**EU INSOLVENCY REGULATION**

**DRAFT POSITION PAPER FOR THE EUROPEAN FINANCIAL MARKET LAWYERS GROUP/INTERNATIONAL SWAPS & DERIVATIVES ASSOCIATION ON THE TREATMENT OF SET-OFF**

1. **INTRODUCTION**

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

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

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

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

1.5 Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (the “Insolvency Regulation”) and the Directives relating to the winding-up of insurance companies and of credit institutions (“the Directives”) offer a solution to these difficulties. They provide special protection for rights of set-off in

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1 This position paper sets out our views on the interpretation of the EU Insolvency Regulation, and is not a formal legal opinion. Specific advice should be sought in relation to particular matters and circumstances.


the context of insolvency proceedings in cases where the set-off applies to a claim of the insolvent debtor which is governed by the law of a country other than the law of the State of the opening of the insolvency proceedings ("the lex concursus"). Where the law applicable to the insolvent debtor’s claim permits set-off, then it should be unnecessary to consider whether the lex concursus is favourable or unfavourable to rights of set-off.

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

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

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

1.9 We believe these arguments to be misconceived on a number of grounds.

(a) These arguments would effectively remove protection from key financial instruments which play a vital role in modern financial markets. 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 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.4 If these arguments were correct, the Insolvency Regulation and the Directives would fail to promote certainty of transactions and to protect the legitimate expectations of parties in an area where any doubt creates severe risk of systemic damage and impaired market efficiency. This result would be plainly at odds with the rationale underlying the set-off protection identified in the recitals to the Insolvency Regulation and its travaux préparatoires.

(b) These arguments also involve an unduly narrow approach to the natural meaning of the term “set-off”, which, in our view, is sufficiently broad to encompass all elements of close-out netting.

4 See, e.g., Case 283/81, CILFIT v Italian Ministry of Health [1982] ECR 3415, 3430.
The purpose of this paper is to set out those arguments which, in our view, support the case for the set-off protection in the Insolvency Regulation encompassing close-out netting. These arguments are derived from the text of the Insolvency Regulation itself and the travaux préparatoires for the Insolvency Regulation, in particular the Virgos/Schmit report. As the Insolvency Regulation was, in effect, an implementation of the Convention on Insolvency Proceedings, the Virgos/Schmit report should provide assistance in the interpretation of the Insolvency Regulation.

### 2. The Protection for Set-Off

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

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6 Report on the Convention on Insolvency Proceedings by Miguel Virgos, Professor, Universidad Autonoma of Madrid, and Etienne Schmit, Magistrate, Deputy Public Prosecutor, Luxembourg, Brussels, 8 July 1996. The Convention on Insolvency Proceedings, signed in Brussels on 23 November 1995, lapsed due to the failure of one contracting State to sign the Convention in due time. All of the provisions of the Convention, with one exception, were transformed into the text of the Insolvency Regulation.

7 The Court of Justice has referred to travaux préparatoires to assist in the interpretation of directive provisions, see e.g., Case 133/00, J.R. Bowden, J.L. Chapman and J.J. Doyle v Tuffnells Parcel Express Limited. Case C-133/00, [2001] ECR I-7031, 7065.

8 Secondary proceedings may be opened in other States in which the debtor has an establishment.
2.2 Article 4 lays down the general rule that the *lex concursus* governs the insolvency proceedings and their effects, including “the conditions for opening the proceedings, their conduct and their closure”.

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

2.4 The general application of the law of the State of the opening of proceedings is subject to certain exceptions set out in Articles 5 to 11 and 13 to 15. The exception relevant for the purposes of this paper is that set out in Article 6, which provides as follows:

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

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

2.5 It is clear from the opening words of Article 4 (“Save as otherwise provided in this Regulation”) that Article 6 qualifies the general rule on set-off in Article 4(2)(d).

The relation between the two provisions can therefore be 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.

