henderson on Derivatives (2003), p. 335.

50 See International Swaps and Derivatives Association, Inc., ISDA Master Agreement, Multicurrency Cross-Border 1992 and 2002 versions, Sections 2(a)(iii) and 6(c).

51 See P. Wood, Title Finance, Derivatives, Securitisations, Set-off and Netting (1995), pp. 74-75.

52 See International Swaps and Derivatives Association, Inc., ISDA Master Agreement, Multicurrency Cross-Border 1992 and 2002 versions, Section 6(e).

53 See also S. Henderson, Henderson on Derivatives (2003), p. 335.

agreements are not protected. If the Insolvency Regulation had been meant to protect close-out netting, it could have included a similar specific protection to Article 25 of the Banks Winding-up Directive. Moreover, while the Collateral Directive provides some support for the view that the term 'set-off' is broad enough to describe the acceleration and net settlement of claims that forms part of the close-out netting procedure, it also supports the view that the overlapping concepts of close-out netting and set-off are in certain respects distinct legal concepts. In particular, the kind of close-out netting provision contemplated by the Collateral Directive, whereby the obligations of the parties are terminated and replaced by an obligation to pay the estimated current value of the terminated obligations, would not technically require any set-off of the resulting single replacement obligation.

II.3 Conclusion

99. We consider that it is deeply uncertain as to whether the set-off protection in Article 6 of the Insolvency Regulation can be interpreted as encompassing close-out netting.

100. Consistent with the case-law of the ECJ, in the case of divergence between the different language versions of a Council Regulation the provision in question must be interpreted by reference to the purpose and general scheme of the rules of which it forms a part. Indeed, it is a cardinal principle of Community law that every provision of Community law must be placed in its context and interpreted in the light of Community law as a whole, regard being had to the objectives thereof and to its state of evolution at the date on which the provision in question is to be applied.

101. As noted in the recitals of the Insolvency Regulation and the *travaux préparatoires*, the set-off protection in the Insolvency Regulation was intended to ensure that set-off should acquire a kind of guarantee. In particular, set-off was viewed as having a function analogous to that of security, thus meriting similar protection. 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.

102. Consistent with the recitals of the Insolvency Regulation and the *travaux préparatoires*, one of the main purposes behind the protection for set-off in the Insolvency Regulation is to protect the legitimate expectations of a party which has entered into transactions with another entity which has since become insolvent. The argument that the Insolvency Regulation was not meant to

protect close-out netting would effectively remove protection from key financial instruments that play a vital role in modern financial markets. If this argument were correct, the Insolvency Regulation would fail to confirm the 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 at odds with the purpose underlying the set-off protection.

103. The *travaux préparatoires* on the Insolvency Regulation also 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'. So the set-off protection in the Insolvency Regulation appears to be intended to allow contractual set-off of contingent and future obligations where the law applicable to the insolvent debtor's claim permits this. There is, therefore, good justification for interpreting the set-off protection in the Insolvency Regulation broadly to include all elements of close-out netting. It may be legitimately argued that a purposive or teleological approach to the interpretation of the Insolvency Regulation thus points to the conclusion that close-out netting is indeed covered by the set-off protection in the Insolvency Regulation.

104. 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. The ECJ has held that a legal provision must be interpreted in such a manner that its implementation is effective and useful (*l'effet utile*). 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. A narrow interpretation of Article 6, which distinguishes close-out netting from set-off and regards elements of close-out netting such as early termination and acceleration of claims as outside Article 6, would rob the set-off protection of virtually any effect in financial market transactions, contrary to the principle of *l'effet utile*.

105. However, Article 6 of the Insolvency Regulation must also be interpreted in the light of the provisions of Community law as a whole, including related provisions on set-off and netting in other Community legal acts (e.g., the Banks Winding-up Directive and the Collateral Directive).

106. Article 23 of the Banks Winding-up Directive contains a protection for set-off worded almost identically to that in Article 6 of the Insolvency Regulation. However, Article 25 of the Banks Winding-up Directive contains an additional protection for 'netting agreements'. A powerful argument can be made that the absence of comparable specific protection for 'netting agreements' in the Insolvency Regulation (or in the Insurance Undertakings Winding-Up

Directive) indicates that close-out netting agreements are not protected. Had the Insolvency Regulation been meant to protect close-out netting, it could have included a similar specific protection to Article 25 of the Banks Winding-up Directive.

107. One possible explanation as to why Article 25 of the Banks Winding-up Directive included special protection for 'netting agreements' as distinct from set-off is that Article 25 of the Banks Winding-up Directive seeks to protect a particular class of netting arrangements, namely netting by novation, which are not otherwise covered by the protection for set-off. The equivalent for 'netting agreements' in the French, Italian, Portuguese and Spanish texts of Article 25 of the Banks Winding-up Directive Article 25 is 'set-off and novation agreements'. It is possible that the significance of banks in the foreign exchange markets justifies a specific reference to netting agreements to ensure that arrangements which operate by way of novation, as opposed to set-off, are clearly protected.

108. Another possible explanation as to why Article 25 of the Banks Winding-up Directive, which was adopted in 2001, included special protection for 'netting agreements' as distinct from set-off is that the concept of close-out netting has, in legal terms, a relatively modern origin compared to the more traditional concept of set-off used in the Insolvency Regulation, the drafting of which began in 1989.

109. However, to establish the proper teleological interpretation of the set-off protection in Article 6, we should consider the current state of evolution of Community law in the area of set-off and netting, rather than the circumstances prevailing at the time the Insolvency Regulation was adopted. The most recent provisions of Community law regarding set-off and netting are contained in the Collateral Directive adopted in 2002. While the definition of close-out netting provisions in the Collateral Directive provides some support for the view that 'set-off' is broad enough to describe the acceleration and net settlement of claims that form part of the close-out netting procedure, the Collateral Directive also supports the view that the overlapping concepts of close-out netting and set-off are in certain respects distinct legal concepts. In particular, the kind of close-out netting provision contemplated by the Collateral Directive, whereby the obligations of the parties are terminated and replaced by an obligation to pay the estimated current value of the terminated obligations (e.g. the ISDA master agreement forms) would not technically require any set-off of the resulting single replacement obligation. Rather, the replacement obligation is a product of mere accounting and not the result of a set-off of claims determined in respect of the terminated obligations.

110. The evolution of Community law provisions on set-off and netting may be seen as distinguishing between the concepts of insolvency set-off and insolvency close-out netting.

111. In conclusion, we consider that it is deeply uncertain as to whether the set-off protection in Article 6 of the Insolvency Regulation can be interpreted as encompassing close-out netting. A review of the term 'set-off' as used in many of the original 11 equally authentic language versions of the Insolvency Regulation, with a review of terminology used in related Community legal acts and a consideration of the underlying concepts known to national laws in many of the original 15 Member States, indicates that the concept of insolvency set-off in Article 6 of the Insolvency Regulation may not encompass the technique of insolvency close-out netting. However, the terms used for 'set-off' in some of the original 11 language versions of Article 6 of the Insolvency Regulation may be properly interpreted to encompass insolvency close-out netting. Also, it could be argued that a purposive or teleological approach to the interpretation of the Insolvency Regulation, based on the recitals and the *travaux préparatoires*, points to the conclusion that close-out netting is indeed covered by the set-off protection in the Insolvency Regulation. This argument is reinforced by the principle of *l'effet utile*. However, it may also be argued that a purposive or teleological approach to the interpretation points to the conclusion that close-out netting is not covered by the set-off protection in Article 6 of the Insolvency Regulation, given that the evolution of Community law provisions on set-off and netting in the Banks Winding-up Directive and the Collateral Directive may be seen as distinguishing between the concepts of insolvency set-off and insolvency close-out netting.

III. Banks Winding-up Directive

112. The Banks Winding-up Directive entered into force on 5 May 2001 and all 25 EU Member States were required to bring into force the laws, regulations and administrative provisions necessary to comply with the Directive by 5 May 2004.[54] The Banks Winding-up Directive applies to credit institutions and their branches set up in Member States other than those in which they have their head offices.[55]

[54] See Winding-up Directive, Articles 34(1), first para., and 34(3).

[55] See Winding-up Directive, Article 1(1).

113. As noted previously, Article 25 of the Banks Winding-up Directive provides as follows: 'Netting agreements shall be governed solely by the law of the contract which governs such agreements.'

114. We interpret Article 25 of the Banks Winding-up Directive as meaning that the selection of a governing law from a netting-friendly jurisdiction should ensure the enforceability of netting against an EU-incorporated credit institution (and/or its liquidator or other insolvency official) even if the credit institution is incorporated in a less netting-friendly jurisdiction. This interpretation may be supported by the text of Article 25, and is fully consistent with a purposive or teleological interpretation of this provision.

115. We note that the use of 'solely' in the text of Article 25 of the Banks Winding-up Directive implies that the law of the contract applies, to the exclusion of any other potentially applicable legal system. Since insolvency law has traditionally applied in assessing whether insolvency close-out netting arrangements are enforceable, we consider that the provision deliberately departs from the general principle established by the Banks Winding-up Directive that a credit institution shall be wound up, and reorganisation measures applied, in accordance with the laws, regulations and procedures applicable in its home Member State.[56]

116. We note that the interpretation that Article 25 of the Banks Winding-up Directive applies, to the exclusion of any other potentially applicable legal system, is also supported by a purposive or teleological interpretation of the provision, having regard to the purpose or object of the provision. Article 25 of the Banks Winding-up Directive was absent from earlier versions of the draft Directive proposed by the Commission and considered by the European Parliament. The first draft of Article 25 was introduced when the Council established a common position on the Directive on 17 July 2000. In the Statement of the Council's reasons for the introduction of this provision, the Council clarified the position as follows: 'This Article derogates from the basic principle of the application of the law of the Home Member States […]. The overall objective of this Article [is] to ensure legal certainty in particular cases where it is thought that the importance or the special nature of the contract justifies the derogation from the principle of universality. Paragraphs 1c) and d) concern contractual netting agreements (agreements to set off positive and negative balances) between a credit institution and its counterparty and repurchase agreements (an agreement between a seller and a buyer of securities where the seller agrees to repurchase the securities at an agreed price) respectively. In both cases the law of the

[56] See Winding-up Directive, Articles 3(2) and 10(1).

Member State applicable to the agreement applies[57]. Such agreements are commonly used on the financial markets and the Council considers that the especial function of such contracts requires a derogation from the principle of universal application of home Member State law in order to protect the functioning of the financial markets and to ensure legal certainty for the contracting parties.'[58]

117. We note that the interpretation that Article 25 of the Banks Winding-up Directive applies, to the exclusion of any other potentially applicable legal system, is the necessary interpretation in the sense that any other interpretation would imply that the provision expresses a mere truism, repeating the tautology that netting agreements are governed by the law of the contract that governs such agreements. We do not consider that any other interpretation is feasible since this would render Article 25 of the Banks Winding-up Directive meaningless, contrary to the principle of Community law applied by the ECJ that a legal provision must be interpreted in such a manner that its implementation is effective and useful (*l'effet utile*).[59]

118. We note that much netting legislation in EU Member States forms part of national law (including civil codes and financial laws as well as insolvency and bankruptcy codes),[60] and in some cases specifies the terms and conditions under which the enforceability of insolvency close-out netting should be recognised. Article 25 of the Banks Winding-up Directive implies, so far as a credit institution is concerned, that the netting legislation of the credit institution's

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[57] As discussed below, it is noted that the law of non-EU jurisdiction (e.g., New York law) might be chosen as the governing law of the agreement.

[58] See Common position EC No 43/2000 adopted by the Council on 17 July 2000 with a view to adopting Directive 2000/…/EC of the European Parliament and of the Council of… on the reorganisation and winding-up of credit institutions, OJ C 300, 20.10.2000, p. 13.

[59] See, e.g., Case 8/55, *Fédération Charbonnière de Belgique* v *High Authority*: [1954-56] ECR 245 and 292; Case 25/59, *The Netherlands* v *High Authority*: [1960] ECR 355; Case 34/62, *Germany* v *Commission*: [1963] ECR 131.

[60] Austria: Bankruptcy Code (Federal Law Gazette 1924/337) as amended; Banking Act (Federal Law Gazette 1993/532) as amended; Belgium: Law of 22 March 1993 on the governance and supervision of credit institutions; Denmark: Securities Trading Act, Lbleg 2002-07-09, num 587; Finland: Act on certain conditions of Securities and Currency Trading as well as Settlement Systems (26.11.99/1084); France: Monetary and Financial Code, *Code Monétaire et Financier*; Germany: Code of October 5, 1994 Insolvency Code (*Insolvenzordnung*), entered into force January, 1, 1999 (BGBI. I. S. 2866); Hungary: Act CXX of 2001 on Capital Markets (including amendments to certain provisions of Act XLIX of 1991 on Bankruptcy, Liquidation and Voluntary Winding up Proceedings); Ireland: Netting of Financial Contracts Act, 1995, supplemented by the Netting of Financial Contracts Act, 1995 (Designation of Financial Contracts) Regulations, 2000; Italy: Decree-Law Num. 58/1998 (*Testo Unico delle disposizioni in materia di intermediazione finanziaria*); Luxembourg: Law of 6 of May of 1996 on the set off of claims and debts of the Financial Sector, as amended; Malta: Set-off and Netting on Insolvency Act – Act IV of 2003; Netherlands: Bankruptcy Act of 1893, as amended (*Faillissementswet*). Civil Code, Book 6, Chapter 12 (*Burgerlijk wefbock*); Poland: Article 85 of the Bankruptcy and Restructuring Law (came into force on 1 October 2003); Portugal: Decree-Law No. 1/97 of 7.01.1997 (*Regula a aceitação pelo Estado das cláusulas de compensação, denominadas "netting" e "set-off", no âmbito de acordos sobre produtos financeiros derivados, celebrados nos mercados financeiros*); Decree-Law No. 70/97 of 03.04.1997; Spain: Securities Market Law 37/1998 (*Ley del Mercado de Valores*) as amended by Law 44/2002 of 22 November 2002; and Sweden: Financial Instruments Trading Act (SFS 1991:980). Bankruptcy Act (1987:672). In England & Wales the enforceability of netting is established at common law, although Rule 4.90 of the Insolvency Rules 1986, S.I. 1925, also makes provision for mandatory set-off of mutual credits, mutual debts or other dealings between a company that goes into liquidation and its creditors.

home state is no longer relevant in any way to determining the enforceability of the netting agreement where the netting agreement is governed by the law of a jurisdiction other than the credit institution's home state, even where this latter contractual jurisdiction is that of a country outside the EU.[61]

119. A residual question is whether the requirement that a netting agreement be governed 'solely by the law of the contract which governs such agreements' allows for the application of the insolvency laws of the jurisdiction whose laws have been chosen by the parties to the netting agreement as the governing law of the contract.[62] In general, we consider that the reference in Article 25 of the Banks Winding-up Directive to the law of the contract should be interpreted as a reference to the substantive law chosen by the parties as the governing law of the netting agreement. While the law of such jurisdiction would, by definition, include the applicable insolvency and/or netting laws of that jurisdiction, we consider that the contractual choice of that jurisdiction's law as the governing law of a netting agreement would not make a party subject to the insolvency and/or netting laws of that jurisdiction if such laws would not, on their terms, apply to that party. Whether the insolvency and/or netting laws of that jurisdiction contain netting rules applicable to a party is a question of interpretation arising under the particular insolvency and/or netting laws of each individual jurisdiction, the laws of which may govern a netting agreement.

120. The practical application of these principles can be more clearly demonstrated by taking the examples of the following four jurisdictions whose laws are commonly chosen as the governing laws of netting agreements to which EU credit institutions are party.

121. England and Wales. The contractual choice of English law as the governing law of a netting agreement to which an EU credit institution is party would, by definition, make an EU credit institution subject to the mandatory set-off provisions of Rule 4.90 of the Insolvency Rules 1986 only if the EU credit institution is a company subject to the winding-up jurisdiction of the

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[61] For example, according to this interpretation the somewhat elaborate Irish Netting of Financial Contracts Act 1995 would no longer be relevant to a determination of the enforceability against an Irish-incorporated credit institution of a netting agreement governed by English or New York law, which is executed by that credit institution. The same analysis would pertain to credit institutions in any EU Member State whose home country laws contain intricate legislation specifying the terms and conditions under which insolvency close-out netting is enforceable.

[62] See generally Jean-Pierre Deguée, Advisor – Belgian Banking and Finance Commission, Directive 2001/24/EC on the reorganisation and winding up of credit institutions, which finally establishes uniform private international law for banking insolvency proceedings, International Conference on Bankruptcy Reform, Siena, 6-7 December 2000, p. 13-14; Jean-Pierre Deguée, Conseiller Adjoint à la Commission Bancaire et Financière (Bruxelles), La Directive 2001/24/EC sur l'assainissement et la liquidation des établissements de crédit: une solution aux défaillances bancaires internationales?, published in Euredia – European Banking & Financial Law Journal, 2001-2002, p. 279, 285-88, 305-7; Christophe Keller, Deutsche Bundesbank, Die Wertpapiersicherheit im Gemeinschaftsrecht, BKR 2002, p. 347, 351; The EC Regulation on Insolvency Proceedings: A Commentary and Annotated Guide (G. Moss, I. Fletcher & S. Isaacs, eds., 2002), p. 185.

courts in England and Wales. This is because Rule 4.90 is contained in Part 4 of the Insolvency Rules 1986, which applies only in relation to companies that the courts in England and Wales have jurisdiction to wind up.[63] General principles of English law, however, applicable outside the scope of statutory insolvency law, would normally support the enforceability of a netting agreement.

122. France. The provisions recognising close-out netting pursuant to the French Monetary and Financial Code do not form part of French insolvency law, and their application is not confined to parties subject to French insolvency proceedings. So these provisions would apply to all netting agreements governed by French law to which an EU credit institution is party.[64]

123. Germany. Under the rules of German insolvency law (cf. Art. 94, 95 and 104 of the German Insolvency Code (Insolvenzordnung – InsO), contractual close-out netting provisions governed by German law are valid and enforceable, even if one of the parties becomes insolvent. According to the current legal framework in Germany as set out in § 340(2) of the Introductory Law to the German Insolvency Code (Einführungsgesetz zur Insolvenzordnung – EGInsO), which implemented Article 25 of the Banks Winding-up Directive, the contractual choice of German law as the governing law of a netting agreement to which an EU credit institution is party would not subject the enforceability of a netting agreement against a (non-German) EU credit institution to the provisions of German law that are designed to ensure the enforceability of the close-out, set-off and netting of financial contracts. Art. 102 EGInsO basically states that the effects of insolvency proceedings on repurchase transactions and netting arrangements (Schuldumwandlungsverträge und Aufrechnungsvereinbarungen) will be subject to the law governing those agreements..

