

Set-offs of Claims in Insolvency Proceedings and the Principle of Proportional Satisfaction of Creditors

Introduction

Insolvency law regulates the method of resolving a debtor's bankruptcy in insolvency proceedings before a court so as to organize property relations with persons affected by the debtor's bankruptcy or imminent bankruptcy to achieve the highest and proportional satisfaction of the debtor's creditors (*pari passu* principle) and the debt discharge of the debtor.¹ The debtor's bankruptcy, i.e. the debtor's inability to pay debts to several creditors, has a negative effect not only on the debtor himself, but also on his creditors, who may fail to satisfy their own debts due to the debtor's insolvency and may then become insolvent themselves. Insolvency law thus protects the economy and society from the negative consequences of bankruptcy by establishing rules for resolving bankruptcy that are based on the proportional satisfaction of all a debtor's creditors and the subsequent debt discharge of the debtor.

The regulation of bankruptcy is necessary in all countries with developed market economies and therefore necessarily affects European Union legislation, as one of the fundamental pillars of European integration is the single European market ensuring the free movement of goods, people, capital and services. European economies are thus interconnected by mutual trade relations among entities from different states, and the bankruptcy of an entity from one state may affect entities from other states. Therefore, insolvency law is also regulated at the European level by Insolvency Regulation², which unifies certain aspects of insolvency proceedings across the states of the Union.

The basic principle common to the insolvency law in all European states is the principle of proportional satisfaction of all of a debtor's creditors in insolvency proceedings. Under this principle, creditors do not satisfy their claims against the debtor individually, rather, in accordance with established procedure, they file their claims in insolvency proceedings in

¹ Section 1 of the Act No. 182/2006 Coll., of 30 March 2006 on Insolvency and Methods of its Resolution (hereinafter 'Czech Insolvency Regulation Act').

² Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings (hereinafter 'Insolvency Regulation').

which they proceed collectively and satisfy their claims in proportion to their type and amount. However, even in the case of insolvency proceedings, the law offers each creditor the opportunity to satisfy their claim individually with the help of a set-off. For cross-border insolvency proceedings at the European level though, set-off entails some ambiguity.

The first ambiguity regarding set-off arises in cases where the creditor unilaterally sets off his claim against the debtor's claim before insolvency proceedings have been opened, but at a time when the debtor is already in bankruptcy or imminent bankruptcy. Such set-off is undoubtedly an act that would result in the claim of one creditor being satisfied to the detriment of other creditors, that is to say, conduct which shortens the satisfaction of other creditors in breach of the principle of proportional satisfaction of creditors. Insolvency law then makes it possible on the basis of voidability to challenge such conduct of the creditor, as a result of which the abbreviating act is ineffective and the creditor who has enriched himself must issue enrichment to the proportional satisfaction of all creditors. Voidability challenges to pre-insolvency set-off in insolvency proceedings within a European context are made possible by the Insolvency Regulation with reference to the legislation in the individual Member States. Some legal systems explicitly regulate the possibility of challenges for the voidability of set-off (Germany) and some have introduced such a possibility by interpretation (Austria). The Czech legal system, however, does not provide explicit regulation of the voidability of unilateral set-off made by a creditor, and such a possibility is not even inferred by interpretation, with the Czech Supreme Court, on the contrary, explicitly stating that the voidability of such a set-off is not possible. However, one might argue that there is no reasonable justification for the stance of the Czech Supreme Court noted above and that precluding voidability challenges to unilateral set-offs made before the opening of insolvency proceedings weakens the principle of proportional satisfaction of creditors. The weakening of the principle of proportional satisfaction of creditors may be particularly evident in cases of insolvency proceedings with a European cross-border element, in which the voidability of certain set-offs is possible under the legal systems of other Member States but not under Czech law.

Another point of ambiguity regarding the set-off relates to the set-off of claims in insolvency proceedings, i.e. after the opening of insolvency proceedings. The Insolvency Regulation allows for insolvency set-offs with reference to the legal systems of the individual Member States. Set-off is then possible in two cases, namely if it is allowed by the law under which the

insolvency proceedings take place or if it is allowed by the law governing the debtor's claim. However, the various legal systems of the Member States approach insolvency set-off differently, allowing set-off if different preconditions are met. As a result, the set-off of an array of claims in one insolvency proceeding may be governed by a number of different legal systems, which may give some creditors an advantage over others who are not allowed to set off under the law applicable to them, thus violating the principle of proportional satisfaction of creditors.

1. Theoretical Framework

Insolvency law is based on independent principles and aims to settle the relationships of the debtor in bankruptcy in an effort to proportionally satisfy all of their creditors. With regard to the complexity of insolvency law itself and the European context, the theoretical basis for a better understanding of the above-mentioned ambiguities related to set-off and voidability in insolvency proceedings is further defined.

A. Collective Nature of Insolvency Proceedings

The purpose of insolvency law is to achieve maximum proportional satisfaction of creditors in the event of a debtor's bankruptcy, i.e. it seeks to maximize benefit in a situation that would otherwise necessarily lead to loss. To this end, creditors in insolvency proceedings proceed jointly in a prescribed manner when satisfying their claims against the debtor. Thus, insolvency proceedings differ significantly from civil and enforcement proceedings, which are based on individual enforcement of legal obligations in court. Insolvency law clearly sets out which creditor will be satisfied, how it will be done, and in what order,³ thus providing creditors and the debtor with legal certainty in a situation as uncertain as the debtor's bankruptcy. Creditors do not compete so much in insolvency proceedings as in civil and enforcement proceedings, as they file their claims⁴ in insolvency proceedings within the fixed time limit and all registered claims are (proportionally) satisfied in the prescribed manner. By contrast, in civil and enforcement proceedings the success of satisfaction depends on the order in which the claims are filed with the court and a previously filed claim may negatively affect

³ T. Jackson, *The Logic and Limits of Bankruptcy Law* (1986), at 20.

