NÁRODNÁ BANKA SLOVENSKA

NETTING IN FINANCIAL MARKETS

PART 4

NETTING BETWEEN INSOLVENT PARTIES OUTSIDE BANKRUPTCY

Mgr. Peter Baláž, DESS-Master*

The fourth part in this series of articles on netting in financial markets focuses on netting between parties, at least one of which is in restructuring proceedings, in a regime with inaccessible client assets, or is insolvent pursuant to the Commercial Code[1], and thus links to the third part of this series, which dealt with netting between contracting parties, of which at least one is in bankruptcy[2]. Even if these proceedings as a rule have a more moderate impact on creditors than bankruptcy itself, they can influence their position substantially in the area of netting.

Since settlement under the current Act on Bankruptcy and Settlement[3] has had only limited application in Slovakia and the law is to lose effect soon, this article will not focus on it.

Restructuring

In general. Restructuring is a type of insolvency proceeding, which with effect from 1 January 2006 will be introduced into the Slovak legal code by the new Act on Bankruptcy and Restructuring[4]. The aim of restructuring is the gradual satisfaction of the debtor's creditors in a manner agreed in a restructuring plan[5]. In contrast to bankruptcy, the basic condition of success is the preservation of the debtor's business[6].

From the wording of the Act on Bankruptcy and Restructuring we can see that this act differentiates between the restructuring of non-financial institutions and that of financial institutions, where the restructuring of financial institutions uses, instead of the third part of the Act on Bankruptcy and Restructuring, rather the respective acts governing forced administration[7].

Restructuring of non-financial institutions. Following the commencement of restructuring proceedings against a non-financial institution a creditor cannot net a claim against the debtor, if this claim is exercised in the restructuring application[8]. Restructuring proceedings commence through the publication in the Commercial Bulletin of a court decision in favour of commencing restructuring[9]. In principle in restructuring all claims are filed by means of an application, with the exception of claims arisen to the debtor during the restructuring proceedings, remuneration of the administrator and non-financial claims[10]. In the explanatory memorandum to the draft Act on Bankruptcy and Restructuring it is stated that the effects of restructuring towards the rights of creditors are an "essential condition for ensuring the purpose of the restructuring, which is the preservation of the maximum satisfaction of the operation of the bankrupt's business or a part of it, which would be very difficult, if individual creditors were able to exercise their rights on an individual basis or could terminate contracts which may be critical for the running of the business"[11].

These effects of the commencement of restructuring would disallow the exercising of the close-out netting mechanism, since, besides the prohibition of netting, through the commencement of restructuring proceedings the effect and contractual arrangements enabling the other contracting party to terminate a contract concluded with a debtor or to withdraw from it due to restructuring proceedings or bankruptcy proceedings are lost. A termination of a transaction is an inherent element of the close-out netting institute.[12]

A solution for contracting parties which qualify under Article 151me of the Civil Code[13] is to conclude a con-

*The author specialised in issues concerning the legal aspects of derivative trades, including netting in financial markets during his DESS-Master's degree in Banking and Financial Law at Lyon University 3, France, and later during his professional career.

[1] Act No 513/1991 Coll. the Commercial Code as later amended (in the text of the whole series simply the "Commercial Code").

[2] See Biatec no 3/2005.

[3] Act No 328/1991 Coll. on Bankruptcy and Settlement as later amended (in the text of the whole series simply the "Act on Bankruptcy and Settlement").

[4] Act No 7/2005 Coll. on Bankruptcy and Restructuring and on the amendment of certain acts (in the text of the whole series simply the "Act on Bankruptcy and Restructuring").

[5] Article 1 of the Act on Bankruptcy and Restructuring.

[6] Commentary to Article 1 in the explanatory memorandum to the draft Act on Bankruptcy and Restructuring pursuant to Government Resolution No 815/2004.

[7] Article 176(3) of the Act on Bankruptcy and Restructuring.

[8] Article 114(1)(f) of the Act on Bankruptcy and Restructuring.

[9] Article 113(3) of the Act on Bankruptcy and Restructuring.

