INSOLVENCY SET-OFF UNDER ENGLISH LAW: LESSONS FOR SERBIA

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ABSTRACT

The thesis provides a comparative analysis of the insolvency set-off rules of England and of Serbia and argues that English approach to set-off in corporate insolvency should serve as a benchmark for assessing quality of Serbian insolvency set-off rules as well as a model for its further development and improvements. The thesis also provides a theoretical background of the insolvency set-off by situating it within a wider system of financial law and by examining a theoretical justification of insolvency set-off in the light of the competing insolvency law policies. Based on such comparative and theoretical analysis, the thesis provides a set of recommendations for mitigating the identified weak points of the Serbian law. In addition, the final Chapter provides a brief comparative analysis of the most typical netting arrangements and their treatment in insolvency.

INTRODUCTION

For an English lawyer, insolvency set-off is "one of the most important protections offered by English law in relation to commercial and financial activity"[1]. In 2010 new Serbian Insolvency Act[2] adopted modern rules regarding insolvency set-off. Except for a limited spotlight from finance law practitioners and foreign bankers in Belgrade this important novelty in Serbian law went largely unnoticed. This ignorance is quite undeserved given that the insolvency set-off is widely recognized as a powerful risk mitigation tool[3]. The aim of this thesis is to draw attention to a legal device of insolvency set-off, this attention being well deserved in the light of the immense positive impacts which this device could potentially have on making Serbian legal environment more hospitable to the much needed financial activities.

The thesis uses a comparative method by examining how the insolvency set-off is regulated and how it operates in England and in Serbia. This comparative approach has two goals: (i) to illustrate how powerful and useful the insolvency set-off device could be by analyzing a successful and sophisticated insolvency set-off model such as the English one and (ii) to serve as a basis for identifying critical points in which Serbian law needs further improvement using English insolvency set-off rules as a model. In addition, besides these practical goals, the thesis also aims to provide a theoretical background of the insolvency set-off by situating it within a wider system of financial law as well as by examining its theoretical justification in the light of the competing insolvency law policies. The theoretical focus is especially important for the Serbian

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[1] Colin Bamford, *Principles of international financial law* (Oxford University Press 2011) 45.

[2] Insolvency Act [*Zakon o stečaju*] (Official Gazette of the Republic of Serbia no. 104/09) (hereinafter: "Serbian Insolvency Act"). The Serbian Insolvency Act became applicable on 23 January 2010 when it replaced the Insolvency Proceeding Act 2004 [*Zakon o stečajnom postupku*] (Official Gazette of the Republic of Serbia no. 84/04).

[3] The jargon "risk mitigation" is used as name of Chapter 4 in Philip R. Wood, *Law and Practice of International Finance* (University Edition, Sweet & Maxwell 2008). However, such phrase is now part of common parlance and it is widely used both by practicing lawyers and academics.

legal theory which has a tradition of neglecting theoretical underpinnings of the insolvency law treating it as a merely procedural legal discipline.

English insolvency law is preferred as the most appropriate comparative benchmark for Serbia due to two main reasons. First of all, the insolvency set-off could perform the expected protective function only if its regulation is properly crafted, rules are clear-cut and enforcement in insolvency cases is not impaired by intricate and knotty procedures. English law meets all these requirements. Secondly, the pro-creditor philosophy underlying English insolvency law most appropriately corresponds to the needs of the Serbian economic reality. Serbia is suffering from a chronic lack of capital while sufficient capital base is a prerequisite for any kind of entrepreneurial activity and maybe more debtor-sensitive insolvency policies. At this moment the primary goal of Serbian legal reforms should be to facilitate the legal environment which is attractive to the capital providers i.e. the potential creditors in Serbian insolvency cases. And these, mostly foreign, investors and other participants in financial and capital markets are vitally interested in the legal devices which could efficiently safeguard their investments in case of insolvency of their local counterparties. English insolvency set-off rules perform this creditor protection function as well.

Other notable international insolvency models are less suitable for Serbian circumstances. The US bankruptcy law which promotes debtor rescue culture seems to be overly idealistic for Serbian debtors to which even the first chance for economic success might not be available. The German model of strict financial discipline with insolvency proceedings usually leading to liquidation often followed by criminal law charges might inhibit business activities in Serbia by deterring companies from taking even tolerable risks.

The scope of this thesis is limited in certain aspects. Namely, the thesis analyses the set-off device only in corporate insolvency cases since the law on individual bankruptcy of natural persons still does not exist in Serbia. Also, the thesis is mainly focused on the corporate liquidation insolvency scenarios because creditors are primarily concerned with the strength of their set-off rights in corporate liquidation cases while out-of-court rehabilitations and formal reorganizations should be case-specific negotiation platforms with flexible and open options. Therefore, in this work, the terms "insolvency" or "insolvency proceeding" shall mean corporate liquidation whenever they are used solely without specification that the case is about out-of-court rehabilitation, reorganization (administration) or other kind of rescue procedure. And finally, the thesis will not step into the historical analysis of Serbian insolvency-like legislation that existed prior to 2004 when Serbia, for the first time in its recent history, adopted modern laws on privately-owned corporations and on corporate insolvency.

The first Chapter provides a theoretical framework which defines and places the insolvency set-off within the general system of financial law and also explains a distinction between the set-off and the security interests. The second Chapter outlines all set-off types that exist in England and in Serbia. The third Chapter is focused on the insolvency set-off: its justification and regulation. It first examines a justification of set-off in the light of the competing insolvency policies. Then is outlines detailed rules governing insolvency set-off in England and in Serbia which will lead to the identification of the weak points of the current Serbian rules and consequent proposals for their improvement based on the English model. The Chapter ends with an analysis of set-off in context of corporate reorganizations. The fourth, and the final, Chapter provides a comparative analysis of the most typical netting arrangements and their treatment in insolvency.

CHAPTER 1 – THEORETICAL FRAMEWORK

During the past twelve years of Serbian transition from ambivalent socialist legal system and economy towards liberal democracy and market economy notions of modern and market oriented legal institutes have been introduced primarily through legislative interventions and reforms. New statutes are, as they should be, inspired by concepts already developed in modern legal systems in the EU and the US. However, legal theory in Serbia has not yet reached the point enabling it to systematically analyze sophisticated financial law concepts. There were no memorable and influential professional debates or reports providing arguments *pro et contra* on contemplated legislative solutions (e.g. like Cork Report in England[4]). Academia was generally not up to the task to adequately follow the novelties with fresh and comprehensive legislative commentaries, beyond the mere paraphrasing of the statutory provisions. Judicial interpretation of the new rules is in its infant stages since market participants are still reluctant to bring their cases to Serbian courts. Only the Government and its regulatory agencies (Securities Commission, Competition Commission) and Central Bank (i.e. the National Bank of Serbia) have provided certain basic interpretation of the new rules; however their opinions and interpretations are not intended to give systematic theoretical analysis of the legal rules.

Having this in mind, prior to entering into comparative analysis of financial engineering techniques, it might not be unreasonable to start with a theoretical framework which defines and places the insolvency set-off within general system of financial law. The idea is not to promulgate, discuss or confront various theories of the financial law or the appropriateness of the systematic approach – this is the topic for a separate work. The idea is to provide a cartesian bird's-eye introductory perspective to the reader and to the extent possible, given the nature of the topic, to save him from trouble of immediate start with the text that, at some points,

[4] Report of the Review Committee on Insolvency Law and Practice prepared in 1982 by Kenneth Cork. *See* Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (2nd edn, Cambridge University Press 2009) 29.

inevitably might resemble technical manuals describing some piece of useful but complex machinery. The next section is built on the inspired and resourceful theoretical framework for financial law recently developed by Professor Joanna Benjamin, a professor at the London School of Economics and renowned London City practitioner[5]. According to Professor Benjamin we are now entering into "the imaginative realm…[which] level of conceptual development is hard to match in theology or literature. Financial law is beautiful as well as useful, and the greatest expression of English imagination since Shakespeare."[6]

1.1. *Financial positions and set-off*

In modern economy where "money comprises debts owed by banks to account holders"[7], the creditor/debtor relationships are everywhere. Creditors are exposed to the inevitable risk that debts would not be paid by their debtors; and the main materialization of this risk is the insolvency of the debtor. Starting point is that risk brings profit and thus it is a desirable activity; however, taking into account equal possibility of immense losses that could be spread through the markets, affecting not only direct risk takers but the whole society, the legal regulation is needed. The role of the financial law is to regulate risk circulation in financial and capital markets and Benjamin conceptualizes it as "system of risk transfer"[8], risk being understood as "a measure of exposure, of the likelihood and extent of loss… identification [of which] provides a basis for decision making… [and leads] to an active approach to uncertain future"[9]. According to Benjamin "the media through which risk circulates are contractual arrangements referred to as

[5] Joanna Benjamin, *Financial Law* (Oxford University Press 2007).

[6] ibid 26.

[7] ibid 12.

[8] ibid 3.

[9] ibid 13.

financial positions".[10] Benjamin classifies these financial positions (i.e. contractual arrangements) in four major types: (i) simple, (ii) funded, (iii) asset-backed and (iv) net financial positions[11].

(i) Simple financial positions

Simple financial positions are guarantees, insurance, derivatives, standby credits, performance bonds, as well as comfort letters and joint and several liabilities[12]. Common to all mentioned transactions and the reason why they are labeled "simple positions" is that "rights and duties of the parties… do not include provisions that address the credit exposure of the protection buyer to the risk taker"[13]. The basic example that illustrates a simple position is the ordinary guarantee i.e. the relationship between the creditor (protection buyer) and the guarantor (risk taker) whereby the creditor accepts (i.e. takes) the risk that loan repayment would not be honored by the guarantor. The creditor has not transferred his funds to the guarantor (funded), but it has a claim against it. Simple positions do not involve security interest (they are not asset-backed) and there are no conditions for a set-off (net position is not available). Of course, combinations of positions between same parties are common, e.g. a guarantor provides collateral.

(ii) Funded financial positions

Funded financial positions are essentially bank loans, bank deposits, all capital market investments (in stocks, bonds and other securities), and units in collective investment schemes[14]. "Unlike other forms of position, funded positions involve the transfer of capital… they also involve transfer of risk; capital goes one way, and risk goes the other… the risk taker is a

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[10] Benjamin, *Financial Law* (n 5) 3, 4.

[11] ibid 20-25.

[12] ibid 49.

[13] ibid 20.

[14] ibid 21, 24.

provider of capital… with exposure of losing its capital."[15] Case specific transactions can be very complex, but their nature is straightforward.

(iii) Asset-backed financial positions

Asset-backed financial positions are advanced funded or simple positions; they comprise all transactions that would qualify as secured transactions under the US Uniform Commercial Code and in English and civilian legal systems they include various mortgages, pledges, charges, liens, financial collateral, and quasi security devices such are title finance (retention of title) arrangements. The bargained priority in enforcing a claim against specified asset(s), giving rise to *in rem* rights on these assets, is the main risk mitigation function of the secured transactions.