⁴ However, an exception is the so-called privileged claim in the sense of § 203 of the Czech Insolvency Act, which are not lodged in the insolvency proceedings, but only asserted against the debtor (or insolvency practitioner), and which are preferentially satisfied at any time during the proceedings.

the satisfaction of later claims.⁵ It follows from the collective nature of insolvency proceedings that the proceedings primarily focus on the relationship between creditors and only secondarily on the relationship between creditor and debtor.⁶

Manifestations of the collective nature of insolvency proceedings, i.e. the principle of proportional satisfaction of creditors, expressed in Latin *as par conditio creditorum (pari passu)*, can be found in several pieces of legislation, and the literature also seeks to define the principle precisely.⁷ One suitable definition of the principle of *pari passu* is given in the Legislative Guide on Insolvency Law issued by the United Nations Commission on International Trade Law (UNCITRAL), which says it is ‘the principle according to which similarly situated creditors are treated and satisfied proportionally to their claim out of the assets of the estate available for distribution to creditors of their rank.’⁸ The importance of the principle of *pari passu* can be seen on two levels. The basic manifestation of the principle is in the procedural position of individual creditors within creditor groups, as creditors belonging to the same creditor group have the same opportunities and equal status (principle of equality). In this respect, the principle is applied only after the opening of insolvency proceedings and is manifested exclusively during the given proceedings in the manner provided by law. Of greater importance is the fairness element of the principle of *pari passu*, i.e. ensuring a fair distribution of the debtor's monetized assets among creditors. In other words, there is no better way to fairly distribute the acquired assets of the debtor among several creditors who have claims of different amounts.⁹

B. General Notes on Set-offs and Voidability

The problems defined above relate to the issues of set-off and the voidability of the set-off. It is necessary therefore first to briefly define what is generally meant by set-off and voidability. With regard to the practically identical concept of set-off and voidability across the laws of the Member States, the demonstration is made on the example of the Czech legislation.

⁵ Cf. P. Sprinz et al. (eds), *Insolvenční zákon. Komentář* (2019), at 1-3.

⁶ Warren, ‘Bankruptcy Policy’, 3 *The University of Chicago Law Review* (1987), at 785.

⁷ Cf. C. Jeremias, *Internationale Insolvenzaufrechnung* (2005), at 142; R. Goode, *Principles of corporate insolvency* (4th ed., 2011) at 235; M. Krumm, *Steuervollzug und formelle Insolvenz* (2009), at 31.

⁸ United Nations Committee for International Trade Law, *Legislative Guide on Insolvency Law* (2004), at 6, available at https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/05-80722_ebook.pdf

⁹ The principle of proportional satisfaction of creditors was known in old Roman law, see Levinthal ‘The Early History of Bankruptcy Law’, 3 *University of Pennsylvania Law Review* (1918), 223 (available at https://scholarship.law.upenn.edu/penn_law_review/vol66/iss3/2).

Set-off is a means of extinguishing an obligation by settling mutual debts between parties who are mutual debtors without the parties actually paying each other. Example: Company A owes Company B an amount of EUR 1,000 from a particular obligation, while Company B owes Company A an amount of EUR 900 from another obligation. By set-off of the mutual debts, the mutual debts of both companies in the amount of EUR 900 cease to exist and only the debt of company B to company A in the amount of EUR 100 remains.

The reciprocal claims (or reciprocal debts) of the parties are therefore simply deducted from each other without any actual performance. This leads to the extinguishment of the obligation (or its part), but not in the manner envisaged in the obligation. The obligation thus is not fulfilled in the agreed manner, but expires for another reason, which is set-off.

The general regulation of set-off is given in Section 1982 et seq. Czech Civil Code,¹⁰ which lays out the conditions for set-off. The basic condition for set-off is the existence of mutual debts of the same type, as well as a statement of set-off against the other party. Set-off can be made as soon as the claims are due. The law explicitly stipulates that by offsetting, both claims (debts) are canceled to the extent that they overlap, if they do not completely cover each other, the claims are set off in the same way as when fulfilled. Claims that can be enforced before the courts are eligible for set-off and those claims that are uncertain or indeterminate are not eligible.¹¹

The principle of set-off is similar across Member States, but the specific conditions for set-off may differ.¹² Some legal systems require the certainty of the claim (German, Czech), some presuppose authenticity in the sense of simply proving the undoubted existence of the claim (Austrian, Czech), some prohibit set-off by a claim denied by the debtor under substantive law (German) and so on. Only in some legal systems is the set-off form of security (French, Swiss) explicitly regulated.¹³

¹⁰ Act No. 89/2012 Coll., of 3 February 2012 the Civil Code (hereinafter 'Czech Civil Code').

¹¹ For further reading on set-offs in Czech law see J. Petrov et al. (eds), *Občanský zákoník: komentář* (2017) at 2133-2141.

¹² For further reading on systematic approaches to set-offs see R. Zimmermann, *Comparative Foundations of a European Law of Set-Off and Prescription* (2002); W. Johnston et al., *Set-Off Law and Practice: An International Handbook* (3rd ed., 2018).

¹³ P. Kavan, 'Kompenzace pohledávek v českém právu' (2016) (PhD thesis on file at PF UP Olomouc, Czech Republic) at 76.

Within the insolvency proceedings, the set-off is regulated in Section 140 of the Czech Insolvency Act. The special legal regulation for set-off in insolvency proceedings follows the general legal regulation of the Czech Civil Code and specifies other conditions in the context of insolvency proceedings.