2.6 By way of example, if the insolvent debtor is an English company then the *lex concursus* will be English law. *English insolvency law* will therefore govern the conditions for the application of insolvency set-off. If the English company has an agreement, which is governed by French law, with a French company, then French law will govern the contractual set-off in a case where such a set-off is prohibited by English insolvency law but permitted under French law.

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9 Article 5 – Third parties rights in rem; Article 6 – Set-off; Article 7 – Reservation of title; Article 8 – Contract relating to immovable 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.

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

11 i.e., in this context, a company whose centre of main interests is in England.
2.7 Conversely, if the insolvent debtor were the French company then English insolvency law would have no application, since the *lex concursus* would be French law. If the agreement were under English law, however, any rule of French insolvency law which would normally have precluded the English company from asserting a right of set-off available under the general rules of English law will not apply.\(^\text{12,13}\)

3. **The Rationale Behind the Article 6 Protection for Set-Off**

3.1 The contextual and purposive interpretation of Community law is of critical importance. As noted by the Court of Justice, "[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."\(^\text{14}\)

3.2 The preamble to the *Insolvency Regulation* explains the rationale for the exceptions to the primacy of the *lex concursus* as follows:

> "Automatic recognition of insolvency proceedings to which the law of the opening State normally applies may interfere with the rules under which transactions are carried out in other Member States. To protect legitimate expectations and the certainty of transactions in Member States other than that in which the proceedings are opened, provisions should be made for a number of exceptions to the general rule."\(^\text{15}\)

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

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

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\(^\text{12}\) This conclusion is obviously dependent to an extent upon the issue considered by this paper, namely the scope of the set-off protection. The example is given to illustrate the relation between Article 4(2)(d) and Article 6(1).

\(^\text{13}\) Article 26 of the *Insolvency Regulation* allows Member States to refuse to recognise insolvency proceedings opened in another Member State, or to enforce judgments handed down in the context of such proceedings, where the effects of such recognition or enforcement would be manifestly contrary to that State’s public policy. Unless the creditor obtained a judgment in insolvency proceedings in another Member State to uphold a contractual right of set-off, it is difficult to see that the *lex concursus* could rely upon this Article to defend its approach to set-off. However, it is possible that some Member States may regard Article 26 as the basis for a more general public policy argument to preserve their own approach to set-off.

\(^\text{14}\) *Case 283/81, CILFIT v Italian Ministry of Health* [1982] ECR 3415, 3430.

\(^\text{15}\) *Insolvency Regulation*, recital 24.
“If a set-off is not permitted under the law of the opening State, a creditor should nevertheless be entitled to the set-off if it is possible under the law applicable to the claim of the insolvent debtor. In this way set-off will acquire a kind of guarantee function based on legal provisions on which the creditor can rely at the time when the claim arises.”

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

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

3.6 The use in paragraph 26 of the preamble to the Insolvency Regulation of the phrase “a kind of guarantee function” indicates that set-off is viewed as having a function analoguous to that of security, and therefore as meriting a like degree of protection. This is reflected in the Virgos/Schmit Report, which uses the word “garantie” 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."

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”

3.7 It is relevant to note that, both in paragraph 26 of the preamble to the Insolvency Regulation itself and in the Virgos/Schmit report, the word in the French text corresponding to the English word “guarantee” is “garantie”. Similarly, the Spanish, Italian and Portuguese texts of the Insolvency Regulation use the terms “garantía”, “garanzia” and “garantia”, respectively. Unlike the English word, which

16 Virgos Schmit report, paragraph 21.
17 Virgos Schmit report, paragraph 109, fourth para.
18 La compensation devient ainsi une forme de garantie régie par une loi par dont le créancier concerné peut se prévaloir au moment de la naissance de la créance.
19 It is noted that the Convention on Insolvency Proceedings, on which the Virgos/Schmit report was commenting, was drawn up in a single original in twelve languages (Danish, Dutch, English, Finnish, French, German, Irish, Italian, Portuguese, Spanish and Swedish), all twelve texts being equally authentic. Convention on Insolvency Proceedings, Brussels, 23.11.1995, Article 55.
would ordinarily refer to a merely personal obligation, the French, Spanish, Italian and Portuguese words would naturally be taken in a wider sense as including proprietary rights of security.

