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THE RIGHT OF SET-OFF IN INSOLVENCY PROCEEDINGS

The right to set off a claim is a legal concept through which reciprocal claims between a creditor and a debtor company are settled against each other reducing or extinguishing the smaller claim and leaving only a balance outstanding. A right of set- off may constitute a self-help remedy upon which a creditor can rely without the assistance of the Courts. In an insolvency situation, a right of set-off can be crucial as it may improve a creditor's overall financial position in relation to the debtor company.

GERMAN INSOLVENCY LAW

According to German insolvency law, the creditor's right of set-off survives the insolvency of the debtor, if at the time of the opening of insolvency proceedings the creditor was entitled to a set-off by law or by virtue of an agreement. Thus, if the right of set-off already exists at the time of the opening of insolvency proceeding then this right is insolvency-proof (*insolvenzfest*). This does, however, not apply, if the right of set-off was acquired after the opening of insolvency proceedings or if it was obtained by an avoidable transaction (see further below). The right of set-off is an exemption from the general principle within German insolvency law, according to which creditors shall be treated equally (*Grundsatz der Gläubigergleichbehandlung, par conditio creditorum, the pari passu* principle). This is because a creditor with the benefit of a right of set-off may have its claim satisfied up to the amount of the debtor's claim – depending on the amount of its own claim. In the absence of a set-off, the creditor would have to fulfill the principal claim of the debtor, while with its own claim, it would simply participate in the insolvency proceedings and merely obtain an insolvency dividend, if any.

I. PREREQUISITES FOR A SET-OFF IN INSOLVENCY PROCEEDINGS

In case of a set-off, the claims of the creditor and the debtor must be reciprocal and of the same kind.

The creditor's claim has to be validly existing and due and payable (that is, maturity is required and a creditor's future claim cannot be the subject of a set-off). There must be no pleas that pose an obstacle to the claim. However, if the off-settable claim of the creditor is time-barred, a set-off is still possible if the right of set-off already existed prior to the end of the limitation period.

The claim of the insolvent debtor, against which the creditor wishes to exercise a right of set-off, must validly exist and be attainable. However, maturity is not required.

II. PROHIBITION ON SET-OFF

Statutory prohibitions to set-off continue to exist during insolvency proceedings. For instance, a set-off is not possible against claims arising from willful tort, unseizable claims or against claims which can be properly contested.

One of the most important prohibitions to set-off under German corporate law is the prohibition on a shareholder exercising a right of set-off against the contribution claim of the limited liability company (*Gesellschaft mit beschränkter Haftung*). As such, it is also the case that a shareholder's claim against a limited liability company cannot be set off against that company's claim for repayment pursuant to the capital maintenance rules under the Limited Liability Companies Act (*GmbHG*).

In order to protect the principle of the equal treatment of creditors (the *pari passu* principle), the German Insolvency Code contains several provisions which invalidate set-off during insolvency proceedings. These statutory provisions may not be waived by an agreement between the parties.

1. EMERGENCE OF THE CLAIM OF THE INSOLVENCY CREDITOR AFTER THE OPENING OF PROCEEDINGS

A creditor's claim which comes into existence only after the opening of insolvency proceedings cannot be the subject of set-off. This ground is of particular importance in connection with current account agreements (*Kontokorrentabreden*). Pursuant to the German Insolvency Code, current account agreements expire on the date upon which the insolvency proceedings are opened. If, after opening of insolvency proceedings, payments of third parties are credited to an account standing to the debit, the bank is no longer entitled to set off against such payments the claims of the bank arising from the current account.

2. GAIN OF POSITION AS A CREDITOR AFTER THE OPENING OF PROCEEDINGS

A debt which has been acquired by a creditor from another creditor by a legal act (e.g., by an assignment) following the opening of the insolvency proceedings cannot be subject to a set-off. This is to prevent the plundering of the insolvency estate by the collusive acquisition of liabilities.