124. New York. The contractual choice of New York law as the governing law of a netting agreement to which an EU credit institution is party would not, by definition, make the enforceability of a netting agreement against an EU credit institution subject to the special provisions of U.S. or New York law that are designed to ensure the enforceability of the close-out, set-off and netting of financial contracts against parties that are subject to various U.S. and New York insolvency proceedings. Obviously, an EU credit institution is not subject to such

63 See Insolvency Rules 1986, S.I. 1925. r. 03.

64 See Monetary and Financial Code, *Code Monétaire et Financier*, Article L. 431-7.

proceedings.[65] However, the U.S. Federal Deposit Insurance Corporation Improvement Act of 1991 contains certain provisions recognising the enforceability of bilateral netting contracts that are governed by the laws of a U.S. jurisdiction (e.g. New York law) and are entered into by two 'financial institutions', which would include certain EU credit institutions.[66]

125. Finally, we note that Article 25 of the Banks Winding-up Directive does not define the concept of 'netting'. In the absence of a statutory definition of netting as used in Article 25 of the Banks Winding-up Directive we conclude that netting should, at least, be understood as referring to the essentially bilateral process of close-out, conversion of obligations into monetary claims, and mutual set-off.

IV. Collateral Directive

126. The Collateral Directive entered into force on 27 June 2002 and Member States were required to bring into force the laws, regulations and administrative provisions necessary to comply with the Directive by 27 December 2003 at the latest.[67] The Collateral Directive applies to financial collateral arrangements in which the collateral taker and the collateral provider must each belong to one of several specific categories, generally speaking covering public authorities, central banks, multilateral development banks, specified supranational institutions, financial institutions subject to prudential supervision (including credit institutions, investment firms, insurance undertakings and UCITS), central counterparties, settlement agents and clearing houses.[68] Where one party to a financial collateral arrangement falls into one of these specified categories and the other party is a non-natural person (including unincorporated firms and partnerships), Member States have an option to include or exclude such a financial collateral arrangement from the scope of the Directive.[69]

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[65] See 11 U.S.C. § 109(b)(3); 12 U.S.C. § 1821(e)(8). However, the U.S. Comptroller of the Currency is empowered in certain circumstances to appoint a receiver to take possession of all the property and assets of a foreign bank in the United States. See 12 U.S.C. § 3102(j)(1). Also, the special provisions of the New York Banking Law that are designed to ensure the enforceability of the close-out, set-off and netting of financial contracts against a New York banking organization that is subject to liquidation proceedings are applicable in the case of the liquidation of a branch or agency of a foreign banking corporation by the New York Superintendent of Banks. See N.Y. Banking Law §§ 618-a(1), 618-a(2) (McKinney 2003).

[66] See 12 U.S.C. §§ 4402(14), 4403(a); 12 C.F.R. §§ 231.2, 231.3.

[67] See Collateral Directive, Article 11, first para.

[68] See Collateral Directive, Article 1(2).

[69] See Collateral Directive, Articles 1(2)(e), 1(3).

127. Article 7(1) of the Collateral Directive provides as follows: 'Member States shall ensure that a close-out netting provision can take effect in accordance with its terms: (a) notwithstanding the commencement or continuation of winding-up proceedings or reorganisation measures in respect of the collateral provider and/or the collateral taker; and/or (b) notwithstanding any purported assignment, judicial or other attachment or other disposition of or in respect of such rights.'

128. Regarding the recognition of close-out netting provisions accorded by Article 7 of the Collateral Directive, we take particular note of the definition of 'close-out netting provision' contained in Article 2(1)(n) of the Collateral Directive, according to which '"close-out netting provision" means a provision of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any statutory rule by 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.'[70]

129. We take particular note of the rationale behind the close-out netting provisions of the Collateral Directive, including the above underlined language, which is clarified in recital 14 of the Collateral Directive: 'The enforceability of bilateral close-out netting should be protected, not only as an enforcement mechanism for title transfer financial collateral arrangements including repurchase agreements but more widely, where close-out netting forms part of a financial collateral arrangement. Sound risk management practices commonly used in the financial markets should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of the collateral.'

130. We consider that these provisions of the Collateral Directive require Member States to ensure the enforceability of close-out netting provisions contained in any master agreement under which exposures are capable of being collateralised by way of title transfer or pledge

[70] See Collateral Directive, Article 2(1)(n) (emphasis added).

arrangements. These master agreements include master repurchase and securities lending agreements, as well as master swap agreements of which a financial collateral arrangement forms part (e.g. an ISDA Master Agreement of which an ISDA Credit Support Annex or Deed forms part, or the Margin Maintenance Annex to the Master Agreement for Financial Transactions, sponsored by the European Banking Associations). In particular, this implies that the close-out netting recognition provisions in the Collateral Directive apply to any master agreement of which a financial collateral arrangement forms part, even if the parties in a particular relationship or transaction have not actually provided any collateral.

V. Need for legislative clarification regarding the scope of insolvency close-out netting protection at the Community level

131. We believe it is desirable to have legislative clarification on the scope of protection for insolvency close-out netting arrangements under Community law.

132. The main reason for such clarification is the deep uncertainty as to whether the set-off protection in Article 6 of the Insolvency Regulation encompasses close-out netting. As a result, in many Member States the enforceability of close-out netting arrangements in insolvency proceedings concerning non-financial counterparties is very uncertain. Financial market participants and regulators consider it essential to have a high degree of certainty on the enforceability of contractual set-off and netting agreements in case a counterparty should default. This concern for certainty is shared by both the Community and the Basel Committee on Banking Supervision in view of the implications of the legal enforceability of set-off and netting agreements for the prudential supervision of credit institutions and the stability of the international financial system. Ensuring legal certainty for close-out set-off and netting arrangements would guarantee the necessary level of protection for key financial instruments, which play a vital role in modern financial markets. This would make transactions and the legitimate expectations of parties more certain in an area where any doubt creates severe risk of systemic damage and impaired market efficiency.

133. The protection for close-out netting provisions in the Collateral Directive is not sufficient to overcome this legal uncertainty, since the Collateral Directive only applies to close-out netting provisions in a financial collateral arrangement, or an arrangement of which a financial collateral arrangement forms part. In addition, Member States may exclude from the scope of the Collateral Directive financial collateral arrangements in which the collateral taker and the collateral provider do not both belong to one of the listed categories of financial institutions and

public authorities. Excluding these arrangements may potentially further reduce the protection for close-out netting provisions contained in such financial collateral arrangements.

134. A second reason supporting legislative clarification is that the Community *acquis* regarding the enforceability of bilateral set-off and netting agreements is incoherent due to the divergent approaches taken by the Community legislator to overcoming legal uncertainties regarding the enforceability of such arrangements. The main legal risks affecting the enforceability of set-off and netting agreements arise under the insolvency law applicable to a defaulting counterparty, rather than the governing law of the contract. The Collateral Directive correctly sought to overcome these risks by requiring Member States to ensure the enforceability of close-out netting provisions in financial collateral arrangements. By contrast, the Insolvency Regulation and the Banks Winding-up Directive sought to overcome these legal risks by creating special conflict-of-law rules designed to avoid applying the insolvency law relevant to the defaulting counterparty by ensuring that the governing law of the contract would determine the enforceability of set-off and netting arrangements. We consider that this conflict-of-law approach to overcoming legal risks regarding the enforceability of insolvency set-off and netting agreements that arise under national insolvency laws is unsatisfactory if not supported by general legislative recognition of such arrangements. Indeed, this approach can create surprising results that are contrary to the expectations of parties, thus replacing one form of legal uncertainty with another. We consider that the approach taken to the enforceability of insolvency set-off and netting agreements in the Collateral Directive is conceptually preferable to the approach taken in the Insolvency Regulation and the Banks Winding-up Directive.

135. Ideally, we would support an EU legal act on (close-out) netting. Such a legal act would deal with inconsistencies between the considerable body of netting legislation that exists at the level of the Member States by providing criteria by which a Member State can assess whether its own netting legislation is adequate against EU standards. However, we recognise that this proposal might not be feasible at present in view of the legislative agenda of the Commission following the Financial Services Action Plan (FSAP). We note, however, that if the conflict-of-law provisions in Article 9 of the Collateral Directive are reviewed in the light of the Hague Convention of 13 December 2002 on the law applicable to certain rights concerning securities held with an intermediary, then this issue might also be addressed. We would urge the Commission to take advantage of the opportunity offered by this review, which will involve discussions with the European Parliament and Council, to also amend and expand the close-out netting provisions of the Collateral Directive.

136. Without prejudice to other possible legislative solutions, including a possible EU legal act on close-out netting, we recommend that the definition of 'close-out netting provision' in Article 2(1)(n) of the Collateral Directive be amended as follows: '(n) "close-out netting provision" means a provision of a**n** []arrangement, **whether** or **not such** arrangement **forms part** of []a financial collateral arrangement[], or, in the absence of any such provision, any statutory rule by 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.'

137. Also, consistent with this amendment we recommend that recital 14 of the Collateral Directive be amended as follows: 'The enforceability of bilateral close-out netting should be protected, not only as an enforcement mechanism for title transfer financial collateral arrangements including repurchase agreements but more widely[]. Sound risk management practices commonly used in the financial markets should be protected by enabling participants to manage and reduce their credit exposures arising from all kinds of financial transactions on a net basis, where the credit exposure is calculated by combining the estimated current exposures under all outstanding transactions with a counterparty, setting off reciprocal items to produce a single aggregated amount that is compared with the current value of **any** []collateral **provided**.'

Annex 1

Danish text of the Insolvency Regulation[71]

1. In recital 26 and Article 6 of the Danish version of the Insolvency Regulation, set-off has been translated as *modregning*. In recital 27, position-closing agreements and netting agreements have been translated using the English words close-out-netting and netting, respectively.

Community legal acts

2. The terminology used for set-off and netting in the context of the Danish versions of the Settlement Finality Directive, the Collateral Directive and the Banks Winding-up Directive can be used as a reference. In the Danish versions of both the Settlement Finality Directive and the Collateral Directive, *netting* has been translated using the English word netting. In the Settlement Finality Directive, payment netting has been translated as *betalingsnetting* and in the Collateral Directive set-off has been translated as *modregning* and close-out netting as *slutafregning* (close out netting). Corresponding to this, the English term netting has been translated as *netting,* whereas set-off has been translated as *modregning* in the Danish version of the Banks Winding-up Directive.

3. It is noted that *netting* has been translated throughout by using the English word netting, including in connection with other words (e.g., *slutafregning*), rather than *modregning*. The Settlement Finality Directive and the Collateral Directive have been implemented into Danish law by amendments to the Securities Trading Act.[72] The Act also uses the term *netting* when giving a definition according to the Settlement Finality Directive.[73] The term n*etting* is used widely in the Act, with the exception that *slutafregning* is used for close-out netting. It can be added that the word *netting* is used in several ministerial orders.[74] The regulation regarding capital requirements for credit institutions lays down rules for 'netting' agreements.

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[71] It is noted that while the Danish text of the Insolvency Regulation is one of the original 11 equally authentic versions of the Insolvency Regulation, Denmark is the only one of the original 15 EU Member States in which the Insolvency Regulation is not applicable.

[72] Consolidated Act No. 1269 of 19 December 2003.

[73] Art. 2, para k.

[74] Ministerial order No. 1122 of 13 December 2003, Appendix 2, and Ministerial order No. 9827 of 18 December 2003, Art. 14, Art. 30, Art. 32 and Appendix 6.

Danish law

4. In Danish case law and literature, it is well established to what extent *modregning* can be claimed by one of the parties. *Modregning* does not need any previous agreement. The main requirements under case law can be summarised as follows: first, the debts must exist between the same parties unless the claims have arisen from the same contract or are similarly connected; second, the debts must be fungible (pecuniary claims may be set off even if they are denominated in different currencies); third, the debts must be due.[75] However, there are some modifications to these general requirements in case law where other aspects are taken into consideration.[76]

5. *Modregning* as a term may also be used in relation to a contractual agreement on set-off between the parties. In that case the terminology might be altered to *aftalt modregning* (agreed set-off). The agreement can either extend or limit the set-off between the parties compared to the set-off based on case law.[77]

6. Modifications as to the extent to which *modregning* can take place is provided in the Danish Insolvency Act[78]; some are for the common benefit of creditors and some for the benefit of the creditor who wishes to set off. The Insolvency Act generally provides that a claim on the debtor on the day of the bankruptcy petition can be used as the basis for *modregning*. As opposed to the case law, the claim on the debtor need not have matured, whereas the claim still has to be fungible. Furthermore, *modregning* can take place between claims where both are acquired after the day of the request but before the date of the bankruptcy order.[79] The Insolvency Act prevents the use of *modregning* of claims on the insolvent debtor acquired from third parties within a certain time limit; in bad faith; claims that are comparable to voidable payments; deferred claims; or if debts to the insolvent debtor have been established in bad faith.[80] These provisions are mandatory and cannot be altered by a previous agreement. The Insolvency Act also contains provisions for the contracts that the insolvent party has concluded. The Act stipulates that the insolvent estate has a right to enter into mutually obligating agreements.[81] The Act's provisions regarding mutually obligating contracts are generally mandatory and cannot be derogated from in contracts except in agreement with the insolvent estate[82]. However, it is also stipulated in the

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[75] The party who claims *modregning* must under the contract be allowed to discharge himself of his obligations. The other party's obligations must be due.

[76] B. Gomard, *Obligationsret*, vol. 3 (1993), p. 177.

[77] *Aftalt modregning* may require an act of perfection according to the law of pledges.

[78] Consolidated act No. 118 of 4 February 1997 as altered by Law No. 402 of 26 June 1998.

[79] Art. 42, subsection 1 and 2.

[80] Art. 42, subsection 3 and 4, Art. 43 and Art. 69.

[81] Art. 55, Subsection 1.

[82] Mogens Munch, *Konkursloven med kommentarer* (1997), p. 367.

Insolvency Act that other acts, contrary to these provisions, should be regarded as *lex specialis*. An example of such an act is the Securities Trading Act and its close-out netting provisions. The Securities Trading Act prevents the insolvent estate from the 'cherry-picking' of favourable contracts it could otherwise be entitled to under the Insolvency Act. In this respect there is a difference in the Insolvency Act between the right to set-off (*modregning*) and the right to terminate a contract. Insofar as insolvency close-out netting may be characterised as a process beginning with the termination of transactions and culminating in the calculation and set-off, this may imply that the concept of *modregning* does not encompass insolvency close-out netting.

7. Unlike *modregning*, the terms *slutafregning* or *netting*, when used in the context of the close-out netting provisions of the Securities Trading Act, are always based on a contractual agreement.[83] In the above ministerial orders, *netting* is also used in situations where there is an agreement between the parties. The term *netting* is only used in the relatively narrow context of financial transactions.

8. The main difference between the cases in which *modregning* and *netting* are used in Danish law is that *modregning* is not necessarily based on an agreement whereas *netting* is. Furthermore, some requirements in case law for *modregning* may not have to be fulfilled under a *netting* agreement. In a typical *netting* agreement, netting would be allowed between debts that do not fulfil the three main requirements under case law. Finally, the terms *slutafregning* or *netting* used in the specific context of the close-out netting provisions of the Securities Trading Act also enjoy a wider protection than other types of agreed *modregning* according to the Insolvency Act.

9. The use of the English word 'netting' in the Danish translations could indicate an interpretation according to English legal terminology. It is, however, more likely that the translation is based on the fact that *netting* is used in the Danish financial sector. In that respect it could be understood as a financial term rather than a legal one.

10. We note that the Securities Trading Act recognising close-out netting agreements specifically modify the Insolvency Act. In the Insolvency Act the only term used is *modregning*. Based on this it could be argued that close-out netting agreements are a specific type of agreed *modregning* under Danish law.

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[83] Art. 57, Subsection 1, and Art. 58.

Conclusion

11. In recital 26 and Article 6 of the Danish version of the Insolvency Regulation, set-off has been translated as *modregning*. In Community legal acts *netting* has been consistently translated by using the English word netting, including in connection with other words (e.g. *slutafregning* (close-out netting*)*), rather than *modregning*.

12. From the perspective of Danish law, as established in case law and as provided in the general provisions of the Danish Insolvency Act, *modregning* is in certain respects wider and in certain respects narrower than *netting*. In particular, *modregning* is not necessarily based on a contractual agreement, whereas *netting* is. However, it can be argued that close-out netting agreements are a specific type of agreed *modregning* under Danish law. On the other hand, insofar as there is a difference in the Danish Insolvency Act between the right to set off (*modregning*) and the right to terminate a contract, it could also be argued that *modregning* does not encompass insolvency close-out netting.

13. In conclusion, it is difficult to reach a definitive legal conclusion regarding the proper meaning of *modregning* as used in the Danish version of Article 6 of the Insolvency Regulation.

Annex 2

Dutch text of the Insolvency Regulation

1. The equivalent Dutch term for set-off as used in Article 6 of the Insolvency Regulation is *verrekening*. Set-off has traditionally been translated in Dutch as *schuldvergelijking* and netting as *verrekening*. While this might imply that 'set-off' as used in Article 6 of the Insolvency Regulation should be understood as 'netting', it should also be noted that several strong arguments support the conclusion that, in Dutch, *verrekening* (netting) and *schuldvergelijking* (set-off) may be used interchangeably.

2. First, as noted in connection with the comparison between the Dutch and the French version of Belgian statutory provisions dealing with netting and set-off (see the analysis of the French text of the Insolvency Regulation), these provisions use the terms netting (*verrekening*) and set-off (*schuldvergelijking*) to express the same legal concept

3. Second, the new Dutch Civil Code uses the term *verrekening* when referring to the basic statutory rules regarding set-off, although the very similar rules are referred to in the French and Belgian Civil Codes as *compensation* (translated as *schuldvergelijking* in the Dutch version of the Belgian Civil Code).

4. Third, the Dutch version of the Banks Winding-up Directive refers, in the heading and text of Article 23, to *verrekening* ('set-off' in the English text) and, in the heading and text of Article 25, to *verrekening and novatie* ('netting agreements' in the English text).

5. Fourth, Article 2(n) of the English text of the Collateral Directive refers to 'netting or set-off or otherwise' and the equivalent Dutch text refers to *saldering, verrekening of anderszins*. Furthermore, recital 14 of the English text of the same Directive refers to 'close-out netting'; the equivalent Dutch text refers to *saldering*. Thus, it appears that the English netting is translated both times in Dutch as *saldering* (cf. in the Dutch version of Belgian law, netting is usually translated as *verrekening* and the concept *saldering* is not widely used).[84] It also appears that the English set-off is translated in Dutch as *verrekening*, although the Dutch version of Belgian statutory law usually refers to *verrekening* to express the concept of netting.