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

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

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

4. CONTINGENT AND PROSPECTIVE CLAIMS: EARLY TERMINATION AND ACCELERATION

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

(a) set-off is simply one element of close-out netting;

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

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

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

(a) by the ordinary meaning of the words used and general principles of law;

(b) by the views expressed in the Virgos/Schmit report, on the specific case of contingent and future claims;

(c) by a comparison with other Community instruments; and

(d) by consideration of the policy objective of Article 6.

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

4.5 The term ‘set-off’ as used in Article 6 of the Insolvency Regulation is not defined. Consistent with the case-law of the Court of Justice, in case of doubt, a particular provision of Community law should be interpreted and applied in the light of the versions existing in the various languages. The equivalent French, Greek, Italian, Portuguese and Spanish terms for “set-off” as used in Articles 4(2) and 6 and recital 26 of the Insolvency Regulation are compensation, sympsifismos, compensazione, compensação and compensación, respectively. In addition, where the English text of recital 27 makes reference to the ‘position-closing agreements and netting agreements’ to be found in payment systems, the French text refers to la compensation et à la liquidation, the Greek text refers to Sypsiphismos & ekkathariseis, the Italian text refers to la liquidazione dei contratti e le compensazioni.

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the Portuguese text refers to ‘vencimento antecipado da obrigação e da compensação’ and the Spanish text refers to contratos de liquidación y acuerdos de compensación. This shows that, within the text of the Insolvency Regulation itself, the same French, Italian, Portuguese and Spanish terms — compensation, compensazione, compensação and compensación — are used for both netting and set-off.

4.6 A review of the terms 'set-off', 'setting-off', 'netting agreements', 'close-out netting', 'close-out netting provisions' and 'netting' used in various Community legal acts, including the Banks Winding-up Directive\(^\text{23}\) and the Collateral Directive,\(^\text{24}\) also demonstrates that a single term is consistently used to cover both netting and set-off in the French,\(^\text{25}\) Greek,\(^\text{26}\) Italian,\(^\text{27}\) Portuguese\(^\text{28}\) and Spanish\(^\text{29}\) texts of Community legal acts.


\(^\text{25}\) Articles 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. The French text thus specifies that there is not only a set-off element, but also an element of novation included in the term netting agreements. 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 of the Collateral Directive 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).

\(^\text{26}\) In the Greek version of the Banks Winding up Directive the term 'set-off is consistently translated as sympsiphismos throughout the text. The term 'netting' appears only once in the English text, in Article 25, where the English caption 'netting agreements' is translated as “Symphona sympsiphismou kai metatropis xreous” (i.e. set-off and debt conversion agreements). The same expression is translated in the same way in the main body of Article 25, but the English term “netting agreements” has been kept within brackets next to the Greek term.

Throughout the text of the Collateral Directive the term “close-out netting” is translated 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 sympsiphismo). In recital 15, in the phrase “on obligations to set-off, or on netting” it seems that “set-off” is translated as antistathmisi (i.e. compensation) and “netting” is translated as sympsiphismos. In Article 2(1), in the phrase “through the operation of netting or set-off or otherwise” it seems that “netting” is again translated as sympsiphismos and “set-off” as antistathmisi. The term 'netting' as defined in Article 2(k) of Directive 98/26/EC of 19 May 1998 on settlement finality in payment and securities settlement systems, OJ L 166, 11.06.1998, p. 45 (the "Settlement Finality Directive") is defined in the Greek text as sympsiphismos.