(iv) Net financial positions

Net transactions are based on legal institute of set-off[16]. "Set-off is the discharge of reciprocal obligations to the extent of the smaller obligation… it is a form of payment… a debtor sets off the cross-claim owed to him against the main claim which he owes to his creditor… instead paying money he uses the claim owed to him to pay the claim he owes."[17] Net financial positions are possible only if parties are in mutual (reciprocal) creditor/debtor relationship since "this mutuality enables each party to use its claim to discharge its obligation"[18]. Mutuality and reciprocal claims are quite common between parties in financial and capital markets, e.g. inter-bank deposit and foreign exchange markets, trading with the central counterparty, securities

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[15] Benjamin, *Financial Law* (n 5) 21.

[16] "Since it is … used, or at least understood, in the three major linguistic families within the EU, the term 'compensation' may well be regarded as the most suitable choice … however, it must also be taken into account that 'compensation' has a different meaning for English lawyers and might therefore be a source of ambiguity or misunderstanding. Thus… we will continue to use the term set-off" *See* Reinhard Zimmermann, *Comparative Foundations of a European Law of Set-Off and Prescription* (Cambridge University Press 2010) 21.

[17] Philip R. Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (2nd edn, Sweet & Maxwell 2007) 4.

[18] Benjamin, *Financial Law* (n 5) 21.

clearing systems, but also OTC trading, swaps, repo agreements, cash pooling and various other kinds of transactions that involve cross-claims and mutuality[19].

Between solvent parties, if regular payments of mutual obligations are reasonably expected to happen, the risk is minor and set-off is mainly designated to reduce transaction costs by curbing multiplicity of payments or litigations. Set-off is far more important in insolvency when credit risk is on the rise – in the nature of insolvency is that debts cannot be honored in full or at all. The idea of set-off in insolvency is to reduce, to mitigate negative effects of insolvency risk by allowing solvent party to use its claim to discharge its mutual debt.

Nevertheless, the justification of set-off is mostly disputed in the context of insolvency. Competing insolvency values are conflicted in their core with respect to insolvency set-off. On one hand, there is a pro-creditor oriented philosophy that insolvency set-off should be permitted because creditor should not receive "five cent on a dollar" from the insolvency estate while, at the same time, it is obliged to fully pay debts that it owes to the estate. On the other hand, there is a pro-debtor approach that bankruptcy estate should be immunized from set-off in the interest of equality of all unsecured creditors (*pari passu* principle) and possible rescue of the debtor. Thus, the insolvency set-off is considered to be an acid test for assessing insolvency policy choices of a particular jurisdiction i.e. "one of the leading and most accurate indicators of pro-debtor or pro creditor attitudes to insolvency"[20].

1.2. Set-off and security interest

Resemblance between net positions based on set-off right and asset-backed secured transactions is provoked by the function which set-off performs in insolvency. Namely, solvent unsecured creditor which is, at the same time, the debtor of the insolvent company is concerned for the

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19 Benjamin points out that in respect of these transactions "asset backing in financial markets is in decline… because of the rise of net positions", *see* Benjamin, *Financial Law* (n 5) 22.

20 Wood, *Law and Practice of International Finance* (n 3) 217.

enforceability of its set-off right as much as the solvent secured creditor is concerned with enforceability of its priority over collateral. Even though the claim of unsecured creditor in net position is not satisfied by monetary payment, its claim is by no means gone. Through the set-off, its claim has been utilized in its full capacity for a discharge of the reciprocal debt owed to the insolvent counterparty. In commercial sense, such creditor is satisfied in full and ahead of other unsecured creditors whose claims are severely impaired by insolvency cutbacks. Set-off thereby performs security function in financial markets where cross-claims and mutuality are common and where classic secured transactions are often put out of work as unpractical and time consuming. However, the key difference compared to secured transactions is that "the right to set-off one debt against another does not constitute an equitable security interest or, indeed, confer on the defendant any right *in rem* over the claim of the claimant"[21]. In fact even Article 9 of the US Uniform Commercial Code with its catch-all functional approach that secured transactions are all transactions, regardless of their form, which create a security interest (*in rem* right), has explicitly disclaimed itself that it does not apply to "a right of recoupment or set-off"[22]. "Hence, a right of set-off would not normally conflict with negative pledges."[23] Therefore, the recharacterization risk is *de minimis*. Set-off is classified as a quasi-security or as "creditor's position enhancing device"[24].

[21] Roy M. Goode, *Legal Problems of Credit and Security* (3rd edn, Sweet & Maxwell 2003) 244.

[22] Article 9-109(d)(10). *See* Douglas G. Baird, Theodore Eisenberg, Thomas H. Jackson (eds), *Commercial and Debtor-Creditor law: Selected Statutes* (Foundation Press, Thomson Reuters 2010) 639, 643.

[23] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 5.

[24] Tibor Tajti, *Comparative Secured Transactions Law* (Akadémiai Kiadó 2002) 404.

CHAPTER 2 – TYPES OF SET-OFF

English law makes a clear distinction between set-off among solvent parties and set-off in insolvency i.e. insolvency set-off is regulated as a standalone legal category with separate status and regulation. In Serbia, on the contrary, insolvency law does not provide for a special category of the insolvency set-off. Instead, Serbian Insolvency Act permits solvent set-off rules to continue to apply in insolvency until certain cut-off dates and subject to specific additional insolvency law procedures. Therefore, solvent set-off rules play much more important rules in Serbia since they must be observed for setting off cross claims in insolvency as well. Nevertheless, for the sake of comparative illustration, a brief overview of solvent set-off rules in England is provided below as well.

2.1. England

English legal theory identifies five types of set-off between solvent parties: (i) independent set-off, (ii) transaction set-off, (iii) contractual set-off, (iv) current account set-off, and (v) Rule in *Cherry v. Boultbee*. The insolvency set-off is a separate category of set-off. The given classification is not to be found in legislation and it is a creation of leading English practitioner and legal writer Professor Philip R. Wood[25]. Classification is fully accepted and promulgated by another leading authority on English commercial law, Professor Roy M. Goode who adds that the taxonomy now "has already gained acceptance in the courts"[26]. For example, according to Bambord in 1995 case *Aectra Refining and Manufacturing Inc v Exmar N.V.* the House of Lords adopted slightly simplified categorization of set-off types as coined by Professor Wood[27].

[25] Philip R. Wood, *English and International Set-Off* (Sweet & Maxwell 1989); Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17); Wood, *Law and Practice of International Finance* (n 3).

[26] Roy M. Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) 278.

[27] Bamford, *Principles of International Financial Law* (n 1) 44.

Preconditions for all types of set-off are that (i) both claims are expressed in or could be reduced to money[28] and that (ii) cross-claims are mutual (reciprocal) i.e. "each claimant must be the beneficial owner of the claim owed to him by the other"[29].

(i) Independent set-off

Independent set-off, traditionally known in common law as legal or statutory set-off, is "set-off of unconnected and independent reciprocal claims arising out of separate transactions"[30]. It was invented as a procedural defense which could be invoked by defendant in court proceedings; it is not mandatory or automatic. English Civil Procedure Rules 1998 (based on Civil Procedure Act 1997) provide that defendant sued for payment may ask that claim against him is consolidated with a claim that he has against plaintiff and, if the conditions for set-off are fulfilled, the court will order that only the net amount is to be paid one way or another.[31]

(ii) Transaction set-off

Transaction set-off is "the set-off of claims arising out of the same or closely connected transactions"[32]. It is not required that the source of the cross-claims is the same transaction; it is sufficient that underlying transactions "are so closely connected that it would be inequitable for one claim to be enforced without credit being given for the other"[33]. Hence, this form is traditionally known as equitable set-off. The term abatement is also in use in England; the US term is recoupment. In comparison with independent set-off, the courts have not imposed strict requirement that cross-claims must be liquidated (ascertained in value) and unliquidated damages

[28] Goode, *Principles of Corporate Insolvency Law* (n 26) 278, 279.

[29] Wood, *Law and Practice of International Finance* (n 3) 235.

[30] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 6.

[31] Bamford, *Principles of International Financial Law* (n 1) 44, 45.

[32] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 7.

[33] Goode, *Principles of Corporate Insolvency Law* (n 26) 279.

claims in principle could be subject to set-off as well[34]. Independent set-off is creation of equity and hence operates with more flexibility.

(iii) Contractual set-off and netting

Contractual set-off is "a set-off created by the contract where it would not otherwise exist"[35]. It is a form of advanced operation of set-off device by various financial engineering techniques known under the effective term – netting e.g. close-out netting, settlement netting, novation netting. Since netting is based on contract, and contractual freedom and party autonomy are cornerstones of English contract law, "the parties are free to agree on almost any kind of netting"[36]. However, there are certain risks whether a netting arrangement, particularly the close-out netting, could survive opening of insolvency proceedings. Outcome of such netting arrangements in insolvency depends on whether protections which they provide, e.g. *ipso facto* and automatic early termination clauses are permitted under mandatory insolvency law. Certain jurisdictions e.g. France, and US nullify *ipso facto* clauses (with limited exemptions for financial markets) while English insolvency law principally allows such kind of protections. Netting arrangements and their insolvency treatment is addressed in more detail in Chapter 4.

(iv) Current account set-off

Current account set-off is "a right given to bankers operating different current accounts for the same customer to combine and treat them as one, thus setting off a debit balance on one account against a credit balance on the other"[37]. In banking practice it is labeled with different terms i.e. "banker's remedy of set-off"[38], banker's lien, running accounts, or just consolidation of

34 Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 7.

35 ibid.

36 Goode, *Principles of Corporate Insolvency Law* (n 26) 287.

37 ibid 280.

38 Sheelagh McCracken, *The Bankers Remedy of Set-Off* (3rd edn, Bloomsbury Professional 2010).

accounts, which might be misleading since such terms could have different meanings as well. Current account set-off is not classified as a contractual set-off since predominant view in practice is that it is an implied right of the bank. "In *Halesowen Presswork v Westminster Bank* [1971] Lord Denning MR referred to the long line of cases which show that a banker is entitled to combine two accounts unless there is an agreement to keep them separate."[39]

(v) Rule in Cherry v Boultbee

According to the landmark case *Cherry v Boultbee* [1839] 41 ER 171 LC, this type is simply referred to as the Rule in *Cherry v Boultbee*[40] although names such as retainer or fund set-off are sometimes also used. "This is not strictly a set-off"[41] and Professor Goode does not even classify it as a type of set-off.[42] However, the rule is similar to a set-off and it is important for managed and investment funds since, according to it, the administrator of the fund is entitled to retain or withheld dividend or other distribution due to the fund participant if the fund participant has not paid-in his contribution to the fund.