[84] It should be noted in this respect that, under French and Belgian civil law, "compensation" and "novation" do not have the same legal meaning.

6. To summarise, it appears that, in Dutch, netting and set-off are translated, according to the legal framework in which these terms are used, as *verrekening*, *saldering* or *schuldvergelijking*, but that these terms all refer to the same legal concept.

Belgian law

7. Subject to certain differences, the Belgian Code Civil contains the same articles regarding 'set-off' as the French Code Civil (*compensation* in the French version of the Belgian Code Civil and *schuldvergelijking* in the Dutch version, both versions having authentic value). While under Belgian law netting and set-off express the same legal concept, this concept is different from close-out netting. This matter is explained in connection with the analysis of the French text of the Insolvency Regulation (see Annex 5, infra).

Dutch law

8. The legal concept of close-out netting in its entirety is not addressed in Dutch doctrine or jurisprudence. Dutch scholars address the three distinct steps of termination, calculation and set-off individually, and all three are generally considered viable under Dutch insolvency law.[85] This may imply that close-out netting encompasses more than mere netting. This interpretation is also supported by recital 5 of the Collateral Directive, where close-out netting has been translated in the Dutch text as *wederkerige saldering bij vroegtijdige beeindiging*. This suggests a recognition that close-out netting encompasses more than netting, i.e. netting after termination.

Conclusion

9. It does not appear that the reference to *verrekening* in the Dutch text of Article 6 of the Insolvency Regulation covers insolvency close-out netting.

[85] See Bob Wessels, Close-out Netting in the Netherlands, [1997] 5 JIBL.

Annex 3

English text of the Insolvency Regulation

1. The English text of the Insolvency Regulation refers to 'set-off' in Article 6, as well as in Article 26 and in recital 26. In addition, the English text of recital 27 makes reference to the 'position-closing agreements and netting agreements to be found in payment systems'.

2. To ascertain the meaning of set-off in the context of the English text of the Insolvency Regulation, and in particular whether it should be interpreted to encompass insolvency close-out netting arrangements, we must analyse and compare other Community legal acts and applicable national (e.g. English and Irish) laws.

Community legal acts

3. The English text of the Collateral Directive provides some support for the view that 'set-off' may be broad enough to describe the acceleration and net settlement of claims. However, the English text of the Collateral Directive also supports the view that the overlapping concepts of close-out netting and set-off in the Collateral Directive are in certain respects distinct. In particular, Article 2(1)(n) of the Collateral Directive defines 'close-out netting provision' as:

   'a provision of a financial collateral arrangement, or of an arrangement of which a financial collateral arrangement forms part, or, in the absence of any such provision, any statutory rule by 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 definition of close-out netting provisions 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. However, the definition of a 'close-out netting provision' under the Collateral Directive also contemplates that close-out netting may be accomplished through 'the operation of netting or set-off or otherwise', implying that insolvency set-off and netting are overlapping, but in certain respects distinct, legal concepts. In particular, the kind of close-out netting provision contemplated by the Collateral Directive, whereby the obligations of the parties are terminated and replaced by an obligation to pay an

amount representing the estimated current value of the terminated obligations, would not technically require any set-off of the resulting single replacement obligation.[86]

4. From one perspective the English text of the set-off and netting provisions of the Banks Windingup Directive gives some support for the interpretation that set-off provides the general legal framework within which the contractual technique of netting operates. From another perspective, however, these provisions could also be seen as distinguishing between insolvency set-off and insolvency close-out netting.

5. Article 23 of the Banks Winding-up Directive states, in substantially the same terms as Article 6 of the Insolvency Regulation:

'1. The adoption of reorganisation measures or the opening of winding-up proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the credit institution, where such a set-off is permitted by the law applicable to the credit institution's claim.

2. Paragraph 1 shall not preclude actions for voidness, voidability or unenforceability laid down in Article 10(2)(l).'[87]

6. Article 25 of the Banks Winding-up Directive states:

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

7. The reference to 'netting agreements', rather than simple 'netting', in Article 25 of the Banks Winding-up Directive may be properly regarded as indicating that netting is conceived as a contractual technique. This is consistent with the fact that close-out netting arrangements are established under the terms and conditions of master agreements that are widely deployed by financial market participants to reduce the effective level of their obligations following counterparty insolvency.[88] By contrast, the reference to 'set-off' rather than 'set-off agreements'

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[86] See also S. Henderson, Henderson on Derivatives (2003), p. 335.

[87] Article 22 of the Insurance Undertakings Winding-up Directive contains a provision about the set-off of claims against the claims of insurance undertakings that is drafted in substantially the same terms as Article 23 of the Banks Winding-up Directive.

[88] The main master agreements used in Ireland and the United Kingdom are the English or New York law-governed ISDA Master Agreement (Multi-currency, Cross-Border 1992 and 2002 versions) sponsored by the International Swaps and Derivatives Association, the English law-governed PSA/ISMA Global Master Repurchase Agreement (1995 version) and TBMA/ISMA Global Master Repurchase Agreement (2000 version) sponsored by The Bond Market Association and the International Securities Market Association and the English law-governed ISLA Overseas Securities Lender's Agreement (1995 version) sponsored by the International Stock Lenders Association.

implies that set-off is regarded as a general legal concept, which may be taken to provide the legal framework within which netting agreements operate.

8. It can also be argued that the absence of specific protection for 'netting' in the Insolvency Regulation indicates that close-out netting is not protected. If the Insolvency Regulation had been intended to protect close-out netting, it would have included a specific protection similar to Article 25 of the Banks Winding-up Directive.

9. A possible explanation for this is that legislative references to close-out netting have a relatively modern origin. The concept of insolvency set-off, which is used interchangeably by English lawyers with that of close-out netting,[89] has been recognised in England by the common law courts and the courts of equity as far back as the seventeenth century, and on a statutory basis since 1705.[90] The current legislation in England on insolvency close-out netting is contained in the mandatory set-off provisions of Section 323 of the Insolvency Act 1986 and Rule 4.90 of the Insolvency Rules 1986. Close-out netting, like set-off, is so innately supported in English law that no legislation specifically referring to the phrase 'netting' was needed before the implementation of EU Directives[91] giving effect to the 1988 Capital Accord of the Basel Committee on Banking Supervision.[92] In Ireland the legal concept of close-out netting also first emerged in connection with the implementation of the Basel Capital Accord and the passage of the Netting of Financial Contracts Act 1995. This relatively modern evolution of legislative references to close-out netting is consistent with the increasing use by market participants of master agreements containing close-out netting provisions following the publication of the ISDA master agreement forms and the first version of the PSA/ISMA Global Master Repurchase Agreement in 1992.[93]

10. The Insolvency Regulation was, in effect, an implementation of the Convention on Insolvency Proceedings, signed in Brussels on 23 November 1995. After the Convention lapsed due to the

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89 See paragraph 13 below.

90 See R. Goode, Legal Problems of Credit and Security (2003), p. 242; P. Wood, Title Finance, Derivatives, Securitisations, Set-off and Netting (1995), p. 160.

91 See Council Directive 89/299/EEC of 17 April 1989 on the Own Funds of Credit Institutions, O.J. L 124/6; Council Directive 89/647/EEC of 18 December 1989 on a Solvency Ratio for Credit Institutions, O.J. L 386/14 (since replaced by Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions, O.J. L 126/1); Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investments firms and credit institutions, O.J. L 141/1.

92 The applicable EU Directives implementing the 1988 Basel Accord are currently implemented in the UK through rules made by the Financial Services Authority (FSA) under section 138 of the UK Financial Services and Markets Act of 2000. See FSA Interim Prudential Sourcebook for Banks and Interim Prudential Sourcebook for Investment Firms, published on the FSA website at www.fsa.gov.uk/vhb/.

93 See Anthony C. Gooch and Linda B. Klein, Documentation for Derivatives (2002), pp. 18-21; The Bond Market Association, Guidance Notes for Use with the PSA/ISMA Global Master Repurchase Agreement (November 1995 version), p. 1, published on The Bond Market Association's website at www.bondmarkets.com/agrees.

failure of one contracting State to sign it in due time, all the provisions of the Convention, with one exception, were transformed into the text of the Insolvency Regulation.[94] It could be seen as natural that the English version of a legal text concluded in 1995 would refer to the more traditional concept of set-off, rather than the modern contractual technique of close-out netting.

11. The Banks Winding-up Directive was adopted in 2001.[95] The ever-increasing use of master agreements by this time may explain why a reference in a Community legal text to the general legal concept of set-off would be accompanied by a more specific reference to the more modern evolution of master agreements containing close-out netting provisions.

English law

12. As noted above, the concept of insolvency set-off has been recognised in England as far back as the seventeenth century. So strongly does modern English policy favour insolvency set-off that its application is mandatory in the sense that it cannot be excluded by prior agreement of the parties.[96]

Section 323 of the Insolvency Act 1986 thus states:

'323 Mutual credit and set-off

(1) This section applies where before the commencement of the bankruptcy there have been mutual credits, mutual debts or other mutual dealings between the bankrupt and any creditor of the bankrupt proving or claiming to prove for a bankruptcy debt.

(2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set off against the sums due from the other....

(4) Only the balance (if any) of the account taken under subsection (2) is provable as a bankruptcy debt or, as the case may be, to be paid to the trustee as part of the bankrupt's estate.'

Rule 4.90 of the Insolvency Rules 1986 provides in similar terms as follows:

'Rule 4.90. Mutual credit and set-off

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94 See Jean-Pierre Deguée, Advisor – Belgian Banking and Finance Commission, Directive 2001/24/EC on the reorganisation and winding up of credit institutions finally establishes uniform private international law for banking insolvency proceedings, International Conference on Bankruptcy Reform, Siena, 6-7 December 2000, p. 2, footnotes 6 & 7.

95 Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions, OJ L 125, 5.5.2001, p. 15.

96 *National Westminster Bank Ltd.* v *Halesowen Presswork and Assemblies Ltd.* [1972] A.C. 785 (House of Lords).

(1) This Rule applies where, before a company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.

(2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums from the other….

Only the balance (if any) of the account is provable in the liquidation. Alternatively (as the case may be) the amount shall be paid to the liquidator as part of the assets.'

13. There is an extensive English jurisprudence analysing the inter-relationship between the concepts of insolvency set-off and insolvency close-out netting.[97] In England, insolvency close-out netting is often viewed by lawyers as merely another term for insolvency set-off, and it is clear that in many circumstances the two terms, set-off and netting, are capable of being used interchangeably. English legal writers thus acknowledge that the netting of foreign exchange, swaps, futures, securities and repo contracts is one of the most common cases of set-off. The specific term 'netting' is often used by financial market participants because in many cases the process of insolvency close-out netting is said to involve, in legal terms, more than a set-off of debts. For contracts involving the payment of a liquidated debt (e.g. loans, deposits) or an unliquidated claim or contingent debt (e.g. contracts for differences typical of futures and options markets and claims under interest rate caps and floors) netting can be achieved solely by setting off reciprocal claims on the insolvency of the counterparty. However, in the case of executory contracts to deliver property or money, including contracts for the exchange or delivery of money (e.g. normal foreign exchange contracts and interest rate swaps), netting involves a process beginning with the rescission or termination of all open or unmatured contracts with the insolvent counterparty followed by the set-off of the resulting losses and gains over the whole series of mutual contracts.[98] Netting has thus been described as both the procedure for, and the outcome of, a contractually completed set-off. Seen from this perspective, the contractual technique of insolvency close-out netting used in some master agreements (e.g., the TBMA/ISMA Global Master Repurchase Agreement)[99] is constructed on the basis of the traditional legal concept of set-off known to English law for centuries. Insolvency set-off can thus be properly regarded as providing the general legal framework within which the particular contractual technique of

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97 See generally, e.g., R. Goode, Legal Problems of Credit and Security (2003), p. 241-42; A. Hudson, The Law on Financial Derivatives (2002), pp. 463-64; P. Wood, Title Finance, Derivatives, Securitisations, Set-off and Netting (1995), pp. 72-73, 151-61.

98 The right to rescind an executory contract was recognised in *Shipton, Anderson & Co (1927) Ltd (in Liquidation)* v *Micks, Lambert & Co* [1936] 2 All ER 1032, where the right to rescind a commodity contract under the standard terms of a commodity market was upheld.

99 See The Bond Market Association (TBMA)/ International Securities Markets Association (ISMA), Global Master Repurchase Agreement (2000 version), Section 10(c)..

insolvency close-out netting is deployed by financial market participants to reduce the effective level of their obligations following counterparty insolvency.

14. Set-off in its ordinary meaning can thus be seen as a broad term, and the net settlement of reciprocal future or contingent claims can be seen as a form of set-off. Indeed, insolvency set-off under English law expressly extends to items which are future or contingent claims at the time of the commencement of insolvency proceedings.100

15. However, insolvency close-out netting provisions in some master agreements are more properly analysed on the basis of a 'flawed assets' theory under English law, rather than on the traditional basis of insolvency set-off. A flawed asset is a conditional debt which is not payable until an event specified in the contractual arrangements occurs. Such an asset is not available for set-off for, if the event in question has not occurred, a debtor has no liability against which a cross-claim can be set off.[101] For example, the ISDA master agreement forms, under which many swap and derivatives transactions are documented under English law, explicitly make performance of payment and delivery obligations in respect of individual transactions subject to the condition that an 'early termination date' for all outstanding transactions has not occurred or been effectively designated.[102] The obligation to pay or deliver in respect of an individual transaction may thus be regarded as a conditional obligation and the occurrence or effective designation of an early termination date as the permanent failure of one of the conditions to the parties' respective rights and obligations under the terms of individual transactions. Based on this 'flawed assets' analysis, the parties' obligations under individual transactions would, upon the occurrence or effective designation of an early termination date, be replaced with a single net obligation calculated in accordance with the insolvency close-out netting provisions of the ISDA Master Agreement.[103] A similar approach is taken by the European Master Agreement.[104] This net obligation is a product

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[100] Rule 4.90 of the Insolvency Rules 1986 and *Stein* v *Blake* [1996] AC 243.

[101] See *obiter dicta* statements of Lord Hoffman in *Re Bank of Credit and Commerce International SA* (No 8) [1998] AC 214, [1997] 4 All ER 568 (House of Lords); *see also* P. Wood, Title Finance, Derivatives, Securitisations, Set-off and Netting (1995), pp. 74-75.

[102] See International Swaps and Derivatives Association, Inc., ISDA Master Agreement, Multicurrency Cross-Border 1992 and 2002 versions, Sections 2(a)(iii) and 6(c).

[103] See International Swaps and Derivatives Association, Inc., ISDA Master Agreement, Multicurrency Cross-Border 1992 and 2002 versions, Section 6(e).

[104] See Banking Federation of the European Union, in cooperation with the European Savings Banks Group and the European Association of Cooperative Banks, Master Agreement for Financial Transactions, General Provisions (Edition 2004), Sections 3(3) and 6(4), which provide, *inter alia*, that in the event of a termination neither party shall be obliged to make any further payment or delivery under the terminated transactions and that these obligations shall be replaced by an obligation of either party to pay a final net settlement amount calculated in accordance with the master agreement's provisions.

of mere accounting and not the result of a set-off of claims determined in respect of those transactions.[105]

Irish law

16. Specific Irish legislation provides for the enforceability of close-out netting arrangements. Section 1 of the Netting of Financial Contracts Act 1995 contains the following definitions of 'netting' and a 'netting agreement':

> '"netting" means the termination of financial contracts, the determination of the termination values of those contracts and the set off of the termination values so determined so as to arrive at a net amount due, if any, by one party to the other where each such determination and set off aforesaid is effected in accordance with the terms of a netting agreement between those parties'; and
>
> '"netting agreement" means an agreement between two parties only, in relation to present or future financial contracts between them—
>
> (a) providing, *inter alia*, for the termination of those contracts for the time being in existence, the determination of the termination values of those contracts and the set off of the termination values so determined so as to arrive at a net amount due, and
>
> (b) which may provide for a guarantee to be given to one party on behalf of the other party solely to secure the obligation of either party in respect of the financial contracts concerned, and
>
> (c) which may provide for the set off against the net amount due under paragraph (a) and that amount only of—
>
> (i) any money provided solely to secure the obligation of either party in respect of the financial contracts concerned,
>
> (ii) the proceeds of the enforcement and realisation of any collateral in the form of—
>
> (I) securities or other property provided, or
>
> (II) money, securities or other property provided solely to secure the obligation of the guarantor under paragraph (b), solely to secure the obligation of either party in respect of the financial contracts concerned.'

17. While it can be argued that the Netting of Financial Contracts Act 1995 recognises that the concept of netting is constructed on the basis of the traditional legal concept of set-off,[106] the

[105] See also S. Henderson, Henderson on Derivatives (2003), p. 335.

Netting of Financial Contracts Act 1995 conceives of netting as a broader legal concept than set-off, encompassing the following three-step process: (1) the termination of financial contracts; (2) the determination of the termination values of those contracts; and (3) the set-off of the termination values so determined to arrive at a net amount due by one party to the other.[107]

18. That Irish law conceives of netting as a broader legal concept than set-off is also reflected in the statutory basis for rights of set-off in the liquidation of insolvent companies provided by paragraph 17(1) of the First Schedule to the Bankruptcy Act 1988, which states: 'Where there are mutual credits or debts as between a bankrupt and any other person claiming as a creditor, one debt or demand may be set off against the other and only the balance found owing shall be recoverable on one side or the other.'

19. This provision contrasts with the position in the United Kingdom, in that paragraph 17(1) of the First Schedule to the Bankruptcy Act 1988 is not expressed in mandatory form, stating that debts 'may' be set off against each other, while section 323 of the UK Insolvency Act 1986 is mandatory, requiring that debts 'shall' be set off against each other.[108] Moreover, the corresponding UK provision refers to 'other mutual dealings', in addition to debts. There is no Irish authority upon which one could rely to establish that paragraph 17(1) of the First Schedule to the Bankruptcy Act 1988 provides a clear statutory basis for insolvency close-out netting provisions contained in master agreements extensively used by Irish market participants, such as the ISDA Master Agreement. Indeed, one of the reasons for the adoption of the Netting of Financial Contracts Act 1995 was to overcome such legal uncertainty.[109]

20. In conclusion, Irish law conceives of netting as a distinct, and broader, legal concept than set-off.

Conclusion

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[106] C.f. William Johnston, Problems of Taking Security Over Cash and Bank Accounts, The Irish Centre for Commercial Law Studies, pp. 28-29, 22 May 2002.

[107] See generally A. Foy, The Capital Markets: Irish and international laws and regulations (1998), pp. 374-79.