3. SET-OFF THROUGH AVOIDABLE TRANSACTION

If the right of set-off already exists as at the date of the opening of insolvency proceedings but arose pursuant to an avoidable transaction, the set-off is inadmissible. In this case, the invalidity of the set-off arises automatically by operation of law (for detailed information on avoidance rights in insolvency proceedings, see White Paper: German Insolvency Law – Overview on Insolvency Challenge Rights).

4. SET-OFF AGAINST CLAIMS TO BE FULFILLED OUT OF THE INSOLVENCY-FREE ASSETS

Finally, a claim of the insolvency estate (*Insolvenzmasse*) may not be set off against a claim of the creditor which is to be fulfilled out of the debtor's insolvency-free assets.

III. SET-OFF AGREEMENT

According to German insolvency law, a set-off is not only possible where statutory law provides for it, but also on the basis of a contractual agreement. This is, however, subject to limitations, such as that the mutual claims have to be effective and that no statutory prohibitions on set-off exist. Such agreements can be entered into until the insolvency proceeding has been opened (but it should be noted that the conclusion of such an agreement may under certain circumstances be subject to avoidance rights of the insolvency administrator). The content of a set-off agreement can provide for the set-off to take effect immediately, i.e. that the set-off may take place without the statutory prerequisites having been fulfilled, that the set-off of future claims shall be possible or that the requirements for a set-off are extended as compared to statutory law.

A subcategory of set-off agreements are those which provide for set-off within a group of companies (*Konzernverrechungsklausel*). By using such clause, the parties eliminate the requirement of reciprocity by agreeing that a group company shall be able to set off against claims of the business partner the claims of other affiliated companies against the same business partner. However, according to the German Federal Court of Justice (*Bundesgerichtshof*) group-set-off-clauses are not insolvency-proof. This inadmissibility results from the fact that a set-off situation does not arise until the two claims have become off-settable against each other. In the case of a group-set-off, where it is the group company which wishes to rely on set-off, this is only determinable at the point in time when the set-off is actually declared. Hence, if the declaration is made after the date of the opening of the insolvency proceeding, the declared set-off is invalid. However, if the declaration is made before the date of the opening of the insolvency proceedings, the declared set-off is valid, unless the set-off can be challenged on other grounds.

IV. EFFECT OF THE SET-OFF

The set-off has to be declared vis-à-vis the insolvency administrator. The declaration extinguishes the reciprocal claims as far as they coincide. There is no need for the creditor to file the off-settable claim with the insolvency schedule (*Insolvenztabelle*). However, any such filing does not cause a waiver of a possible set-off. A potential residual claim existing after the set-off can still be filed with the insolvency schedule.

V. EMERGENCE OF THE RIGHT OF SET-OFF AFTER OPENING OF INSOLVENCY PROCEEDINGS

If at the time the insolvency proceedings are opened, the claims cannot yet be set off (for example because one claim is still subject to a condition precedent, the creditor's claim is not yet due or the claims do not cover the same kind of performance) then a set-off cannot be effected prior to the prerequisites having been met. This provision protects the creditor's legitimate expectation on a subsequent set-off situation. However, a set-off will not be possible if the creditor's claim becomes due after the claim of the debtor.

VI. CROSS-BORDER CONTEXT

In insolvency proceedings with a cross-border context regulations of international insolvency laws have to be considered. According to the principles of the German international insolvency law, the laws of the state in which the proceedings have been opened (*lex fori concursus*) determines the admissibility of a set-off in insolvency proceedings. If a set-off is permissible under the laws of the state opening the proceedings then the regulations of this state apply. In cases in which the *lex fori concursus* leads to a limitation or prohibition of the right to set off a claim, the German international insolvency law nevertheless permits a set-off, provided, however, that a set-off situation exists pursuant to the laws applicable to the claim of the debtor and the set-off would be permissible in the insolvency of the debtor.

A similar regulation exists in Regulation (EU) 2015/848 of the European Parliament and of the Council on insolvency proceedings (the "recast Insolvency Regulation"). The regulation permits a set-off, regardless of the *lex fori concursus*, in all those cases where according to the national laws of the principal claim (*lex causae*), a set-off was admissible before the opening of insolvency proceedings.

