INSOL International

Inter-Company Debts and Set-Off

January 2008

Technical Series Issue No. 4.

Inter-Company Debts and Set-Off

Contents

Acknowledgement	i
1. The base on which inter-company debts can arise	1
2. Insolvency set-off	3
3. Subordination	8
3.1 Statutory Subordination	8
3.2 Structural Subordination	9
3.3 Equitable Subordination	10
3.4 Contractual Subordination	11
4. The challenges for a liquidator	12
5. The challenges for corporate business and finance	13
6. The challenges for governments	14
7. Looking ahead	14
8. Appendix A	16

INSOL International
2-3 Philpot Lane, London EC3M 8AQ, UK
Tel: +44 (0)207 929 6679 Fax: +44 (0)207 929 6678
www.insol.org

Acknowledgement

We are pleased to present the fourth paper under our Technical Papers Series on "Inter-Company Debts and Set-Off."

Conducting business through the formation of corporate groups is a feature of the increasingly globalised world economy as it promotes international trade and commerce. An inevitable consequence however of international trading is that often companies do get into financial difficulties. Where such a business of a corporate group fails, it is important to know how those groups will be treated in insolvency proceedings.

There are significant differences between jurisdictions in the way in which issues relating to corporate groups are addressed. In particular, giving due consideration to the possible repercussions on secured creditors and other stakeholders in the group is paramount. It is equally important to ensure that the insolvency regime prevailing in a country facilitates the effective treatment of claims of both foreign and local creditors in an equitable manner.

This paper discusses how inter company claims are settled by way of set-off in an insolvency situation and presents key arguments for and against set-off. It also covers the subordination of inter-company claims, and highlights some of the challenges for corporate businesses as well as governments when dealing with insolvent companies in a group.

The paper is very well written and presented in a practical context which is most helpful to practitioners in the insolvent field. Our sincere thanks to Alastair Beveridge, Partner, Kroll Limited and Deborah King, Director, Kroll Limited for writing this excellent paper.

Inter-Company Debts and Set-Off

By Alastair Beveridge, Partner, Kroll Limited
Deborah King, Director, Kroll Limited

Today's business world is more complex and global than ever before, with a growing number of companies doing business internationally and finance providers looking outside of their traditional markets to exploit a wider range of opportunities. Global competition is increasing, forcing businesses and governments to ensure that they are strategically positioned to benefit where possible. While for-profit companies seek to maximise value for their shareholders, governments have a wider responsibility to the community they serve. The tensions this can create are aptly demonstrated in circumstances when a company fails where the interests of competing stakeholders, not only shareholders but also creditors and employees, need to be balanced. The legal framework in which a corporate failure is regulated therefore needs to consider how creditors' claims should be treated.

This paper considers some of the issues relevant to dealing with inter-company claims in the event of corporate failure (liquidation) and the approaches adopted by various legislative frameworks, in particular, the availability of set-off and subordination in respect of inter-company claims and cross-claims. It does not consider the particular rules relating to financial institutions.

The bases on which inter-company debts can arise

It would be unusual in a group of trading companies for there to be either no transactions between associated entities or for the payments due to be made under those transactions to be settled immediately. The pace of corporate life, the need to minimise risk, the costs of financing and managing a business, together with a common stakeholder interest all mean that it is often practical for companies within a group to both transact between themselves and defer settlement. There are therefore a number of ways in which inter-company debts arise including:

Trading debts - A trading debt arises each time there is a sale and/or purchase of products and/or services between group companies. A group may derive its competitive edge from having a number of complementary businesses under common control and being able to benefit from retained profits on each transaction or as a result of clever transfer pricing or tax strategies.

Management recharges - Recharges are a mechanism to facilitate the recognition in each group company of services provided by one entity for the benefit of all. These commonly include but are not limited to senior management's remuneration, accounting, research, marketing and central support functions.

Treasury arrangements - A group may operate central treasury arrangements. Each time funds are transferred between an operating company and the treasury company, an inter-company transaction ought to be recorded in the books of each.

Financing debts - Corporate banking has developed in recent years to simplify lending to a group of companies. Rather than require that each company arrange its own facilities, a group facility may reduce risk for the funders (as each business may have a different risk profile) and reduce the overall cost for the borrower (given the increased size of the overall transaction). Commonly, lending is made into one company which (subject to the funder's consent and possibly supported by cross guarantees as discussed further below) is made available to other group companies through inter-company loans, the terms of which also ought to be carefully drafted.