[108] See generally A. Foy, The Capital Markets: Irish and international laws and regulations (1998), pp. 385-86; William Prentice, A Note on the Legal Background to the Set-off Contractual Termination and Netting in Financial Contracts (Miscellaneous Provisions) Bill 1995, p. 3.

[109] See William Prentice, A Note on the Legal Background to the Set-off Contractual Termination and Netting in Financial Contracts (Miscellaneous Provisions) Bill 1995, pp. 2-4. The main reason for the passage of the Netting of Financial Contracts Act 1995 was to insulate close-out netting agreements from various provisions of Irish insolvency law, including the power of an examiner under Section 7(5) of the Companies (Amendment) Act 1990 to halt, prevent or rectify the effects of a contract by the company to which he has been appointed which is likely to be the detriment of that company. See Prentice, id., pp. 4-7; Ronan Malony and Judith Lawless, Irish legislation validates close-out netting, International Financial Law Review, Sept. 1995, p. 15..

21. The English text of the Collateral Directive provides some support for the view that 'set-off' is broad enough to describe the acceleration and net settlement of claims, which form part of the close-out netting procedure. However, the English text of the Collateral Directive also supports the view that the overlapping concepts of close-out netting and set-off are in certain respects distinct. From one perspective the English text of the set-off and netting provisions of the Banks Winding-up Directive provide some support for the interpretation that set-off provides the general legal framework within which the contractual technique of netting operates. From another perspective, however, these provisions could also be seen as distinguishing between the concepts of insolvency set-off and insolvency close-out netting.

22. The contractual technique of insolvency close-out netting is constructed on the basis of the traditional legal concept of set-off known to English law for centuries. As a matter of English law, insolvency set-off can thus be properly regarded as providing the general legal framework within which the particular contractual technique of insolvency close-out netting is deployed by financial market participants to reduce the effective level of their obligations following counterparty insolvency. However, in the case of executory contracts to deliver property or money, insolvency close-out netting has been said to involve a legal process. This begins with the rescission or termination of all open or unmatured contracts with the insolvent counterparty, followed by the set-off of the resulting losses and gains over the whole series of mutual contracts. Also, there is a doctrinal discussion about whether insolvency close-out netting is more properly analysed on the basis of a 'flawed assets' theory under English law, rather than on the traditional basis of insolvency set-off. Seen from this perspective, the net obligation calculated by applying the close-out netting provisions of certain master agreements (e.g. the ISDA forms of master agreement) can be viewed as a product of mere accounting, and not the result of a set-off of claims determined in respect of those transactions.

23. Irish law conceives of netting as a broader legal concept than set-off, encompassing a three-step process: (1) the termination of financial contracts; (2) the determination of the termination values of those contracts; and (3) the set-off of the termination values so determined to arrive at a net amount due by one party to the other.

24. In conclusion, based on Community legal acts and applicable national laws, a credible argument can be made that the term 'set-off', as used in the English version of Article 6 of the Insolvency Regulation, should be interpreted to encompass insolvency close-out netting arrangements. However, counter-arguments can be made, and it is difficult to predict with a high degree of legal certainty how the concept of 'set-off' referred to in the English version of Article 6 of the Insolvency Regulation should be interpreted.

Annex 4

Finnish text of the Insolvency Regulation

1. The Finnish term used as an equivalent to the English term 'set-off' in Article 6 of the Insolvency Regulation, is *kuittaus*.

2. Also, both in Article 4(2) and in recital 26 of the Insolvency Regulation, where the English term 'set-off' is used the Finnish language version refers to *kuittaus*. Where recital 27 of the English language version of the Insolvency Regulation, which addresses the special protection that payment systems and financial markets enjoy, refers to 'position-closing and netting agreements', the Finnish version refers to *selvitys- ja nettoutussopimus*.

Community law

3. As regards other Community legal acts, where the English version of the Settlement Finality Directive, the Banks Winding-up Directive and the Collateral Directive refer to 'set-off' the Finnish versions consistently use *kuittaus*. Where the English versions of the same directives refer to 'netting', the Finnish versions use *nettoutus*.

4. The consistent use of the terms *kuittaus* and *nettoutus* for set-off and netting respectively in different Community legal acts may imply that these two terms are treated as two different concepts.

Finnish law

5. In Finnish civil law *kuittaus* means that reciprocal, similar and enforceable claims are discharged against another (distinguished), and the remaining difference, if any, is paid out. Chapter 6 of the new Finnish Bankruptcy Act of 20 February 2004[110] sets out the conditions for allowing set-off in bankruptcy situations.

6. The preparatory works of the new Finnish Bankruptcy Act[111] appear to treat *nettoutus* as a special form of *kuittaus.* The explanatory memorandum of the Act refers to the general principle of *lex specialis,* stating that the special provisions concerning set-off and the eligibility of liabilities for set-off in a debtor's insolvency enjoy priority against the general set-off provisions set out in the

[110] Bankruptcy Act, Konkurssilaki, statute No. 2004/120 of 20 February 2004, in force as of 1 September 2004.

[111] Government proposal HE 26/2003.

Finnish Bankruptcy Act. As one of the most important of these special provisions the explanatory memorandum refers to the Netting Act.

7. According to the Netting Act *nettoutus* means basically that the multiple opposite payments or delivery obligations of the parties are combined to form one single net liability or asset for each party or that all the payment or delivery obligations of the parties can be terminated and combined as agreed, if insolvency proceedings are opened against one party. The Netting Act provides, in its relevant part, that such obligations that existed before a bankruptcy begins can be netted (*nettouttaa*) irrespective of the bankruptcy; and netting (*nettoutus*) is binding in the bankruptcy of the party that is a participant of a clearance system.[112]

8. Significantly, the explanatory memorandum of the new Finnish Bankruptcy Act states that 'the right to set off (*kuittaus*) obligations within the meaning of the Netting Act, i.e. netting (*nettoutus*) of obligations, shall take place as provided for in the said Act'. The reasoning for this is stated to be that the purpose of the Netting Act is to ensure the enforceability of customary provisions in the trade in securities and currency irrespective of the provisions limiting the general right to set off and rules concerning recovery by the bankruptcy estate. The preparatory works of the new Finnish Bankruptcy Act thus make it fairly clear that the Finnish legislator appears to treat netting as a special form of set-off that relates to claims referred to in the so-called Netting Act.[113] So, in this particular context the two terms 'set-off' and 'netting' are practically synonymous.

9. After generally describing the priorities of general and special provisions on set-off in bankruptcy and the interpretation of the set-off provisions of the Bankruptcy Act in the light of general principles concerning set-off, the explanatory memorandum of the new Finnish Bankruptcy Act refers to the provisions concerning choice of law of Article 6 of the Insolvency Regulation. On the one hand this could be taken to mean that the set-off mentioned in Article 6 would in Finland be interpreted as covering netting as well. On the other hand, based on the fairly loose drafting techniques in preparatory works, there does not have to be such a connection and the express wording of the preparatory works leaves the question open.

10. Finally, we note there is no case law or legal doctrine dealing with this question in Finland.

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[112] Section 3.1 of the Netting Act, "Ennen konkurssin alkamista syntyneet velvoitteet saadaan nettouttaa konkurssin estämättä ja nettoutus sitoo sopijapuolen ja selvitysjärjestelmän osapuolen konkurssissa".

[113] Laki eräistä arvopaperi- ja valuuttakaupan sekä selvitysjärjestelmän ehdoista (Act on certain conditions to be applied on securities and foreign exchange trade), statute No. 1999/1084 of 26 November 1999. This Act also implements the Settlement Finality Directive in Finland.

Conclusion

11. The consistent usage of the terminology *kuittaus* and *nettoutus* for set-off and netting respectively in different Community legal acts may imply that these two terms are treated as two different concepts. However, the preparatory works of the new Finnish Bankruptcy Act make it fairly clear that the Finnish legislator appears to treat netting (*nettoutus*) as a special form of set-off (*kuittaus*) that relates to claims referred to in the Finnish Netting Act. So, in this context set-off and netting are practically synonymous.

12. In conclusion, based on Finnish insolvency law it would appear that *kuittaus* as used in Article 6 of the Finnish version of the Insolvency Regulation may be properly interpreted as encompassing insolvency close-out netting.

Annex 5

French text of the Insolvency Regulation

1. The equivalent French term for 'set-off' as used in Article 6 of the Insolvency Regulation is *compensation*. To ascertain the meaning of *compensation* in the context of the Insolvency Regulation, and in particular whether it should be interpreted to encompass insolvency close-out netting arrangements, it is necessary to analyse and compare applicable national laws (i.e. French, Belgian and Luxembourg law), as well as the use of the relevant terminology in various Community legal acts.

Community legal acts

2. Article 23 of the Banks Winding-up Directive, which is captioned 'Set-off' and makes provision for 'set-off' in the English text, is captioned *Compensation* and makes provision for *la compensation* in the French text. The text of Article 25 of the Banks Winding-up Directive, which is captioned 'Netting agreements' and makes provision regarding 'netting agreements' in the English text, is captioned *Convention de compensation et de novation* and makes provision for *les conventions de compensation et de novation* ('netting agreements') in the French text. It is noted that the reference to netting agreements in the French text of Article 25 of the Banks Winding-up Directive conceives of netting agreements as including two kinds of agreements, namely *conventions de novation* and *conventions de compensation*. *Conventions de novation* are widely used to novate contractual obligations in the settlement of transactions in the foreign exchange markets. *Conventions de compensation* in the Banks Winding-up Directive may thus be taken to refer to close-out netting agreements.

3. Where the English text of the Collateral Directive refers to 'close-out netting' and 'close-out netting provisions', the equivalent French text refers to *la compensation avec déchéance du terme* and *des clauses de compensation avec déchéance du terme* (recital 14, Article 2(n), Article 7). Where the English text refers to 'setting off reciprocal items to produce a single aggregated amount' the equivalent French text refers to *une compensation des positions symétriques permettant d'obtenir un montant total unique* (recital 14).

4. The consistent use of *compensation* to refer to the related English concepts of 'set-off' and 'netting' in the French versions of various Community legal acts may imply that the reference to *compensation* in Article 6 of the Insolvency Regulation covers both insolvency set-off and insolvency close-out netting.

French law

5. *Compensation* is a well-established civil law concept, the scope and conditions of which are set out in Articles 1289 to 1299 of the French Code Civil. Debts may be *compensées* (or set off) either automatically by operation of law (*compensation légale*), pursuant to the provisions of an agreement that the law recognises as enforceable (*compensation conventionnelle*), or pursuant to a court-ordered *compensation (compensation judiciaire).*

6. For debts to qualify for *compensation légale* the debts must fulfil four criteria set out in Article 1291 of the Civil Code: first, the debt must exist between the same parties; second, the object of the debt must be a sum of money or a quantity of fungible things; third, the debt must be liquid (a debt is liquid when its existence is certain and its amount is determined); and fourth, the debt must be due.[114] When these four conditions are met Article 1290 of the Civil Code provides that the *compensation légale* takes place by operation of law,[115] and the two debts are reciprocally extinguished when they both exist at the same time, up to their respective amounts.[116] When the condition that the debt be liquid and/or due is not met, a judge may, at the request of one party, order a *compensation (compensation judiciaire).*[117]

7. Debts not qualifying for *compensation légale* may still be *compensées* (or set off) if the parties have agreed to compensate them (*compensation conventionnelle*). The parties may thus agree to compensate debts which are not liquid, not due or have different objects, for instance a sum of money and a thing. Because it gives an advantage to one creditor where a debtor is insolvent, the *compensation conventionelle* is deemed to constitute an abnormal payment, which raises the suspicion that it may be fraudulent in case of insolvency.[118] The *compensation conventionelle* is thus null and void if concluded during the suspect period, which can be up to 18 months before the date of issue of a judgment declaring a debtor insolvent and ordering its judicial reorganisation.[119] Therefore, in cases where the parties would attempt to conduct a *compensation*

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[114] Article 1291 of the Civil Code provides in relevant part as follows: *La compensation n'a lieu qu'entre deux dettes qui ont également pour objet une somme d'argent, ou une certain quantité des choses fongibles de la même espèce et qui sont egalement liquides et exigeables.*

[115] While, pursuant to Article 1290 of the Civil Code, *compensation* occurs by operation of law even if the debtors are not aware that the *compensation* took place, the French courts have considered that *compensation* can only take effect where it has been invoked by one of the parties. P. Malaurie et L. Aynès, *Les Obligations* (1999/2000), p. 644.

[116] Article 1290 of the Civil Code provides as follows: *La compensation s'opère de plein droit par la seule force de la loi, même à l'insu des débieteurs; les deux dettes s'éteignent réciproquement, à l'instant où elles se trouvent exister à la fois jusqu'à concurrence de leurs quotités respectives. '*

[117] P. Malaurie et L. Aynès, *Les Obligations* (1999/2000), p. 645.

[118] Article L 621-107 of the commercial code.

[119] P. Malaurie et L. Aynès, *Les Obligations* (1999/2000), p. 644.

conventionelle after the opening of a bankruptcy proceeding, such *compensation conventionelle* would in principle be paralysed on the basis of article L 621-24 of the commercial code relating to the suspension of payments. More generally, it should be remembered that *compensation* is possible even when all the conditions for *compensation* are not met if the debts to be *compensated* are connected (*connexes*)[120], i.e. arise from the same contractual relationship.

8. Concerning financial transactions, the French Parliament had to enact laws recognising the enforceability of agreements providing for termination (*résiliation*) and set-off (*compensation*) in case of insolvency. Law No. 93-1444 of 31 December 1993, as amended by Law No. 94-679 of 8 August 1994 (the Repo Law) and Law No. 87-416 of 17 June 1987, as amended by Law No. 96-597 of 2 July 1996 (the Securities Loan Law), created a sweeping exemption to the mandatory provisions of French insolvency law (exception to the unenforceability of agreements) providing for *compensation conventionelle* in insolvency for repos and securities loans fulfilling specified criteria. The Repo Law and the Securities Loan Law provide in almost identical terms that debts relating to repos or securities loans which are binding on third parties and are governed by a master agreement (which, in the case of repos, has been approved by the Governor of the Banque de France, President of the Commission Bancaire), regulating relations between two parties, are *compensables* in accordance with the terms of the said master agreement. The Repo and the Securities Loan Laws further provide that such a master agreement may provide for the automatic termination (*resiliation de plein droit*) of such repo or securities loan operations.[121] The Repo and Securities Loan Laws thus imply that the concept of close-out netting embraces two distinct legal concepts under French law, namely termination (*résiliation*) and set-off (*compensation*). Based on this approach, the concept of set-off (*compensation)* may not be construed as covering the entire close-out netting procedure.

9. In addition, Law No. 96-597 of 2 July 1996 (the Investment Services Directive Law or ISD Law) provides in similar terms that debts relating to financial instrument transactions that are governed by such a master agreement may be set off (*sont compensables*) in accordance with the terms of the master agreement. Significantly, the ISD Law further provides that the provisions related to termination, valuation and set-off (*les modalités de résiliation, d'évaluation et de compensation*)

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[120] P. Malaurie et L. Aynès, *Les Obligations* (1999/2000), p. 643.

[121] Article 12-V bis of Law No. 93-1444 of 31 December 1993 (subsequently codified as Article L. 432-16 of the Monetary and Financial Code) provides in relevant part as follows:

« Les dettes et les créances afférentes aux opérations de pension opposables aux tiers, régies par une convention cadre, approuvée par le gouverneur de la Banque de France, président de la commission bancaire, et organisant les relations entre deux parties sont compensables selon les modalités prévues par ladite convention cadre.

Cette convention cadre, lorsqu'une des parties fait l'objet d'une des procédures prévues par la loi n° 85-98 du 25 janvier 1985 relative au redressement et à la liquidation judiciaires des entreprises, peut prévoir la résiliation de plein droit de l'ensemble des opérations de pension mentionnées à l'alinéa précédent. »

incorporated in master agreements that meet the general requirements of a national or international master agreement prevailing in financial markets, are binding upon attaching creditors, and that any termination, valuation and set-off (*toute opération de résiliation, d'évaluation et de compensation*) resulting from an event of default linked to attachment proceedings will be considered to have occurred prior to the occurrence of such attachment proceedings.[122] The ISD Law thus implies that the concept of insolvency close-out netting embraces three distinct legal concepts under French law, namely termination (*résiliation*), valuation (*évaluation*) and set-off (*compensation*), and that the concept of set-off (*compensation*) may not be construed to cover the entire close-out netting procedure. The relevant provisions are now contained in Article L431-7 of the Monetary and Financial Code.

10. Finally, Law No. 2001-420 of 15 May 2001 relating to new economic regulations (the Global Netting Law), as amended by Law No. 2003-706 of 1 August 2003 relating to financial security, increased the legal certainty associated with cross-product netting arrangements by removing the requirement of 'connexity' between the debts relating to repos, securities loans and other financial transactions. The Global Netting Law provides in particular that debts and claims related to all transactions on financial instruments, when governed by one or several master agreements which meet the general requirements of domestic or international master agreements prevailing in such markets and which organise(s) the relations between at least two parties, one of which is an investment services provider, a public establishment, an institution, firm or establishment referred to in Article L. 531-2 of the Monetary and Financial Code or a non-resident establishment of comparable status, may be set off *(sont compensables)* in accordance with the methods provided in the master agreement(s) and may give rise to the calculation of a single netted settlement amount *(d'un solde unique compensé)*. Article L. 431-7 of the Monetary and Financial Code goes on to state, however, that, when one of the parties is subject to one of the proceedings provided for in Book VI of the Commercial Code, the regulations or master agreements may provide for the automatic termination (*resiliation de plein droit*) of the transactions specified in the first and second paragraphs of Article L. 431-7. As in the ISD Law, Article L. 431-7 further provides that the terms and procedures of termination, valuation and set-off (*les modalités de résiliation, d'évaluation et de compensation*) contemplated by one or several master agreements shall be binding on the attaching creditors, and that any termination, valuation and set-off (*toute opération de résiliation, d'évaluation et de compensation*) made because of civil execution proceedings is

[122] Article 52 of Law No. 96-597 of 2 July 1996 provides in relevant part as follows: *Les modalités de résiliation, d'évaluation et de compensation prévues par les règlements ou convention cadres visées aux alinéas précédents sont opposables aux créanciers saisissants. Toute opération de résiliation, d'évaluation et de compensation effectuée en raison d'une procédure civile d'exécution est réputée être intervenue avant ladite procédure.*

deemed to have occurred before the proceedings.[123] Like the ISD Law, the Global Netting Law also implies that the concept of close-out netting embraces three distinct concepts under French law, namely termination (*résiliation*), valuation (*évaluation*) and set-off (*compensation*). Based on this analysis, the concept of set-off (*compensation*) may not be construed to cover the entire close-out netting procedure. Otherwise it seems that the legislator would not have needed to use three different terms.