Voidability means the possibility of claiming the relative unenforceability of the legal act by which the debtor disposes of his property or deprives himself or herself of the possibility of acquiring property, if this thereby shortens the possibility for his or her creditor to satisfy an enforceable claim. Example: Company A owes Company B EUR 1,000 of an obligation. Company A then donates a machine worth EUR 1,000 to Company C. Company B wants to enforce the decision to satisfy a claim of EUR 1,000 against Company A, but finds that Company A no longer has assets that could be affected by the enforcement of the decision. Company B can therefore claim the relative unenforceability of the donation of the machine in the amount of EUR 1,100, as it has lost the opportunity to enforce the decision to satisfy its claim as a result of that donation. Company B can claim relative unenforceability against Company C, which will be obliged to give the benefit obtained to Company B to satisfy the claim against Company A.

Thus, it is possible on the basis of voidability to challenge the legal act against the entity that enriched itself while the legal act remains valid, but the creditor has the right to issue a property benefit that was shortened by the legal act. Thus, the one who has been enriched usually keeps the acquired thing and gives the creditor its monetary value.

The general regulation of voidability is contained in Section 589 et seq. Czech Civil Code. The basic condition for voidability is the existence of an enforceable claim against the debtor and that the debtor's action reduces the satisfaction of such a claim. Relative unenforceability is established by a court decision on an action that can be brought against those who have legally acted with the debtor or who benefit from the legal act. Furthermore, the substance of the abbreviating legal acts and the time limits within which relative unenforceability can be invoked are determined.

A special legal regulation of voidability is then contained in the Czech Insolvency Act, specifically in Sections 235 through 242. The purpose of the special legal regulation of voidability in insolvency proceedings is retrospective protection of property. The debtor can

thus objectively be in bankruptcy for a longer period before the insolvency proceedings are opened. In the meantime, the debtor may carry out legal acts that may subsequently disrupt the collective nature of the insolvency proceedings and reduce the value of the assets, thereby primarily damaging unsecured creditors and their level of satisfaction. The aim of voidability in the insolvency proceedings is thus to prevent breaches of the principle of proportional satisfaction of creditors.¹⁴

C. Legislative Competence of the Union in the Field of Insolvency Law

At the Community level, the issue of insolvency proceedings is, as already mentioned, regulated by the Insolvency Regulation. This regulation was adopted on the basis of Article 81 of the Treaty on the Functioning of the European Union ('TFEU'), which states, 'The Union shall develop judicial cooperation in civil matters having cross-border implications' and to that end 'the European Parliament and the Council, acting in accordance with the ordinary legislative procedure, shall adopt measures,' in particular 'when necessary for the proper functioning of the internal market.'¹⁵ These measures aim, inter alia, at 'the elimination of obstacles to the proper functioning of civil proceedings, if necessary by promoting the compatibility of the rules on civil procedure applicable in the Member States.'¹⁶ According to the preamble to the Insolvency Regulation, it was adopted to foster proper functioning of the EU internal market in which cross-border insolvency proceedings are efficient and expeditious.¹⁷ It should be noted that the EU internal market is one of the areas in which the shared legislative competence of the EU and the Member States under Article 4 TFEU applies. For shared legislative competence, Member States can only legislate to the extent that the EU has not enacted legislation in this area.¹⁸

It follows from the above that the EU is entitled to adopt measures (regulations, directives, recommendations) governing the conduct of insolvency proceedings in the Member States. However, its competence in this area is limited by two preconditions, namely (i) the need for

¹⁴ United Nations Committee for International Trade Law, *supra* note 8, at 135.

¹⁵ Article 81(1) and (2) of the TFEU.

¹⁶ Article 81(2)(f) of the TFEU.

¹⁷ Preamble (3) of the Insolvency Regulation.

¹⁸ European Commission, *Areas of EU action*, available at https://ec.europa.eu/info/about-european-commission/what-european-commission-does/law/areas-eu-action_en.

a cross-border element; (ii) the interest in the proper functioning of the internal market (although in this context there has been some loosening with the adoption of the Lisbon Treaty, which inserted the words “in particular” in the original wording of Article 81 TFEU).¹⁹ For the procedural regulation of set-off in insolvency proceedings with an international element, it can therefore be concluded that the EU has the power to issue binding legislative acts in this area.

2. Set-off and Voidability

A. Pre-insolvency Set-off and its Voidability

Every reasonable creditor strives to maximize its benefit from the business relationship and consistently enforces all its claims. If it then happens that the creditor is also a debtor to their own debtor, it may be advantageous to set off mutual claims and thus achieve the termination of the obligation or part thereof in this way rather than by fulfilling the obligation under the contract. If the debtor is not bankrupt or in insolvency proceedings, the set-off is not fundamentally limited other than by the conditions stipulated by law for the set-off of claims. However, if the debtor is already in bankruptcy or imminent bankruptcy but no insolvency proceedings have yet been instituted against them, or if they would cause bankruptcy by the set-off, the set-off may be an abbreviating legal act, as only the creditor who made the set-off will be satisfied as a result of the set-off to the detriment of other creditors. In order to prevent harm to other creditors by the set-off and a breach of the principle of proportional satisfaction of all creditors, insolvency law offers the possibility of voidability (i.e. to claim unenforceability) of the pre-insolvency set-offs as well. In such a case, the enriched creditor is obliged to issue the enrichment to the proportional satisfaction of all creditors according to the principles of insolvency proceedings.