Capital debts - An outstanding inter-company balance can arise where there is unpaid share capital between a parent and its subsidiary. Where a company is limited by guarantee or is unlimited, its shareholders may be liable to make a further contribution to its assets on insolvency. This contingent liability is unlikely to be recognised in the balance sheet of the parent company, but nonetheless could require a cash sum to be paid between two group companies on insolvency.

Rights of contribution - Where a group borrowing facility is in place (such as outlined above in "financing debts") it is common for each group company to provide a cross-guarantee such that each entity (at least ones incorporated in England & Wales) guarantees repayment of the whole borrowing. An inter-company balance may also arise where, having given a guarantee or indemnity in respect of another group company's liability, the guarantor is required to make payment. A good example of this would be where a parent company provides a guarantee to a subsidiary company's landlord. Where payment is made on behalf of the other company, a claim between the two arises.

Statute – Sales tax (VAT in the UK) groups are common as these not only reduce the administrative burden associated with accounting for the tax, but may also improve working capital. As there can be joint and several liability between members of a tax group, on the insolvency of one company, the payments of its share of the liability by other group companies will lead to an inter-company claim.

Capital replacement debts - An unprofitable subsidiary may require cash either because it is unable to meet its debts as they fall due, or in order to ensure that the balance sheet conforms to statutory requirements (e.g. not insolvent). Cash can be advanced by a parent company either as a loan or by way of increased equity. In certain European countries, where liquidity is improved by way of a loan that would not have been made by a third party lender, the inter-company creditor which arises is either considered to be, or is in law, subordinated to other unsecured claims in the event of insolvency.

As illustrated in this brief summary, there are a number of ways in which inter-company balances can arise and while the group continues as a going concern for the benefit of the ultimate shareholder(s) the status of each of these is of little concern outside of general liquidity, capital maintenance, accounting issues and directors' concerns to ensure their duties are met in respect of individual companies. However, on the insolvency of one entity within a group, or as the zone of insolvency is approached, inter-company balances are subject to further scrutiny mainly due to the need to identify and separate an insolvent company's assets and liabilities. Further, it should not be assumed that just because there are credit and debit balances between two companies that they are capable of being set-off, in whole or in part.

Given this introductory back-drop we outline below a number of key issues in relation to inter-company claims following insolvency.

Insolvency set-off

An understanding of the key arguments for and against set-off (in insolvency) is helpful to appreciate the basis from which alternative treatments are derived.

In favour of set-off is the primary argument that to not allow set-off would be unfair to an individual creditor: it would be unjust for one party to have to perform fully but potentially receive nothing in return and it would be inequitable for one party to have to make payment in full, but potentially receive no corresponding payment or only part-payment through dividend. It also prevents circuitous flows of cash (particularly where both claimants are insolvent and paying dividends). This treatment accommodates the point that the right to set-off may well have existed between the parties prior to the insolvency of either one of them and to disallow set-off would be to deprive the other party of a right to which he would have otherwise been entitled to exercise in the normal course of business. This emphasis on fairness towards the individual is a feature of many common law systems such as in England, Australia, Canada, Hong Kong, India and Bermuda.

Against this, is the position that the effect of set-off is to prefer one creditor over the general body of creditors as a whole. As such, it is a breach of the *pari passu* principle which requires that all creditors should be treated equally; in fact, allowing set-off could be considered tantamount to a preference of one creditor over another, as it would allow assets, which would otherwise have been made available for all creditors, to be depleted. This approach with a stronger emphasis on equality between all creditors is a feature of many civil law systems including Belgium, Luxembourg, Spain, Brazil, Argentina and Colombia.

Set against this background, is a need to give consideration to the practical impact that a policy choice may have on trade and an enterprise's ability to raise finance. At one end of the policy spectrum lies full set-off and, at the other, no set-off. In practice, neither of these may offer the optimal approach, with many jurisdictions opting to allow insolvency set-off subject to certain limitations or conditions. Restrictions on the availability of set-off in insolvency generally concern **the need for mutuality**, **measurability of claims**, **timing** and the **mechanism used to effect it**. Here, we explore the impact that each of these restrictions in various legal frameworks can have on the availability of set-off in relation to inter-company balances.