Belgian law

11. The Belgian Code Civil contains the same Articles 1289 to 1299 regarding 'set-off' as the French Code Civil (*compensation* in the French version of the Belgian Code Civil and *schuldvergelijking* in the Dutch version, both versions having authentic value). The French Civil Code principles referred to above regarding *compensation légale* (*wettelijke schuldvergelijking* in the Dutch version of Belgian law), *compensation conventionnelle* (*conventionele schuldvergelijking* in the Dutch version of Belgian law) and *compensation judiciaire* (*gerechtelijke schuldvergelijking* in the Dutch version of Belgian law) apply in Belgian law in the same way as they do in French law and have in Belgian law the same meaning as in French law, subject to the following differences.

12. First, the *compensation légale* is null and void under Belgian law when it takes place after the issue of a judgment declaring a debtor bankrupt, i.e. when the conditions under which the *compensation légale* arises are only fulfilled after the issue of the judgment. An exception to this prohibition is made for claims which are interrelated, i.e. if there is an objective connection between these claims because they arise from the same contract or from the same legal relationship. In this case, if the claims have arisen before the issue of the bankruptcy judgment, then the fact that the conditions for the *compensation légale* are only fulfilled afterwards will not prevent the operation of the *compensation.*

[123] Law No. 2001-420 of 15 May 2001 relating to new economic regulations, as amended and codified as Article L. 431-7 of the Monetary and Financial Code, provides in relevant part as follows: *Les dettes et les créances afférentes à toutes opérations sur instruments financiers, lorsqu'elles sont effectuées dans le cadre du règlement général de l'Autorité des marchés financiers ou lorsqu'elles sont régies par une ou plusieurs conventions-cadres respectant les principes généraux de conventions-cadres de place, nationales ou internationales, et organisant les relations entre deux parties au moins, dont l'une est un prestataire de services d'investissement ou un établissement public ou une institution, entreprise ou un établissement bénéficiaire des dispositions de l'article L. 531-2 ou un établissement non résident ayant un statut comparable, sont compensables selon les modalités prévues par ledit règlement, la ou lesdites conventions-cadres et peuvent donner lieu à l'établissement d'un solde unique compensé…. Lorsque l'une des parties fait l'objet de l'une des procédures prévues par le règlement ou lesdites conventions-cadres peuvent prévoir la résiliation de plein droit des opérations mentionnées aux premier et deuxième alinéas du présent article. Les modalités de résiliation, d'évaluation et de compensation prévues par le règlement. la ou les convention-cadres visées aux alinéas précédents sont opposables aux créanciers saisissants. Toute opération de résiliation, d'évaluation et de compensation effectuée en raison d'une procédure civile d'exécution est réputée être intervenue avant ladite procédure.*

13. Second, the *compensation conventionelle* is null and void when it takes place during a suspect period of up to a maximum of six months before the date of issue of a judgment declaring a debtor bankrupt. Because *compensation conventionelle* is null and void in insolvency situations, a specific statutory provision was needed to avoid this nullity for certain transactions, i.e. Article 157 of the Belgian law of 22 March 1993 on credit institutions (see infra, no. 60, for a discussion of the content of this provision).

14. In support of the argument that, under Belgian law, the terms netting and set-off express the same legal concept, and that this concept is different from the concept of 'close-out netting', it is, first of all, interesting to compare the French and Dutch versions of Article 157. First, the French heading to this Article refers to *compensation* (i.e. set-off), whereas the Dutch version refers to *verrekening* (i.e. netting). Second, Article 157 provides that, in case of bankruptcy or any other form of insolvency, agreements on bilateral and multilateral *set-off* (the term *compensation* is used in the French version and the term *schuldvergelijking* in the Dutch version; both terms can be translated as set-off) between credit institutions or between credit institutions and clearing or settlement institutions can be invoked vis-à-vis the creditors if the claim and debt to be *netted/set off* (the term *à compenser* (to set off) is used in the French version and the term *verrekenen* (to net) in the Dutch version) are part of the same patrimony.

15. In support of the same argument, it is also interesting to compare the French and Dutch version of the Belgian law of 28 April 1999 implementing the Settlement Finality Directive. Both the heading and the text of the French version of the provision that deals with netting refer to *compensation*, which is the traditional French translation for set-off, whereas the heading and the text of the Dutch version of the same provision refer to *verrekening*, which is the traditional Dutch translation for netting.[124]

16. Finally, the way Belgian legal scholars recently have defined and referred to *netting* also seems to indicate that they consider it synonymous with *set-off* (*compensation*).[125] These scholars then explicitly distinguish a *netting* clause from a *close-out* clause, which they consider to be an explicit termination clause. Therefore, while it can be argued that the concepts of *set-off* and *netting* are used as synonyms by these legal scholars, it is clear that they do not consider *set-off* as synonymous with *close-out netting*, which they refer to as 'a number of agreements regarding the

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[124] We also note that the Settlement Finality Directive itself uses, in its English version, "netting", whereas the French version uses *compensation* and the Dutch version refers to "verrekening (netting)". The last reference again supports the idea that both terms express the same legal concept.

[125] See e.g. G. Schrans and R. Steennot, *Algemeen deel van het financieel recht*, Antwerp, Intersentia, 2003, p. 406, no. 498, where "*netting* is considered as a form of *set-off*", and p. 408, no. 501, where the set-off agreements mentioned in Article 157 of the Law of 1993 are discussed under the heading "netting agreements".

application of *set-off* between reciprocal claims and debts and an explicit termination clause to enable *set-off*'.[126]

17. In view of the above consequences of insolvency under Belgian law generally on the validity of *compensation*, the Belgian legislator had to enact a specific legal provision recognising the enforceability of agreements providing for the termination and set-off (*compensation*) in case of insolvency. This specific provision is laid down in Article 157 of the Belgian law of 22 March 1993 on credit institutions. In particular Article 157, §1, of this law provides a valuable insight into the legal meaning of the concept of set-off in Belgian law:

'Agreements of bilateral and multilateral set-off and explicit termination clauses to enable set-off, between credit institutions or between credit institutions and institutions responsible for the netting or the settlement of payments or of financial transactions may, in case of bankruptcy or of any other situation of concursus creditorum, be invoked vis-à-vis the creditors, if the claim and the debt to be [netted/set off][127] are part of the same patrimony (…).'

18. The fact that this provision explicitly refers to, on the one hand, set-off (*compensation*) agreements and, on the other hand, explicit termination clauses (*clauses résolutoires expresses*) to enable the set-off, demonstrates that the concept of set-off that is used in this provision differs from the concept of close-out netting, understood as a procedure including termination, the calculation of the termination amounts, and set-off. In other words, *compensation* may not be construed under Article 157 to cover close-out netting. This conclusion corresponds with the definition that Belgian authors give to *set-off*, *close-out* and *close-out netting* (see above).

Luxembourg law

19. The Luxembourg Code Civil contains the same general Articles 1289 to 1299 regarding 'set-off' (translated as *compensation* in the Luxembourg Code Civil) as both the French Code Civil and the Belgian Code Civil, and the concept has the same legal meaning under Luxembourg law. The Luxembourg law of 12 January 2001 implementing the Settlement Finality Directive also refers to *compensation* when dealing with the netting provisions in the Settlement Finality Directive.

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[126] See e.g. G. Nejman, *Les contrats de produits dérivés. Aspects juridiques*, Brussels, Larcier, 1999, p. 75-76, no. 49; G. Schrans and R. Steennot, *Algemeen deel van het financieel recht*, Antwerp, Intersentia, 2003, p. 409, no. 504. For the latter authors, the evaluation method to determine the money amount of the reciprocal claims and debts does not seem to be part of the *close-out netting*, although this evaluation method is part of the "General netting agreement for the Belgian Financial Centre", which is a master agreement drafted by the Belgian Banking Association to which all financial institutions, including the Belgian branches of foreign financial institutions, may adhere.

[127] The Dutch version of the provision mentions *te verrekenen*, i.e. *to be netted*, whereas the French version mentions *à compenser*, i.e. *to be set off.*

20. Furthermore, Article 61-1 of the Luxembourg law of 5 April 1993 on the financial sector contains a specific provision on the effect of close-out netting between credit and similar institutions in case of bankruptcy in a similar insolvency situation. Under this provision, set-off (*compensation*) agreements, clauses establishing set-off, 'connexity', indivisibility, acceleration, close-out, margin call and substitution, as well as clauses relating to the terms of valuation and set-off, and clauses stipulated to allow set-off, are valid and binding on third parties, including the bankruptcy receiver or a similar insolvency officer.

21. From the three paragraphs into which Article 61-1 is divided, it appears that in Luxembourg law also, *close-out netting* as a procedure including termination, calculation of the termination amounts and set-off differs from the concept of *set-off* (*compensation*), which is only one part of this procedure. Indeed, the first paragraph of Article 61-1 only deals with *compensation* (set-off) and *conventions ou clauses de compensation bilatérales ou multilatérales* (bilateral or multilateral set-off agreements or clauses), while the second paragraph with a number of clauses *pour permettre les compensations* (to enable the set-off), among which are *les clauses de résiliation* (the termination clauses) and *les modalités d'évaluation et de compensation* (the modalities for the valuation and the set-off). Finally, the third paragraph clearly sets out the three separate stages of the close-out netting procedure, since it refers to *la résiliation, l'évaluation et la compensation* (the termination, valuation and set-off).

22. Also, although Article 61-1 does not explicitly refer to the term *netting,* but only to the term *compensation* (*set-off*), some Luxembourg law practitioners translate the term *compensation* as *netting*. Thus, it seems that, under Luxembourg law also, the terms *set-off* and *netting* may be used interchangeably, but that the legal concept that they express is different from *close-out netting*.

Conclusion

23. The consistent use of the term *compensation* to refer to the related English concepts of 'set-off' and 'netting' in the French versions of various Community legal acts may imply that the reference to *compensation* in Article 6 of the Insolvency Regulation covers both insolvency set-off and insolvency close-out netting. However, from the perspective of French, Belgian and Luxembourg law the concept of close-out netting appears to embrace two, if not three, distinct concepts or stages. The first stage in the close-out process involves termination (*résiliation*), which may be accomplished through explicit termination clauses (*clauses résolutoires expresses*). The second stage involves valuation (*évaluation*). The third stage involves set-off (*compensation*). Based on this analysis, the concept of *compensation* may not be construed as covering the entire close-out netting procedure.

24. In conclusion, it does not appear that the reference to *compensation* in the French text of Article 6 of the Insolvency Regulation covers insolvency close-out netting.

Annex 6

German text of the Insolvency Regulation

1. The German term used as the equivalent to the English term 'set-off' in Article 6 of the Insolvency Regulation is *Aufrechnung*.

2. The Insolvency Regulation itself refers to 'set-off' in Article 4 and recital 26. In both instances, the corresponding German term is *Aufrechnung*. In addition, in recital 27, when the English version speaks about 'position-closing agreements and netting agreements', the equivalent German terms are *Glattstellungsverträge und Nettingvereinbarungen*. This in itself does not allow a conclusion on the scope of the concept of *Aufrechnung* as used in the Regulation.

3. To ascertain the legal meaning of *Aufrechnung* in the context of the Insolvency Regulation, and in particular whether it could be interpreted as encompassing the legal concept of '(close-out) netting', it is necessary to analyse and compare the use of the respective terminology both in Community and national (German and Austrian) law.

Community legal acts

4. In the context of EC financial markets legislation, several other Community legal acts refer to 'set-off' and 'netting'. For the purpose of the current exercise, the most relevant examples are the Settlement Finality Directive, the Banks Winding-up Directive and the Collateral Directive.

5. Among those legal acts, the Settlement Finality Directive is notable, as it uses the terms *Aufrechnung* and 'netting' interchangeably. Article 2(k) of the Settlement Finality Directive contains the definition of netting, which in the German text is referred to as '*Aufrechnung*' (netting), thus placing the English expression after the German term for clarification. The same use is to be found in Article 3(1) as well as recitals 1 and 11 of the Settlement Finality Directive. It should be noted that in the substantive definition of netting, in Article 2(k), '*Aufrechnung*' (netting) is defined as the *Verrechnung* ('conversion' in the English text) of rights and obligations.

6. The German version of the Collateral Directive equates in its Article 2(1)(n) the concept of 'close-out netting' with *Aufrechnung infolge Beendigung*[128] ('close-out netting'). Again, the English expression is combined with the German term for clarification. Moreover, Article 7 equates 'close-out netting provisions' with *Aufrechnung infolge Beendigung*, but without the English term added in brackets. In recitals 5 and 14, where the English version refers to 'bilateral close-out netting', the German version refers to *bilaterale Aufrechnung infolge Beendigung* ('close out netting'). To the extent that Article 2(1)(n) defines 'close-out netting' as being based on the 'operation of netting or set-off or otherwise', the corresponding German rendering is *im Wege der Verrechnung, Aufrechnung oder auf andere Weise*, thus assimilating 'netting' with *Verrechnung* and 'set-off' with *Aufrechnung*. Furthermore, recital 14 *in fine* assimilates 'setting off reciprocal items to produce a single aggregate amount' in the English version with *wobei die gegenseitigen Forderungs- und Verbindlichkeitsposten miteinander verrechnet werden*. Lastly, recital 15 in the English version reads 'bringing into account claims, on obligations to set-off, or on netting', whereas the German text just reads *Aufrechnung oder Verrechnung*.

7. Finally, Article 23 of the Banks Winding-up Directive uses *Aufrechnung* in correlation with the English 'set-off'. More interestingly, the German version of Article 25 defines two legal concepts as being the equivalent to the English version's 'netting agreements', namely *Aufrechnungs- und Schuldumwandlungsvereinbarungen*[129].

8. To sum up, the German versions of the Insolvency Regulation, the Settlement Finality Directive, the Collateral Directive and the Banks Winding-up Directive refer to different legal concepts and terms regarding set-off and netting. In particular, the Community law references to *Aufrechnung* are not entirely consistent between the various legal acts and may denote 'traditional' statutory set-off as well as various categories of netting (netting agreements, close-out netting, settlement netting), depending on the specific context.

German law

9. Under German civil law, the legal concept of '*Aufrechnung* is understood as the reciprocal discharge of two corresponding obligations of the same nature[130], based on the traditional Roman law principles of set-off. The correspondent legal definition of *Aufrechnung* is to be found in

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[128] Literally translated "set-off due to early termination".

[129] Literally "Set-off and novation agreements".

[130] Palandt-Heinrichs, Bürgerliches Gesetzbuch, 62nd ed., § 387 Rn 1.

Section 387 of the German Civil Code[131], with further related statutory provisions in Sections 388 to 396 of the German Civil Code (Bürgerliches Gesetzbuch). The insolvency treatment of *Aufrechnung* is provided by Sections 94 to 96 of the German Insolvency Code (Insolvenzordnung).

10. In addition to the statutory set-off provided for by the German Civil Code, German doctrine and jurisprudence has generally recognised contractual set-off arrangements (*Aufrechnungsvertrag* or *Aufrechnungsvereinbarung*) as being valid and enforceable, whereas under the principles of contractual freedom and party autonomy, contractual set-off arrangements do not necessarily have to comply with the statutory limitations[132].

11. In Germany, contractual set-off arrangements and netting arrangements are based entirely on the application of the principle of contractual freedom of parties. The notion of 'netting' entered into the German legal terminology at the end of the 1980s in the context of financial transactions and has no clear and unambiguous legal definition.

12. Usually, German legal literature refers to netting as *Verrechnung* or *Saldierung* (balancing/settlement of accounts)[133], while some authors also include set-off as a subcategory under the general notion of netting[134]. The only reflection in a German legal provision of 'netting' is in the heading of Section 10 of the Grosskredit- and Millionenkreditverordnung. This regulation stipulates how obligations arising from certain financial transactions under a master agreement are being accounted for capital adequacy purposes.

13. In Germany, netting may denote a variety of legal concepts all based on the principle of contractual freedom, such as payment or settlement netting (*Abwicklungstechnische Verrechnung* or *Automatische Positionenaufrechnung*), netting by novation (*Schuldersetzende Verrechnung* or *Novation*), current account netting (*Kontokorrentverrechnung*) and close-out netting (*Glattstellung nach Vertragsbeendigung* or *Liquidations-Netting*).[135]

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[131] § 387 German Civil Code reads. "Schulden zwei Personen einander Leistungen, die ihrem Gegenstand nach gleichartig sind, so kann jeder Teil seine Forderung gegen die Forderung des anderen Teils aufrechnen, sobald er die ihm gebührende Leistung fordern und die ihm obliegende Leistung bewirken kann."

[132] Palandt-Heinrichs, Bürgerliches Gesetzbuch, 62nd ed., § 387 Rn 19 ff.

[133] Bosch, WM 1995, p. 365 ff, 413 ff; Ebenroth/Benzler, ZverglRWiss 95 (1996), p. 335, 350; Hess/Wyss, AJP 97, p. 1219 ff.

[134] Jahn, Bankrechtshandbuch III, 2nd ed., § 114 Rn 131.

[135] For details, see Bosch, WM 1995, p. 365 ff, 413 ff; Ebenroth/Benzler, ZverglRWiss 95 (1996), p. 335, 350 ff.

14. The legal concept that is most relevant in the context of master agreements for financial transactions is close-out netting (*Glattstellung nach Vertragsbeendigung* or *Liquidations-Netting*), whereby, upon an event of default, pending transactions will be terminated and replaced by a single net obligation calculated on the basis of a market valuation of the transactions.[136] This concept is to be seen as distinct from the statutory concept of *Aufrechnung*, as the corresponding obligations that are normally subject to close-out netting are not of the same nature or not due at the same time.[137]

15. As regards the insolvency treatment of master agreements with close-out netting provisions, Section 104 of the German Insolvency Code has a special provision outside the general framework for insolvency set-off provided by Sections 94 to 96 of the German Insolvency Code (Insolvenzordnung). Finally, the Insolvency Code contains two distinct conflict-of-laws provisions for *Aufrechnung* (Section 338) and *Schuldumwandlungs- und Aufrechnungsvereinbarungen*, substantially dealing with close-out netting arrangements (Section 340 (2))[138].

16. To sum up, the current provisions of German law related to *Aufrechnung* and netting arrangements imply that statutory set-off and netting, especially close-out netting in the context of master agreements, are two distinct legal concepts. This does not allow netting to be subsumed under the German legal notion of set-off as contained in the German Civil Code. However, the borderlines between contractual set-off arrangements and netting might be more fluid.

