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Set-Offs in Cross-Border Bankruptcy: A Comparative Study of the United States, the European Union, Germany, Austria, and Croatia

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Set-off, or the legal right to discharge reciprocal obligations in bankruptcy, is recognized in the United States and Europe. But, despite its broad availability, this right has different characteristics in each jurisdiction. As a result, this Article offers a comparative analysis of this right in the United States and Europe. By doing so, it identifies inconsistencies and ways to overcome any such issues with respect to how the law of set-offs is applied in a transnational context.

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I. INTRODUCTION

The right of set-off, or the legally recognized option to discharge reciprocal obligations in lieu of perfect performance of a contract, is available in the United States and all member states of the European Union.[1] It is well established that in bankruptcy, the right of set-off may function as security for creditor claims against an insolvent debtor.[2] As such, the right of set-off fulfills a guarantee function, which permits solvent parties to enforce their claim up to the amount of the obligations that they are owed by the insolvent party.[3]

Although U.S. law and all European Union member states permit set-off in bankruptcy proceedings, the approach to granting and exercising this right differs significantly. In the United States, the right of set-off is conferred by two different levels of government.[4] At the federal level, the right of set-off is conferred by U.S. bankruptcy law, whereas at the state level it is not.[5] One result is that the U.S. Bankruptcy Code determines the

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1. *See* REINHARD ZIMMERMAN, COMPARATIVE FOUNDATIONS OF A EUROPEAN LAW OF SET-OFF AND PRESCRIPTION 19 (2004) [hereinafter ZIMMERMAN]. For the United States, *see, e.g.*, Borden Company v. Bohack (*In re* Bohack, 599 F.2d 1160 (2d Cir. 1979)).

2. Stephen L. Sepinuck, *The Problems with Setoff: A Proposed Legislative Solution*, 30 WM. & MARY L. REV. 51, 55-58 (1988) [hereinafter Sepinuck].

3. H. RÜSSMANN, AUFRECHNUNG (2004), https://ruessmann.jura.uni-saarland.de/bvr 2006/vorlesung.htm.

4. *See, e.g.*, Sepinuck, *supra* note 2, at 58-61; *see also*, 11 U.S.C. § 553; U.C.C. §§ 4-303, 9-340.

5. 11 U.S.C. § 553; For state specific provisions, *see, e.g.*, LSA-C.C. art. 1893, LA Rev Stat § 6:394:1 (2018) (Louisiana), M.C.L.A. § 600.6008 (Michigan), N.C.G.S.A. §§ 25-9-340, 54B-131, 54C-169, 105A-1 *et seq.* (North Carolina); Conn. Gen. Stat. 52-139 (stating that "[i]n any action brought for the recovery of debt, if there are mutual debts between the plaintiff or plaintiffs, or an of them, and the defendant or defendants, or any of them, one debt may be set off against the other.").

contours of this right at the federal level, but principles of equity decide how set-off is granted to and exercised by rights-holders at the state level.[6]

In the European Union, all member states have their own national-level set-off rules.[7] In addition, as a supranational organization, the European Union also provides for a number of rules that regulate Union-wide insolvency proceedings.[8] Some of these procedural rules dictate how the right of set-off may be exercised throughout the Union. Among the most important of these rules is the Recast Regulation on Insolvency Proceedings.[9] The Recast Regulation went into effect in 2017 and, with the exception of Denmark, applies in all European Union member states.[10]

Because the national-level set-off rules continue to have primacy under the Recast Regulation,[11] the main purpose and focus of the regulation is to deal with conflicts of law. For example, the Recast Regulation helps to determine which national insolvency and set-off rules apply in any given proceeding in the European Union.[12] As such, the Recast Regulation aligns with the European Union's overall goal of enhancing and facilitating closer cooperation between all EU member states and contributing to the better functioning of the European Union single market.[13]

In addition to the Recast Regulation, twenty-seven national-level laws remain in force among all Union member states,[14] which directly or

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6. *See* CHARLES J. TABB, LAW OF BANKRUPTCY 565 (West Academic Publishing, 4th ed. 2016) [hereinafter TABB]. ("The right of setoff is grounded in general principles of equity."); *see also*, Sepinuck, *supra* note 2, at 52 (noting that "some early courts of chancery, exercising equitable jurisdiction and conscious of the unfairness of denying setoff against parties with few or dwindling financial resources, found a basis for setoff outside the formalities of law.").

7. ZWEIGERT K. & KÖTZ H., INTRODUCTION TO COMPARATIVE LAW 3 (Tony Weir trans., Oxford University Press 3d rev. ed. 2011) (1998).

8. Regulation 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings, recast, 2015 O.J. (L 141) 19 [hereinafter "Recast Regulation"].

9. *See id.*

10. *See id.* at Recital 88.

11. *See id.* at art. 7.

12. *See id.* at Recital 70.

13. According to the objective in the Recast Regulation: "the proper functioning of the internal market requires that cross-border insolvency proceedings should operate efficiently and effectively." *See id.* at Recital 3 ("[T]he proper functioning of the internal market requires that cross-border insolvency proceedings should operate efficiently and effectively.").