Restriction 1 : Type of claims available for set-off

A common theme amongst legal frameworks is a requirement of *mutuality*. In general, mutuality requires that the claims concerned are between the same parties and in the same right; it does not usually require that the claims be connected (i.e. arise under one contract) nor that the claims are similar. The principle of mutuality means that it should not be permitted for one person to use the property of another to pay his own debt. For example, a bank could not set-off a loan made to a parent company against a deposit held on behalf of a subsidiary company (unless specifically otherwise agreed).

However there are a number of common limitations across legal frameworks:

Capital debts - Mutuality is likely to exclude set-off between general claims and capital debts. For example, under English law an amount owed to a person in his capacity as a director cannot be set-off against any amounts owed by him in his capacity as a shareholder[1]. This ensures that third party creditors can rely on the stated share capital of a company being available to them, even if it is as yet uncalled or unpaid.

Claims for delinquencies - Claims made by the office holder for delinquencies such as wrongful or fraudulent trading are generally not available for set-off, on the basis that funds received are for the benefit of the whole estate.

Recovery of property - Recovery of property to an insolvent company, such as in relation to transaction at an undervalue or a preference of a creditor, are generally unavailable for set-off on the basis that the payment seeks to redress a breach of the *pari passu* principle.

Cash balances - Some jurisdictions did not until recently allow set-off of cash held in different currencies. This has become less of an issue following the EU Regulation on the Introduction of the Euro (No 974/1998), as a result of which former national currencies are regarded as sub-units of the Euro. However, outside the EU this can sometimes be an issue.

Differing priorities - Mutuality does not necessarily exclude set-off between preferential and unsecured obligations, nor between subordinated and unsubordinated claims. However, where there is set-off between claims of differing statutory priority, care must be taken to ensure a fair approach and to balance the interests of creditors as whole. For instance, should a creditor set-off an unsecured balance owed to him first against his preferential claim or against his unsecured claim or *pro-rata*?

Restriction 2 : Requirement for claims to be measurable

For set-off to have effect, all parties need to be clear as to the amounts that are to be set-off and for them to be defined in monetary terms. The ability to quantify a claim can be difficult where its quantum remains to be determined by the outcome of a particular (future) course of action, or because the debt is not payable until a future date.

Contingent claims are those which are dependent on the outcome of a particular course of action. In a group situation, a parent company may have a contingent claim against an insolvent subsidiary where, for example, it has provided a rent guarantee on the subsidiary's behalf, or has provided an indemnity. This is an area where there are a broad range of approaches. The insolvency laws of France, India and Luxembourg require that both claim and cross-claim are liquid before set-off can be effected. The Italian approach requires both claims to be easily assessable (or be made liquid

[1] Re Overend Guerney, Grissell's case (1864); Re Pinecord Limited [1995]

promptly). In English law, contingent and unliquidated liabilities can be estimated (as provision is made for the purposes of paying a dividend). German law is more relaxed on this point and does not require liquidity of claims.

Where an amount is not due and payable today, to effectively bring forward settlement by the exercise of set-off could be argued to favour the beneficiary. One method of mitigating this is to adjust the value of the claim to reflect the time value of money, an option which is available in some jurisdictions.

Restriction 3 : Point at which claims are to be measured

The point at which claims are to be measured for the purposes of set-off may be important for two reasons: firstly, where set-off is automatic the timing must be defined and known; secondly, if set-off were allowed across the barrier of the date of the commencement of proceedings, it would be difficult for a business to continue to trade post-insolvency without risking the loss of income due post commencement which could ultimately have the effect of damaging a “rescue culture” and breach the *pari passu* principle. For these reasons, most legislative frameworks provide for an account of claims and cross-claims to be taken as at the date of the opening of proceedings.

There is therefore an opportunity for a group to “optimise” its inter-company balances by assigning balances to minimise the impact on the wider group. Recognising this, the Italian Civil Code seeks to protect the insolvent estate and its general body of creditors by excluding the availability of set-off where a credit balance is acquired from another creditor in the year preceding the opening of proceedings. This prevents a debtor of an insolvent company from acquiring credit balances from a third party (perhaps by assignment) to avoid making payment to an insolvent estate. Similarly, Austrian law excludes set-off where claims were acquired in the six months prior to the opening of proceedings where the creditor knew that the debtor was insolvent.