Jurisprudence and legal literature

17. As of today, the scope of application of Article 6(1) of the Insolvency Regulation has not been subject to a court ruling by a German court.

18. Moreover, the question of whether Article 6 of the Insolvency Regulation also encompasses netting agreements has so far been dealt with only in a rather cursory manner by German legal literature.

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[136] Ebenroth/Benzler, ZverglRWiss 95 (1996), p. 335, 352; Jahn, Bankrechtshandbuch III, 2nd ed., § 114 Rn 134.

[137] Bosch, WM 1995, p. 365, 368.

[138] Implementing Art. 23 and 25 of the Winding-up Directive, respectively.

19. Two legal writers have expressed the view that Article 6 indeed applies to netting agreements.[139] Their line of reasoning is based on the fact that close-out netting arrangements under master agreements for financial transactions do involve set-off features.

20. This view is disputed. Article 6(1) of the Insolvency Regulation does not apply to arrangements that include other features than set-off, such as valuation and conversion of transactions into commensurable claims. This argument could be supported by a comparison of the wording of Articles 23 and 25 of the Banks Winding-up Directive, which may imply that Community law distinguishes between set-off rules and netting agreements. Moreover, Article 9 of the Insolvency Regulation provides for special rules for netting arrangements within payments or security settlement systems. However, this view does not take into account a comprehensive analysis of Community legal acts.

Austrian law

21. Similar to the German situation, under Austrian law, the statutory legal concept of set-off is understood as the reciprocal discharge of two corresponding obligations of the same nature.[140] The term used by the Austrian Civil Code (Allgemeines Bürgerliches Gesetzbuch) is *Kompensation* (cf. Section 1438), which in modern practice is used interchangeably with *Aufrechnung*. The related statutory provisions are in Sections 1438 to 1443 of the Austrian Civil Code. The insolvency treatment of *Aufrechnung/Kompensation* is provided by Section 20 of the Austrian Insolvency Code (Konkursordnung) and Section 20 of the Austrian Reorganisation Code (Ausgleichsordnung), respectively.

22. A specific legal regime for netting is to be found in the Finalitätsgesetz (Finality Act), implementing the Settlement Finality Directive in Austrian. Here, *Abrechnung* (netting) is being used to define the concept of netting as established by Article 2(k) of the Settlement Finality Directive.

23. Moreover, the Austrian Finanzsicherheitengesetz (Financial Collateral Act), transposing the Collateral Directive into Austrian law, contains in its Section 3 (14) a definition of *Aufrechnung infolge Beendigung* ('close out netting') which adopts literally the terminology used in the German language version of Article 2(19)(n) of the Collateral Directive. The Austrian Financial

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[139] von Wilmowski, WM 2002, p. 2264, 2277; Liersch, NZI 2003, p. 302, 305.

[140] Palandt-Heinrichs, Bürgerliches Gesetzbuch, 62nd ed., § 387 Rn 1.

Collateral Act establishes a special regime for collateral transactions involving close-out netting arrangements as distinct from the general legal regime applicable to *Kompensation/Aufrechnung*.

24. The insolvency treatment for close-out netting arrangements under master agreements for financial transactions are to be found in Section 20 (4) of the Austrian Insolvency Code (Konkursordnung) and Section 20 (3) of the Austrian Reorganisation Code (Ausgleichsordnung), respectively. Both sections also contain in the preceding paragraphs the general insolvency regime for *Aufrechnung* (set-off). In connection with the wording used to define close-out netting provisions, it is worth noting that that the constitutive elements are being defined as early termination and subsequent set-off (the provisions use *aufrechnen*).

Conclusion

25. In conclusion, the comparison between the usage of the terms *Aufrechnung* in German and Austrian law and relevant Community legal acts seems to imply that *Aufrechnung* is used in a broader sense in Community law than in national legislation. Legislation in Germany uses *Aufrechnung* (or the correspondent terminology (*Kompensation*) in Austria) as being limited to statutory set-off, whereas under the principles of contractual freedom and party autonomy, contractual set-off arrangements, which do not necessarily have to comply with the statutory limitations, are also recognised.

26. The Community law usage covers a broad range of legal concepts. Yet the Community law references to *Aufrechnung* are not entirely consistent between the various legal acts (in particular the Settlement Finality Directive, the Collateral Directive and the Banks Winding-up Directive) and may denote 'traditional' statutory set-off as well as various categories of contractual set-off arrangements and netting (netting agreements, close-out netting, settlement netting), depending on the specific context.

27. Thus, the analysis of Community legal acts in their German version does not permit us to establish an unambiguous meaning of set-off/*Aufrechnung* that would enable us to determine whether, in the context of the Insolvency Regulation, the use of set-off/*Aufrechnung* encompasses (close-out) netting or not.

Annex 7

Greek text of the Insolvency Regulation

1. The Greek term used as the equivalent for the English term 'set-off' in the Insolvency Regulation is '*sympsiphismos*' («συμψηφισμός»).

2. The Insolvency Regulation refers to set-off both in Article 4 and recital 26. In recital 27, when the English version speaks about 'position-closing agreements and netting agreements', the equivalent Greek terms are *sympsiphismos* and *ekkathariseis*. In Greek-English dictionaries the term '*ekkatharisi*' is translated as 'liquidation', 'winding up' or 'settlement', since it can be used in any of the above three senses depending on the context.

3. To ascertain the legal meaning of *sympsiphismos* in the context of the Insolvency Regulation, and in particular whether it could be interpreted as encompassing the legal concept of '(close-out) netting', we must analyse and compare the use of the respective terms in Community and Greek law.

Community legal acts

4. In the context of EC financial markets legislation, a number of other Community legal acts refer to 'set-off' and 'netting'.

5. The definition of netting in Article 2(k) of the Settlement Finality Directive is as follows:

   '"netting" shall mean the conversion into one net claim or one net obligation of claims and obligations resulting from transfer orders which a participant or participants either issue to, or receive from, one or more other participants with the result that only a net claim can be demanded or a net obligation be owed.'

   In the Greek version, 'netting' is expressed as '*sympsiphismos*'. The same word is also used in the Greek Civil Code (see infra) to define the *ex lege* netting and set-off in an abstract and general manner, whereas in Article 2(k) of the Settlement Finality Directive the same term refers to a specific aspect of the notion of netting. The Settlement Finality Directive was transposed into Greek law by way of Law 2789/2000. This implementing Law also uses '*sympsiphismos*', reiterating the definition provided in the Settlement Finality Directive for 'netting'.

6. Throughout the text of the Winding up Directive, 'set-off' is consistently translated in Greek as '*sympsiphismos*'. The term 'netting' appears only once in the English text, in Article 25. The English reference to 'netting agreements' is translated as '*Symphona sympsiphismou kai metatropis xreous*' (i.e. set-off and debt conversion agreements). In the body of the text, the same expression is translated in the same way, but the English term 'netting agreements' has been kept within brackets next to the Greek term.

7. Under the Collateral Directive the term 'close-out netting' is translated throughout the text as '*sympsiphismos*'. In Article 4(1)(a), in the phrase 'by setting-off their value against', the term 'setting-off' is translated as '*sympsiphizondas*' (i.e. in conducting '*sympsiphismos*'). In recital 15, in the phrase 'on obligations to set-off, or on netting', 'set-off' is translated as '*antistathmisi*' and 'netting' is translated as '*sympsiphismos*'. In Article 2(1)(n), in the phrase 'through the operation of netting or set-off or otherwise', 'netting' is again translated as '*sympsiphismos*' and 'set-off' as '*antistathmisi*'. We suggest that the last term '*antistathimisi*' is misleading since it is the Greek term used for 'hedging'.

Greek law

8. Under Greek law '*sympsiphismos*' covers two broad categories of set-off: set-off imposed by law (*ex lege* set-off) and contractual set-off. Both are a legal means of cancelling or settling an obligation.

9. Legal set-off results in the cancelling/settling of obligations/debts mutually owed between two parties to the extent they overlap, provided that they are of the same nature as to their object and they are due and payable. More specifically, if two parties mutually owe acts of performance which are of the same kind, either party may set off against the claim of the other party as soon as he can demand the performance due to him and carry out the performance due by him (art. 440 of the Greek Civil Code). The articles following the latter provision of the Greek Civil Code regulate special aspects of legal set-off ('*sympsiphismos*')[141].

[141] A creditor who has granted his debtor a period of grace is not prevented by it from setting off his claim (art. 445 Greek Civil Code). Prescription does not exclude set-off if the claim barred had not been prescribed at the time at which the two claims coexisted (art. 443 Greek Civil Code). The set-off is made by declaration to the other party. The declaration is ineffective if made subject to any condition or limitation (art. 444 Greek Civil Code). The effect of the set-off is that the mutual claims, insofar as they cover each other, are deemed to have expired as from the moment they coexisted (arts. 440, 441 Greek Civil Code). The guarantor may set off the claim of the debtor against the creditor but the debtor may not set off a claim of the guarantor against the creditor (art. 447 Greek Civil Code). Set-off is not permissible against a claim which is not subject to attachment (art. 451 Greek Civil Code) or against a claim arising from wilful delict (art. 450 Greek Civil Code).

10. Contractual set-off is a much looser form of set-off and is based on the principle of the freedom of contract as provided in article 361 of the Greek Civil Code. Its legal effect of cancelling debts/obligations in whole or in part takes place in accordance with the set-off terms expressly agreed by the contracting parties, provided that such agreement and/or its legal effect does not prejudice the legal provisions of Greek public policy, including provisions intended to protect the interests of third parties. Such provisions may render set-off null and void.

11. Greek insolvency law prohibits set-off during the 'suspect' period as well as 10 days before the commencement of the suspect period (Article 537 of the Greek Commercial Code) and after the declaration of the insolvency (Article 2 of Law 635/1937). But Article 16 of the recently adopted Law 3156/2003, concerning insolvency set-off, in the context of OTC derivatives, makes contractual set-off valid and enforceable on the conditions set out therein. In particular, Article 16 of this Law states:

'In case of insolvency or any other collective measure or proceedings which results in the suspension or restriction of the power of disposal of rights, the netting and set-off ("sympsiphismos") of the mutual claims, including the multilateral "sympsiphismos" and the "ekkatharistikos sympsiphismos", arising out of transactions […], is valid and enforceable and can be maintained against all creditors, provided that the relevant contract, the rights under which are to be set off, is perfected and evidenced by a document bearing a date certain (such date being a date certified by the relevant public authority) and which must precede the date of the commencement of the insolvency or the other collective measure or proceedings.'142

12. Law 3156/2003 does not define the terms '*sympsiphismos*', '*multilateral sympsiphismos*' and '*ekkatharistikos sympsiphismos*', but it makes clear that the first term encompasses the latter terms. The term '*multilateral sympsiphismos*' encompasses the notion of netting and the (after netting) set-off. '*Ekkatharistikos sympsiphismos*' is equivalent to the concept of 'close-out netting'. Thus *sympsiphismos* in Law 3156/2003 covers both netting (including close-out netting) and set-off.

Conclusion

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142 Άρθρο 16 "Συμψηφισμός και εξωχρηματιστηριακά παράγωγα προϊόντα": Σε περίπτωση πτώχευσης ή άλλου συλλογικού μέτρου ή διαδικασίας που συνεπάγεται την απαγόρευση ή τον περιορισμό της εξουσίας διάθεσης, ο συμψηφισμός των εκατέρωθεν απαιτήσεων, συμπεριλαμβανομένου του πολυμερούς και του εκκαθαριστικού συμψηφισμού, που πηγάζει από συναλλαγές κάθε φύσεως, καθώς και συμψηφισμού απαιτήσεων που προκύπτουν από συναλλαγές, σε εξωχρηματιστηριακά παράγωγα μεταξύ προσώπων από τα οποία ένα τουλάχιστον είναι το Δημόσιο ή ίδρυμα κατά την έννοια της παρ. 5 του άρθρου 2 ν. 2396/1996 (ΦΕΚ 73 Α'), είναι έγκυρος και ισχυρός και αντιτάσσεται έναντι όλων των πιστωτών εφόσον διέπεται από σύμβαση μεταξύ δικαιούχων των συμψηφιζόμενων απαιτήσεων, που καταρτίζεται με έγγραφο βέβαιης χρονολογίας, προγενέστερης της κήρυξης της πτώχευσης ή της έναρξης του συλλογικού μέτρου ή της διαδικασίας.

13. The term '*sympsiphismos*', as used in Greek law and the relevant Community legal acts, covers both the related English legal concepts of insolvency 'set-off' and insolvency close-out 'netting'.

Annex 8

Italian text of the Insolvency Regulation

1. The equivalent Italian term for 'set-off' as used in Article 6 of the Insolvency Regulation is *compensazione*.

2. The Insolvency Regulation itself refers to the term 'set-off' both in Article 4 and recital 26. In both instances, the corresponding Italian term is *compensazione*. In addition, in recital 27, when the English version speaks about 'position-closing agreements and netting agreements', the equivalent Italian terms are *liquidazione dei contratti e le compensazioni*'. This indicates that '*compensazione*' is used to describe both set-off and netting within the Italian version of the Insolvency Regulation.

3. To ascertain the legal meaning of *compensazione* in the context of the Insolvency Regulation, and in particular whether it could be interpreted as encompassing the legal concept of close-out netting, we must analyse and compare the use of the these terms in Community and Italian law.

Community legal acts

4. Where the English text of the Collateral Directive refers to 'close-out netting' and 'close-out netting provisions', the Italian text refers to '*compensazione per close-out*' (recital 14). While it therefore appears that 'close-out netting' is a contractual form of 'set-off', the definition of 'close-out netting provision' in Article 2(n) refers to both the terms 'netting' and 'set-off' (in the Italian text, such reference is expressed with the following text: '*compensazione (netting o set-off)*'). This may imply that *compensazione* is understood to embrace both netting and set-off.

5. Regarding the Italian text on set-off and netting in the Banks Winding-up Directive, Article 23 of the Directive, which is captioned 'Set-off' and makes provision for 'set-off' in the English text, is captioned '*Compensazione*' and makes provision for '*compensazione*' in the Italian text. However, the text of Article 25 of the Banks Winding-up Directive, which is captioned 'Netting agreements' and makes provision regarding 'netting agreements' in the English text, is captioned '*Accordi di compensazione e di novazione*' and makes provision for '*accordi di compensazione e di novazione*' in the Italian text, similar to the French text. In this respect, it is important to point out that, according to the Italian Civil Code, '*novazione*' has a different meaning to '*compensazione*', as it refers to the case when the parties agree to substitute the original obligation with a new obligation that has a different object or nature. In addition, '*novazione*' is

regulated by Articles 1230-1235 of the Italian Civil Code, while *compensazione* is regulated by Articles 1241-1252 of the same Civil Code. It would therefore appear that netting in the Italian language text of the Banks Winding-up Directive has an overlapping but in certain respects distinct meaning as compared to set-off, with set-off translated as *compensazione*; while netting encompasses both *compensazione* and '*novazione*', which are distinct legal concepts under Italian law.

Italian law

6. *Compensazione* is a well-established civil law concept whose scope and conditions are set out in Articles 1241–1252 of the Italian Civil Code. Debts may be set off either automatically by operation of law (*compensazione legale*), or under an agreement which the law recognises as enforceable (*compensazione convenzionale*), or under a court order *(compensazione giudiziale).*

7. For debts to qualify for *compensazione legale* the debts must fulfil four criteria in Article 1243 of the Civil Code: first, the debts must exist between the same parties (criterion of reciprocity); second, the object of the debt must be a sum of money or a quantity of the same fungible things; third, the debt must be liquid (a debt is liquid when its existence is certain and its amount is determined); and fourth, the debt must be due. When these four conditions are met, Articles 1241 and 1242 of the Civil Code provide that the *compensazione legale* takes effect when the two debts exist at the same time, up to their respective amounts. When the condition that the debt be liquid is not met, a judge may, at the request of one party, order a *compensazione giudiziale* when the debt is of 'easy' liquidation.

8. In addition, debts not qualifying for *compensazione legale* or for *compensazione giudiziale* may still be set off if the parties have agreed to compensate them (*compensazione convenzionale*). The parties may thus agree to compensate debts which are not liquid or which have different objects, for instance a sum of money and a thing. However, the condition of reciprocity must still be met.

9. Finally, the Italian Civil Code provides a specific application of the *compensazione legale* for the relationships between a bank and its client. In this case, the active and passive net sums are set off against each other, unless the parties agreed the contrary (Article 1853 of the Civil Code).

10. Article 56, first paragraph, of the Italian Insolvency Law allows for a general right of set-off or *compensazione* of the credits and the debts of the non-insolvent party against the insolvent party, even if the credits against the insolvent party have not yet matured at the time of the declaration of insolvency. However, according to Article 56, second paragraph, of the Italian Insolvency

Law, the *compensazione* is not allowed if the creditor has acquired the claim in the year before or after the start of the insolvency proceeding (the so-called suspect period).

11. A separate rule governs the right of termination for forward stock exchange contracts. Article 76 of the same Insolvency Law provides for an automatic termination of such contracts when expiring after one of the parties has been declared insolvent, and for the netting of the transactions between the parties upon the date of insolvency declaration. Article 76 has been extended by Article 203 of the Italian Law on Financial Intermediation to other contracts, such as forward contracts, financial derivatives and repurchase agreements; Article 203 also acknowledges the criterion of the replacement cost of the financial instruments, calculated according to market values, when operating the netting of the transactions.

12. To clarify the enforceability of 'close-out netting' provisions under Italian law in case of the insolvency of one of the parties, we must also distinguish between different insolvency proceedings provided for under Italian insolvency legislation. In the case of ordinary winding-up proceedings, the above rules of the Insolvency Law apply. In such cases, the Italian courts will acknowledge the set-off between the insolvent party and the non-insolvent party by operation of law (unless the credit has been acquired after the insolvency declaration or in the previous year), based on Article 56 of the Insolvency Law. With regard to forward stock exchange contracts and to the contracts listed in Article 203 of the Law on Financial Intermediation, the Italian courts will also acknowledge the early termination of the relevant contracts and the netting of the positions of the parties by operation of law, under Article 76 of the Insolvency Law or to Article 203 itself.