1. Set-off and Voidability in the Insolvency Regulation and in Selected Member States

At the level of European law, voidability is regulated by Article 9(2) of the Insolvency Regulation in conjunction with Article 7(2)(m) of the regulation. According to this legal framework, voidability is governed in principle by the mechanisms provided for in the rules of applicable law (*legis fori concursus*), i.e. the law of the state where insolvency proceedings are opened. The purpose of this provision is to provide a defense mechanism against set-off

¹⁹ J. Syllová et al., *Lisabonská smlouva. Komentář* (2010), at 376-377.

that cannot be afforded legal protection, typically for cases where the motive was reduction of the debtor's insolvency estate.²⁰ The diversity of Member States' legislation on the issue of voidability of set-off can be seen as another problem and challenge for European legislation.

In terms of pre-insolvency set-off, this paper mentions several Member States and their approach to this issue. First of all, the *German insolvency law* expressly makes room for voidability of the pre-insolvency set-off, with attention paid to the possibility of set-off (Section 387 of the German Civil Code). The establishment of the possibility to set off before the opening of insolvency proceedings is assessed according to the general rules of voidability (Section 130 and Section 131 of the German Insolvency Act).²¹ *Austrian insolvency law*, on the other hand, does not contain an express provision concerning the voidability of pre-insolvency set-off but that possibility has been deduced by the case law of the Austrian courts.²² Another procedural approach to voidability of pre-insolvency set-off is provided by the *French legislation*. Here an insolvency practitioner brings action to deny the set-off itself and that, if successful, results in the voidness of the legal act in question.^{23,24} A different approach to pre-insolvency set-off can be found in English law, where in case of the opening of insolvency proceedings (set-off takes place by law, see the next chapter), the possibility of voidability of the pre-insolvency set-offs is excluded in principle with the exception of pre-insolvency set-offs that in some way go beyond the conditions of subsequent statutory set-off, i.e. set-offs that could not occur after the opening of insolvency proceedings (e.g. when the creditor had some qualified indication of the debtor's bankruptcy at the time of obtaining the claim and therefore was not in good faith).²⁵ It can therefore be concluded from the above examples that all these jurisdictions allow some form of defense against pre-insolvency set-offs made by the creditor.

2. Set-off and Voidability Under the Czech Law

²⁰ A. Bělohávek, *EU and international insolvency proceedings: Regulation (EU) 2015/848 on insolvency proceedings. Commentary* (2020), at 304.

²¹ For further reading see Jeremias, *supra* note 7, at 148-149.

²² For further reading see B. König, *Die Anfechtung nach der Insolvenzordnung, Handbuch für die Praxis* (5th ed., 2014), at marginal No. 14/4.

²³ C. Saint-Alary-Houin, *Droit des entreprises en difficulté* (8th ed., 2013), at 448 et seq.

²⁴ For further reading on voidability in Czech law see T. Troup and A. Rakovský, *Zápočet v předvečer insolvence ve světle odpůrčího práva – I. Díl* (2018), available at <http://www.bulletin-advokacie.cz/zapocet-v-predvecer-insolvence-ve-svetle-odpurciho-prava-i.-dil>.

²⁵ Cf. Goode, *supra* note 7, at margin No. 918; Jeremias, *supra* note 7, at 119 et seq.

Finally, there is the Czech insolvency law. The general rules of voidability are set out in Sections 240 to 242 of the Insolvency Act, while there is no specific provision on voidability of set-off. The case law of the Supreme Court of the Czech Republic has already established that only legal acts occurring before the opening of the insolvency proceedings can be opposed as voidable on the basis of the above-mentioned rules.²⁶ This has led some legal experts to seek a way to apply the regulation of voidability to unilateral pre-insolvency set-offs, which the Supreme Court ruled out in its case law (see below), concluding that all three general rules can, in principle, be applied.²⁷ However, the case law of the Supreme Court of the Czech Republic says rather the opposite. First of all, it is concluded that the set-off is not a way of fulfilling the obligation, but a way of terminating the obligation, and that therefore the set-off does not lead to any performance that could be challenged on the basis of voidability as provided for by the provisions of Section 240 of the Czech Insolvency Act. In other words, the Supreme Court is of the opinion that by set-off the parties do not receive any performance that could be used to satisfy the debtor's registered creditors, because it is not a performance (as in cases where the debtor has a claim against a third party). On the contrary, set-off is intended to extinguish mutual obligations, which is an equivalent act. Voidability of the set-off according to Section 240 of the Czech Insolvency Act is therefore conceptually completely excluded.²⁸

Consequently, it restricts the voidability of unilateral set-offs by the creditor through Section 241 of the Czech Insolvency Act, which deals with the acts performed by the debtor.²⁹ Thus, only the voidability of bilateral set-offs comes into consideration, as the activity of the debtor is required. The same conclusion can subsequently be drawn with regard to the last general rule, Section 242 of the Czech Insolvency Act, which also expressly mentions the acts of the debtor. The ability of the creditor in the Czech Republic to challenge for voidability of pre-insolvency set-offs is thus considerably limited, if not completely ruled out. This conclusion can also be underlined by the fact that the Supreme Court does not allow any other options for voidability than according to the Sections 240 to 242 of the Czech Insolvency Act.³⁰ It is thus not possible to use Section 235 of the Czech Insolvency Act as a general clause on the basis

²⁶ Decision of the Czech Supreme Court of 28 February 2017, file number Rc 139/2018.

²⁷ T. Troup and A. Rakovský, *Zápočet v předvečer insolvence ve světle odpůrčího práva – II. Díl* (2018), available at <http://www.bulletin-advokacie.cz/zapocet-v-predvecer-insolvence-ve-svetle-odpucihoprava-ii-dil>.

²⁸ Decision of the Czech Supreme Court of 28 February 2017, file number 29 ICdo 12/2015.

²⁹ Decision of the Czech Supreme Court of 28 February 2014, file number 29 Cdo 677/2011.