Restriction 4 : Point at which set-off is to be effected

Once the point at which claims are to be measured has been established the time at which the operation of set-off is effective may vary. If set-off operates automatically (as in English law) the effective timing is defined and known. Alternative approaches include those of Germany and Italy where a unilateral declaration is required to assert set-off and, once completed, its effect may be retrospective which are in contrast to that of Sweden where set-off, once claimed, has an immediate (rather than retrospective) effect.

There are clearly a range of approaches taken but where policy states or suggests that set-off could not be agreed and available, the lack of certainty may have a negative impact on the willingness of funders (both externally and inter-company) to make funds available as this risk becomes harder to measure and control.

With so many considerations it is not surprising that there are a number of different approaches across the international community. The UNCITRAL Legislative Guide to Insolvency Law recommends that "…insolvency law should protect a general right of set-off existing under law other than the insolvency law that arose prior to the commencement of insolvency proceedings, subject to the application of avoidance provisions"[2]. This allows flexibility as to the types of obligations that are capable of set-off, but it is emphasised that a clear definition is critical in order to provide the required level of commercial predictability and thereby enhance the availability of credit.

The Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings (**EC Regulation**) is applicable to all EU Member States except Denmark. Article 4(2) states that the law of the state opening proceedings shall determine the conditions for the opening of proceedings, their conduct and closure. This includes the conditions under which set-off may be invoked. Article 6(1) states that: "The opening of insolvency proceedings shall not affect the rights of creditors to demand the set-off of their claims against the claims of the debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim"[3]. This represents one of the general exceptions to Article 4, and protects a party's legitimate expectations as to its rights and obligations associated with transactions made in other Member States, while also preventing interference with rules governing local market transactions.

For example, consider a company with its centre of main interests (**COMI**) in Spain with borrowings from an English company clearing bank which are governed by English law. The starting point is that the conditions for set-off in the company's main Spanish insolvency proceedings should be as provided under Spanish law. In addition, there is the added protection under Article 6 which allows set-off "as permitted by the law applicable to the insolvent debtor's claim", in this example, English law. In England, the bank should be able to exercise any contractual or common law rights of set-off it has against any deposits held by the company with the bank in England.

It is worth noting that the applicable law under Article 6 may relate to parties who are outside of the EU. From a lender's perspective, it may make good commercial sense to have a lending agreement subject to a law which permits wide rights of set-off, and this also highlights the need to fully understand the relevant local provisions as regards set-off when making the lending decision.

[2] UNCITRAL Legislative Guide on Insolvency Law, Recommendation 100
[3] Article 5(1) of the Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings

Subordination

In a formal insolvency, the subordination of an inter-company claim renders the wider group at a disadvantage compared to third party creditors. Subordination may be statutory, structural, contractual, or equitable.

Statutory subordination

One form of statutory subordination is common throughout most jurisdictions and that is where unsecured creditors rank behind defined categories of other unsecured creditors who are given preferential, priority or privileged status. This is often done in an attempt to either recognise a superior ethical claim or to benefit the state. As a result, creditors given preferential status are commonly those whose claims arise under contracts of employment or state tax agencies. The breadth of claims given such priority status varies greatly internationally and in some jurisdictions, such as Brazil, can significantly increase the risk that unsecured inter-company claims would have little opportunity to receive a return from the estate. It is interesting to note however that the present German insolvency legislation[4] has removed all privileged or preferential claims.

A second form of statutory subordination is used in some jurisdictions to give priority to the claims of third party creditors over certain types of inter-company creditor balances. In Italy, Germany, Austria, Spain and Portugal, certain inter-company balances are considered to be subordinated on the grounds that they are capital replacement debts. This approach is favoured in these jurisdictions as it is perceived that such rules safeguard the interests of creditors in the case where a company has continued to trade, with group support, despite being in a financial crisis (including being insolvent or under-capitalised). Such claims may arise where, for example, a parent company provides a subsidiary with a loan which, given the perilous financial position of the subsidiary company, could be considered to be quasi-equity. Logically, a parent company would only provide financial support to a subsidiary where there is acceptable economic reward for the parent – and therefore the associated risk ought perhaps to belong to the parent and not be shared with the general body of creditors.