\(^\text{27}\) Similar to the French text, the Italian text of Article 23 of the Banks Winding-up Directive is captioned Compensazione and makes provision for compensazione, while Article 25 is captioned “Accordi di compensazione e di novazione” and makes provision for “accordi di compensazione e di novazione”, again specifying that there is not only a set-off element, but also an element of novation within netting agreements. Where the English text of the Collateral Directive refers to}
The equivalent Dutch term for set-off in Articles 4(2) and 6 of the Insolvency Regulation is *verrekening*, which is the term traditionally used in Dutch for netting. This is also the term used for netting in the Banks Winding-up Directive, but not in the Collateral Directive.\(^\text{30}\)

"close-out netting" and "close-out netting provisions", the Italian text refers to "*compensazione per close-out*" (recital 14). In Article 2(n) the definition of "close-out netting provision" 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 implies that the Italian term *compensazione* is understood to embrace both netting and set-off.

Similar to the French and Italian texts, the Portuguese text of Article 23 of the Banks Winding-up Directive refers to *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 element, but also an element of novation within netting agreements.

Recitals 5 and 14 of the Portuguese version of the Collateral Directive equate 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 the brackets. Regarding the reference in recital 15 to requirements under national law on bringing into account claims, on obligations to set-off, or on netting, it is noteworthy that only one term is used for both netting and set-off (*compensação*), clearly subsuming the terms netting and set-off. Again, the reference in Article 2 (1)n) to ‘through the operation of netting or set-off or otherwise’ is rendered as ‘*por compensação (netting ou set-off) ou por outro meio*’. In Article 7 ‘close-out netting provisions’ is translated as ‘*cláusula de compensação com vencimento antecipado*’.

In recitals 1 and 11 and Article 2(k) of the Settlement Finality Directive ‘netting’ is defined in Portuguese as *‘compensação (netting)*’, with the English expression left within brackets for clarification purposes. Further down (in the heading of Article 3 and in Articles 3(1) and 3(2)) the term *compensação* appears without the explanation, but after having seen it above a Portuguese reader would still understand it as if it were there, that is, as a specific type of *compensação*.

To sum up, the Portuguese versions of the Banks Winding-up Directive, the Collateral Directive and the Settlement Finality Directive are referring to slightly different, although overlapping, legal concepts and terms regarding ‘set-off’ and ‘netting’, reflecting the inconsistency between the English versions of the various Community legal acts. However, the term *compensação*, in conjunction with other descriptive terms, is consistently used throughout all Community texts.

Similar to the French, Italian and Portuguese texts, Article 23 of the Spanish text of the Banks Winding-up Directive is captioned *Compensación* and makes provision for *compensación (netting)* and Article 25 of which is captioned ‘*acuerdos de compensación y de novación*’ and makes provision for ‘*acuerdos de compensación y de novación*’, again specifying that there is not only a set-off element, but also an element of novation within netting agreements. Where the English text of the Collateral Directive 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*’.

The term *verrekening* has been used inter-changeably to describe both set-off and netting in the Dutch version of the Banks Winding-up Directive, which 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 en novatie*’ (‘netting agreements’ in the English text), again specifying that there is not only a set-off element, but also an element of novation within netting agreements. However, the Collateral Directive appears to translate the English term ‘netting’ into Dutch as *saldering*, so that where Article 2(n) of the Directive refers to ‘netting or set-off or otherwise’, the Dutch text refers to ‘*saldering, verrekening van anderszins*’, and where recital 14 refers to ‘*close-out netting*’, the equivalent Dutch text refers to ‘*saldering*’.\(^\text{30}\)
In Article 6 and recital 26 of the Danish version of the Insolvency Regulation, set-off has been translated as modregning. In recital 27 of the Insolvency Regulation, position-closing agreements and netting agreements have been translated into the English terms 'close-out-netting' and 'netting'. Consistent with this, in the Danish version of the Collateral Directive set-off has been translated as modregning and close-out netting as slutafregning (close out netting). Again, consistent with this approach, in the Danish version of the Winding-up Directive the English term 'netting' has been translated into netting, whereas set-off has been translated into modregning.

The corresponding German term for 'set-off' both in Article 6 and recital 26 of the Insolvency Regulation 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'.