[10] Article 120 of the Act on Bankruptcy and Restructuring.

[11] Commentary to Article 114 in the explanatory memorandum of the report on the draft Act on Bankruptcy and Restructuring pursuant to Government Resolution No 815/2004

[12] For more details see the first part of this series of article (Biatec 1/2005, pgs. 25 and 26).

[13] Act No 40/1964 Coll. the Civil Code as later amended (in the text of the whole series simply the "Civil Code").

tract on the final settlement of profits and losses which fulfils the criteria already mentioned in connection with bankruptcy proceedings[14]. Under the Act on Bankruptcy and Restructuring such a contract then has no effect on the commencement of restructuring proceedings[15]. Persons other than those designated in Article 151me of the Civil Code do not have this option to net.

It could seem that such a restriction on netting is not in accordance with the Regulation on Insolvency Proceedings[16]. As has already been stated in the preceding article[17], under this regulation a creditor must have the right to set-off its claims against the claims of a debtor, where such a set-off is permitted by the law applicable to the insolvent debtor's claim. In the Act on Bankruptcy and Restructuring this rule applies only for bankruptcy[18].

The Regulation on Insolvency Proceedings relates to "collective" insolvency proceedings which entail partial or total divestment of a debtor and the appointment of a liquidator"[19]. At the same time however the Regulation on Insolvency Proceedings lays down the list of insolvency proceedings to which the Regulation relates[20]. Currently this list includes, in the case of Slovakia, bankruptcy, forced settlement and settlement. The Council at the proposal of the Commission or its members can unanimously supplement the list of insolvency proceedings[21]. However, it is unlikely that restructuring would fulfil the condition of the liquidation of the debtor's assets and that there would be the political will to include it in this list[22]. Therefore the allowance of netting between contracting parties one of whom has entered restructuring proceedings and which has not concluded a recognised contract on the final settlement of profits and losses will probably not be able to solicit even on the basis of the Regulation on Insolvency Proceedings.

Restructuring of financial institutions. Under the Act on Bankruptcy and Restructuring the restructuring of banks, electronic money institutions, insurance undertakings, reinsurers, securities dealers, asset management companies, pension asset management companies registered in the Slovak Republic and branches of equivalent foreign institutions is performed in the framework of forced administration[23].

The provisions of the third part of the Act on Bankruptcy and Restructuring do not apply to this forced administration[24], other provisions of this Act which govern restructuring do however relate to it. Therefore these institutions, a large share of which also qualify as institutions with a special regime under Article 151me of the Civil Code, may use the advantage of the special treatment of contracts on the final settlement of profits and losses and thereby avoid the prohibition of netting in the framework of the forced administration of these institutions.

Forced administration

In general. The institute of forced administration existed in Slovakia even before the introduction of the new regulation of restructuring. Indicators signalling potential future financial difficulties which could lead to bankruptcy as a rule appear earlier than the requirements for declaration of bankruptcy having been fulfilled. In order to avert bankruptcies in sensitive sectors of the economy, there was introduced the option to commence forced administration against some financial institutions in the framework of which public administration authorities take over pursuant to the Act on Control over the Running of a Company.

The forced administration is applied in financial markets mainly in the case of the above-mentioned financial institutions[25]. There can be various reasons for introducing forced administration: losses, a fall in own funds, or severe shortcomings in activity.

Banks. The conditions for imposing forced administration on a bank are governed by the Act on Banks. Over the six months from the introduction of forced administration mutual claims may not be netted between the bank under forced administration and other persons. An exception is where such netting is allowed