The nature of what is considered to comprise a statutory subordinated claim varies across those jurisdictions that recognise this class of creditor but they are commonly understood to be such claims that rank behind general unsecured creditors and are either not provable or would not receive a dividend until prior ranking creditors had been paid in full.

[4] Insolvenzordnung-InsO, 1995. Came into force 1 January 1999.

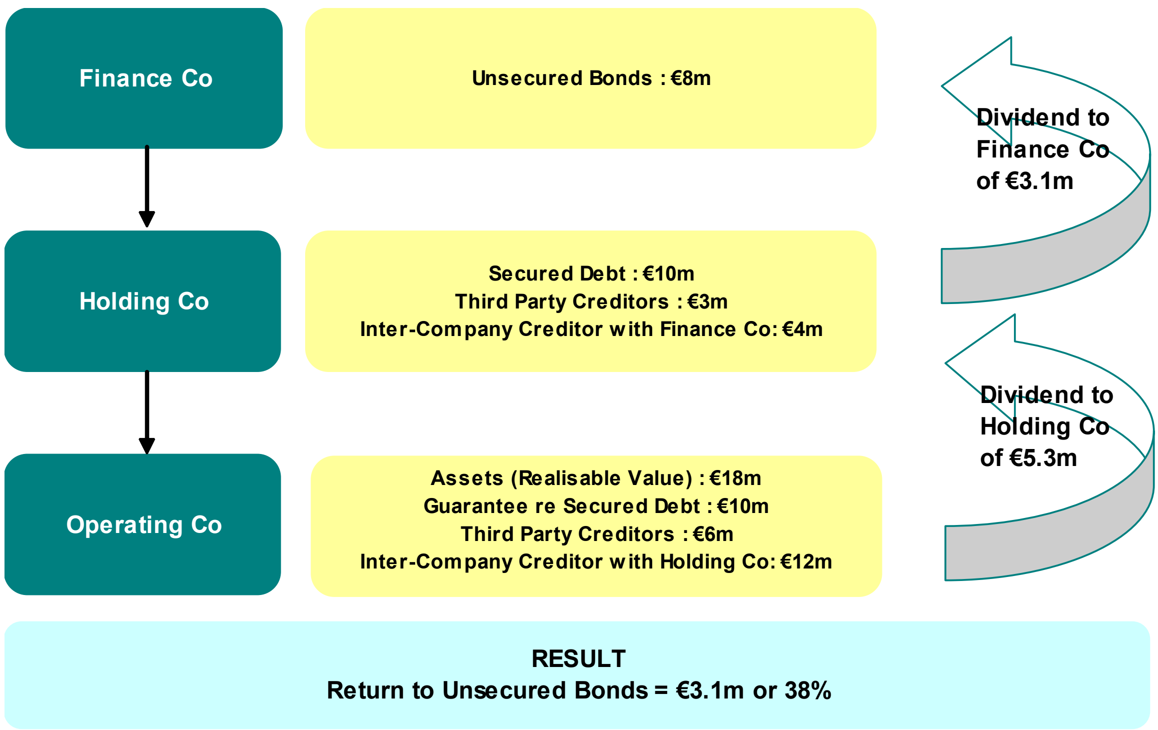
Having identified that such claims are subordinated, German and Austrian legislation does not allow them to be set-off against any unsubordinated debts as this would effectively be a repayment of an equitably subordinated loan, while Italian and Spanish legislation does not prevent this approach.

Structural subordination

Structural subordination arises as a result of a creditor's position within a group's wider structure. For example, where a financing vehicle has been set up, which then on-lends to operating or asset owning subsidiaries, a creditor could have an additional barrier to deal with before they were able to access the very assets that the borrowing was used to acquire. In such circumstances the claim would rank *pari passu* with other claims in the funding vehicle but may have to compete with a variety of other claimants throughout the group.