14. For German law, *see* Bürgerliches Gesetzbuch [BGB] [Civil Code], § 387, https://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html#p1431 (Ger.) [hereinafter BGB]; 2 JULIUS VON STAUDINGER ET AL., KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH, MIT EINFÜHRUNGSGESETZ UND NEBENGESETZEN, RECHT DER SCHULDVERHÄLTNISSE [COMMENTARY ON THE CIVIL CODE WITH THE INTRODUCTORY LAW AND SUBSIDIARY LAWS, LAW OF OBLIGATIONS] §§ 362–396, 295 (2016) [hereinafter STAUDINGER ET AL.]; KARL LARENZ, LEHRBUCH DES SCHULDRECHTS, ALLGEMEINER TEIL [TEXTBOOK OF THE LAW OF OBLIGATIONS, GENERAL PART]

indirectly regulate the use of set-offs in insolvency proceedings.[15] Some of these rules have specific requirements for exercising the right of set-off,[16] determining its legal nature,[17] enforcing this right,[18] deciding its legal effect,[19] and governing its availability.[20]

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263 (Beck, 13th ed. 1982) [hereinafter LARENZ]. For Austrian law, *see* ALLGEMEINES BÜRGERLICHES GESETZBUCH [ABGB] [Civil Code], § 1441 https://www.ris.bka.gv.at/Geltende Fassung.wxe?Abfrage=Bundesnormen&Gesetzesnummer=10001622 (Austria) [hereinafter ABGB]. For Swiss law, *see* OBLIGATIONENRECHT [OR], CODE DES OBLIGATIONS [CO], CODICE DELLE OBBLIGAZIONI [CO] [Code of Obligations] Mar. 30, 1911, SR 220, RS 220, art. 120 (Switz.) [hereinafter OR]. For French law, *see* Code civil [C. civ.] [Civil Code] art. 1291 (Fr.) [hereinafter Fren CC]. For English law, *see* The Civil Procedure Rules 1998, Part 16, Rule 16.6 (Eng.). For Spanish law, *see* CÓDIGO CIVIL [C.C.] [Civil Code] art. 1196 (Spain).

15. For example, under German law, the provisions of § 95 of the Insolvenzordung (the German Insolvency Law, hereinafter: InsO) apply directly to set-off proceedings, while the set-off provisions of the BGB, which determine the fulfillment of the set-off requirements, apply indirectly. *See, e.g.*, INSOLVENZORDNUNG [InsO] [Insolvency Code], § 95 (Ger.), https://www.gesetze-im-internet.de/inso/95.html [hereinafter INSOLVENZORDNUNG].

16. *See* PETAR KLARIĆ & MARTIN VEDRIŠ, GRAĐANSKO PRAVO: OPĆI DIO, STVARNO PRAVO, OBVEZNO I NASLJEDNO PRAVO [CIVIL LAW: GENERAL PART, REAL LAW, OBLIGATORY AND INHERITANCE LAW] 466-467 (Narodne novine, 14th ed. 2014).

17. For example, in Germany, Austria, and Croatia, set-off is a type of transformational right (ger. *Gestaltungsrecht, Gestaltungsbefungis*.), which means that the set-off beneficiary has the right to set-off the mutual claims with the counter-party by a unilateral declaration of set-off at the moment when the set-off requirements are fulfilled, even if the counter-party objects. For more on this, *see, e.g.*, JOACHIM GERNHUBER, DIE ERFÜLLUNG UND IHRE SURROGATE: SOWIE DAS ERLÖSCHEN DER SCHULDVERHÄLTNISSE AUS ANDREN GRÜNDEN [FULFILLMENT AND ITS SURROGATES AS WELL AS THE EXTINCTION OF THE OBLIGATIONS FOR OTHER REASONS] 218 (Mohr, 1983) [hereinafter GERNHUBER]; Paul Oertmann, *Die rechtliche Nature der Aufrechnung* [*The Legal Nature of Set-Off*], 113 ARCHIV FÜR DIE CIVILISTISCHE PRAXIS 335, 376 (1915) [hereinafter Oertmann]. For Austrian law, *see, e.g.,* Peter Bydlinski, *Die Aufrechung mit verjährten Forderungen: Wirklich kein Anderungsbedarf?* [*Offsetting with Statute-Barred Claims: Really No Need to Change?*], 196 ARCHIV FÜR DIE CIVILISTISCHE PRAXIS 276, 286 (1996). For Swiss law, *see, e.g.,* PETER GAUCH ET AL., DAS ERLÖSCHEN DER OBLIGATIONEN: Art. 114–126 OR [The Expiry of Obligations: Arts. 114-126 of the Civil Code] 282 (Schulthess, 1991) [hereinafter GAUCH ET AL.].