(vi) Insolvency set-off

The foregoing types are concerned with the set-off between solvent parties; however "set-off usually only matters on insolvency. If everybody could pay, then there would be no need for the protection of set-off."[43] As Professor Goode points out the "insolvency displaces other forms of set-off"[44] i.e. upon insolvency of one party in creditor/debtor relationship, only English

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[39] Bamford, *Principles of International Financial Law* (n 1) 47.

[40] Look Chan Ho, 'Understanding and Displaying the Rule in *Cherry v Boultbee*' [2009] Vol. 24 No. 8 Butterworths Journal of International Banking and Financial Law 459.

[41] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 7.

[42] Goode, *Legal Problems of Credit and Security* (n 21) 237-296, and Goode, *Principles of Corporate Insolvency Law* (n 26) 277-313.

[43] Wood, *Law and Practice of International Finance* (n 3) 217.

[44] Goode, *Principles of Corporate Insolvency Law* (n 26) 286.

Insolvency Rules (rule 4.90 for liquidation and 2.85 for reorganization i.e. administration) are applicable. "This is of no great significance in relation to independent set-off, transaction set-off and current account, for in virtually every situation in which these forms of set-off are available there would be an automatic set-off under the rules of insolvency set-off"[45].

The most distinctive feature of English insolvency set-off, comparing to other types, is that insolvency set-off is, in principle, automatic and mandatory upon insolvency of one counterparty in mutual creditor/debtor relationship. Insolvency set-off operates as a mandatory and automatic discharge of mutual cross-claims that could be reduced to money and that have existed between parties so only the net balance is outstanding to be paid either by the solvent party to the insolvency estate or from the estate to the solvent party within the regular insolvency distribution scheme. "All the debts that arise from the mutual dealings of the parties are aggregated, and only the net balance is payable to (or from) the insolvent company."[46] The following Chapter 3 is fully devoted to the insolvency set-off type.

2.2. Serbia

In Serbia, insolvency law does not provide for a special type of insolvency set-off; thus solvent set-off rules play much more important role since they must be observed for setting off cross claims in insolvency as well. Namely, Serbian Insolvency Act permits solvent set-off rules to continue to apply in insolvency until certain cut-off dates and subject to specific and additional procedures and restrictions.

There are two types of solvent set-offs that are recognized in Serbian law and legal theory i.e. (i) statutory set-off and (ii) contractual set-off. Statutory solvent set-off rules are provided in the

[45] Goode, *Principles of Corporate Insolvency Law* (n 26) 287.

[46] Bamford, *Principles of International Financial Law* (n 1) 45.

Serbian Obligations Act[47] which foresees that a debtor may set-off the claim owed to its creditor against the claim the creditor owes to the debtor, if both claims are of a monetary nature, or other exchangeable objects of the same kind and quality, and if both claims are mature (Article 336(1)). Set-off is also confirmed as a method of payment by mutual discharge of cross-claims in Article 46(2) of the Payment Operations Act[48]. Cross-border set-offs are liberalized by recent 2011 amendments to Article 6 of the Serbian Foreign Exchange Act[49].

According to Article 337(1)of the Obligations Act and the existing legal practice, statutory set-off may be exercised either (i) outside court proceedings whereby one party makes a declaration of set-off i.e. notifies the other party of its intention to set-off or (ii) as a result of a relevant objection or counterclaim raised in judicial proceedings if accepted by the court. In the latter case, set-off is sometimes referred it theory as a judicial set-off. Therefore, Serbian statutory set-off does not occur automatically after the conditions for it have emerged; one party needs to make a set-off statement or raise objection in the court proceeding for the set-off to take place. However, after the set-off declaration has been made, the effects are retroactive i.e. it is considered that set-off took place at the moment when the conditions for it were created (Article 337(2) of the Obligations Act).

Apart from these statutory stipulations, it is generally accepted that based on fundamental principle of contractual freedom[50] Serbian law recognizes contractual set-off (*pactum de*

[47] Obligations Act 1978 [*Zakon o obligacionim odnosima*] (Official Gazette of the Socialistic Federal Republic of Yugoslavia, nos. 29/78, 39/85, 45/89, 57/89, Official Gazette of the Federal Republic of Yugoslavia, nos. 31/93, (22/99, 23/99, 35/99, 44/99)) (hereinafter: “Obligations Act”).

[48] Payment Operations Act 2002 [*Zakon o platnom prometu*] (Official Gazette of FRY, nos. 3/2002, 5/2003, Official Gazette of the Republic of Serbia, nos. 43/2004, 62/2006 and 31/2011).

[49] Foreign Exchange Act 2006 [*Zakon o deviznom poslovanju*] (Official Gazette of the Republic of Serbia, nos. 62/2006, 31/2011) (hereinafter: “Foreign Exchange Act”).

[50] Contractual freedom principle is explicitly proclaimed in Article 10 of the Serbian Obligations Act i.e. parties are free to regulate their relations in accordance with their own will within the framework of mandatory rules, public order and good business practices.

compensando) even in the absence of the statutory conditions for set-off[51], except for the general requirement of the existence of mutual obligations between the parties. This means that the contractual set-off in principle enables the parties to set-off heterogeneous claims and not yet matured obligations as well (e.g. claims for payment of money against counterclaim for delivery of securities). Contractual set-off availability is important for enforcement of various netting arrangements in financial markets.

Therefore, in comparison with English law, it may be concluded that Serbian unitary statutory set-off concept provided by the Obligations Act functionally covers both the independent type and the transaction set-off type of English law, while contractual set-off and netting are equally available based on general contract law freedom. Insolvency set-off is, in England, treated as a separate category while in Serbia, set-off in insolvency is subject to the general solvent set-off requirements with additional procedures and restrictions imposed by the mandatory insolvency regime.

According to Serbian banking practice, current account set-off is not an implied right of the bank; it is rather a form of contractual set-off since it is usually agreed by the bank and the customer, either in the agreement on account opening, or in special authorization thereto [*trajni nalog*] or in the general terms and conditions of the bank which are publicly available and properly referenced in the agreement between the bank and its client. Serbian legal writing and court practice so far have not identified the set-off related concept equivalent to English rule in *Cherry v Boultbee*.

[51] Jakov Radisić, *Obligations Law: Common Part* [*Obligaciono pravo: opšti deo*] (7th edn, Nomos 2004) 355, 356.

Chapter 3 – Insolvency Set-Off

3.1. *Insolvency context*

"The risk of business failure is an essential concomitant of entrepreneurial activity. Risk can only be avoided by not doing business at all."[52] The risk of insolvency of the counterparty in a financial transaction is the main concern for financial institutions, especially when obligations have not been secured which is often the case both on regulated markets and in OTC trading. Security, in European jurisdictions particularly, involves time consuming transaction publication formalities. In sophisticated financial markets, participating institutions can have a large number of unsettled reciprocal (i.e. mutual) unsecured transactions at any point in time. In such context, the worst case scenario is that a counterparty becomes insolvent and its insolvency representative (i.e. liquidator, trustee, receiver as the case may be) demands that all payments owed by the solvent party are fully performed for the benefit of the estate while the same solvent creditor is left to compete with all other unsecured creditors for a severely reduced slice of the pie from the estate. The loss could be immense, and even a solvent party could thereby be driven into insolvency for not receiving the budgeted income (the domino effect).

The main idea of insolvency set-off is exactly to prevent such catastrophic scenario by allowing a solvent party to set-off i.e. to pay the claim it owes to the insolvent party by using the reciprocal claim owed to it by the same insolvent counterparty. Insolvency set-off results in the discharge of mutual cross-claims that can be reduced to money and that have existed between solvent and insolvent party so only the net balance is outstanding to be paid either by the solvent party to the insolvency estate or from the estate to the solvent party within the regular insolvency collective distribution scheme. It is a result of "the strange and beautiful idea that mutual obligations match

[52] Goode, *Principles of Corporate Insolvency Law* (n 26) 57.

and extinguish each other."[53] With the insolvency set-off, even though the claim of unsecured creditor (solvent party) is not satisfied in money, its claim is by no means gone. The claim was utilized in its full capacity and value for payment of the reciprocal debt owed to the insolvent counterparty. Claims of other unsecured creditors which are not in a position to set-off will most likely evaporate in just tiny traces of what they used to be. Thereby, in economic sense, unsecured creditor with a net position and the right to set-off is basically paid in full and ahead of other unsecured creditors and there lays the security function, risk cutback and all that appeals for insolvency set-off.

On the other hand, the result of insolvency set-off – discharge of mutual obligations – basically reduces the value of bankruptcy estate i.e. fulfillment of the obligations due by the creditor to the insolvent debtor via set-off device has not effectively increased assets of the estate available for distribution to other creditors. In certain jurisdictions, mainly those based on French law, such effect of the set-off is strongly opposed by corporate insolvency policy which prefers immunizing the bankruptcy estate from the set-off in the interest of equal treatment of all unsecured creditors (*pari passu* principle), and possible rescue of the debtor.

The dispute and its outcome very much resemble the discussions concerning abortion issue. The first point of the discussion is the question whether insolvency set-off should be allowed. If permissive approach prevails, the question is how to regulate it. The international trend is that set-off should be allowed, but legal conditions and procedures regulating it and cut-off dates within which it could be exercised differ among jurisdictions. English law was newer among opposing jurisdictions. Serbian law has just left the opposing camp; however, due to the procedural hurdles, set-off is not as water resistant as in English insolvency cases. Next sections will first provide justifications for insolvency set-off in the light of its advantages and overall objectives of insolvency law, before the work proceeds to the detailed insolvency set-off rules.

[53] Benjamin, *Financial Law* (n 5) 24.

3.1.1. Objectives of insolvency law

Both English and Serbian laws in essence share the same fundamental philosophy of corporate insolvency law. Namely, even though certain business failures may not be a surprise for business people, in a legal sense every insolvency case is an extraordinary situation, a light form of civilian "martial law" applying to the parties connected with the insolvent debtor. Legal consequences of an insolvency case involve deep cuts into the flesh of ordinary business dealings. The following legal consequences of insolvency are generally present in English and in Serbian law: the representation and management rights of the management and supervisory bodies of the debtor cease and are transferred to the insolvency administrator; insolvency is deemed a justified cause for unilateral termination of employment contracts between the debtor and its employees; business name of the debtor is often "enriched" with a suffix "in bankruptcy" or "in administration"; upon insolvency banks will block the accounts of the debtor; secured creditors and other title holders can exercise their *in rem* rights only subject to special procedures for lifting the automatic stay on enforcement, while automatic stay is heavily imposed on enforcement of unsecured creditors claims – private enforcement is fully replaced with collective distribution scheme; insolvency triggers statutory acceleration of all debts of the insolvent debtor, recurring payments shall become one-off; claims in foreign exchange converted into local currency at the exchange rate on the specific cut-off date.