[14] The requirements for a contract on the final settlement of profits and losses were described in more detail in the third part of this series of articles (Biatec 3/2005, pgs. 15 and 16).
[15] Article 180(3) of the Act on Bankruptcy and Restructuring.
[16] Council Regulation No 1346/2000 of 29 May 2000 on Insolvency Proceedings (in the text of the whole series simply the "Regulation on Insolvency Proceedings").
[17] Biatec 3/2005, pgs. 16 and 17.
[18] Article 190 of the Act on Bankruptcy and Restructuring.
[19] Article 1(1) of the Regulation on Bankruptcy Proceedings.
[20] See Annex A of the Regulation on Insolvency Proceedings and Article 18(A)(b) of Annex II to the Act concerning the conditions of accession of the Czech Republic, Republic of Estonia, Republic of Cyprus, Republic of Latvia, Republic of Lithuania, Republic of Hungary, Republic of Malta, Republic of Poland, Republic of Slovenia and the Slovak Republic to the European Union and the adjustments to the Treaties on which the European Union is founded.
[21] Article 45 of the Regulation on Bankruptcy Proceedings.
[22] The list, for example, does not include the older French institute of redressement judiciare, which is markedly similar to Slovak restructuring.

[23] Article 176(1), (2) and (5) of the Act on Bankruptcy and Restructuring.
[24] Article 176(3) of the Act on Bankruptcy and Restructuring.
[25] In this article we shall not look at other forms of forced administration, such as forced administration of municipalities pursuant to Act No 583/2004 Coll. on Budgetary Rules of Local Authorities and on the amendment of certain acts, or forced administration under Act No 581/2004 Coll. on Health Insurance Companies, Supervision of Health Insurance Companies and on the amendment of certain acts, and only marginally the forced administration of funds, such as forced administration pursuant to Act No 650/2004 Coll. on Additional Pension Saving and on the amendment of certain acts or pursuant to Act No 594/2003 Coll. on Collective Investment and on the amendment of certain acts as later amended.

during the introduction of similar reorganisation measures, by the law of the member state of the European Union in which the creditor has its registered seat[26]. Such a creditor can net its claims with those of the bank at which forced administration in Slovakia has been introduced.

This exception probably was introduced into the Slovak Act on Banks in the framework of implementing Article 23 of the Directive on the Reorganisation and Winding Up of Banking Institutions[27]. In the light of Whereas 28 of this Directive, Article 23 must be interpreted in the manner that through the adoption of reorganisation measures or the commencement of liquidation, the right of creditors to demand set-off of their claims against the claims of the credit institution is unaffected, provided such netting is allowed by the law governing the claims of the credit institution.

Correctly implemented, Article 23 of the Directive on the Reorganisation and Winding Up of Banking Institutions should stipulate that the commencement of forced administration has no effect on the right of creditors to set-off, provided such claims may be set-off under the law governing the claim of the bank in reorganisation or liquidation. If thus the legislator relates the right of set-off to the creditor's jurisdiction, this is not correct according to the Directive on the Reorganisation and Winding Up of Banking Institutions, since the Directive relates to the jurisdiction to which the claim of the financial institution in reorganisation or liquidation is subject[28].

This interpretation is indirectly supported also by Article 25 of the Directive of the Reorganisation and Winding Up of Banking Institutions relating to netting agreements, under which netting agreements are governed exclusively by the law of the contract governing these agreements. The Act on Banks denotes these agreements as agreements (arrangements) on settlement or other similar arrangements, the purpose of which is to substitute or change the overall difference of several mutual claims of contracting parties, and correctly implements the option of netting them.

A notable fact is also that the Act on Banks does not provide the same exceptions for subjects registered in Slovakia, as those enjoyed by subjects from other member states where netting is possible. Furthermore the current implementation of the Directive on the Reorganisation and Winding Up of Banking Institutions is not completely covered by this directive. For this reason it is possible that current banking law may be brought into doubt by the Court of Justice of the European Communities, which has already decided on a case of discrimination of own residents[29].

Provisions on the forced administration of banks[30] relate analogously to forced administration at an electronic money institution.

Securities dealers. The Financial Market Authority can impose forced administration on a securities dealer, and concurrently appoint a forced administrator. As in the case of banks it is not possible in the six months from introducing forced administration at a securities dealer to net mutual claims between such securities dealers and third parties[31]. At present the Act on Securities does not recognise any exceptions from this rule. An exception must however be provided in relation to securities dealers on the basis of the Directive on Financial Collateral. This Directive relates to reorganisation measures in, among other persons, securities dealers, where we can include forced administration at securities dealers. Harmonisation with this European legislation should be achieved through the Act on Bankruptcy and Restructuring, the part of which concerning securities dealers is to be changed as of 1 July 2005 by the Act on Securities. In the field of netting, this law will be similar to that applicable for forced administration at banks, i.e. it, too, being implemented imprecisely.