ENGLISH INSOLVENCY LAW

A form of statutory set-off (known as „insolvency set-off") applies in a liquidation and, in certain circumstances, in an administration. As explained below, insolvency set-off is compulsory and self-executing. In general terms, if it is engaged, it displaces other forms of set-off which are inconsistent with it.

However, if insolvency set-off is not engaged in the insolvency proceedings (for instance, as mentioned below, in a non-distributing administration), it is possible that other forms of set-off (such as contractual set-off) may remain available notwithstanding the existence of insolvency proceedings.

I. INSOLVENCY SET-OFF

Insolvency set-off is a statutory set-off which is compulsory and, as such, parties cannot contract out of it. Subject to the conditions outlined below, insolvency set-off applies automatically in a liquidation (or winding up) as well as in an administration if the administrators give notice of their intention to make a distribution to creditors (the „Administrators' Notice").

In each case, an account must be taken of what is „due" from the debtor company and the creditor to each other in respect of their „mutual dealings". The sums due from the one must be set off against the sums due from the other, so that only the balance may be claimed by the liquidator/ administrator (as and when it becomes due and payable) or proved for by the creditor in the liquidation or administration.

A form of insolvency set-off also applies in a standalone moratorium. However, it only applies for the purpose of valuing creditor claims for voting purposes as distributions to creditors are not made in a standalone moratorium.

1. MUTUAL DEALINGS

"Mutual dealings" means mutual credits, mutual debts and other mutual dealings between the company and the creditor.

In the case of administration, mutual dealings do not include either debts arising out of an obligation incurred or debts acquired by the creditor by assignment or otherwise, in each case:

- when the creditor was on notice of a pending administration;
- after the company entered administration; or
- where a winding up immediately preceded the administration, when the creditor was on notice of the pending winding up or while the winding up was in progress.

In the case of liquidation, mutual dealings do not include either debts arising out of an obligation incurred or debts acquired by the creditor by assignment or otherwise, in each case:

- when the creditor was on notice of a pending liquidation;
- after the company entered liquidation; or
- where an administration immediately preceded the liquidation, when the creditor was on notice of the pending administration or while the administration was in progress.

Whilst mutuality does not require that the claims are connected, the claims must be between the same parties (i.e., the company and the creditor) and they must be held in the same capacity, right or interest. The claims must be monetary claims, rather than proprietary claims.

2. DATE AT WHICH ACCOUNT IS TAKEN

In a liquidation, set-off is automatic and applies as at the date on which the liquidation commences. In an administration, the account for the purposes of calculating the set-off is taken as at the date of the Administrators' Notice.

3. SUMS WHICH ARE „DUE" FOR THE PURPOSES OF INSOLVENCY SET-OFF

For the purposes of insolvency set-off, a sum is treated as being „due" to or from the company irrespective of whether: it is payable at present or in the future; the obligation by virtue of which it is payable is certain or contingent; or its amount is fixed or liquidated or is capable of being ascertained.

Where an obligation does not have a certain value (for instance, as it is subject to a contingency), its value is estimated by the liquidator or administrator. Where a sum due to/from the company is payable in the future, it is discounted to take into account accelerated receipt.

The claim by the creditor must be one which is provable in the insolvency proceedings (at the date the liquidation commences or the date of the Administrators' Notice, as applicable). For instance, it cannot be statute barred.