The reason for such heavy intrusion into private relationships is that insolvency procedure is designed to refine mutual relationship of the parties left behind business failure of the debtor/employer/supplier or other role which the insolvent may have played. Namely, from the public policy perspective, it is better to provide aggravated unsecured creditors with *ex ante* prescribed rights and positions than to leave them to fight between themselves like vulchers in the desert. Moreover, it is argued that "compulsive collective proceedings… would be agreed by the creditors from behind Rawlsian veil of ignorance because creditors would see such collectivity as administratively efficient and productive of a greater aggregate pool of assets for distribution"[54].

In setting the objectives of insolvency, starting point is that the pre-insolvency rights of the creditors should be preserved to the extent possible[55] and that redistributions and cut-backs should be minimal; however in the interest of the fairness and sustainability of the whole process, certain redistribution sacrifices need to be made. Such limited redistribution is reflected in the fact that insolvency law makes a distinction between creditors grouping them in separate classes[56] with the intention to "protect venerable parties who would bear insolvency risks inefficiently or unfairly if left unprotected"[57]. The ultimate justification for insolvency law is that at the end of the day it brings more than it takes.

In sum, the main goals of corporate insolvency law are (i) efficiency i.e. "to maximize the return to creditors" [58]; and (ii) fairness i.e. "to establish a fair and equitable system for the ranking of claims and the distribution of assets among creditors [footnote omitted], involving a limited redistribution of rights"[59]. In this respect, the Serbian Insolvency Act is straightforward by proclaiming that the aims of insolvency are to ensure the most favorable collective settlement of insolvency creditors by achieving the highest possible value for the debtor or its assets (Article 2)

[54] Vanessa Finch, 'Is Pari Passu Passé?' [2000] 5(Oct) Insolvency Lawyer 194.

[55] Principle in the US known as Butner principle according to the case *Butner v United States*, 440 U.S. 48, 55 (1979). *See* Douglas G. Baird, *Elements of Bankruptcy* (5th edn, Foundation Press 2010) 5.

[56] Relationships between the classes are accorded to the absolute priority rule i.e. that the creditors of lower class could only be satisfied after the creditors of higher class are paid.

[57] Finch, 'Is Pari Passu Passé?' (n 54) 206. Professor Finch gives an example of employees: "When employees negotiate employment contracts with a firm there would be little discussion of insolvency risk".

[58] Goode, *Principles of Corporate Insolvency Law* (n 26) 58.

[59] ibid.

and to ensure proportional settlement (Article 3) and equal treatment of creditors in the same payment rank (Article 4).[60]

In achieving these objectives the insolvency law is based on certain fundamental principles. Such operative principles, even if some of them are not strictly proclaimed in the insolvency legislation, are considered as embodied in the essence of insolvency process. Professor Goode has distilled from English "Insolvency Act, with its 587 sections and 20 schedules"[61] a set of principles[62], all of which should, *mutatis mutandis,* be applicable in theoretical understanding of Serbian insolvency law. Two of those principles are of importance for insolvency set-off: (i) the principle that that the liquidator takes the assets subject to all pre-insolvency limitations and defenses and (ii) the principle that unsecured creditors rank *pari passu*.

The former principle i.e. that that the liquidator takes the assets subject to all pre-insolvency limitations and defenses, clearly upholds availability of set-off in insolvency given that a set-off is one of the strongest defense weapons available to the solvent parties. However, the effect of such principle is at the same time undermined in English law by the very concept of insolvency set-off. Namely, the "insolvency displaces other forms of set-off"[63] i.e. in insolvency only English Insolvency Rules (rule 4.90 for liquidation and 2.85 for administration) are applicable, meaning that solvent set-off defenses are trumped by mandatory insolvency set-off regime. This is not an issue at all for the concerned creditors in view of the fact that insolvency set-off is even more potent than its solvent equivalents.

In Serbia, on the other hand, the respective principle could provide a valid ground for set-off in insolvency. Nevertheless, given that such principle is not expressly proclaimed in Serbian

[60] However, we should always bear in mind that the insolvency law could never be perfect – its goals should not turn it into a self-sufficient totalitarian system like Huxley's Brave New World with all its innate fallacies.

[61] Goode, *Principles of Corporate Insolvency Law* (n 26) 93.

[62] ibid 93-107.

[63] ibid 286.

Insolvency Act, the question is how solid that ground could be. Namely, both Serbian and English insolvency laws are expressly proclaiming another, more famous principle, the principle that unsecured creditors rank *pari passu* in distributions from the estate, in other words, as foreseen in the Serbian Insolvency Act that insolvency ensures proportional settlement of unsecured creditors (Article 3). And exactly that *pari passu* distributive principle is used as a main argument against availability of the set-off in insolvency.

3.1.2. *Pari passu* principle

"The *pari passu* principle is often said to constitute a fundamental rule of corporate insolvency law [footnote omitted]. It holds that, in a winding up, unsecured creditors shall share rateably in those assets of the insolvent company that are available for … distribution".[64] It is the main distributive principle, expression of collective justice, designated to ensure fairness and give legitimacy to the mandatory insolvency regime. Certain jurisdictions, mainly those based on French law, firmly insist on this principle and disallow set-off in insolvency (with certain carve-outs in netting statutes applicable only to financial institutions). The reason for this attitude is the fact that set-off reduces the value of bankruptcy estate to detriment of the unsecured creditors which are not in a position to set-off. Unsecured creditor with enforceable set-off position is released from the obligation to pay its debt to the estate (or to pay it in full, depending on the net balance side), while he is not forced to give up the value of its claim – its claim is fully deployed to discharge its debt. Thereby such creditor does not share the misfortune of insolvency rateably with other creditors; instead, in economic sense it is satisfied in full and in priority comparing to creditors without set-off position.

Therefore, the key question is whether *pari passu* principle should be a cornerstone rule placed in such a high position that it would defeat all practical arguments in favor of insolvency set-off?

[64] Finch, *Corporate Insolvency Law: Perspectives and Principles* (n 4) 599.

Or, *pari passu* should abdicate the throne in the interest of more individualized and pro-creditor view of justice?

There are strong policy reasons behind the permission for set-off in insolvency, "it would be unjust, on the advent of liquidation, to deprive the solvent party of his security by compelling him to pay [to the estate] what he owes in full and be left to prove for his own claim"[65], with the likely prospect of collecting no more than a few per cent, or even nothing. "It seems unjust that the defaulter is paid but does not pay."[66] In addition, practical advantages of insolvency set-off could not be denied by any system that strives to facilitate economic activity. Apart from being a life saving remedy for creditors in net financial positions, the following advantages of insolvency and solvency set-offs are usually pointed out: "they reduce exposures… including the risk of systematic collapses or cascade melt-downs of the banking systems; reduce cost of credit; reduce capital adequacy costs; reduce transaction costs… this frees capital, increases liquidity, and enlarges the capacity of the financial system; reduce paperwork of processing a multiplicity of gross contracts; ensures that an insolvent debtor is not bankrupted on a debt which the debtor does not 'owe' after set-off is applied"[67].

Balancing between the primal significance of *pari passu* principle and convincing justifications for not applying this principle in respect of set-off in insolvency, majority of the worlds jurisdictions[68] have decided to tolerate or even actively support set-off in insolvency, but without abandoning the *pari passu* principle in entirety. Given that no better basic principle of distribution

[65] Goode, *Principles of Corporate Insolvency Law* (n 26) 278.

[66] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 8.

[67] ibid.

[68] ibid 171-189.

has been invented so far[69], it remains to apply wherever it is not displaced by an explicit exemption provided in the insolvency law i.e. *pari passu* remains the general principle of distribution, while insolvency set-off is firmly positioned as its explicit statutory exemption (*lex specialis*).[70] Both English law and Serbian law, in order to guard insolvency set-off from the *pari passu* attack have resorted to this explicit statutory exemption from the *pari passu* principle. English law did this "as far back as the seventeenth century"[71] and Serbian law provided such exemption in 2010.

3.1.3. Corporate rescue policy

Besides abstract opposition to set-off from the *pari passu* principle, the only practical disadvantage raised against insolvency set-off is based on the rescue culture i.e. the tendency of modern insolvency laws to give chance to corporate debtors to reorganize themselves and survive insolvency. The rescue tendency is based on the commonly invoked utilitarian notion that "going concern value of the company is higher than liquidated one". Set-off essentially impairs insolvency estate and without the set-off, there would be more money available for successful reorganization of the debtor. However, such argument is applicable only in relation to corporate reorganizations i.e. it does not provide a justification for prohibiting set-off in corporate liquidations. In the light of the above mentioned advantages, the insolvency set-off should be clearly available in liquidations when creditors with net positions mostly count on it. In corporate reorganizations, set-off should not be mandatory imposed, and in this respect, Serbian law appears to be more flexible than English law; however there are no reasons why set-off

[69] Alternative distributive principles are such are (i) ranking the debts chronologically, (ii) ranking the debts on a case by case basis based on ethical concerns, (iii) ranking the debts on size etc. are not particularly convincing. *See* Vanessa Finch, 'Is Pari Passu Passé?' (n 54) 208, 209.

[70] Finch in 'Is Pari Passu Passé?' (n 54) 194, 195 points out that insolvency set-off is not the only one widely recognized exemption to *pari passu* principle, other exemptions are priority of insolvency administrative expenses, preferential debts of workers or taxes and contracting out of the *pari passu* through subordinated claims

[71] Goode, *Legal Problems of Credit and Security* (n 21) 242.

should be totally banned. Corporate reorganizations should be viewed as facts-sensitive negotiation platforms which demand flexible and open options. In addition, there are also other devices for shoring up rescue policy such is, for example, administrative priority for post-liquidation financing of the debtor ("new money")[72]. The set-off and corporate reorganizations are addressed in section 3.5 below.

3.2. *Insolvency set-off in England*

3.2.1. Characteristics

English insolvency set-off is regulated as a separate type of set-off and in case of insolvency, only English Insolvency Rules (rule 4.90 for liquidation and 2.85 for administration) are legally relevant. Professor Goode succinctly pointed out that: "insolvency displaces other forms of set-off"[73]. Even though respective statutory rules are designed to be comprehensive and clear-cut, especially after several amendments and clarifications of the rules, the interpretative genius of English court practice could not be bypassed. English courts were never prepared only to silently apply the statutory prescriptions without laying some flesh on the formalistic normative frame. In *MS Fashions*[74], Lord Hoffmann identified three main applicative principles of English insolvency set-off: (i) the mandatory principle, (ii) the retroactivity principle and (iii) the hindsight principle.