Asset management companies. In the case of asset management companies it is necessary under the Act on Collective Investment[32] to differentiate between forced administration at an asset management company and forced administration at a mutual fund it administers.

Forced administration may only be introduced at such an asset management company licensed to perform certain activities normally performed by securities dealers, for example portfolio management, and which administers at least one open-ended mutual fund. In the case of such forced administration, the rules relating to securities dealers apply, i.e. including the prohibition on the netting of mutual claims during the period of 6 months from its introduction.

In the author's opinion, forced administration at a mutual fund does not affect the possibility of creditors

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[26] Article 59(2) of Act No 483/2001 Coll. on Banks and on the amendment of certain acts a later amended (in the text of the whole series of articles simply the "Act on Banks").

[27] Directive No 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the Reorganisation and Winding Up of Credit Institutions.

[28] For an analogous interpretation, see Duursma-Kepplinger, H. C. et al. Europäische Insolvenzverordnung, Commentary Springer Wien New York: Vienna 2002, pg. 248.

[29] See for example Baláž, P.: "Vylúčenie rezidentov z upisovania cenných papierov emitovaných v zahraničí." [Exclusion of Residents from Underwriting Securities Abroad"] V: SEP, Journal on European and Slovak Law, No. III/1-2. Bratislava: Stichting EMP Utrecht 2002, pgs. 58 – 60.

[30] Article 21c(6) of Act No 510/2002 Coll. on the System of Payments and on the amendment of certain acts as later amended.

[31] Article 153 of Act No 566/2001 Coll. on Securities and Investment Services and on the amendment of certain acts as later amended (in the text of the whole series of articles simply the "Act on Securities").

[32] Act No 594/2003 Coll. on Collective Investment and on the amendment of certain acts as later amended (in the text of the whole series simply the "Act on Collective Investment").

to net their claims against an asset management company. Nor does the Act on Collective Investment contain any such limitation in relation to forced administration at mutual funds.

Pension asset management companies. In the field of pension asset management companies we at present have the paradoxical situation that the new Act on Bankruptcy and Restructuring for pension asset management companies uses a regime pursuant to which the third part of this act governing restructuring does not relate to such companies[33]. Instead, its restructuring is to be carried out in the framework of forced administration[34]. Forced administration however under the Act on Old-Age Pension Saving is imposed on pension funds administered by a pension asset management company, and not on the pension asset management company itself[35]. Such an institution cannot be included among some of the financial institutions listed in Article 151me of the Civil Code and thus the regime of contract on the final settlement of profits and losses is available only if the counterparty is a financial institution listed in this paragraph. As regards the effect of forced administration at pension funds, in the author's opinion, it is possible to use analogously the analysis of the relationship between forced administration at a mutual fund and an asset management company.

Insurance companies. The Act on the Insurance Industry also prohibits disposal with claims against an insurance undertaking in forced administration. During the six months from the introduction of forced administration mutual claims may not be netted between the insurance undertaking under forced administration and other persons[36].

Pursuant to the Directive on the Reorganisation and Winding Up of Insurance Undertakings there should in Slovakia be put in place the option for creditors to net their claims against the claims of an insurance undertaking in forced administration, provided such netting is allowed by the legal code by which they are governed[37]. The new law, effective as of 1 July 2005, implements these provisions similarly as in the case of banks, thus it is equally questionable whether such an implementation is correct[38].

33 Article 176(5) of the Act on Bankruptcy and Restructuring.
34 Article 176(3) of the Act on Bankruptcy and Restructuring.
35 Article 118 of Act No 43/2004 Coll. on Old-Age Pension Saving and on the amendment of certain acts (in the text of the whole series simply the "Act on Old-Age Pension Saving").
36 Article 57(1) of Act No 95/2003 Coll. on the Insurance Industry and on the amendment of certain acts as later amended (in the text of the whole series simply the "Act on the Insurance Industry").
37 Article 22 of Directive 2001/17/EC of the European Parliament and the European Council of 19 March 2001 on the reorganisation and winding up of insurance undertakings (in the text of this whole series simply the "Directive on the Reorganisation and Winding Up of Insurance Undertakings".
38 Article 57(2) of the Act on the Insurance Industry.