To illustrate this, consider the following group structure:

Example 1 (a)[5]

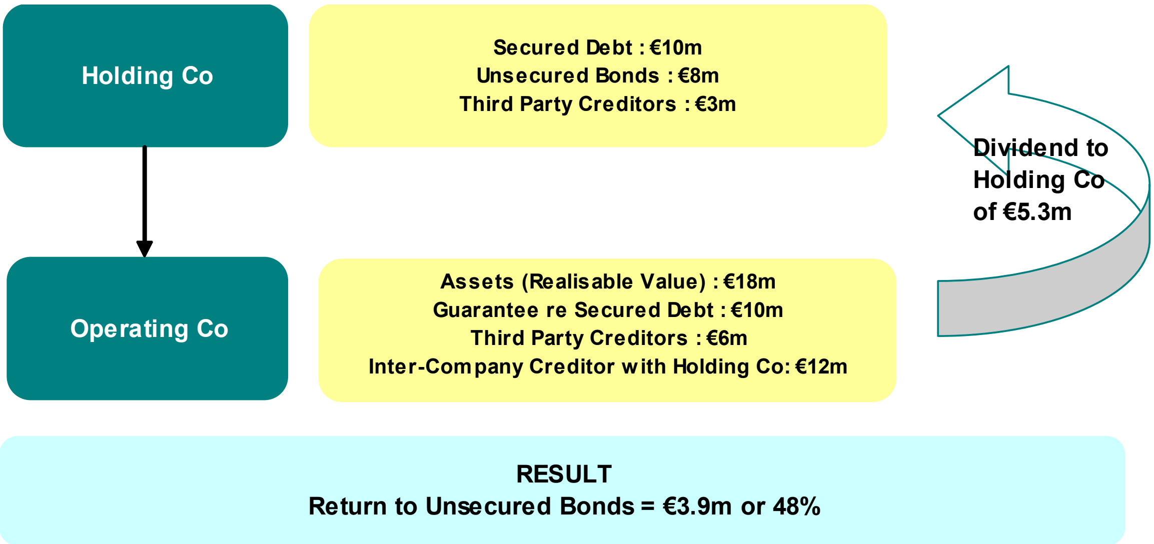


Here, the bond holders have made funds available to the group through the ultimate parent company (Finance Co). In the event of the group's formal insolvency, the bond holders only access to assets would be through Finance Co's inter-company claim against Holding Co (and any equity interest in

[5] Calculations are included in Appendix A

Holding Co). On the facts of this example, the bond holders would be likely to recover only 38% of their lending.

Example 1 (b)[6]



However, if the bond holders had lent into Holding Co alongside the secured creditors (as summarised above), they would have had access to assets alongside the third party creditors in Holding Co. On the facts of this example, the bond holders would be likely to recover an extra 10% of their lending.

Equitable subordination

Equitable subordination seeks to redress an imbalance with the aim of fairness among the parties. There has been an acceptance of equitable subordination in the United States since the 1930's. In the decision in Benjamin v Diamond (Re Mobile Steel)[7] the Court set out three conditions to be fulfilled before ordering subordination: (1) inequitable conduct of the creditor which (2) resulted in unfair advantage and (3) to make an order would not be inconsistent with the terms of bankruptcy legislation (i.e. would be an abuse of process). The United States Court has ordered[8] equitable subordination of inter-company lending where a parent company's loan was recharacterised as equity, partly as a result of under-capitalisation of the subsidiary and the mismanagement of the subsidiary by the parent company.

[6] Calculations are included in Appendix A
[7] Benjamin v Diamond (Re Mobile Steel) [1997] 563 F 2d 692
[8] Taylor v Standard Gas and Electric Co [1969] 306 US 307

Contractual subordination

Contractual subordination arises by agreement between the parties. There may be mechanisms within the agreement to protect the rights of each party such as the senior creditor requiring the junior creditor to prove and pay over to it any proceeds of distribution, or to prevent the junior creditor proving until the senior creditor has been repaid in full. Contractual subordination seeks to improve a lender's position on insolvency, and is most often used by a third party lender who requires priority over inter-company claims.

Set out below is an example to demonstrate the impact of contractual subordination. In the example, we show the outcome without contractual subordination but also where inter-company claims have been subordinated to those of the unsecured bond holders. Whether the subordination requires the inter-company creditors to "prove and pay", (that is, prove for their claim in the estate but pay over any dividends received to the unsecured bond holders) or to refrain from proving until the bond holders are repaid in full, in both cases, the subordination significantly improves the return to the bondholders.