³⁰ Decision of the Czech Supreme Court of 28 February 2014, file number 29 Cdo 677/2011.

of which it would be possible to challenge unilateral set-off.³¹ However, it is possible to raise voidability of the legal act which created the claim to be set-off.³²

Pursuant to Article 21 of the Insolvency Regulation, the insolvency practitioner appointed by the competent court has the power to perform all the acts entrusted to it by the law of the state where proceedings are opened. The voidability of set-off is thus, in principle, governed by the jurisdiction of the state in which the insolvency proceedings are conducted, including the persons who may bring a relevant action. Therefore, if insolvency proceedings with an international element are to be initiated on the territory of the Czech Republic, only the insolvency practitioner within the meaning of Section 239 of the Czech Insolvency Act may challenge legal acts for voidability. In cases where the insolvency practitioner would like to raise voidability for a unilateral set-off by a creditor within the Czech Republic, this would most likely not be possible. However, this problem is more interesting in cases where the set-off takes place according to the law applicable to the insolvent debtor's claim, i.e. in cases where the set-off may be governed by the jurisdiction of another state that provides for such set-off (e.g. Germany). In these cases, set-off will be admissible, however, voidability will be ruled out due to different conditions of voidability for the creditor's pre-insolvency and unilateral set-offs.

3. Partial Conclusion

The diversity of approaches to the voidability of pre-insolvency set-offs made by creditors is mainly due to the different approaches of Member States to insolvency proceedings as such. The Czech Insolvency Act is interpreted by the case law of the Supreme Court exclusively according to its literal expression, without taking into account the specific principles of insolvency law (collective nature, *pari passu*). It has already been indicated above that in insolvency proceedings it is mainly a relationship between creditors and not a plurality of creditors' relations with the debtor. This distinction is fundamental in that it directly affects the understanding of the principle of *pari passu* and the nature of insolvency. Czech law is based on the classical civil concept of the debtor-creditor relationship, which also ultimately justifies precluding voidability of set-off under Section 240 of the Czech Insolvency Act. However, insolvency law, as opposed to private law, contains the already mentioned

³¹ For further reading on voidability see Sprinz et al., *supra* note 5, at 638-340.

³² P. Sprinz, 'Odporovatelnost právních jednání bez přiměřeného protiplnění aneb rizika ex post úsudku o výši protiplnění', 1 *Obchodněprávní revue* (2020), at 20-26.

principles, which are based on the relationship between creditors, where they decide on the manner of resolution of the debtor's bankruptcy (which may affect the fate of the insolvency estate).³³

Furthermore, the Czech regulation of voidability of unilateral set-off by the creditor does not provide the option of using the rules under Sections 241 to 242 of the Czech Insolvency Act, because the Supreme Court concludes (purely from a literal reading of the law) that the debtor's action is necessary. However, there is no rational reason to protect these creditors and their possibility of set-off compared to consensual set-off, which can be challenged on the basis of voidability. Such an approach is a gap in law and needs to be closed by analogy.³⁴ Therefore, if the law provides for the voidability of (dishonest) bilateral set-offs (in which the debtor participates), there is no reason why this procedure could not be applied by analogy in cases of unilateral set-offs by creditors. However, the current case law does not yet share this view.

When comparing the legal frameworks for voidability of unilateral set-offs in Member States, it can be concluded that the differing rules lead to a violation of the principle of proportional satisfaction of creditors (*pari passu*). An appropriate means of remedying this situation would be to uniformly regulate the rules on the voidability of set-off in cross-border insolvency proceedings at the level of EU law. It would also be reasonable for a person actively entitled to make challenges of voidability to be able to use the rules of voidability under the law applicable to the debtor's claim, since it is precisely under that law that the set-off takes place.

B. Set-off in Insolvency Proceedings

The set-off is a traditional way of satisfying a creditor's claim and has a place also in insolvency proceedings. In the case of cross-border insolvency proceedings, the rules on set-off result both from directly binding European Union rules and from the national law of the Member States. However, with the simultaneous application of national and European rules, some foreign creditors may benefit. The section that follows therefore deals with the legal framework of set-off in insolvency proceedings at the level of Community law and contains a comparison of selected national regulations (Austrian, Spanish, French and others) with the

³³ To the nature of Czech insolvency proceedings see T. Richter, *Insolvenční právo* (2nd ed., 2017), at 111-126.

³⁴ On analogy see F. Melzer, *Metodologie nalézání práva. Úvod do právní argumentace* (2 ed., 2011), at 230.

objective of highlighting the problems arising from inconsistent regulation of set-off in national legal systems.

1. Set-off According to the Insolvency Regulation

The Insolvency Regulation is a source of Community law and, by its nature, is a directly applicable law in the territory of the EU Member States, which takes precedence over national law. The rules of set-off can be found in Article 9 of the Insolvency Regulation, which provides: “The opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of a debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim.” However, this provision does not preclude the possibility of bringing an action for voidness or unenforceability pursuant to Article 7(2)(m) of the Insolvency Regulation.³⁵ European legislation thus leaves a relatively wide possibility of set-off, with two aspects being decisive in this regard. First, it will be the determination of the *legis fori concursus* within the meaning of Article 7 of the Insolvency Regulation, i.e. the determination of the law of the state of the opening of the insolvency proceedings which governs all procedural and substantive effects of the insolvency proceedings in relation to the persons and legal relationships (applicable law). A list of individual effects of applicable law can be found in Article 7 of the Insolvency Regulation, where letter d) stipulates “the conditions under which set-offs may be invoked”. In this respect, and this is the second decisive aspect, it will be crucial to determine in which state the debtor’s center of main interest (hereinafter “COMI”) is located and which will therefore be internationally competent to conduct insolvency proceedings under Article 3 of the Insolvency Regulation.