Inaccessibility of assets

A special case of the prohibition of netting can be said to lie in that of securities dealers. If the Financial Market Authority declares a securities dealer unable to fulfil obligations towards clients or if a court suspends its disposal with clients' assets (whichever is the earlier), it is not possible as of this date until the date of ending the payment of compensation from the Guarantee Fund to net mutual claims between securities dealers and third parties[39]. There are no exceptions to this rule.

A securities dealer's client assets may become inaccessible also outside bankruptcy or forced administration, and therefore it is necessary to ensure that in financial contracts with securities dealers there is also included inaccessibility of client deposits among the reasons for termination of the contract in the contractual documentation, with effect, where possible, as of the date preceding the first day of the client assets becoming inaccessible. If transactions with a securities dealer are terminated later, there will be little possibility to use close-out netting.

Insolvency under the Commercial Code

The Commercial Code lays down the rule that through a unilateral legal act, it is not possible to set off a non-payable claim against a payable claim, safe where this concerns a claim against a debtor unable to fulfil its financial liabilities. The Commercial Code however does not define insolvency.

The Act on Bankruptcy states that a debtor is in failure, if it has several creditors and is not able to fulfil its liabilities for a period of 30 days from maturity[40]. Here it is not possible to identify insolvency pursuant to the Commercial Code with the term failure. A debtor may be insolvent pursuant to the Commercial Code even before the requirement of a 30-day default is fulfilled. Since the author does not know of any case law that would clarify the term insolvency for the purposes of netting pursuant to the Commercial Code, only a theoretical opinion may be given. The purpose of the regulation of the Commercial Code is clearly to protect the creditor in the case of the debtor's insolvency, which is intensively present throughout commercial law by means of the principle of synallagma. Therefore commercial law allows the netting of a claim against an insolvent debtor by means of a unilateral act even in the case that the claim is not payable yet. The stated provision should be interpreted broadly and insolvency should be understood to mean any delay by the debtor in paying a liability towards any of its debtors at a time when the directly realisable assets of the

39 Article 86(7) of the Act on Securities.
40 Article 1(2) of the Act on Bankruptcy and Restructuring.

debtor do not cover liabilities payable. Neither is this definition identical with delay by a debtor, something which is another condition for the declaration of bankruptcy[41]. This is because in the case of a debtor's insolvency, debt need not exceed assets (meaning no negative equity exists)[42]. As a precondition it is enough that such a debtor does not have sufficiently liquid assets to fulfil debts payable or soon to fall payable.

Some commentators state that a debtor's insolvency may result in particular from its declaration that it is not able to meet its payable liability due to insufficient funds[43]. It can be agreed that a debtor may make this declaration at the time it is insolvent, nevertheless insolvency is an objective fact and should also be judged independently of whether or not the debtor declares its insolvency.

41 Article 1(3) of the Act on Bankruptcy and Restructuring.
42 In legal practice it is not settled what precisely should be understood by the term "in delay", and therefore we are using this commonest interpretation.
43 Dědič, J. et al: Obchodný zákonník s podrobným komentárom pre právnu a podnikateľskú prax [Commercial Code with a detailed commentary for legal and business practice]. Práca, Bratislava 1992, pg. 352. ISBN 80-7094-267-3.

Conclusion

Slovak law on the netting of claims in insolvency proceedings, both in bankruptcy as well as in restructuring will in the coming year undergo significant changes, which will in all probability be of benefit to the Slovak financial market. Even if certain gaps are noticeable in the framework of the new law on forced administration from the aspect of its implementation of European law, the contribution of the new legal regime covering netting towards insolvent debtors cannot be overlooked, and already now it is necessary to start adjusting contractual documentation so as to use to the full all the possibilities of netting which the new law provides them.