The Settlement Finality Directive is quite notable as it uses the terms of Aufrechnung and 'netting' interchangeably. Article 2(k) of the Settlement Finality Directive contains the definition of 'netting', which in the German text is being referred to as 'Aufrechnung' (netting), thus placing the English expression behind the German term for clarification purposes. 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 as contained in Article 2(k), "Aufrechnung" (netting) is being defined as the Verrechnung (conversion' in the English text) of rights and obligations.

Article 2(1)(n) and recital 14 of the German version of the Collateral Directive equates the concept of 'close-out netting' with 'Aufrechnung infolge Beendigung' ("close out netting"); the German term being literally translated as "set-off due to termination". Again, the English expression is combined with the German term for clarification purposes. Moreover, Article 7 equates 'close-out netting provisions' with 'Aufrechnung infolge Beendigung', but without the additional English term added in brackets. 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.

Finally, Article 23 of the Banks Winding-up Directive uses the term Aufrechnung in correlation with the English 'set-off'. More interestingly, the German version of Article 25 defines two legal concepts as being equivalent to the English version's 'netting agreements', namely 'Aufrechnungs- und Schuldnendauerversprachungen', literally "Set-off and novation agreements".

To sum up, the German versions of the Insolvency Regulation, the Settlement Finality Directive, the Collateral Directive and the Banks Winding-up Directive are referring 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.

In recital 26 and Articles 4(2) and 6 of the Swedish text of the Insolvency Regulation, the term "set-off" is translated as kvittning. The reference in recital 27 to the "netting agreements" to be found in payment systems is translated as givtal om netting.

In the Banks Winding-up Directive the term "set-off" used in Articles 10(2) and 23 of the Directive is translated into Swedish as kvittning, while the term "netting agreements" in Article 25 is translated as nettningsöverenskommelser.

In recital 15 to the Collateral Directive, where the two terms "netting" and "set-off" stand next to each other, set-off is translated as kvittning and netting as avräkning. Elsewhere in the Collateral Directive, "close-out netting provision" is translated as slutavräkningsklausul, and "close-out netting" as slutavräkning.

In Article 2(k) of the Settlement Finality the definition of "netting" is translated as netting.
compared to the terms used for netting both in recital 27 to the Insolvency Regulation itself and in other Community legal acts.

4.9 [Finnish text/ analysis to follow.]

4.10 While there is much authority for the Court of Justice having regard to the various language versions in order to interpret provisions of Community law, the Court will have regard to a contextual and purposive interpretation where linguistic analysis fails to resolve the interpretation of a provision. The Court of Justice 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."34

4.11 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*.35 The Article 6 protection is therefore clearly intended to allow contractual set-off of contingent and future obligations where the law applicable to the insolvent debtor’s claim permits this. 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 -

4.12 "*Article 6 covers only rights to set-off arising in respect of mutual claims incurred prior to the opening of the insolvency proceedings.... If in the event of a contractual set-off agreement covering different claims between two parties, the law of the Contracting State applicable to that agreement will continue to govern the set-off of claims covered by the agreement and incurred prior to the opening of the insolvency proceedings.***"36 Support for the view that the term “set-off” is broad enough to describe the acceleration and net settlement of claims is also provided by the Collateral Directive, which defines “close-out netting provision” as a *provision of a financial collateral arrangement*:

“*by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or otherwise:*”

To sum up, in Community legislation the term "set-off" is consistently translated into Swedish as *kvittning*, meaning, generally, the legal term by which one debt is set off against another, and any difference is paid. The term "netting" is translated into Swedish as *nettning* or *avräkning*. These two terms are equivalent in Swedish, *avräkning* is the original Swedish term, while the word *nettning* was imported into the Swedish language from English more recently. "Close-out netting" is translated into "slutavräkning" and "netting agreement" is translated as "nettningssöverenskommelse".

35 Virgos/Schmit report, paragraph 109, third para.
36 Virgos/Schmit report, paragraph 110.
(i) the obligations of the parties are accelerated so as to be immediately
due and expressed as an obligation to pay an amount representing
their estimated current value, or are terminated and replaced by an
obligation to pay such an amount; and/or

(ii) an account is taken of what is due from each party to the other in
respect of such obligations, and a net sum equal to the balance of the
account is payable by the party from whom the larger amount is due to
the other party.”