Example 2

€000's	X Co
Net Realisations	3,000
Unsecured Creditors: Bonds	(2,000)
Unsecured Creditors: Third Party	(3,000)
Unsecured Creditors: Inter-Company	(1,000)

Return to Creditors	No Contractual Subordination		Contractual Subordination: *Prove and Pay Over*		Contractual Subordination: *Not Prove Until Repaid*	
Bonds	1,000	*50%*	1,500	*75%*	1,200	*60%*
Third Party	1,500		1,500		1,800	
Inter-Company	500		-		-	
	3,000		**3,000**		**3,000**	

In England, it was recently held that a group may subordinate inter-company claims behind those of a third party lender, and that to do so was not in breach of the pari-passu principle[9]. Before agreeing to the sub-ordination of inter-company claims, the wider group would need to be satisfied that the increased risk of probably not receiving payment in full on formal insolvency was merited given the advantages that the financing generated.

[9] SSSL Realisations (2002) Limited [2006] EWCA Civ 7

All subordination is a breach of the pari-passu principle in its broadest sense. This may be less of a problem for a group where all entities have knowingly agreed to subordinate any inter-company debts to another creditor, or where the local law includes provision for subordination; in these cases a group is aware of the risk of a shortfall in the event of the formal insolvency of one of their number. More difficult is where subordination is not mandatory but may be effected by a decision of the liquidator or Court, as the outcome will not be known with any certainty at the time that the balances arise; this lack of predictability continues to cause friction in many cross-border insolvency matters.

The EC Regulation[10] provides for the rules governing the distribution of assets and the ranking of claims to be determined by the law of the state of the opening of proceedings (main or secondary). For an international group of companies, this means that the applicable jurisdiction may not necessarily be that applicable to the place of a company's incorporation. When assessing the potential recoverability of a debt, consideration should be given to the laws applicable to the countries where group companies are incorporated or where they could otherwise have their centre of main interests or an establishment. This clearly provides further potential for forum shopping in the zone of insolvency, something which the EC Regulation was meant to prevent.

The challenges for a liquidator

A liquidator's duties include an obligation to realise a company's assets and distribute the net realisations amongst its creditors. This broad description opens a liquidator to a number of challenges.

Firstly, when recovering and realising assets, a liquidator may be asked to form a view as to how a valid claim for set-off should practically operate. For example, where there is set-off between claims of differing statutory priority, care has to be taken to ensure a fair approach - should a creditor set-off an unsecured balance owed to him first against his preferential claim or against his unsecured claim or pro-rata? Each option has its merits and where there is a material claim, if consensual agreement cannot be reached, a liquidator (or other Court appointed practitioner) may consider that seeking directions from the Court or the views of any applicable committee(s). A similar issue may arise in relation to subordinated and unsubordinated claims.

Secondly, in a cross-border insolvency, a liquidator may need to manage differing and sometimes competing expectations as to the approach that is to be taken as regards the priority of claims. Consider a company with a COMI in England and an establishment in Italy: following the opening of

[10] Article 4 of Council Regulation (EC) No 1346/2000 of 29 May 2000 on Insolvency Proceedings

proceedings in England, under the EC Regulation the claims of creditors should rank according to English law. Italian creditors may feel that such an approach would be prejudicial to their position on the basis that they could expect a better return if secondary proceedings were opened as certain material inter-company debts would be subordinated to their, more local, claims. The liquidator in the main proceedings may well wish to avoid secondary proceedings on the basis that to do so would be unlikely to enhance overall net realisations. A similar situation was experienced by the administrators of the Collins and Aikman group. Recognising the key issues, the sanction of the English Court was sought (and received) to apply the local rules of creditor priority rather than those of England. This approach offered a practical solution to the problem of differing priorities across ten European jurisdictions.

Lastly, in the liquidation of a group of companies, one party may act as liquidator of all group companies in the interests of efficiency. However, when adjudicating on inter-company claims this approach can present difficulties, particularly if claims are contingent or estimated and an element of discretion is required. In circumstances where the parties have entrenched and differing views, a liquidator may consider requesting an opinion from a third party.