II. AVAILABILITY OF OTHER FORMS OF SET-OFF IN INSOLVENCY PROCEEDINGS

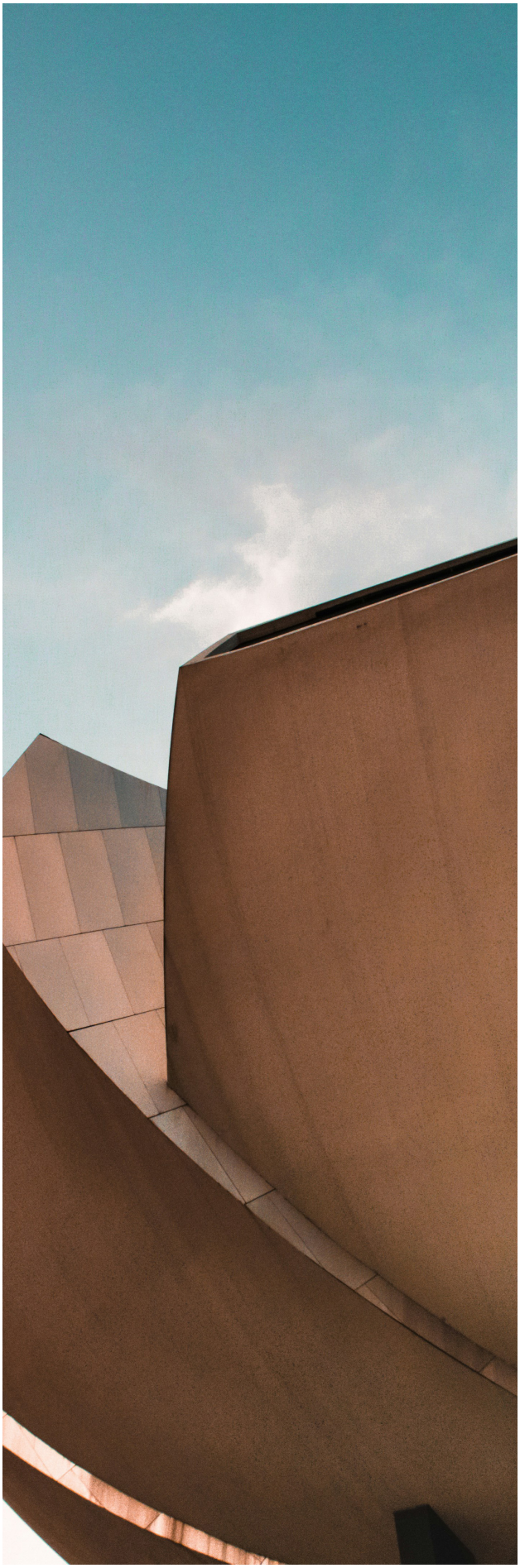
As noted above, in general terms, if insolvency set-off is engaged, it displaces other forms of set-off which are inconsistent with it.

If insolvency set-off is not engaged within the insolvency proceedings, it is possible that other forms of set-off (such as contractual set-off) may remain available notwithstanding the existence of insolvency proceedings but subject potentially to limitations.

For instance, where a set-off is created by contract, the validity of that set-off may be subject to a number of limitations:

- a contractual set off may be impugned if it constitutes (i) a preference, (ii) a transaction at an undervalue or (iii) a transaction defrauding creditors or (iv) if it constitutes a disposition of the company's property after the commencement of its winding up.
- a contractual set off may be inconsistent with the rule in British Eagle (*British Eagle International Airlines Ltd v Cie Nationale Air France* [1975] 1 WLR 758), which is a common law rule that renders invalid an arrangement for the distribution of the assets of an insolvent estate otherwise than in accordance with the pari passu distribution regime under English insolvency law.

Endnote: The concept of "netting" (as distinct from set-off), including the statutory protection of close-out netting under Directive 2002/47/EC on financial collateral arrangements, falls outside the scope of this note.



TALK TO US

GERMANY

PARTNER
DR. MARCO WILHELM
+49 69 7941 2731
MWILHELM@MAYERBROWN.COM

COUNSEL
DR. MALTE RICHTER
+49 69 7941 2533
MRICHTER@MAYERBROWN.COM

COUNSEL
TINA HOFFMANN
+49 69 7941 1281
THOFFMANN@MAYERBROWN.COM

ENGLAND AND WALES

PARTNER
AMY JACKS
+44 20 3130 3756
AJACKS@MAYERBROWN.COM

PARTNER
DEVI SHAH
+44 20 3130 3669
DSHAH@MAYERBROWN.COM

COUNSEL
ALEXANDRA WOOD
+44 20 3130 3717
AWOOD@MAYERBROWN.COM

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