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

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

5. “SET-OFF” AND “NETTING”

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

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

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

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

37 Collateral Directive, Article 2(n).
5.4 The term “netting” is more recent than “set-off” and does not have a recognised or precise legal meaning. It is in our view necessary to be particularly cautious about basing arguments on interpretation on comparisons between the two terms: such a comparison is not a comparison of like with like.

5.5 Netting and set-off can be distinct terms since netting applies to a broader range of provisions than set-off. Netting does not necessarily involve two gross payment obligations being discharged by way of set-off: netting by novation, for example, involves the discharge of existing obligations and their replacement with new obligations to make net payments on an agreed value date. In addition, although it is possible to speak of netting in relation to a number of different types of payment or delivery obligations, set-off is in general only applicable to obligations to pay sums of money (or currency).

5.6 It is possible that the purpose of Article 25 of the Banks Winding-up Directive is to protect the class of netting arrangements, such as netting by novation, which are not otherwise covered by the protection for set-off. This interpretation is supported by the Dutch, French, Italian, Portuguese and Spanish texts of Article 25, which indicate that there is not only a set-off element, but also an element of novation included within the term ‘netting agreements’. This raises the question of why such arrangements with banks are accorded special protection. Netting by novation is a particularly common mechanism in the foreign exchange markets, and one possibility is 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.

5.7 In any event, we do not consider that the presence of a specific protection for netting in the Banks Winding-up Directive precludes an interpretation of Article 6 which covers close-out netting arrangements. There is nothing particularly surprising about the presence of two provisions that may overlap in some respects. Moreover, where the ordinary interpretation of Article 6 covers close-out netting, which we consider that it does, it would seem odd to reject that interpretation on the grounds that the Bank Winding-up Directive contains a complementary, though potentially overlapping, provision.

6. **PROTECTION UNDER ARTICLE 13**

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

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

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38 The Dutch text describes a netting agreement as ‘verrekening and novatie’ (‘netting agreements’, the French text as conventions de compensation et de novation (“netting agreements”), the Italian text as “accordi di compensazione e di novazione” the Portuguese text as convenções de compensação e de novação’ and the Spanish text as “acuerdos de compensación y de novación.”
- the said act is subject to the law of a Member State other than that of the State of the opening of proceedings; and

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

6.2 The aim of Article 13 set out in the Virgos/Schmit report is similar to that for set-off itself, namely “to uphold 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.”

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

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

7. The effect of Articles 6(2) and 4(2)(m)

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

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

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

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

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

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40 For example under English law, if, in the specific case, there was a prima facie case for undue influence or mistake.
41 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.
7.5 First, it would render Article 6(1) largely, if not completely, devoid of application, since any rule of the *lex concursus* restricting the availability of set-off will, almost by definition, be a rule doing so on the basis that it constitutes “a legal act detrimental to all creditors”. This would be contrary to the principle endorsed by the Court of Justice that a legal provision must be interpreted in such a manner that its implementation is effective and useful (*l’effet utile*).  

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

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

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

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

8. **CONCLUSION**

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

8.2 A narrow interpretation of Article 6, which distinguishes close-out netting from set-off and regards those elements of close-out netting, such as early termination

and acceleration of claims, as outside Article 6 will rob the set-off protection of virtually any effect in financial market transactions, contrary to the effect utile principle.

8.3 There is nothing in the Insolvency Regulation itself, or in the travaux préparatoires, which compels this narrow interpretation. On the contrary, the broader interpretation is supported by the natural meaning of set-off, confirmed by the terminology used for 'set-off' in a majority of the eleven equally authentic texts of the Insolvency Regulation, general principles of law and the clarifications made in the recitals to the Insolvency Regulation and its travaux préparatoires. Most importantly, however, the broad interpretation is the one which best achieves the objectives of the Article 6 protection. The significance of this protection for a vital area of European Union commerce is, in our view, a powerful reason to accept the broad view of Article 6.