The mandatory and retroactivity principles are reflecting the fundamental approach to the concept of the insolvency estate i.e. upon insolvency, mutual claims or their parts that are eligible for set-off, in principle, are not to be viewed as part of the estate. Even before *MS Fashions*, mandatory nature of insolvency set-off has been decisively confirmed by Lord Denning in *Rolls Razor Ltd. v Cox*: "the parties cannot contract out of the statute. Where there are mutual dealings,

[72] For the rationale behind "new money" priority *see* Baird, *Elements of Bankruptcy* (n 55) 221.

[73] Goode, *Principles of Corporate Insolvency Law* (n 26) 286.

[74] *M.S. Fashions Ltd. v Bank of Credit and Commerce International SA* [1993] Ch 425 (AC) in ibid 291.

the statute says that 'the balance of the account and no more shall be claimed and paid on either side'. That is an absolute statutory rule which must be observed"[75]. As per retroactivity principle, Lord Hoffmann in *MS Fashions* specified two points: (i) that set-off operates retroactively i.e. it is to be considered that it took place at the moment when the liquidation order was made, and in order for such effect to be achieved (ii) the set-off must operate automatically i.e. "insolvency set-off is self-executing and once the facts are known… operates automatically without the need for any procedural step[76]". The hindsight principle tells us that court, nevertheless, takes into account the events which have occurred or are about to occur after the date of liquidation order, for example, crystallization of a contingent claim owed to the estate under certain condition precedent. "This enables the trustee to quantify a creditor's contingent or unascertained claim, for the purpose of set-off."[77]

3.2.2. Insolvency Rule 4.90

The Insolvency Rules, issued for the first time in 1986, and amended on several consecutive occasions – for set-off, the most important amendments have occurred in 2005 – comprise the procedural part of the English insolvency law. The Insolvency Rules 1986 represent a supporting secondary legislation based on the Insolvency Act 1986, as amended in 2000 and in 2002 by the Enterprise Act[78].

The provision that governs English insolvency set-off is located in Rule 4.90 of the English Insolvency Rules. Insolvency set-off also applies in English corporate reorganization (i.e. administration), based on Rule 2.85 of the Insolvency Rules, as they are amended in this respect in 2005. "Given that rule 2.85 is deliberately almost identical in wording to rule 4.90, it is safe to

[75] *Rolls Razor Ltd. v Cox* [1967] 2 WLR 241 (AC) in Benjamin, *Financial Law* (n 5) 279.

[76] Goode, *Principles of Corporate Insolvency Law* (n 26) 294.

[77] ibid 293.

[78] ibid 21.

assume that the liquidation set-off… apply mutatis mutandis to administration set-off."[79] This section will be focused only on the Rule 4.90. Key provisions of the Rule 4.90[80] read as follows:

> "4.90. – (1) This Rule applies where, before the 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) The reference in paragraph (1) to mutual credits, mutual debts or other mutual dealings does not include – (a) any debt arising out of an obligation incurred at a time when the creditor had notice that – (i) a meeting of creditors had been summoned under section 98; or (ii) a petition for the winding up of the company was pending. […] (3) 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) A sum shall be regarded as being due to or from the company for the purposes of paragraph (3) whether – (a) it is payable at present or in the future; (b) the obligation by virtue of which it is payable is certain or contingent; or (c) its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion. […] (8) Only the balance (if any) of the account owed to the creditor is provable in the liquidation. […]"

English legal theory – principally Professor Goode and Professor Wood, have extracted from the Rule 4.90 a set of conditions[81] that must be fulfilled for insolvency set-off to take place. According to Professor Goode and Professor Wood, the insolvency set-off is available subject to the conditions regarding: (i) provability of claims, (ii) mutuality of claims, (iii) observance of

[79] Look Chan Ho, 'Set-Off', in Peter Totty, Gabriel Moss and Nick Segal (eds), *Insolvency* (Sweet & Maxwell 2008) H-10.

[80] The whole rule is quoted in Rory Derham, *Derham on the Law of Set-Off* (4th edn, Oxford University Press 2010) 263, 264. In addition, the Rule 4.90 could be found online at the following link: http://www.legislation.gov.uk/uksi/2005/527/article/23/made, visited on 20 March 2012.

[81] Goode, *Principles of Corporate Insolvency Law* (n 26) 295 and Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 27. This section combines and in one aspect confronts conditions for insolvency set-off that have been developed by Professor Goode and Professor Wood.

certain cut-off dates, (iv) monetary nature of claims and (v) negative condition that set-off is not excluded by the build-up prohibition.

(i) Provability

This condition means that there could be no insolvency set-off involving claims which are for some reason unenforceable e.g. due to statute of limitation. A clam is provable if "the creditor is entitled to claim it in the insolvency"[82]. Because of the mandatory and self-executing nature of insolvency set-off it is not required that the claim is actually proven in insolvency, it is sufficient that a claim is provable[83]. Special clarifications are required with respect to provability of (i) unmatured claims, (ii) unliquidated debts (i.e. debts not ascertained in amount), (iii) contingent claims (e.g. claims against guarantor, or claims depending on occurrence of the condition precedent), and (iv) secured claims.

It is generally recognized that, due to statutory imposed acceleration of all claims owed by the insolvent company, unmatured claims are considered as provable. Also "unliquidated debts, such as claims for damages for breach of contract, are available for set-off at their valued or assessed amount."[84] Also, English law generally "permits contingent claims owing by the insolvent debtor… e.g. the liability of a guarantor to the principal creditor… to be set-off at their valued amount"[85]. However, a claim that is "so contingent as to be inapplicable of estimation by the liquidator[86] would not be eligible for the insolvency set-off. Likewise, the claim the existence of which has been denied by the liquidator should be resolved in litigation and it is not eligible for the set-off.

[82] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 31.

[83] Goode, *Principles of Corporate Insolvency Law* (n 26) 297.

[84] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 34.

[85] ibid 35.

[86] Goode, *Principles of Corporate Insolvency Law* (n 26) 296.

In respect of the secured claims the construal of the rule is not entirely clear. On the one hand, according to Professor Goode, insolvency set-off should apply "in relation to a secured debt and in cases where the creditor intends to enforce his security rather than proving. The effect of the automatic nature of set-off is that the debt due to the secured creditor is *pro tanto* reduced by the company's cross claim."[87] Hence, professor Goode concludes: "secured creditor's decision not to prove its claim is irrelevant"[88].

However, Professor Wood, on the other hand, argues that the secured creditor has an election either to rest on its security (and prove only for possible shortfall) or to give up security and prove the whole debt[89]. If the secured creditor elects not to prove i.e. "if the [secured creditor] rests on its security, its proof is excluded [save for the shortfall], and there is no set-off. No proof, no set-off."[90]

In the light of the above mentioned widely accepted principles affirmed by Lord Hoffmann in *MS Fashions* i.e. the principles that insolvency set-off is mandatory, retroactive and self-executing, the logical outcome should probably be, as Professor Goode argues, that insolvency set-off automatically reduces the claim of the secured creditor and that proof of claims is not decisive. This view imposes no burden on the secured creditor – its claim was directly and *ab initio* used for payment of its debt; in respect of the claim or its part that has been discharged via set-off, there is no need for the creditor to initiate lifting of the automatic stay, or to apply for adequate protection and eventually collect from the proceeds of the collateral. The insolvency set-off had performed its security function.

[87] Goode, *Principles of Corporate Insolvency Law* (n 26) 297.

[88] ibid.

[89] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 39.

[90] ibid.

(ii) Mutuality

Paragraph (1) of the Rule 4.90 explicitly states that it applies only where, before the company goes into liquidation, there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company. Mutuality requirement implies that, for example, a solvent company A may not set-off the debt that it owes to the insolvent company C with the debt that such insolvent company C owes to B which is the subsidiary of the company A. "The doctrine of mutuality requires that one person's claim shall not be used to pay another person's debt."[91] "The claim and the cross-claim must be between the same parties in the same right… In determining mutuality, the court will look at the beneficial ownership of the claim rather than the legal title."[92] Mutuality does not require that mutual claims have their source in the same or connected transactions.[93]

Because of the requirement of mutuality, certain contractual set-off mechanisms like multilateral netting or cash-pooling might not survive opening of the insolvency of a participating company. In this respect, specific safe harbors are provided in the EU Settlement Finality Directive[94], which, however, applies only to payment and securities settlement systems.

(iii) Monetary claims

It is not possible to set-off a monetary claim against a proprietary claim. "As a general rule, insolvency set-off is only available where there is a debtor-creditor relationship both ways, not where one of the parties has an *in rem* or proprietary claim for the restitution or delivery of its

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[91] Wood, *Law and Practice of International Finance* (n 3) 235.

[92] Goode, *Principles of Corporate Insolvency Law* (n 26) 297, 298.

[93] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 27.

[94] Directive 98/26/EC of the European Parliament and of the Council on settlement finality in payment and securities settlement systems [1998] (OJ L 166 , 11/06/1998 P. 0045 – 0050).

property."[95] However, "the fact that one of the debts is secured does not affect the right of the debtor to set-off his own cross-claim against it; the automatic set-off simply reduces the amount of the secured obligation"[96]

(iv) Cut-off events

In principle, the cross-claims should have been "incurred… or arouse out of contracts or other dealings entered prior to insolvency date"[97]. This insolvency date is determined with reference to a specific cut-off events. English Rule 4.90 in its paragraph (2) *inter alia* specifies that mutual debts arising out of an obligation incurred after certain dates are not eligible for set-off i.e. a debt ineligible for the insolvency set-off is any debt arising out of an obligation incurred at a time when the creditor had notice that (i) a meeting of creditors had been summoned, or (ii) a petition for the winding up of the company was pending. Hence, in principle, only claims incurred prior to the commencement of the insolvency liquidation are eligible for the insolvency set-off. "Debts due from the company [already] in liquidation to another party are not to be included in the account of mutual dealings."[98] The contractual netting mechanisms are thus usually designed to give effect to set-off immediately before or simultaneously (automatic early termination and close-out provisions) with an insolvency event.

(v) Build-up prohibition

The preferential position of a solvent party in a position to fully use its claim (which is an asset as any other) to discharge via set-off a debt that it owes to the insolvent company makes the insolvency set-off appealing for manipulations. Namely, a solvent company could purchase at a deep discount the claim against the insolvent company just for the purpose of setting it off

[95] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 66.

[96] Goode, *Principles of Corporate Insolvency Law* (n 26) 300.

[97] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 27.

[98] Goode, *Principles of Corporate Insolvency Law* (n 26) 304.

against the insolvent company's cross-claim. Professor Wood gives the following illustrative example: "the bankrupt owes a creditor 100. A debtor owes the bankrupt 100. If the debtor buys the creditor's debt, then the debtor will be able to set-off and will not have the pay their 100 to the estate. If the expected dividend [i.e. recovery] from the bankrupt is only 10 per cent, the creditor will be better off if they sell to the debtor for more than 10 since this is all they would get on the bankruptcy"[99]. Such situations cannot be mitigated by classic voidable preferences or fraudulent conveyance restrictions because the insolvent company is not taking part in these transactions.