13. The Italian courts should therefore allow for the termination and set-off of the financial markets agreements by operation of law rather than by contractual arrangement. In this regard, some commentators have remarked that it is not clear to what extent the courts would uphold the full effectiveness of the contractual 'close-out netting' arrangements of the parties (for example, those concerning the calculation of the close-out amounts using the replacement cost criteria) in the absence of the above statutory provisions.[143]

14. This issue assumes some practical importance in that different rules are set out in the case of the insolvency of large companies under Legislative Decree No 270 of 1999, which provides for a special reorganisation procedure (*amministrazione straordinaria*) for companies meeting certain size and indebtedness requirements. Article 50 of Legislative Decree No 270 of 1999 provides

[143] See A. Perrone, "La riduzione del rischio di credito negli strumenti finanziari derivati. Profili giuridici", Milan, 1999, p. 108.

that executory contracts which have not yet expired continue notwithstanding the reorganisation procedure, unless the receiver decides to terminate them. Article 51 provides that in the case of continuation or termination of the contract by the receiver, the parties' rights are governed by specific provisions of the Insolvency Law, including Article 76. This seems to conflict with the continuation of the contracts, since Article 76 provides for the termination and netting of the parties' positions. A more consistent interpretation is therefore that the contracts continue to the extent that the receiver so decides. So it is questionable whether, in the case of an *amministrazione straordinaria*, the statutory provisions and the receiver's decision override contractual 'close-out netting' provisions that would otherwise entitle the non-insolvent party to terminate the contract.

15. Italian insolvency law thus appears to distinguish between the termination of transactions against an insolvent party and the calculation of the close-out amounts and consequential set-off or *compensazione* of those amounts. From an Italian insolvency law perspective, the reference to *compensazione* in Article 6 of the Insolvency Regulation would seem not to encompass the full process of insolvency close-out netting, starting with the termination of the agreement after default or insolvency, continuing with the calculation of the close-out amount and culminating in the set-off of the resulting amounts.

Conclusion

16. The same word - *compensazione* – is used to describe both set-off and netting in the Italian version of the Insolvency Regulation. While the Collateral Directive also implies that *compensazione* is understood to embrace both netting and set-off, the Banks Winding-up Directive indicates that the concept of netting in the Italian language text of the Banks Winding-up Directive has an overlapping, yet in certain respects distinct meaning as compared to set-off, with set-off translated as *compensazione*, and netting encompassing both *compensazione* and *novazione*, which are distinct legal concepts in Italian law.

17. Italian insolvency law appears to draw a distinction between the termination of transactions against an insolvent party and the calculation of the close-out amounts and consequential set-off or *compensazione* of those amounts. From an Italian insolvency law perspective, the reference to *compensazione* in Article 6 of the Insolvency Regulation would seem not to encompass the full process of insolvency close-out netting, starting with the termination of the agreement after default or insolvency, continuing with the calculation of the close-out amount and culminating in the set-off of the resulting amounts.

Annex 9

Portuguese version of the Insolvency Regulation

1. The Insolvency Regulation refers to the term 'set-off' in recital 26 and in the heading and text of Article 6. In both instances, the corresponding Portuguese term is *compensação*. In addition, in recital 27, where the English version refers to 'position-closing agreements and netting agreements', the equivalent Portuguese terms are *vencimento antecipado da obrigação e da compensação*. The translation of 'position-closing agreements' is arguably not quite accurate and, in respect of 'netting', it is exactly the same term as that used for set-off.

2. Decree-Law No. 53/2004 of 18 March 2004 abrogates and replaces the existing Code on Rehabilitation and Bankruptcy (CPEREF) by a new Portuguese Insolvency and Company Reorganisation Code ('the new Insolvency Code'). The new Insolvency Code was officially published on 18 March 2004, and will enter into force 180 days thereafter.[144] One of its aims is to reform Portuguese general insolvency laws in line with the Insolvency Regulation, whose provisions are implemented in Titles XIV and XV (Articles 271 to 296, inclusive). These provisions relate mainly to rules on international jurisdiction and conflict of laws and to the recognition of foreign insolvency proceedings, and throughout the text only *compensação* is used.

3. To ascertain the legal meaning of the term 'set-off' in the context of the Insolvency Regulation, and in particular whether it could be interpreted to encompass the legal concept of '(close-out) netting' in the light of Portuguese law, it is necessary to analyse and compare the use of the respective terms in Community and Portuguese law.

Linguistic analysis of Community law and national implementing texts

4. In recitals 1 and 11 and in Article 2(k) of the Settlement Finality Directive 'netting' is defined in Portuguese as *compensação* (*netting*), with the English expression left in brackets for clarification. Further down (in the heading of Article 3 and in Articles 3(1) and 3(2)) *compensação* appears without the explanation, but after seeing it earlier a Portuguese reader would still understand it as if it were there; that is, as a specific type of *compensação*. But in national implementing measures (Decree-Law 486/99 of 13 November, and Decree-Law

[144] Insurance undertakings, credit institutions, financial companies, investment undertakings and UCITs are expressly exempted from the application of its provisions to the extent that they are inconsistent with the *lex specialis* applicable to each sector (Article 2 (2) (b)). The same happens in relation to collateral agreements (Article 16 (2)). In the case of credit institutions, such legal regime is set out in the Winding-up Directive and respective national implementation measures. Collateral is regulated by the Collateral Directive, and national implementation rules are expected soon.

221/2000, of 9 September), the Portuguese term was *compensação*, without the English term added.

5. In the Banks Winding-up Directive the heading of Article 23 uses *compensação* for 'set-off'. But in Article 25 the equivalent to the English version's 'netting agreements' is *convenções de compensação e de novação* (literally set-off and novation agreements), specifying that there is not only a set-off, but also an element of novation in those contracts. The expression 'netting agreements', in English, was kept between brackets.

6. Implementation at national level (due by 5 May 2004) is still in the consultation phase, but the application of the relevant provisions will be backdated to this date. Such implementation is carried out in the precise terms of the Directive, and the words used by the Portuguese legislator in the new legal act on the winding-up of credit institutions and financial companies correspond entirely to the ones used in the Portuguese version of the Directive. Article 20 (2) (g) and 31 (reflecting the contents, respectively, of articles 10 (c) and 23 of the Directive) refer only to *compensação*. Interestingly, in article 33 (reflecting article 25 of the Directive), it was also felt necessary to include the English term 'netting' after *convenções de compensação e de novação*. The preamble and the explanatory memorandum do not contain any useful clarification for interpretation purposes.

7. The Portuguese version of the Collateral Directive equates in its recitals 5 and 14 the concept of '(bilateral) close-out netting' with *compensação (bilateral) com vencimento antecipado* (literally, bilateral set-off due to early termination), without any additional clarification in English within brackets. In terms of Portuguese law, the inclusion of the word bilateral is relevant, since it unambiguously denotes the contractual or agreed type of set-off (as opposed to the legal set-off, which is unilateral, as explained below).

8. The sentence in recital 15 regarding 'requirements under national law on bringing into account claims, or obligations to set-off, or on netting, ...' also deserves attention. In the Portuguese version, and considering that reference is being made to national law, only one term (*compensação*) is used for both set-off and netting, apparently encompassing netting as the only concept known to Portuguese law (set-off).

9. This could also be the case in Article 2 (1)(n), to the extent that 'through the operation of netting or set-off or otherwise' is rendered as *por compensação* (netting *ou* set-off) *ou por outro meio*. Both terms (*netting* and *set-off*) are included in the broader concept of *compensação*. However,

the fact that both processes are still mentioned and left in English suggests that there may, indeed, be conceptual differences.

10. In Article 7, 'close-out netting provisions' is translated as *cláusula de compensação com vencimento antecipado*. The validity and enforceability of this clause seem to have been recognised in Article 16 (2) of the new Insolvency Code, which states that '[T]he provisions of this Code are without prejudice to any separate legal regime specifically relating to collateral'. In this particular case there seems to be no doubt that it is dealing with contractual set-off.

11. The Collateral Directive should have been transposed into domestic law by 27 December 2003, but as at the end of April 2004 there was still no reference available concerning national implementing measures.

12. To sum up, the Portuguese versions of the Insolvency Regulation, the Settlement Finality Directive, the Banks Winding-up Directive and the Collateral Directive, as well as the wording of the respective national implementation measures, reflect the inconsistency between the English versions of the various Community legal acts. Although *compensação*, sometimes with other descriptive terms, is consistently used throughout all Community texts, from a mere linguistic perspective it is not clear in every instance whether the Community legislator is referring to contractual or to legal set-off, or when the Community legislator intends to encompass both. Such inconclusiveness would definitely require in-depth cross-language purposive analysis, bearing in mind the 'useful effect principle' applied by the ECJ (a legal provision must be interpreted in such a manner that its implementation is effective and useful).

Portuguese law

13. Portuguese law is a civil law system strongly influenced by Roman law and, more recently, by the French Civil Code (1804) and by German nineteenth century constitutional theory. Many of the traditional Roman private law concepts still persist nowadays, slightly changed, including the *compensatio* (the cancelling of cross claims). Article 847 of the Portuguese Civil Code defines *compensação* (set-off) as a form of extinction of obligations, either in full or in part, whereby a reciprocal discharge of due and payable debts of the same nature can take place provided that certain statutory requirements are met. It can be unilateral or bilateral, though not expressly defined that way.

14. Article 847 and ss. of the Civil Code deal mainly with the unilateral type of set-off, the so-called *compensação legal* (legal set-off) which, to be effective, requires a declaration from one of the

parties to the other for that purpose (Article 848). However, once made, its discharging effect is retroactive (Article 854), except in cases of the declared bankruptcy of the debtor (under the general insolvency regime) for the protection of its creditors (Article 153 of the Portuguese Code on Companies Reorganisation and Bankruptcy (*CPEREF*), soon to be abrogated).

15. In the new insolvency regime there is no mention of a provision similar to the one contained in article 153 of the current Code. (Legal) set-off (*compensação*) is now regulated by Article 99 and 102 (e).

16. The bilateral type of set-off is called *compensação contratual ou convencional* (contractual or agreed set-off) and its legal basis is Article 405 of the Portuguese Civil Code, which provides for freedom of contract. Having a contractual basis it is, therefore, not subject to most of the requirements and limitations that apply to legal set-off. The only requirement is that the parties have claims that they intend to extinguish by contractual means (set-off agreement or *acordo de compensação*), and Article 432 of the Civil Code allows any contractually agreed grounds for termination of contracts. However, it should be noted that contractual set-off made during the year before the opening of any procedures leading to an insolvency declaration may be challenged.

17. Whereas the Portuguese legal concept of *compensação legal* (legal set-off) is based exclusively on statutory provisions, netting arrangements are based entirely on the application of the principle of contractual freedom of parties. The notion of netting has quite recently entered into the Portuguese legal terminology in the context of financial transactions and has no clear and established legal definition, nor do there appear to be any Portuguese court rulings or substantial legal literature on the subject of netting.

18. In Portugal, outside the insolvency environment, depending on the specific context, netting may be used in several legal contexts, all based on the principle of contractual freedom and therefore fully admissible. Those are (i) *compensação de pagamentos* (payment or settlement netting), (ii) *compensação bancária* (current account netting) provided that the early termination is not due to an event of default, (iii) *compensação e novação* (netting accompanied by novation) or (iv) *compensação com vencimento antecipado* (close-out netting).

19. 'Netting', albeit limited, is clearly what was in the mind of the drafter of a Notice from Banco de Portugal (Aviso No. 1/93 on the weighting of assets items and off-balance sheet items of credit institutions for calculating the solvability ratio, as last amended) when, in para 6.4. of Part I of its

Annex, reference is made to the possibility, under certain circumstances, of 'contracts that match perfectly, included in a set-off agreement (*contrato de compensação*), being considered as a single agreement, whose notional capital is equivalent to the respective net amount.'

20. It goes on to specify that 'a set-off agreement would be relevant for the purposes of this paragraph when (a) it derives from its provisions that all transactions covered by its scope must be set-off when one party is in default, for whatever reason, and (b) that the credit institution is entitled to receive or to pay only the net amount resulting from the sum of positive and negative figures relating to all transactions, valued at market prices' (para 6.7). Such net payment is calculated on the basis of the market valuation of the underlying transactions, which is not a feature of a traditional set-off. Nevertheless, this method only applies to 'forward currency contracts and similar contracts […], provided that they have the same maturity date and are denominated totally or partially in the same currency'.

21. Even so, a credit institution wishing to avail itself of this possibility will have to provide a well-grounded legal opinion issued by a competent, experienced and external entity, confirming that such contract would be enforceable against third parties in all relevant jurisdictions and under any circumstances, including in the context of insolvency proceedings brought against one of its counterparties. The enforceability of such set-off agreements must be continuously monitored, and if the competent authority supervising the counterparty does not consider such contract to be enforceable under its law, its opinion will override a contrary view contained in the legal opinion mentioned above.

22. Close-out netting operates at another level and implies early termination of transactions. It involves two concepts: close-out and netting or set-off. The industry-wide master agreements governing financial transactions typically provide for both close-out and netting rights of individual contracts under its scope. Close-out permits a solvent counterpart to: (a) terminate a contract under certain conditions (mechanism equivalent to the Portuguese *vencimento antecipado*), corresponding to early termination of executory contracts or to acceleration of non-executory contracts triggered by a certain event, typically, an incident of default, including the start of insolvency proceedings against the debtor (article 119 (3) of the new Insolvency Code) and (b) demand immediate payment of a single net obligation. Close-out netting would then be a complex process ending with the set-off of the parties' obligations.

23. Article 33 of the draft national measures implementing the Winding up Directive, namely its article 25, expressly recognises that netting agreements shall be governed solely by the *lex contractus*. Given that the standard agreements relating to financial instruments so far are

normally governed by English law or by New York State law, a Portuguese court would recognise the enforceability and validity of close-out clauses included in a netting agreement to the extent that they are also recognised by these jurisdictions.

24. In an insolvency context, Portuguese law permits close-out netting/set-off solely for designated financial instruments, especially in the field of derivatives. This specific netting legislation creates a carve-out from the general principles of Portuguese insolvency law, which is generally pro-debtor and averse to cherry picking. The rationale is not so much to create a privileged class of claimants to the detriment of the remaining creditors, but to recognise that the current legal solution, based on the principle of equal treatment of creditors, is inconsistent with the contractual and legal certainty required by modern financial markets. Although acting cautiously, the national legislator clearly opted to bolster the integrity and efficiency of the financial markets, to the detriment of the protection of common creditors.

25. Decree-Law 70/97 of 3 April 1997 states, in its preamble, that its aim is to recognise so-called bilateral set-off agreements (*acordos bilaterais de compensação*) or contractual set-off (*compensação contratual*), and to protect them against insolvency in certain cases. Execution of most contracts is stayed when insolvency is declared (article 102 of the new Insolvency Code). Decree-Law 70/97 provides an exception to the general and special insolvency regimes (such as the one applicable to supervised credit institutions and insurance companies), affording netting protection for claims arising from all contractual relationships governed by Portuguese law and relating to 'financial instruments'.

26. Article 1(1) of Decree-Law 70/97 provides that the validity of an agreement by means of which the parties (in their capacity as parties to contracts on 'financial instruments', from which similar rights and obligations emerge for both of them) agree that all obligations that have arisen between them under such contracts shall be considered set off (*compensadas*) if one of the parties is declared bankrupt or is submitted to rehabilitation proceedings or any other proceedings of a similar nature. Article 1(2) of Decree-Law 70/97 provides that the same provisions apply, *mutatis mutandis*, if the relevant agreement provides that the above-referred set-off (*compensação*) will take place even if one of the parties is subject to rehabilitation or reorganisation measures or other measures of a similar nature.

27. Article 2 provides that for the purposes of Decree-law 70/97, financial instruments are agreements in relation to securities, currency contracts, interest rate contracts, foreign exchange contracts, swaps, options and other contracts of a similar nature.

28. Article 3 provides that the provisions of Decree-Law 70/97 supersede all other legal provisions, either of a general or special nature.

29. An earlier act, Decree-Law 1/97 of 7 January 1997, allows the State to accept netting/set-off clauses (*cláusulas de compensação (denominadas de netting e set-off)*) which are contained in master agreements normally used in financial markets for the management of government debt. In the preamble the lawmaker explicitly defines *cláusulas de compensação* to include both the English terms 'netting' and 'set off'.

30. To sum up, the current provisions of Portuguese law related to set-off and netting arrangements seem to imply that netting, and especially close-out netting in the context of master agreements could, when expressly foreseen and authorised by law, be subsumed under the Portuguese legal notion of contractual set-off (*compensação contratual*).

Conclusion

31. In conclusion, the comparison between the use of *compensação* in Portuguese law and relevant Community legal acts seems to imply that *compensação* is used in a rather vague and imprecise manner both in Community law and in national legislation. The related English concepts of 'set-off' and 'netting' find expression in a single word under Portuguese law – *compensação*, but it is not always clear to which type of set-off (legal or contractual) they are referring. As regards the Portuguese text of Article 6 of the Insolvency Regulation, we consider that the wording of this article does not allow '*compensação*' to be interpreted restrictively as referring exclusively to either type of set-off (legal or contractual). That would have to be determined in each specific case, with recourse to teleological interpretation.

Annex 10

Spanish text of the Insolvency Regulation

1. The equivalent Spanish term for 'set-off' as used in Article 6 and in recital 26 of the Insolvency Regulation is *compensación*. In addition, where the English text of recital 27 refers to the 'position-closing agreements and netting agreements to be found in payment systems', the Spanish text refers to *contratos de liquidación y acuerdos de compensación*. This appears to indicate that, within the Insolvency Regulation, the same Spanish term - *compensación* - is used for both netting and set-off.

2. To ascertain the legal meaning of the Spanish term *compensación* in the context of the Insolvency Regulation, and in particular whether it could be interpreted to encompass the legal concepts of close-out netting and set-off, it is necessary to analyse and compare the use of the respective terms in Community and Spanish law.

Community legal acts

3. The same use of *compensación* has the appearance of being mirrored in the Spanish text of the Collateral Directive. Where the English text refers to 'bilateral close-out netting' and 'close-out netting provision', the equivalent Spanish text refers to *liquidación bilateral por compensación exigible anticipadamente*' and '*cláusula de liquidación por compensación exigible anticipadamente*. However, even though from a linguistic perspective the use of this terminology might lead to confusion, from a Spanish legal perspective this terminology has a different meaning from the term *compensación* used in Article 6 of the Insolvency Regulation.

4. The Spanish text of the provisions on set-off and netting agreements in the Banks Winding-up Directive set out the legal distinction between 'set-off' and 'netting agreements'. Article 23, which is captioned 'Set-off' and provides for 'set-off' in the English text, is captioned *Compensación* and makes provision for *compensación* in the Spanish text. Article 25, which is captioned 'Netting agreements' and makes provision regarding 'netting agreements' in the English text, is captioned *acuerdos de compensación y de novación* and makes provision for *acuerdos de compensación y de novación* in the Spanish text.

