AN ITALIAN PERSPECTIVE ON SET-OFF AS PERMITTED BY THE INSOLVENCY REGULATION

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This article seeks to examine briefly the impact which Council Regulation 1346/2000/EC (the 'Insolvency Regulation') can be expected to have when interpreted by Italian courts with regard to rights of set-off potentially available to financial institutions in order to hedge exposures to counterparties created as a result of a wide range of financial arrangements, including OTC derivatives, repurchase and stock-lending agreements, loans and debt securities. This article will not analyse all of the provisions of the Insolvency Regulation, but will focus only on those provisions which are of relevance to set-off.

The Insolvency Regulation affects proceedings relating to non-financial institutions and has been of direct application in Italy since 31 May 2002, although there is as yet no practical experience of its impact or interpretation with regard to set-off. The Insolvency Regulation must be interpreted purposively and in conformity with Community law. Nevertheless, its interpretation in the facts of any particular case is up to the courts of the member state in which the insolvency proceedings (whether 'main' or 'secondary') have been opened in respect of which a right of set-off is claimed.

Even prior to entry into force of the Insolvency Regulation, Italian insolvency laws were not completely hostile to set-off. In particular, art 56 of the Bankruptcy Law states that creditors have the right to set off their debts owed to the bankrupt against their claims against it, even if the latter are not yet matured at the time of the declaration of insolvency. However, the second paragraph of art 56 states that such right of set-off does not apply if the creditors acquired their claims against the bankrupt by any transaction either after the declaration of the admission to insolvency proceedings or within one year preceding such date. This limitation embodies an 'anti build-up' rule and derives from a suspicion that a creditor may acquire a credit in relation to the bankrupt in order to avoid payment of its own debt.

The starting position under the Insolvency Regulation is that the insolvency laws of the member state in which insolvency proceedings are commenced will determine the rules regarding the conditions under which set-offs may be invoked (art 4(2)(d)). However, as an exception to this general rule, art 6 provides that 'the opening of insolvency proceedings shall not affect the right 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'. The 'law applicable to the insolvent debtor's claim' is the law governing the liability owing by the solvent person to the insolvent person. If that liability arises under one of the standard industry master agreements governing OTC derivatives, stocklending or repos, this law will typically be English or New York law.

Recital 26 of the Insolvency Regulation states that 'If a set-off is not permitted under the law of the opening state, a creditor shall 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 concerned can rely at the time when the claim arises.'

IMPACT OF ARTICLE 6

Whenever the Insolvency Regulation applies to proceedings taking place in Italy, the one year anti build-up rule set out in art 56 of the Bankruptcy Law will no longer apply if the law applicable to the insolvent debtor's claim is not Italian law.

It has, however, been debated whether art 6 of the Insolvency Regulation, in speaking of 'set-off', should be construed simply with respect to the ability to set off one liquid and collectable claim against another liquid and collectable cross-claim. This is likely because the so-called Virgos-Schmit Report, which was prepared in connection with the Convention on Insolvency Proceedings of 1995 which ultimately became the Insolvency Regulation, states that art 6(1) only covers rights of set-off arising in respect of *mutual debts* (ie as opposed to mutual obligations) incurred prior to the opening of the insolvency proceedings.

This unfortunate drafting of the Virgos-Schmit Report appears also to have influenced the drafting of a proposed bill of law which has recently been put before the Italian Parliament to provide the government with powers to adopt legislation reforming Italian insolvency laws in conformity with the Insolvency Regulation. In particular, this draft Bill indicates that the government should, inter alia, 'regulate the effects of insolvency proceedings for the debtor and for creditors, avoiding cases of incapacity which are not strictly useful for the proceedings and permitting, among other, . . . the setting-off of debts and credits, even if not liquid or collectable, arising prior to the first phase of the proceedings . . .'. Since art 56 of the Bankruptcy Law already extends beyond cases of setting off liquid and collectable claims, if the reform is to have real meaning, Italian courts should interpret the concept of debts and credits *'arising'* prior to proceedings as referring to debts and credits in relation to obligations *'arising'* prior to proceedings and should interpret art 6 of the Insolvency Regulation in the same way, notwithstanding any weight which might be attached to the Virgos-Schmit Report. In other words, in order to achieve the stated goal of ensuring greater legal certainty in relation to set-off, Italian courts are likely to recognise that it is sufficient for the purposes of art 6 that the obligation, rather than the liability to pay the claim, arose prior to proceedings (meaning, in the case of contractual obligations, that the contract was entered into prior to proceedings being commenced).