The second aspect explicitly mentioned in the Insolvency Regulation in Article 9(1) is the possibility for the creditor to claim set-off, if the law applicable to the debtor’s claims allows for such set-off. Clearly, set-offs are mostly claimed between entities within one legal order. However, it may happen that the debtor has its COMI and consequently also the *legis fori concursus* in one Member State, but its claim is governed by the law of another Member State. The creditor may thus proceed in accordance with the law applicable to the debtor’s claim, against which it set-off its claim. Creditors from other Member States (with the

³⁵ Article 9 of the Insolvency Regulation follows almost identically in content the previous legal regulation of set-offs provided in Article 6 of Regulation (EU) 1346/2000 of the European Parliament and of the Council. Therefore, if the sources relating to the previous regulation are argued, this is done intentionally.

exception of Denmark) can therefore benefit from this provision, the only corrective being the fulfillment of the conditions for such set-off under the law applicable to the debtor's claim to be set off and provided that the claim existed before the opening of the insolvency proceedings. Thus, the Insolvency Regulation does not lay down any specific conditions for set-off which may be encountered across the jurisdictions of the Member States and the scale of which is quite varied (e.g. creditor's application to the proceedings, creditor's lack of knowledge of the debtor's bankruptcy, etc.). The main purpose of this regulation is to protect the good faith of creditors who rely on a certain property status of the debtor at the time of the creation of its claim.³⁶ Sometimes legal certainty is also mentioned (perception of set-off as a form of guarantee).³⁷ In other words, this purpose can be expressed by the principle that the rights of a creditor acquired in good faith before the opening of insolvency proceedings cannot be restricted by a decision of the insolvency court.³⁸ This purpose of the extended set-off concept, as set out in Article 9 of the Insolvency Regulation, can be accepted in principle.

However, other situations may arise outside this general framework. First, it may be that the law applicable to the debtor's claim does not allow for set-off, but such set-off is possible under the law applicable to insolvency proceedings (Article 7). In the event of such a conflict, the law which is more favorable to the set-off should be applied, i.e. the right allowing set-off.³⁹ Advocate General Bobek also commented on this issue, concluding in his Opinion that: "...the Insolvency Regulation should apply not only where the *lex concursus* entirely excludes the possibility of applying a set-off, but also in cases where the specific conditions of access to a set-off differ, so that, according to the *lex concursus*, set-off would not be possible in a specific case, whereas it would have been possible under the law applicable to the main claim."⁴⁰ The unresolved question then remains whether the creditor can choose the method of set-off under the law applicable to the debtor's claim even if the *lex fori concursus*

³⁶ M. Virgos and E. Schmit, *Report on the Convention on Insolvency Proceedings* (1996), at para 107 et seq. Although the report concerned the previous Regulation No. 1346/2000, in view of the minimal change concerning the adjustment of set-offs (Article 6 = Article 9 of the Insolvency Regulation), the conclusions of this report can also be applied to the current Insolvency Regulation.

³⁷ Opinion of advocate general M. Bobek delivered on 30 April 2019 in Case C-198/18, *CeDe Group AB v KAN Sp. z o. o. (in insolvency)* (EU:C:2019:335), available at <https://curia.europa.eu/juris/document/document.jsf?jsessionid=9C658CCE7904155D8F184FDBBFC0EA44?text=&docid=213506&pageIndex=0&doclang=CS&mode=lst&dir=&occ=first&part=1&cid=5082427>.

³⁸ Most jurisdictions, in principle, support this approach by allowing set-offs in insolvency proceedings which have already begun, provided that the conditions for set-offs were met before the proceedings were opened, cf. Section 140 of the Czech Insolvency Act.

³⁹ Bělohávek, *supra* note 20, at 308.

⁴⁰ Bobek, *supra* note 37.

(applicable law) generally allows set-off, but under other conditions which may not be favorable to the creditor, or at what stage of insolvency proceedings he or she may do so.⁴¹

The Virgós-Schmit⁴² report also touches on the question of whether it is necessary to apply only the rules of civil law (general rules on set-off) of the applicable law or whether the rules of insolvency law must also be applied. The interpretation reached in the report seems logical and correct, i.e. it is necessary for the claim to be set off not only according to the regulations of general civil law, but also according to the insolvency law of such a legal system.⁴³

The Court of Justice of the EU has also ruled on the issue of set-off. It stated in one of its rulings that set-off is to be understood as meaning the simultaneous termination of two obligations between two persons, while it is both the method of payment (fulfillment of an obligation) and at the same time an enforcement of a claim. By applying the set-off, one party forces its debtor to pay.⁴⁴ Such an understanding of set-off must necessarily mean, in the context of insolvency law (its collective nature and the principle of *pari passu*), that set-off has a direct effect on the proportional satisfaction of creditors, since creditors holding set-off claims can obtain full satisfaction of their claims outside of the framework of insolvency proceedings.⁴⁵

2. *Set-off in Selected Member States*

Over time, the different national legal systems of the Member States have become aware of the effect of set-off on the debtor's insolvency estate and related issues, taking different positions on these issues in insolvency proceedings, the general wording of which will be explained in the following paragraphs. In principle, two approaches should be considered when reading the following lines. Firstly, some legal systems prefer legal certainty in the form of creditor protection (perception of set-off as a kind of security or guarantee) whereas, secondly, other legal systems favor the aforementioned *pari passu* principle, i.e. protecting the debtor's insolvency estate for the highest possible proportional satisfaction of unsecured creditors.

⁴¹ We leave this question for discussion.

⁴² Virgós and Schmit, *supra* note 36, at para 107 et seq.

⁴³ Cf. S. Leible and A. Sstaudinger, *Die europäische Verordnung über Insolvenzverfahren* (2000), at 533-575; Bělohávek, *supra* note 20, at 304.