Spanish law

5. *Compensación* is a well-established civil law concept under Spanish law, which is set out in Articles 1195 to 1202 of the Spanish Civil Code. Debts may be *compensados* either (i)

automatically by operation of law (*compensación legal*, which is stipulated in the above articles of the Civil Code), or (ii) under an agreement between two parties (*compensación convencional,* falling under the principles of contractual freedom and party autonomy set out in Article 1255 of the Spanish Civil Code) which does not necessarily have to comply with the statutory limitations, or (iii) under a court order (*compensación judicial*).

6. For debts to qualify for *compensación legal* the debts must fulfil five criteria set out in Article 1196 para. 1 – 5 of the Civil Code: there must be various (at least two) debts existing between the same parties, which are liquid, due and enforceable and arise from different agreements.[145]

7. A relatively new and distinct legal concept of *acuerdos de compensación contractual*, on the other hand, has been introduced by the 10th Additional Provision of Law 37/1998 (10th AP), of 16 November reforming the Spanish Securities Markets Law 146 (amended by Law 44/2002 of 22 November, *Ley Financiera*). The fundamental aims of this provision are to ensure that, in cases involving the counterparty's bankruptcy or an equivalent situation, the non-defaulting party can terminate all the transactions covered by an *acuerdo de compensación contractual* (netting agreement), to protect the netting of all exposures arising from such transactions and establish the collateral regime (including transfers as well as security interests recognised for derivative products, repurchase transactions and security loans).[147] To qualify for the calculation of net amounts under this protection the agreements must comply with the following statutory limitations: (1) at least one of the parties to the *acuerdo de compensación contractual* must be a credit institution or an investment services provider or a non-resident entity authorised to carry out activities reserved under the Spanish legislation for credit institutions or investment services providers and (2) the agreement must include a provision under which, in the event of early termination, only the net balance of the terminated transactions shall be payable by one party to the other and such net balance shall be calculated in accordance with the agreement or agreements

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[145] Article 1196 of the Spanish Civil Code provides as follows: *Para que proceda la compensación, es preciso: 1. Que cada uno de los obligados lo esté principalmente, y sea a la vez acreedor principal del otro. 2. Que ambas deudas consistan en una cantidad de dinero, o, siendo fungibles las cosas debidas, sean de la misma especie y tambié de la misma calidad, si ésta se hubiese disgnado. 3. Que las dos deudas estén vencidas. 4. Que sean líquidas y exigibles. 5 Que sobre ninguna de ellas haya retención o contienda promovida por terceras personas y notificada oportunamente al deudor.*

[146] Ley 24/1988, *de 28 de julio del Mercado de Valores.*

[147] Paragraph 2 of the 10th Additional Provision provides in its last subparagraph as follows: *Las operaciones financieras a que se refiere este apartado serán válidas y eficaces frente a terceros, cualquiera que sea la Ley que la rija, sin más requisitos que su formalización documental privada y la entrega, transmisión o anotación registral de los valores, según proceda, y el depósito o transferencia del efectivo, siendo de aplicación lo dispuesto en la disposición adicional sexta de la Ley 37/1998, de 16 de noviembre, de reforma de la Ley 24/1988, de 28 de julio, del Mercado de Valores.*

related to it.[148] Thus, an *acuerdo de compensación contractual* qualifying for the protection of the 10th AP constitutes what may be referred to in English as a close-out netting agreement.

8. It is emphasised that *compensación legal* and an *acuerdo de compensación contractual* must fulfil different legal conditions. As mentioned above, for debts to qualify for *compensación legal* they must comply with statutory limitations while, on the other hand, an *acuerdo de compensación contractual* is a contractual procedure to determine – through the termination of a series of transactions – one debt, which is due, liquid and enforceable under a single master agreement.

9. The Spanish legislator views the general legal concept of *compensación* (including *compensación convencional*) and *acuerdos de compensación contractual* as two distinct legal concepts. This is the case regardless of the fact that 'netting' has been translated in Spanish by *acuerdos de compensación contractual*. That these legal concept are distinctive is mirrored explicitly in Law 22/2003, de 9 julio (*Ley Concursal*), which will enter into force in September 2004 - *compensación* under Articles 58 and 205 and *acuerdos de compensación contractual* under Article 63 para. 2 and 2nd Additional Provision. This conclusion results from a systematic interpretation of that law: Article 205 of the *Ley Concursal* has basically the same wording as Article 6 of the Insolvency Regulation and allows a creditor to set off (*compensar*) debts in insolvency situations under certain conditions.[149] This provision is designed to create an exception to the general prohibition against the set-off (*compensación*) of debts in insolvency situations, as provided for in Article 58 of the *Ley Concursal*.[150] However, the 2nd Additional Provision of the *Ley Concursal* deals explicitly with *acuerdos de compensación contractual* and confirms that the *Ley Concursal* does not have any effect on existing legislation concerning the validity of *acuerdos de compensación contractual*, in particular the 10th AP of the Ley 37/1998

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[148] Paragraph 1 of the 10th Additional Provision provides as follows: *Las normas de la presente disposición se aplicarán a las operaciones financieras que se realicen en el marco de un acuerdo de compensación contractual o en relación con el mismo, siempre que en el mismo concurran los siguientes requisitos:*

a. Que al menos una de las partes del acuerdo sea una entidad de crédito o una empresa de servicios de inversión, o una entidad no residente autorizada para llevar a cabo las actividades reservadas en la legislación española a las referidas entidades o empresas.

b. Que el acuerdo prevea la creación de una única obligación jurídica que abarque todas las operaciones financieras citadas incluidas en el mismo y en virtud de la cual, en caso de vencimiento anticipado, las partes sólo tendrán derecho a exigirse el saldo neto del producto de la liquidación de dichas operaciones. El saldo neto deberá ser calculado conforme a lo establecido en el acuerdo de compensación contractual o en los acuerdos que guarden relación con el mismo.

[149] Art. 205, para. 1 of the Ley Concursal provides as follows: *La declaración de concurso no afectará al derecho de un acreedor a compensar su crédito cuando la ley que rija el crédito recíproco del concursado lo permita en situaciones de insolvencia.*

[150] Art. 58 of the Ley Concursal provides as follows: *Sin perjuicio de lo previsto en el artículo 205, declarado el concurso, no procederá la compensación de los créditos y deudas del concursado, pero producirá sus efectos la compensación cuyos requisitos hubieran existido con anterioridad a la declaración. En caso de controversia en cuanto a este extremo, ésta se resolverá a través de los cauces del incidente concursal.*

for credit institution, investment services and insurance undertakings.[151] However, the 2nd Additional Provision of the *Ley Concursal* would not have been necessary if the general legal concept of *compensación* as stated in Articles 58 and 205 of the *Ley Concursal* already included *acuerdos de compensación contractual*. In relation to the insolvency of undertakings the *acuerdos de compensación contractual* is covered by Article 63 para. 2, which creates an exception to the prohibition against the early termination of agreements on the sole ground of bankruptcy when early termination is expressly permitted by other national laws. This is the case for *acuerdos de compensación contractual* where para. 3 of the 10th Additional Provision creates an exception to the general prohibition by determining that the amount to be part of the debtor's estate will be the net amount calculated under the single agreement.[9]

10. From the perspective of Spanish insolvency law, therefore, 'set-off' and 'netting' are two different legal concepts. Thus, the traditional legal term *compensación* (including *compensación convencional*) only covers 'set-off' irrespective of the fact that the English term 'netting agreements' may be understood in Spanish by the term *acuerdos de compensación contractual.*

Conclusion

11. While the term *compensación* is consistently used throughout the Spanish texts of various Community legal acts to describe both set-off and netting, netting agreements are referred to in Spanish law as *acuerdos de compensación contractual*.

12. Taking account of Spanish insolvency legislation, the term *compensación* (including *compensación convencional*) only refers to the traditional concept whereby various debts arising from different agreements can be set off against each other. The fact that the word *compensación*

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[151] The 2nd Addicional Provision, para. 1 of the Ley Concursal provides as follows: *En los concursos de entidades de crédito o entidades legalmente asimiladas a ellas, empresas de servicios de inversión y entidades aseguradoras, así como entidades miembros de mercados oficiales de valores y entidades participantes en los sistemas de compensación y liquidación de valores, se aplicarán las especialidades que para las situaciones concursales se hallen establecidas en su legislación específica, salvo las relativas a composición, nombramiento y funcionamiento de la administración concursal.*

[9] Art. 63, para. 2 of the Ley Concursal provides as follows: *Tampoco afectará a la aplicación de las leyes que dispongan o expresamente permitan pactar la extinción del contrato en los casos de situaciones concursales o de liquidación administrativa de alguna de las partes.*

Paragraph 3 of the 10th Additional Provision, Law 37/1998, of 16 November, amended by Law 44/2002, of 22 November, Ley Financiera: *La declaración del vecnimiento anticipado, resolución, terminación ejecución o efecto equivalente de las operaciones financieras definidas en los apartados anteriores realizadas en el marco de un acuerdo de compensación contractual o en relación con el mismo, no podrá verse limitada, restringida o afectada en cualquier forma por un estado o solicitud de quiebra, suspensión de pagos, liquidación, administración, intervención o concurso de acreedores que afecte a cualquiera de las partes de dicho acuerdo, sus filiales o sucursales.*

En los supuestos en que una de las partes del acuerdo de compensación contractual se halle en una de las situaciones concursales previstas en el párrafo anterior, se incluirá como crédito o deuda de la parte incursa en dichas situaciones exclusivamente el importe neto de las operaciones financieras amparadas en el acuerdo, calculado conforme a las reglas establecidas en el mismo o en los acuerdos que guarden relación con él.

is also used in the equivalent Spanish concept of netting agreements (*acuerdos de compensación contractual*) does not mean that set-off and netting are overlapping legal concepts under Spanish insolvency law. From a Spanish insolvency law perspective the concepts of set-off (*compensación*) and netting agreements (*acuerdos de compensación contractual*) may be properly understood as distinct, rather than overlapping, legal concepts.

13. In conclusion, the term *compensación* as used in the Spanish text of Article 6 of the Insolvency Regulation does not encompass close-out netting agreements. This conclusion relates only to the interpretation of the Spanish text of Article 6 of the Insolvency Regulation. This conclusion should not be understood as suggesting that under the Spanish *Ley Concursal*, which will regulate Spanish insolvency proceedings for undertakings, there is any uncertainty regarding the protection accorded to close-out netting agreements.

Annex 11

Swedish text of the Insolvency Regulation

1. In recital 26 and Articles 4(2) and 6 of the Swedish version of the Insolvency Regulation, 'set-off' is translated as *kvittning*.

2. Recital 27 of the Insolvency Regulation states that special protection is needed in the case of payment systems and financial markets. This applies for example to the 'position-closing agreements' and 'netting agreements' to be found in such systems. The term 'netting agreements' is here translated into Swedish as *avtal om nettning*. The terms 'payment and set-off systems' are mentioned further on in this recital, and set-off systems are here translated in Swedish as *kvittningssystemen*.

3. To ascertain the legal meaning of the term *kvittning* in the context of the Insolvency Regulation, and in particular whether it could be interpreted as encompassing insolvency close-out netting, we must analyse and compare the use of the respective terms in Community and Swedish law.

Community legal acts

4. In recital 15 to the Collateral Directive the two English terms 'set-off' and 'netting' stand side by side, and are translated in Swedish as *kvittning* and *avräkning*, respectively. Elsewhere in the Collateral Directive, the English term 'close-out netting provision' is translated in Swedish as *slutavräkningsklausul*, and the term 'close-out netting' is translated as *slutavräkning*.

5. In Articles 10(2)(c), 10(2)(h) and 23 of the Banks Winding-up Directive the English term 'set-off' is consistently translated in Swedish as *kvittning*. In Article 25 of the Banks Winding-up Directive the English term 'netting agreements' is translated in Swedish as *nettningsöverenskommelser*.

6. In the Swedish version of Article 2(k) of the Settlement Finality Directive the definition of 'netting' is translated in Swedish as '*nettning*', while the word *kvittning* (set-off) does not appear in the Directive.

7. It thus seems that in Community legislation, the term 'set-off' is consistently translated in Swedish as *kvittning*. The term 'netting' is translated as either *nettning* or *avräkning*. Consistent

with this, the term 'close-out netting' is translated as *slutavräkning* and the term 'netting agreement' is translated as *nettningsöverenskommelse*.

Swedish law

8. Under Swedish law the concept of set-off or *kvittning* has not been codified, but is an acknowledged legal concept, which basically means that two (monetary) claims are netted against each other.[152] There are three main principles applicable to set-off: first, claims must be mutual, meaning that the party that is the debtor in one of the claims has to be the creditor in the other claim and vice versa; second, the party claiming the right of set-off must have a claim that has fallen due and have a debt which he is entitled to pay; and third, the claims standing against each other must be compatible, i.e. leading to the same type of performance.

9. Chapter 5 Article 1 of the Swedish Bankruptcy Law (KL)[153] provides that in principle, to be valid in a bankruptcy, a claim has to have occurred before the decision of bankruptcy has been published. A claim is valid in a bankruptcy, even if it is dependent on conditions or has not reached maturity. The bankruptcy of a debtor strengthens the creditor's right to set-off since according to KL 5.15, first paragraph, a creditor's claim can be set off against the debtor's claim, notwithstanding that the claim has not reached maturity. Although not specifically provided in the KL, the same rule would apply for a creditor's debts.[154]

10. It should be noted that the Swedish words for 'netting', i.e. *avräkning* or *nettning*, do not occur in Swedish Bankruptcy Law. Rather, the Swedish rules on netting are contained in the Financial Instruments Trading Act.[155]

11. According to the State Official Investigation (SOU: 1993:114 on account, clearing and settlement), which preceded the Swedish Government bill on the Financial Instruments Trading Act, bilateral netting (*bilateral nettning*) is from a legal point of view to be regarded in the same way as a set-off procedure (*kvittningsförfarande)*. The State Official Investigation considered whether netting should be given a general legal definition, but decided that it should not.

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[152] See S. Lindskog, Kvittning: Om avräkning av privaträttsliga fordringar (1984), pp. 24, 29 f.

[153] Konkurslag (1987:672).

[154] Wistrand Advokatbyrå, "Bilateral Close-Out Netting,and Multibranch Close-out Netting under Swedish Law", 7 January 2003, p. 11.

[155] Lag 1991:980 om handel med finansiella instrument.

12. As noted above, the Swedish rules on netting are governed by the Financial Instruments Trading Act.[156] This legislation applies to trading in financial instruments, in other similar rights or obligations or in currencies (and to new instruments with equivalent characteristics). The preparatory work (Government bill) to this legal act[157] states that in trade with financial instruments and currencies on the financial markets it is common that an agreement is concluded between the parties concerning netting of mutual obligations to deliver and to pay. The Government bill states that 'netting (*avräkningen)* can best be described as a set-off procedure (*kvittningsförfarande)* that in addition to payment obligations also contains an obligation to deliver the financial instruments or currency. Through the netting (*avräkningen)* the actual exchange of the financial instruments, currencies and payments can be dramatically reduced.'[158] The Government bill also states that a netting agreement or *avtal om avräkning* usually contains a clause that close-out netting or *slutavräkning* shall be made in case one of the parties becomes bankrupt.

13. Chapter 5 Article 1 of the Financial Instruments Trading Act states:

> 'An agreement between two parties concerning trade with financial instruments, with other similar rights or obligations or with currencies, stating that obligations between the parties shall be close-out netted (slutavräknas) if one of the parties is declared bankrupt, will be valid against the bankruptcy estate and against the creditors in the bankruptcy. The same is applicable for netting (avräkning) of obligations between two or several participants in an approved settlement system, if the netting has taken place in accordance with the rules of the system'.

This article thus encompasses both bilateral and multilateral netting. The Swedish word for 'set-off', i.e. *kvittning*, as used in the Insolvency Regulation, does not occur in the Financial Instruments Trading Act.

14. No distinction seems to be made between 'close-out' and 'netting' under Swedish law. The Swedish *slutavräkning* can encompass both the termination of the contract and the netting. The close-out provisions in agreements, providing that close-out netting should occur on the day of the bankruptcy or the following day, are regulated in Swedish law by Chapter 5 Article 1 of the Financial Instruments Trading Act, which provides that the close-out netting is valid against the bankruptcy estate and the creditors.

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[156] Lag 1991:980 om handel med finansiella instrument.

[157] Prop. 1994/95:130 on netting agreements in trade with financial instruments and currencies (SW: Avtal om avräkning (nettning) vid handel med finansiella instrument och valuta)

[158] In Swedish: "Avräkningen kan närmast beskrivas som ett kvittningsförfarande som utöver betalningsförpliktelser även omfattar skyldighet att leverera finansiella instrument eller valuta".

15. To sum up, in the legal preparatory work[159] for the Financial Instruments Trading Act the question of what netting is from a legal point of view has been discussed. The prevailing view is that netting is a contract-based construction between two or more parties with effects similar to those of set-off. One could say that the scope of netting, taking place largely on financial markets in trading with financial instruments and currencies, is more narrow than that of set-off, but wider in the sense that the definition of the concept, in addition to payment obligations, also includes a duty to deliver financial instruments or currencies.

16. Insolvency set-off and insolvency close-out netting thus have similar effects. However, claims based on close-out netting provisions in an agreement have a wider protection where one of the parties is insolvent than claims based on set-off, which may only be recognised under the conditions described above. The Government bill for the Financial Instruments Trading Act states:

> 'The fact that all outstanding obligations that are covered by an agreement between the parties shall be netted against each other with legal effect against the bankruptcy estate and against the creditors in the bankruptcy implies a broader right of set-off as compared to what applies according to general rules, primarily since the close-out netting may also include obligations that are not interchangeable with each other, e.g. netting a duty to deliver financial instruments against a monetary claim. Concerning transactions that are covered by a close-out netting, neither the bankruptcy estate nor the creditors in the bankruptcy can successfully claim that the creditor that is party to the netting agreement would not have been entitled to set them off according to the general rules.'[160]

This would imply that insolvency set-off and insolvency close-out netting are distinct concepts under Swedish law.

Conclusion

17. In Community legislation, including Article 6 of the Insolvency Regulation, 'set-off' is consistently translated in Swedish as *kvittning,* and 'netting' is translated as either *nettning* or *avräkning*. The preparatory work to Swedish netting legislation indicates that netting is a contract-based construction between two or more parties with effects that are similar to those of set-off. However, claims based on close-out netting provisions in an agreement seem to have a wider protection where one of the parties is insolvent than claims based on set-off, which may

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[159] State Official Investigation (SOU: 1993:114 on account, clearing and settlement)

[160] Prop. 1994/95:130 on netting agreements in trade with financial instruments and currencies (SW: Avtal om avräkning (nettning) vid handel med finansiella instrument och valuta), p. 24.

only be recognised under certain specified conditions. This would imply that insolvency set-off and insolvency close-out netting are distinct concepts under Swedish law.

Annex 12

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