Therefore, a special provision of the insolvency law – the so called "build-up prohibition" – is designed to protect the insolvency estate from such manipulative accrual of claims after certain cut-off events just for the purpose to use them for set-off. Rule 4.90(2)(d) foresees that there may not be an insolvency set-off involving any debt which has been acquired by a creditor by assignment or otherwise, pursuant to an agreement between the creditor and any other party where that agreement was entered into: (i) after the company went into liquidation, (ii) at a time when the creditor already had notice that a meeting of creditors had been summoned, (iii) at a time when the creditor had notice that a winding up petition was pending, (iv) where the liquidation was immediately preceded by an administration, at a time when the creditor had notice that an application for an administration order was pending or a person had given notice of intention to appoint an administrator, or (v) during an administration which immediately preceded the liquidation. Professor Goode points out that "accordingly, where an assignment is caught by r. 4.90(2)(d), the assigned claim ceases to be capable of being raised as a set-off by anyone: not by the assignee because of r. 4.90(2)(d) and not by the assignor because there is no longer mutuality."[100]

[99] Wood, *Law and Practice of International Finance* (n 3) 229.

[100] Goode, *Principles of Corporate Insolvency Law* (n 26) 305.

(vi) Cross-border insolvency

In case that the insolvent debtor's centre of main interest (COMI) is in the European Union the EU Insolvency Regulation 2000[101] will be directly applicable in the United Kingdom. Article 4(2)(d) of the EU Insolvency Regulation foresees that the law of the state of the opening of proceedings shall determine the conditions under which set-offs may be invoked. Article 6 specifies 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. For the cross-border insolvencies not involving EU jurisdictions in 2006 the UK implemented the 1997 United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency. However the UNCITRAL Model Law on Cross-Border Insolvency "does not set-out conflicts [of laws] rules for set-off"[102].

3.3. Set-off in insolvency in Serbia

3.3.1. General set-off requirements

The insolvency set-off is not regulated in Serbia as a special type of set-off. Contrary to the English law, insolvency in Serbia does not displace solvent set-off requirements; instead, Serbian Insolvency Act in Article 82 permits solvent set-off rules to continue to apply in insolvency until certain insolvency cut-off dates and subject to specific and additional insolvency related procedures and restrictions outlined in the next section 3.3.2. Therefore, the solvent set-off requirements must be observed for setting off cross claims in insolvency as well.

Pursuant to Article 337 of the Serbian Obligations Act, the general precondition for the set-off to take place in Serbia is that one party makes a set-off declaration [*izjava o prebijanju*]. In case of

[101] Council regulation (EC) No 1346/2000 on insolvency proceedings [2000] OJ L 160 , 30/06/2000 P. 0001 – 0018 (hereinafter: "EU Insolvency Regulation").

[102] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 126.

the insolvency, a set-off declaration must be lodged together with filed (i.e. proved) claims. Therefore, unlike English insolvency set-off, set-off in Serbia is never mandatory and automatic (self-executing), though, after the set-off declaration has been made, the effects are retroactive i.e. it is considered that the set-off took place at the moment when the conditions for it were created.

Other solvent set-off requirements are also provided in the Obligations Act and in respect of cross-border set-offs, the additional requisite is imposed by the Foreign Exchange Act. According to these general requirements, claims are eligible for the set-off if they are: (i) enforceable (i.e. provable in case of insolvency), (ii) mutual (i.e. reciprocal), (iii) if they are of monetary nature, or they are other exchangeable objects of the same kind and quality, (iv) if the set-off of a particular claim is not forbidden by law and (v) if set-offs of cross-border claims are compliant with special foreign exchange regulations.

(i) Enforceability

The enforceability requirement of Serbian law is equivalent to English law requirement that a claim must be provable i.e. that creditor can legally raise such claim against a debtor. Therefore claims that are time barred due to the statute of limitation are not eligible for set-off. Article 339 of the Serbian Obligations Act specifies that, exceptionally, a debt may be discharged via set-off against a time barred claim only if such claim has not been time barred at the moment when conditions for the set-off have occurred, which is a consequence of the above mentioned retroactive effect of the set-off.

The Obligations Act in Article 336 explicitly requires that both cross-claims are mature. This is not an issue for creditors in case of insolvency of their counterparties due to the statutory acceleration clause foreseen in Article 81 of the Insolvency Act – all creditors' claims that have not matured are *ex lege* deemed matured as of the date of opening of the insolvency proceeding against a debtor.

Serbian legislation is silent in respect of the requirements that claims should be liquid (clearly ascertained in value) and that claims must not be contingent (e.g. subject to certain future conditions[103]), however, Serbian legal theory points out that the liquidity and non-contingency requirements are outdated and unnecessary requirements and that these claims are also eligible for the set-off subject to certain appraisal techniques[104]. In this respect, Serbian law is in principle fully aligned with English law.

(ii) Mutuality

In Serbian law, as in well as in English law, the mutuality is the undisputable prerequisite for any kind of set-off. "One person's claim shall not be used to pay another person's debt."[105]. Article 338(1) of the Obligations Act gives an example of the lack of mutuality: a debtor may not set-off a debt it owes to the creditor against a debt owed by that creditor to the guarantor of the debtor. However, Article 338(2) allows that the guarantor may set-off the debtor's obligation to the creditor against the debtor's claim against the creditor.

In addition, the Obligations Act relaxes the mutuality requirement in the following three situations. In the first situation, pursuant to Article 338(3), if a party gives its asset as a collateral securing another person's obligation, that party may request from the secured creditor the restitution of the pledged asset as soon as conditions for termination of such obligation through set-off have occurred between the creditor and the principal debtor. Secondly, Article 340 allows that a debtor of an assigned claim may set-off against the assignee all of its claims it could have

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[103] Article 87 of the Serbian Insolvency Act provides that if the condition does not arise until the decision on the main distribution of the bankruptcy estate has become final, the claims subject to such condition shall cease to exist.

[104] Radisić, *Obligations Law: Common Part* (n 51) 354.

[105] Wood, *Law and Practice of International Finance* (n 3) 235. Also Jakov Radisić, *Obligations Law: Common Part* (n 51) 353.

set-off against the assignor until the notification of assignment. It may also set-off with assignee even those claims which it had acquired against the assignor prior to notification of assignment and which were not matured at the moment of the notification of the assignment, but only if the maturity date for such claims falls before or coincides with the maturity date of the assigned claim. This relaxed mutuality will not apply in case the assignor or assignee have managed to procure explicit statement (in writing) of the debtor that it accepts the assignment. And thirdly, according to Article 415(2), a joint and several debtor may set-off the creditor's claim with the claim that its co-debtor has against that creditor, but only in an amount equal to the share of the debt of such co-debtor within the joint and several obligation.

(iii) Monetary or other generic nature

According to Article 336 of the Obligations Act, in order to be eligible for the set-off, the claims must be of monetary nature, or they must be other exchangeable objects of the same kind and quality. This condition is not an issue in respect of the claims against the insolvent company since the Insolvency Act in Article 81(2) foresees that as of the day of opening of the insolvency proceeding nonmonetary claims shall be converted to monetary values.

(iv) Statutory prohibition of set-off

In certain situations, the Obligations Act prohibits set-off even if all other conditions are fulfilled. The set-off is prohibited by Article 341 if it involves, *inter alia* (i) a claim impossible to seize (i.e. to attach), (ii) a claim relating to an asset or to a value of the asset delivered to the debtor for custody, or taken unlawfully by the debtor, or retained unlawfully by the debtor, and (iii) a claim for damages caused by an intentional tort (i.e. willful misconduct)[106].

[106] The statutory set-off prohibitions which include natural persons are (i) claims for damages to personal health or for causing death and (ii) claims arising from statutory duty or alimony.

(v) Cross-border set-off

In Serbia, solvent set-off between cross-border claims is subject to an additional special regime. Namely, besides the forgoing requirements of the Obligations Act, the cross-border claim must also comply with the additional requirements set forth in the Serbian Foreign Exchange Act. Until recently, cross-border set-off was not allowed in Serbia at all. This unreasonable restriction was finally eliminated by 2011 amendments to Article 6 of the Foreign Exchange Act which now generally allows: (i) the set-off between residents and non-residents in foreign trade of goods and services and (ii) the set-off between the cross-border claims arising from foreign credit operations, foreign trade and direct investments as well as real estate investments. Nevertheless, Article 6 of the Foreign Exchange Act still imposes a requirement that cross-border set-off could only be achieved within additional procedure that, for each particular case, involves a duty to obtain the approval from the Ministry of Finance confirming the fulfillment of the relevant conditions, issued on the basis of credit and debt status confirmation provided by the Serbian Central Bank. Article 6 delegates detailed regulation of these additional conditions and procedure to secondary legislation adopted by the Serbian Government[107].

Given that neither the Foreign Exchange Act nor the Insolvency Act have specified the relationship between mandatory procedures which they (separately) require for the set-off to be enforced, it may be concluded that in case of insolvency of their Serbian counterparties, the non-Serbian creditors would most likely be obliged to comply with both sets of requirements. Therefore, the cross-border set-off regime in Serbia still has not been fully liberalized – these additional foreign exchange bureaucratic barriers could only have the effect to further inhibit cross-border financial activities and Serbian law should abolish them *in toto* and as soon as possible.

[107] Such separate secondary legislation was recently adopted: (i) the Regulation No. 05: 110-9510/2011 (Official Gazette of the Republic of Serbia no. 99/2011) and (ii) the Regulation No. 05: 110-1082/2012 (Official Gazette of the Republic of Serbia no. 14/2012).

3.3.2. Insolvency law requirements

Article 82 of the Serbian Insolvency Act prescribes that if a creditor has acquired the right to set-off his claim against the debtor with the debtor's claim against such creditor before specific insolvency cut-off events, the opening of insolvency proceedings shall not constitute a ground for the loss of the right to set-off such claim. Therefore, if a creditor properly acquired the set-off right prior to the insolvency – meaning that all general requirements for solvent set-off outlined in the preceding section 3.3.1. have been duly satisfied – the insolvency by itself will not prevent the set-off to occur. Unlike in English law the insolvency regime does not displace and replace solvent set-off rules with a new legal category of insolvency set-off; instead, Serbian Insolvency Act allows solvent set-off to continue to apply subject to (i) additional procedural step, (ii) prescribed cut-off events and (iii) and restrictions regarding on build-up and preferential transactions.