The challenges for corporate businesses and finance

"Financial market participants and regulators consider it essential to have a high degree of certainty on the enforceability of contractual set-off…ensuring legal certainty… would make transactions and the legitimate expectations of parties more certain in an area where any doubt creates a severe risk of systemic damage and impaired market efficiency"[11].

By allowing set-off and/or providing for the subordination of certain inter-company claims, one might hope that finance providers would consider that the risks of lending could be reduced, thereby enhancing the availability of finance and credit facilities and, in doing so, encourage trade and commerce. While it is clearly not a form of security, knowing that a right of set-off exists and has a predictable outcome should give confidence to any creditor (who is also a debtor) that the overall risk can be mitigated.

But what can a group of companies do to manage the risk that is associated with inter-company balances?

[11] Protection for Bilateral Insolvency Set-Off and Netting Agreements Under EC Law, European Financial Markets Lawyers Group

In the first instance, directors and their advisors need to be aware of the wide range of approaches to set-off and subordination that exist around the globe. It may well be possible to choose a jurisdiction for contracts (including those in respect of debt finance) that maximises the availability of set-off.

Appropriate treasury arrangements could enhance the outcome for a group on insolvency. Cash balances can either be held centrally with corresponding inter-company balances or, alternatively, cash can be held by each entity but subject to set-off by the lender; the most appropriate approach will depend on the particular circumstances. In addition, outstanding balances could be net-off against each other regularly to ensure that large gross claims would not exist in the event of a formal insolvency. Further, where there are balances across companies within a group, consideration could be given to the assignment of claims (for value) to reduce the number of net balances outstanding (although advice should be sought regarding the risk of such transactions being set aside in the event of insolvency). Companies within a group could also consider remedies more often used by third parties such as insurance, retention of title clauses and security in order to reduce the risk of non-payment. As in all financial matters it is important that companies have clear records and detailed back-up documentation so that getting claims agreed, where insolvency occurs, is straightforward as opposed to being the subject of litigation.

The challenges for governments

There is continued discussion within the international community about forum shopping: both in terms of the basis on which money is lent and the choices that are made when seeking to recover lending following insolvency. There is no doubt that businesses will continue to seek to gain a competitive advantage and that one of the considerations will be the ease with which they can obtain reasonable and appropriate finance. One of the aims of government is to encourage economic growth and to boost employment. To do this, governments' recognise the need to provide a predictable and practical regulatory environment for lenders and corporates. Different countries have very different views as to the best way to achieve economic growth and this is therefore set to be an issue for years to come.

Looking ahead

One aspect of this area is currently being taken forward by the UNCITRAL Working Group V (Insolvency Law) which continues its work to consider the treatment of groups in corporate insolvency. Indeed, the Working Group has recently drafted a glossary of terms as the first step towards some more substantive guidance for legislators and practitioners. The issues are complex, not least because they need to consider differing approaches in a number of jurisdictions but also the separate entity principle and any resulting proposals will no doubt take time to be put into effect. Those practising in the insolvency arena have long recognised that there are many practical as well as legal issues that arise when dealing with groups of companies and the attention being brought to bear on this area is very welcome.

Appendix A

The calculations supporting the outcomes described in Example 1 (a) are:

€000's	Operating Co	Holding Co	Finance Co
Net Realisations	18,000	5,333	3,048
Less: Secured Creditor	10,000	0	0
Available to Unsecured Creditors	**8,000**	**5,333**	**3,048**
Unsecured Creditors : Bonds	0	0	8,000
Unsecured Creditors : Third party Creditors	6,000	3,000	0
Unsecured Creditors : Inter-Company Creditors	12,000	4,000	0
	18,000	**7,000**	**8,000**
Dividend Rate	**44%**	**76%**	**38%**
Return to Bonds			**3,048**

The calculations supporting the outcomes described in Example 1 (b) are:

€000's	Operating Co	Holding Co
Net Realisations	18,000	5,333
Less: Secured Creditor	10,000	0
Available to Unsecured Creditors	**8,000**	**5,333**
Unsecured Creditors : Bonds	0	8,000
Unsecured Creditors : Third party Creditors	6,000	3,000
Unsecured Creditors : Inter-Company Creditors	12,000	0
	18,000	**11,000**
Dividend Rate	**44%**	**48%**
Return to Bonds		**3,879**