⁴⁴ P. Pichonnaz and L. Gullifer, *Set-off in Arbitration and Commercial Transactions* (2014), at 72.

⁴⁵ Bobek, *supra* note 37, at paragraph 61.

German law provides for the regulation of pre-insolvency set-offs and their possible voidability. First of all, the institute of set-off is regulated in Section 94 of the German Insolvency Act, which stipulates, “If a creditor is entitled to set-off under a law or agreement at the time of opening of insolvency proceedings, this right is not affected by insolvency proceedings.” Furthermore, the possibility of set-off is limited in Section 96(1)(3) of the German Insolvency Act, which provides that set-off is inadmissible if the insolvency creditor has acquired the possibility of set-off through a voidable legal act. This provision applies to both pre-insolvency and insolvency set-off. The legal regulation thus leaves the possibility of set-off even after the opening of insolvency proceedings with a slight correction.⁴⁶ German insolvency law also directly regulates the inadmissibility of set-off with claims arising only after the opening of insolvency proceedings or in cases where the creditor obtained his claim from another creditor only after the opening of the proceedings (Section 96(1)(2)).⁴⁷

Austrian insolvency law provides for set-off in Section 19 of the Austrian Insolvency Act, which provides that claims which were eligible for set-off at the time the insolvency proceedings were opened need not be registered in the insolvency proceedings. It is therefore possible to set off during the insolvency proceedings at the discretion of the creditor. Furthermore, Section 20 sets out the conditions under which set-off is not permitted after the opening of insolvency proceedings. For example, set-off is not permitted if the insolvency creditor becomes a debtor of the bankruptcy estate only after the opening of insolvency proceedings or if the claim against the debtor in bankruptcy was acquired only after the opening of the proceedings. The same applies if the bankruptcy debtor has obtained a claim against the debtor in insolvency proceedings but must have known or should have known of the debtor's bankruptcy (para. 1). Austrian insolvency law thus links the institute of set-off to the moment of the opening of insolvency proceedings, which is more logical than the Czech legislation,⁴⁸ which does not do so, as the effects associated with the ban on disposing of assets belonging to the insolvency estate essentially arise from the opening of insolvency proceedings. At the same time, it does not require the creditor to register in insolvency proceedings.

⁴⁶ Troup and Rakovský, *supra* note 30.

⁴⁷ Set-off is not permissible if the insolvency creditor owes the bankruptcy estate something after the opening of insolvency proceedings, cf. Section 96(1)(1) of the German Insolvency Act.

⁴⁸ Section 140(2) of the Czech Insolvency Act sets the decisive moment for set-off to the decision on the method of resolving the insolvency.

The **legislation of the Slovak Republic** is based on the principle that set-off is generally permissible for registered creditors, but with certain limitations arising from Section 54 of the Slovak Insolvency Act. The Slovak legislation excludes the possibility of set-off with a creditor whose claim arose before the declaration of audition on the debtor's property against a claim which arose to the debtor after this declaration. Furthermore, the Slovak legislation restricts the set-off of claims acquired by a creditor through a transfer (e.g. assignment or inheritance) after a declared audition against the debtor's property, as well as limits the set-off of claims acquired through a voidable legal act (para. 3). Other prohibitions can be found in Section 167c of the Insolvency Act, which prohibits the set-off of a creditor's claim that arose after the declaration of audition with the debtor's claim, which arose before the declaration of audition and vice versa. At the same time, the Slovak legislation explicitly stipulates that by registering the creditor's claim, the claim against the debtor becomes due (para. 1). This *ex lege* debt maturity can play a significant role in relation to the general conditions of compensability.⁴⁹ In principle, the Slovak legislation on set-off in insolvency proceedings does not address pre-insolvency set-offs and provides for a declaration of audition as a point in time limiting set-off.

The **French legislation** on set-off is a completely unique approach to the above. Following the declared bankruptcy of the debtor, the general rule applies here that the debtor may not pay on his obligations that arose before his bankruptcy (pre-insolvency obligations).⁵⁰ The only way to set off after the debtor's bankruptcy is a set-off made on the basis of a decision of the insolvency court, for which special conditions are set. Specifically, the condition of proximity of the set-off claims (*créances connexes*) and the condition of registration of the creditor's claim in the insolvency proceedings.⁵¹ French insolvency law thus considerably reinforces the importance of the principle of proportional satisfaction of creditors, since the preclusion of set-off after a declaration of bankruptcy increases (not reduces) the debtor's insolvency estate by any set-offs, unless the insolvency court decides otherwise.

The **English approach** to set-off in insolvency proceedings prefers the principle of legal certainty, placing creditors with a set-off claim in a position that is basically equal to that of a

⁴⁹ The maturity of the debt is one of the conditions for set-off. In other words, if the debt did not become due by law at the time the claim was registered, no set-off could take place. This approach thus supports the possibility of set-off, in contrast to legal jurisdictions, which do not provide such a possibility (Czech legislation only links the maturity of a debt to the declaration of bankruptcy).

⁵⁰ Article L622-7 of the French Code de Commerce.

⁵¹ *Ibid.* See also Troup and Rakovský, *supra* note 24.

secured creditor. The moment a declaration of the debtor's bankruptcy is made, the set-off of mutual claims takes place automatically.⁵² The law thus does not give the creditor the opportunity not to set off his or her claim and at the very beginning of the insolvency proceedings it is certain that the insolvency estate will not change as a result of a possible set-off in the future. However, the above procedure excludes cases where the creditor obtained a claim against the debtor after obtaining knowledge of certain exhaustively listed indications of the debtor's bankruptcy (e.g. the creditor knew about the debtor's bankruptcy and filing for insolvency proceedings).⁵³ Thus, the English concept, unlike other legal systems presented, represents an exception to the principle of proportional satisfaction of creditors (*pari passu*), as it gives creditors with a mutual claim a preferential position.