(i) Procedure

With regard to the procedural aspect, Serbian set-off in insolvency is not mandatory, automatic and self-executing. Article 82(2) of the Serbian Insolvency Act provides that in each case, the creditor must file (i.e. prove, register) its claim together with a set-off declaration with the insolvency court before the expiry of the deadline for filing claims; otherwise it will lose the set-off right. The deadline for registering claims in insolvency for each case is to be decided by the competent insolvency judge, but this period may not be longer than 120 days, as of the date of the announcement of the opening of the insolvency procedure in the Official Gazette of the Republic of Serbia (Article 111(5) of the Serbian Insolvency Act).

(ii) Cut-off events

There are two cut-off events relevant for set-off in insolvency in Serbia: (i) the initiation [*pokretanje*] of the insolvency proceeding and (ii) the opening [*otvaranje*] of the insolvency. Namely, Articles 55, 69 and 71 of the Serbian Insolvency Act provide that the insolvency proceeding is initiated when a creditor, insolvency debtor or a liquidation receiver files the petition for the initiation of the insolvency proceeding to the competent insolvency (i.e. commercial) court. After the petition is filed, the insolvency proceeding will be opened if the insolvency judge renders a decision on opening of the insolvency, accepting the petition. The exact moment of opening of the insolvency proceeding is when the respective decision is announced on the notice board of the court, which is typically immediately after the decision is rendered[108].

The general regime for insolvency set-off in Serbia is that only the set-off rights acquired *prior to the initiation* of the insolvency proceeding i.e. acquired before petition for the initiation of the insolvency proceeding was filed, may be effected in insolvency (Article 82(1) of the Serbian Insolvency Act).

However, the Insolvency Act recognized that close-out netting mechanisms typically agreed in standard market financial and derivatives agreements might in certain situations trigger the set-off entitlement of the solvent party *after the initiation* (e.g. by a third party) of the insolvency against its counterparty. Namely, the most typical netting arrangement i.e. the close-out netting consists of "the cancelation of series of open executory contracts… on the [event of insolvency] of the counterparty and set-off of the resulting gains and losses… so as to produce single net balance owing one way or the other".[109] In order to facilitate enforceability of such standard netting agreements, the Insolvency Act provided for the special insolvency netting [*netiranje*] regime with slightly relaxed cut-off dates. Article 82(3) specifies that in respect of cross-claims arising out of or in connection with framework financial agreements (master agreements) entered

108 The announcement on the opening of the insolvency is also published in one high circulation daily newspapers distributed on the entire territory of the Republic of Serbia, and in the Official Gazette of the Republic of Serbia. However, these other publications are not relevant for the cut-off opening date.

109 Wood, *Law and Practice of International Finance* (n 3) 218.

into *prior to the initiation*[110] of the insolvency, the creditor's set-off right (netting) will be enforceable even if it is acquired[111] *after the initiation* of the insolvency proceeding, *but not later than the moment of opening of the insolvency proceeding*[112]. The right to set-off may be acquired and exercised either (i) automatically – if *ipso facto* or ISDA[113] Master Agreement automatic early termination provisions were agreed, or (ii) by serving the set-off notice to the insolvency debtor at the latest within three days as of the opening of the insolvency proceedings. Article 82(4) further specifies the scope of this special insolvency netting regime is limited only to the (i) transactions with financial derivates (swaps, options, futures, forwards and other non-standardized financial derivates), (ii) repo transactions and (iii) securities lending, all entered into in writing or orally if the content of the respective agreement is evidenced in writing in a manner customary for these types of transactions.

(iii) Build-up prohibition and voidable preferences

The Insolvency Act also provides for certain situation in which set-off in insolvency is not enforceable. Pursuant to Article 83, the set-off is not permitted: (i) if the creditor acquired or became entitled to the claim concerned within six months before the filling of the petition for initiation of the insolvency proceedings, provided that the creditor knew or ought to have known that the debtor is insolvent or over-indebted, or (ii) if the creditor acquired the right to set-off its claim through a voidable preferential transaction.

In regard to voidable preferences, it is worth noting that Article 49(3) of the Insolvency Act provides that only security interests acquired within 60 days before opening of the insolvency

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110 i.e. before petition for the initiation of the insolvency proceeding was filed.

111 As a consequence of a defaulting event e.g. due to the existence of an insolvency triggering reason, the filing of an petition for the initiation of the insolvency proceeding or the opening of the insolvency proceeding against a counterparty.

112 i.e. moment when the insolvency judge renders a decision on opening of the insolvency procedure and announces it on the notice board of the court.

113 International Swaps and Derivatives Association.

proceedings shall terminate *ex lege* upon insolvency and the respective creditors shall be deemed unsecured creditors. Given that (i) set-off and netting are not explicitly mentioned in this Article, and (ii) that functional approach which could theoretically recharacterize set-off into a security interest is not adopted even in the US Uniform Commercial Code, it may be concluded that in Serbia, set-offs are subject only to general voidable preference restrictions[114] whereby the insolvency receiver on a case-by-case basis decides whether she will attack a particular transaction as a preference.

3.4. Recommendations for Serbian law

In January 2010 the Serbian Insolvency Act finally introduced into the Serbian legislation modern rules applicable to insolvency set-off and netting. More individualized view of justice in corporate insolvency law thereby defeated the absolutistic view of *pari passu* principle which romantically strived to provide collective equality of all unsecured creditors. This mind-set change is undoubtedly one of the most significant reforms that the Serbian insolvency law has taken over the last decade. However, the newly introduced Serbian rules for set-off in insolvency have not reached their full protective potential, they are not as clear-cut and water resistant as they could be – as they are in English law.

There are two main weak points in the current Serbian insolvency set-off law[115]. The first one is that rules regulating it are scattered in two, or in case of cross-border claims, three, different legislative sources. Namely, for assessing whether they are entitled to the set-off in case of insolvency of their counterparties in financial transactions the creditors are now forced to look first into the Serbian Obligations Act – to verify that the general solvent set-off requirements have been satisfied. In case the creditors are not Serbian residents seeking to set-off a cross-

[114] Voidable preference rules are stipulated in Section VIII, Articles 119 – 130 of the Serbian Insolvency Act.

[115] It should be noted that issues raised here as weak points are not only features of the Serbian law – they might be pointed out in respect of majority of jurisdictions in the continental part of the Europe.

border claim, most likely they will need to ensure that additional requirements set out in the Foreign Exchange Act are also observed. Finally, if the solvent set-off is properly and definitely accrued, the creditors then must determine how to exercise their set-off right under the insolvency regime provided by the Insolvency Act – what procedural steps to take and what are the deadlines? This unnecessary complexity leads to legal uncertainty.

The second main weak point is that set-off in Serbian insolvency liquidation cases requires an active approach by the creditors i.e. the set-off is not mandatory, automatic and self-executive as it is in England. Serbian Insolvency Act requires that in each case the creditor files its cross-claim together with a set-off declaration with the insolvency court before the expiry of the deadline for filing claims; otherwise it will lose the set-off right. This presupposes that creditors are properly and timely informed about the insolvency of their Serbian counterparties. In order to be timely informed, the creditors will need to take care that information covenants are always properly implemented in their contracts and thereby the transaction as well as further monitoring costs will be higher.

However, these weak points are not written in stone, they might be viewed as a childhood diseases of an icebreaking regime that could be further reformed. And in its reforms, Serbian law should be more like Caesar and less like Spartacus – it should march straight to Rome. And in case of international financial law regimes, modern Rome is the London City where rules of English insolvency set-off law apply. The present set-off in insolvency regime should be improved following the rationales of the English insolvency set-off law and its Rule 4.90. The following improvements might be considered, all based on the existing English insolvency set-off rules which are outlined in this thesis:

(i) The insolvency set-off should be provided as a special type of set-off which, in case of insolvency entirely displaces and replaces solvent set-off regime. This insolvency set-off type must be equal or even broader than its solvent counterparties;

(ii) The rules governing the new insolvency set-off should be comprehensively placed in one legislative source – the Insolvency Act. All requirements for exercising a set-off right in insolvency i.e. enforceability (provability) of claims, mutuality, insolvency cut-offs, monetary or other generic nature of claims and build-up and preference prohibitions, should be easily accessible in one place;

(iii) The insolvency set-off should be mandatory in corporate liquidation scenarios. This would reflect new understanding of the insolvency estate as a pool of assets which in principle should not at all count on the claims that are dischargeable via set-off;

(iv) The insolvency set-off should be automatic and self-executive in corporate liquidation cases i.e. creditors should not be burdened with additional procedure and with the possibility to lose the set-off right if they do not act fast enough. Since the insolvency set-off is an acid test of the pro-debtor or pro-creditor insolvency policy, and given that Serbian law already decided to shift into the pro-creditor camp, there is no good reason for a residual reluctance;

(v) The set-off of cross-border claims should by fully liberalized, or the additional foreign exchange procedural requirements should not be applicable in insolvency cases. There is no need for the Ministry of Finance to verify fulfillment of the set-off requirements in the presence of the insolvency judge and the insolvency receiver;

(vi) Although new Serbian Insolvency Act did regulate the international insolvency (mostly on the basis of the 1997 UNCITRAL Model Law on Cross-Border Insolvency), it omitted to specify treatment of the set-off in the context of cross-border insolvency cases. Given that Serbia this March 2012 became an official candidate for joining the EU, applicability of the EU Insolvency Regulation is on the mid-term horizon. Nevertheless, there is nothing that prevents Serbia from improving its international insolvency rules by adopting solutions from the EU Insolvency Regulation (i.e. its Article 6 in regard to set-off) even before joining the EU.

With these improvements, it might be expected that insolvency set-off would better perform its protective function, making Serbian markets more attractive to both foreign and local investors and capital providers.

3.5. Corporate reorganizations and insolvency set-off

Both in England and in Serbia, set-off is generally available in corporate reorganization procedures as well. Taking into account that corporate reorganizations are always case specific and that prescribed legal procedures should do no more than facilitate effective negotiations between the concerned parties, creditors are usually more prepared to negotiate (to work-out) their set-off rights. In this respect, Serbian law appears to be more flexible and rescue oriented than English law.

In England, prior to 2003, Insolvency Rules had no special insolvency set-off rules for administration cases. In 2003 situation changed when Insolvency Rules were amended by introducing new Rule 2.85 regulating set-off in administration correspondingly to Rule 4.90 concerning liquidation set-off. Rule 2.85 was further amended in 2005 in order to be fully aligned with liquidation set-off Rule 4.90[116]. Professor Goode concludes that, assuming that in the particular case the administrator is authorized to make distributions, "the regimes applicable to set-off in administration and liquidation are [now] essentially the same"[117]. Therefore, set-off is powerful and far-reaching in English administration cases as well, the "cram-down" risk is reduced for the benefit of creditors but at the expense of overall flexibility of English formal rescue procedure.

[116] Derham, *Derham on the Law of Set-Off* (n 80) 265.

[117] Goode, *Principles of Corporate Insolvency Law* (n 26) 313.