A second consideration in relation to art 6 is whether it should be the insolvency laws or the general laws of the jurisdiction applicable to an insolvent debtor's claim which apply. It has been suggested that where no insolvency proceedings have been commenced in this jurisdiction, then the court where proceedings have been opened should consider only whether the set-off would be allowed in a non-insolvency context. It is argued that looking to the insolvency laws in this case would create undue uncertainty, since it would be necessary simply to deem that insolvency proceedings were in existence in the relevant jurisdiction, but it would not be clear which type of proceedings should be deemed to exist or when they should be deemed to have commenced.

In practice, Italian courts are unlikely to be dissuaded from looking at the insolvency laws applicable to the insolvent debtor's claim to determine whether the set-off should be allowed, even if no insolvency proceedings have been commenced in that jurisdiction. For one thing, the insolvency law approach is favoured by the Virgos-Schmit Report. The court will probably overcome the obstacles mentioned simply by deeming that the nearest equivalent proceeding has been commenced in that jurisdiction at the same time that the Italian proceedings were opened. In many, and possibly most, cases, there will be no other connection between the debtor and the jurisdiction applicable to the relevant claim, making it impossible for proceedings to be opened in that jurisdiction in any event. The fact that art 6 allows one to look to the laws of a jurisdiction without reference to where assets of the debtor are situated will probably be seen as an exception to the fact that the Insolvency Regulation is, after all, concerned exclusively with administering insolvency proceedings.

IMPACT OF ARTICLE 13

The second paragraph of art 6 states that actions in relation to voidable preferences will continue to be governed by the law applicable to the proceedings, rather than the law applicable to the insolvent debtor's claim. However, art 13 of the Insolvency Regulation allows the creditor a defence to any challenge of an 'act' as a voidable preference where it can be proved that the act is subject to the law of another member state and that law does not allow any means of challenge in the relevant case.

Article 56 of the Bankruptcy Law has been held to provide for a particular form of legal set-off which is not subject to avoidance. Contractual set-off is generally only at risk under Italian insolvency laws when the contract itself was executed within the one year period preceding the date of the insolvency, with the liquidator required to prove that the solvent party was aware of a state of insolvency at the time the agreement was entered into. This is because Italian courts distinguish between the agreement to set-off and its effect in extinguishing reciprocal claims, recognising that only the former embodies an 'act by the debtor', which is a necessary precondition for challenge of a transaction as a preference. This reasoning is in accordance with the Virgos-Schmit Report, which states that art 13 applies only where the relevant 'act' is carried out prior to the opening of the insolvency proceedings. In other words, Italian courts should recognise that it is sufficient for the purposes of art 13 that the agreement for set-off is executed prior to such time, regardless as to when the set-off actually occurs.

The proposed reform of Italian insolvency laws to ensure compliance with the Insolvency Regulation does not add anything specifically to art 13, but does propose generally that the current suspect periods of one and two years be reduced to, respectively, six months and one year.

As with art 6, it has been questioned whether for the purposes of art 13 the court where proceedings have been opened should take into consideration challenges available under the general law or the insolvency laws of the jurisdiction whose laws apply to the 'act'. However, the fact that art 13 makes reference to 'any means of challenge' appears to indicate the court should consider challenges under the general or insolvency law, even if no insolvency proceedings have been opened in the relevant member state. This is, in fact, the approach likely to be taken by the Italian courts.

LIMITATIONS OF THE INSOLVENCY REGULATION

SET-OFF GOVERNED BY THE LAWS OF A NON-MEMBER STATE

In contrast to art 13, art 6 of the Insolvency Regulation does not state that the law applicable to the insolvent debtor's claim need necessarily be that of a member state, although the Virgos-Schmit Report appears to imply that this is the case. The proposed reform of Italian insolvency laws, which purports to be motivated in part by the desire to ensure conformity with the Insolvency Regulation, does not make any distinction between the laws of a member state and a non-member state and provides that set-off should only be disallowed if 'strictly useful' in the context of proceedings. To the extent that Italian courts are influenced by the spirit of the proposed reform, they may be more inclined to recognise that a distinction based on the whether or not the applicable law is that of a member state is not 'strictly useful' and therefore allow art 6 to apply even if the law applicable to the insolvent debtor's claim is, for example, New York law.

Nevertheless, art 13 of the Insolvency Regulation clearly provides protection from avoidance risk only where the set-off is subject to the laws of a member state. The proposed reform does not add anything specific in terms of interpretation of art 13 and so Italian courts will almost certainly restrict its application to cases where the applicable law is that of a member state.