3. *Partial Conclusion*

First of all, it follows from the described approaches to set-off in the insolvency proceedings that the legal regulation is diverse for different EU states. Of import is the contrast between jurisdictions in the preference of *pari passu* over legal certainty or vice versa, in the context of the theoretical background described in the first section. Secondly, the comparison shows that, in principle, each jurisdiction protects in a certain way the possibility of set-off if conditions for it were fulfilled either before opening of the insolvency proceedings (Germany, Austria), before the declaration of bankruptcy (England, France) or before declaration of audit (Slovakia). The Czech legislation goes its own way, setting the decision on the method of bankruptcy resolution as a milestone. Finally, the variety of conditions making set-off possible in various states is also evident (the need to be a registered creditor, the possibility of set-off on the basis of a court decision, the preclusion of set-off against claims arising after the opening of proceedings, *ex lege* set-off, the possibility of litigation regarding the amount to be set off, etc.).

It is clear that such divergent substantive legislation in the various Member States cannot be easily changed. Without an overall detailed knowledge of the particular insolvency laws, the specific conditions for set-off in insolvency proceedings already opened cannot be clearly established. What can be harmonized, however, are procedural issues which are consistent with the overriding common interest of creditors, the principle of *pari passu* and the

⁵² Goode, *supra* note 7, at margin No. 901 and 907.

⁵³ Article 14.25 (6) of the Insolvency (England and Wales) Rules of 2016, available at <http://www.legislation.gov.uk/uksi/2016/1024/article/14.25/made>. See also Troup and Rakovský, *supra* note 24.

collective nature of insolvency proceedings. It can therefore be concluded that it would be appropriate to regulate set-off at the level of Community law, either by means of a directive and subsequent implementation in the law of the Member States or by means of a regulation. Tying the possibility of set-off to a court decision may be consistent with the principles of private law (legal certainty, autonomy of the parties, protection of rights acquired in good faith) and with the principles of insolvency law (in particular *pari passu*). With regard to the public insolvency registers, this approach could simply be justified by the fact that, from the moment the insolvency proceedings are opened, no creditor can be in good faith that a person is not bankrupt (material publicity of the public registers). It is clear that only the right to set-off before the opening of proceedings is protected and that this procedure is consistent with the Insolvency Regulation. However, the point at which the principles of insolvency law should come into play is bankruptcy from a substantive point of view (e.g. retrospective voidability), i.e. also *pari passu*. Therefore, if the set-off of a claim arising at a time when the debtor was already insolvent (with the creditor's knowledge of insolvency) is contrary to the principle of *pari passu*, this should also be reflected in the European law.⁵⁴ However, one must not forget creditors in good faith who were not aware of the debtor's insolvency at the time of the acquisition of the set-off claim, i.e. before the opening of the proceedings. They must be protected by the law.

The French solution, which allows set-off on the creditor's proposal and on the basis of a decision of the insolvency court, is therefore inspiring. The insolvency court would then assess the creditor's good faith at the time of the creation of its right to set-off. At the same time, it would also request the insolvency practitioner's opinion and the set-off could be decided at a later procedural stage. This would protect the debtor's insolvency estate from the (often uncontrollable) efforts of a dishonest creditor to obtain as much of the debtor's assets as possible for itself by means of a set-off, while preserving legal certainty in the possibility of set-off by honest creditors from the perspective of non-insolvency law.

Conclusion

The aim of this text is to highlight the different regulation of set-off possibilities across EU countries and the options available to oppose this form of legal action. The present

⁵⁴ Bobek, *supra* note 37.

conclusions are based on an economic analysis of the law (see Chapter 1). The following deals with pre-insolvency (unilateral, creditor) set-offs and their voidability. The possibility to challenge the unenforceability of these legal acts is a fundamental defense mechanism of insolvency law in most Member States. The conclusions regarding the divergent approach of Czech law have already been described in the partial conclusion of this section. However, it is worth highlighting again the differences in the rules of voidability in the different jurisdictions, which may undermine the principle of proportional satisfaction of creditors (*pari passu*) in cases where insolvency proceedings with an international element are opened. Community legislation should therefore consider the future unification of a rule allowing challenges to such set-offs by way of voidability across EU countries in a similarly broad way as the set-off rule in Article 9 of the Insolvency Regulation. Thus, it may be suggested as a possible *de lege ferenda* solution that persons with active standing to bring a counterclaim (typically the insolvency practitioner) should also be able to avail themselves of the means of voidability under the law applicable to the debtor's claim, as set-off may occur under that law. The current state of the law, however, does not allow this procedure.

The next part of the text dealt with set-off in insolvency proceedings already opened, where the focus was again on the EU environment. The current wording of Article 9 of the Insolvency Regulation can be considered to broadly favor legal certainty in the sense that it protects the creditor's right to set-off according to the law applicable to the debtor's claim, i.e. the law on which the addressee of the legal rule could have expected the set-off to be available. It can therefore be argued that Article 9 of the Insolvency Regulation fulfils the element of legal certainty, but that legal certainty is consequently compromised in a practical sense as different States protect the possibility of set-off in different ways unless creditors are restricted in that regard by one of the aforementioned methods. This difference presents a major problem, and a proposal for a solution has been set out at the end of this section.⁵⁵

⁵⁵ It is difficult to imagine an addressee of legal rules (within the EU) being able to distinguish between the various conditions of set-off in insolvency proceedings for the Member State where the insolvency proceedings are opened, or according to the law applicable to the debtor's claim. Therefore, they will not be able to assess the real impact in advance (including the impact of the possibility of opposing the set-off).