In Serbian reorganization, set-off is generally subject to the same rules and procedures as for liquidation set-off, requiring active approach by the creditor with the intention to set-off. However, set-off in reorganization might be on the standstill or even displaced because of the adopted reorganization plan. Upon the decision confirming adoption of the reorganization plan, all claims and rights of the creditors and other parties and obligations of the debtor specified by the plan will be governed solely by the terms stated in the plan. According to Article 167 of the Serbian Insolvency Act, the adopted plan of reorganization has the force of executive title and it is considered to be a new contract for the satisfaction of claims presented therein.

CHAPTER 4 – NETTING

"The terms netting and set-off are sometimes treated as interchangeable, but in financial circles netting is used to denote contractual arrangements by which claims of different parties against each other are reduced to a single balance… Netting can thus be viewed as both the procedure for and the outcome of a contractually competed set-off."[118] English law considers netting as an advanced form of contractual set-off. Contractual set-off is "a set-off created by the contract where it would not otherwise exist"[119]. Serbian law does not mention netting apart from its recognition in the Insolvency Act. However, since netting is a contractual mechanism and Serbian contract law is based on the party autonomy principle allowing parties to freely regulate their relations within the framework of mandatory rules, public order and good business practices, it is clear that netting could be achieved as long as it is not trumped by mandatory insolvency law.

Netting "procedure" or "outcome" can be realized or achieved by use of various financial engineering techniques out of which the close-out netting and settlement (or payment) netting are internationally crystallized as the most widespread. Given the contractual nature of netting, the following types of netting mechanisms could equally apply both in England and in Serbia.

4.1. Close-out netting

Article 2(1)(n) of the EU Financial Collateral Directive[120], which is implemented in English law, but not yet in Serbian law, provides useful definition of close-out netting:

> "Close-out netting provision means a provision of a financial… arrangement… by which, on the occurrence of an enforcement event, whether through the operation of netting or set-off or

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[118] Goode, *Principles of Corporate Insolvency Law* (n 26) 282.

[119] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 7.

[120] Directive 2002/47/EC of the European Parliament and of the Council on financial collateral arrangements [2002] (OJ L 168 , 27/06/2002 P. 0043 – 0050).

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."

Close-out netting is designed to terminate (to close) all executory[121] (open) contracts which exist between two parties upon insolvency of one of them (or upon other event of default) and using the set-off device to leave only a net amount outstanding. It consists of "the cancelation of series of open executory contracts… on the default of the counterparty and set-off of the resulting gains and losses. Close-netting requires two steps on a counterparty default: cancelation of the unperformed contracts, and then set-off of the gains and losses on each contract, so as to produce single net balance owing one way or the other".[122]

The purpose of the close-out netting is to protect a solvent party from immense losses that it could suffer in case of insolvency of the counterparty from still open i.e. unperformed excutory contracts. If there would be no close-out netting, and the cross-claims from such contracts are not eligible for the insolvency set-off (which is usually the case with claims under contractual set-off arrangements), the solvent party would be obliged to pay its debts to the insolvent while at the same time it is faced with great uncertainty to which extent it will be able to recover its claims from the insolvency estate. Hence, the close-out netting is routinely agreed in standard derivatives agreements – the most important of them and most commonly used is the ISDA Master Agreement (2002) which Section 6 envisages the close-out netting mechanism.

[121] Wood defines executory contracts as "contracts to sell or deliver property or money where both parties still have obligations and the transfer and payment for the transfer are still to take place in future – the civilian synallagmatic contract" in Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 17.

[122] Wood, *Law and Practice of International Finance* (n 3) 218.

However, the insolvency is an extraordinary legal situation; almost all pre-insolvency entitlements are somehow affected: either temporarily suspended or even permanently novated or reduced. The netting is therefore also under the risk it might not be enforceable upon new – insolvency – legal regime. The principal risk arises from the scope of the liquidator's power to assume or to reject the unperformed executory contracts i.e. to "cherry-pick"[123] only the contracts that are profitable for the insolvency estate. "In nearly all commercial jurisdictions, the insolvency administrator can abandon or terminate loss-making contracts… but require the counterparty to perform contracts profitable to the estate – a process known as cherry-picking."[124] For example, Article 94 of the Serbian Insolvency Act explicitly provides that if the insolvent debtor and its counterpart did not, before opening of the insolvency, perform obligations arising from an executory contract, the insolvency receiver may assume the contract and demand from the other party to perform its obligations. If the receiver decides to reject the contract, the other party may pursue its claim only as (often unsecured) creditor in insolvency.

The effective mitigation of the cherry-picking risk are *ipso facto* or automatic early termination (AET) clauses i.e. the clauses that automatically terminate or entitle the solvent counterparty "to cancel the contract by reason of the commencement of insolvency proceedings against the other party"[125]. If automatic and/or early termination upon insolvency is possible, the liquidator may not cherry-pick those executory agreements that have already been closed-out.

Therefore, the ultimate outcome of all netting mechanisms in insolvency in principle depends on whether *ipso facto* and AET clauses are compatible with mandatory insolvency law. Although certain important jurisdictions e.g. France, US[126], expressly nullify such kind of clauses (with

[123] The cherry-picking jargon is used in Wood, *Law and Practice of International Finance* (n 3) 76, 219; Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 55; and Goode, *Principles of Corporate Insolvency Law* (n 26) 287, 311.

[124] Wood, *Law and Practice of International Finance* (n 3) 219.

[125] ibid.

[126] Baird, *Elements of Bankruptcy* (n 55) 129.

limited exemptions for financial institutions based on special netting statutes), both English law and, from recently, Serbian law have adopted permissive approach in respect of *ipso facto* and automatic early termination clauses[127] consequently allowing the close-out netting to be enforced on insolvency. As per English law, Professor Goode concludes that "the solution is to provide in each [master] contract that all executory contracts will automatically be terminated, rescinded or closed out… in the event of either party going into liquidation"[128]. Serbian Insolvency Act in Article 82(3) expressly allows automatic termination by reason of insolvency and consequent netting [*netiranje*] (subject to certain procedures and cut-off dates) "only" in respect of (i) transactions with financial derivates (swaps, options, futures, forwards and other non-standardized financial derivates), (ii) repo transactions and (iii) securities lending. Taking into account that these transactions are the most usual sources of the close-out netting provisions, it can be concluded that Serbian law also provides for a wide (but not unlimited) enforceability of close-out netting mechanism.

At the end, it is worth noting that although close-out netting is understood as very useful device it could also have the negative effects – it carries a risk that cancelation by the solvent party can trigger cross-default clauses in other agreements which that solvent party has with third parties[129].

4.2. Settlement netting

Settlement netting is a contractual mechanism facilitating mutual payments under executory contracts through set-off. Wood defines settlement netting as "the advance set-off by contract of equivalent fungible claims under executory contracts… where the mutual deliveries fall due for payment or delivery on the *same day*"[130] and explains that it "is different from set-off because it

[127] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 57.

[128] Goode, *Principles of Corporate Insolvency Law* (n 26) 311.

[129] Wood, *Law and Practice of International Finance* (n 3) 233.

[130] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 4.

applies to deliveries under executory contracts still to be performed, while set-off applies to debts for performance already made"[131]. It is simultaneously referred to as both payment and settlement netting. It has two closely connected intentions: (i) to reduce the number and cost of reciprocal payments and (ii) to reduce the risk of insolvency i.e. the risk that one party will pay or perform delivery while the other party becomes insolvent and thus unable to perform its payment or delivery. Payment/settlement netting provision is commonly included in standard market and derivatives agreements.

The main risk concerned with payment netting is that it could be avoided in insolvency as a preference payment occurred within designated suspect period before insolvency.[132] Probably with the intention to provide a safe harbor for enforceability of settlement netting mechanisms in derivatives transactions, Article 126(3) of the Serbian Insolvency Act specifies that legal transactions or legal actions cannot be challenged under the avoidance rules provided that such transaction or action was undertaken: (i) before the motion for initiation of bankruptcy procedure has been filed, (ii) on the basis of the financial framework (i.e. master) agreements defined in Article 82(3) i.e. financial derivates, repo and securities lending agreements, and (iii) in accordance with customary business practice for performance of such types of agreements. Therefore, settlement netting is generally enforceable both in England and in Serbia, with exposure to the transaction-specific vulnerability in case of insolvency.

[131] Wood, *Set-Off and Netting, Derivatives, Clearing Systems* (n 17) 15.

[132] ibid 14.

CONCLUSION

The comparative analysis of English and Serbian insolvency set-off laws presented in this thesis is aimed at achieving two goals. The first goal is to illustrate how powerful and useful the insolvency set-off device could be by analyzing a successful and sophisticated insolvency set-off model such as the English one. The second goal is to use English rules as a suitable benchmark for identifying critical points in which Serbian law could be further improved. Based on such comparative analysis, the thesis provided a set of recommendations for mitigating the identified weak points of the Serbian law in order to make Serbian legal environment more appealing to much needed financial activities.

However, besides these practice oriented goals, the thesis also provides a theoretical background of the insolvency set-off by situating it within a wider system of financial law and by examining a theoretical justification of insolvency set-off in the light of the competing insolvency law policies. This theoretical focus is especially important for the Serbian legal theory which for some reason has a tradition of treating insolvency law as a merely procedural law discipline which tends to neglect its own philosophical underpinnings. In the context of this theoretical vacuum, it is not a surprise that introducing the insolvency set-off into Serbian law by the new Insolvency Act was mostly ignored by Serbian legal theory. Of course, one may argue that the positive result that this important legal device now exists in Serbian law is more important than the motive or the path that led to it: "no matter if it is a white cat or a black cat; as long as it can catch mice, it is a good cat."[133] However, applying only this kind of wisdom in legislative reforms would be a mistake. Without self-reflectivity, legal rules as well as legal practice are poor and condemned to stagnation. For the emerging markets it is not sufficient just to transplant[134] new and trendy institutes into the reformed legal system. The same savvy that is required for understanding

[133] Unsourced quote of Deng Xiaoping.

[134] Alan Watson, *Legal Transplants: An Approach to Comparative Law* (2nd edn, University of Georgia Press 1993).

modern financial engineering techniques is also needed for their successful application in practice. Without understanding the theoretical and economic rationale of a particular legal device, such device cannot be adequately applied and enforced in legal practice and remains untapped potential, a missed opportunity, or even a dead letter. And there lays the ultimate lesson for Serbian law: mutual understanding of the legal theory and legal practice which has found its most successful unity in English financial law should be the source of inspiration for the ongoing reforms. Such underlying philosophy and the way of thinking have, in the first place, enabled English lawyers to grasp full potentials of the set-off, a traditional and fairly simple legal device that has been around since Roman times, and to turn it into a powerful risk mitigation tool widely used as a prime protection in complex financial transactions.

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