18. For example, under German law, in order for the legal effects of set-off to take place, there has to be a declaration of set-off (ger. *Aufrechnungserklärung*), in addition to the requirements of set-off. *See* LARENZ, *supra* note 14, at 261-62. If set-off is declared, then the declaration of set-off transforms the right to set-off to the rights from the set-off, i.e., the claims will be satisfied in the amount in which they overlap. Therefore, the obligations are not discharged automatically by the mere fulfillment of the requirements for set-off under German law (which is the case under Spanish law) or on the basis of a court decision, but there must be a unilateral declaration of set-off. *See* GAUCH ET AL., *supra* note 17, at 281. *Also see, e.g.*, STAUDINGER ET AL., *supra* note 14, at 251-52; LARENZ, *supra* note 14, at 243, 255; GERNHUBER, *supra* note 17, at 211.

19. *See* Christian Wolf, *Die Prozessaufrechnung–Teil 1* [*The Process of Set-Off–Part 1*], 10 ZEITSCHRIFT FÜR STUDENTEN UND REFERENDARE 673, 673 (2008); GERNHUBER, *supra* note 17, at 211; LARENZ, *supra* note 14, at 260; GAUCH ET AL., *supra* note 17, at 282, 304; STAUDINGER ET AL., *supra* note 14, at 423.

20. *See, e.g.*, Oertmann, *supra* note 17, at 412. For German law, *see, e.g.*, STAUDINGER ET AL., *supra* note 14, at 510. For Swiss law, *see* OBLIGATIONENRECHT [OR], *supra* note 14, at §§ 125-126. For Austrian law, *see, e.g.*, ABGB, *supra* note 14, at § 1440.

This Article offers a comparative analysis of the different characteristics of the right of set-off in insolvency proceedings in the United States and the European Union. It does so in five different sections. The initial section (Part I) contains the Article's introduction. The second section (Part II) provides a general definition of the right of set-off as well as a brief discussion of its history and context. This definition provides a baseline for the comparative analysis that is pursued in Part III and IV. A comprehensive description and analysis of the characteristics of the right of set-off in the United States is the focus of Part III, which is followed by a discussion of the Recast Regulation in the European Union and its impact upon the national level set-off rules in the Union (Part IV). Finally, in the Article's conclusion (Part V), the characteristics of the right of set-off are further analyzed and properly contextualized.

II. HISTORY AND TERMINOLOGY OF THE RIGHT OF SET-OFF

In order to understand the right of set-off, its origins, and terminology, it is first necessary to define the right of set-off in general terms and explain the often-confusing terminology used when discussing this right in the United States and Europe. This is of particular importance in the context of insolvency and bankruptcy because the creditor asserting a right of set-off in bankruptcy is generally himself also a debtor to the debtor in bankruptcy.[21]

Some commentators describe set-off in its basic form as "the cancelation of cross demands, that is, the satisfaction of all or part of a debt owed by X to Y through the simultaneous discharge or forgiveness of a debt due to X from Y."[22] Claiming a set-off as a discharge seems misleading, however. In context of the concept of a debt discharge in bankruptcy, this appears obvious.[23] Further, the characterization as the forgiveness of debt seems equally confusing, because the creditor claiming the set-off clearly receives something of value in return, which is not subject to *pari passu*. At the same time, the creditor's own debt is

21. ZIMMERMAN, *supra* note 1, at 43.

22. *See* Stephen L. Sepinuck, *The Problems with Setoff: A Proposed Legislative Solution*, 30 WM. & MARY L. REV. 51, 51 (1988) [hereinafter Sepinuck].

23. *See, e.g.*, John C. McCoid II, *Setoff: Why Bankruptcy Priority*, 75 VA. L. REV. 15, 15-16 (1989) (noting that "with the advent of discharge" the traditional misplaced any natural justice justification) [hereinafter McCoid II, *Setoff: Why Bankruptcy Priority*]; *see also* D. E. Murray, *Banks Versus Creditors of Their Customers: Set-offs Against Customers' Accounts*, 82 COM. L.J. 449, 464 (1977).

extinguished with no remaining liability to the bankruptcy estate.[24] Finally, in the bankruptcy setting, the creditor seems to receive a preference and is treated as a secured creditor without the need for perfection.

Maybe the best way to describe set-off is by defining the effect of asserting or effectuating the right of set-off as the extinction of debt between two persons that are reciprocally or mutually debtors and creditors to one another simultaneously.

Under the U.S. Bankruptcy Code,[25] asserting a set-off operates as a counterclaim of the creditor against the debtor. While this initially may appear counterintuitive or even confusing, because the creditor technically is not in the position of a defendant when he claims set-off against the debtor in bankruptcy and not the party that would typically claim the right or raise it as a defense, the definition as a counterclaim makes good sense. Civil law may provide the best explanation in this context. For example, German law distinguishes between an active claim (*Aktivforderung)* and a passive claim (*Passivforderung)*.[26] The active claim, which may also be called the counterclaim (*Gegenforderung)* is the claim of the party asserting the right of set-off or the creditor of the debtor in bankruptcy.[27] The passive claim, on the other hand, which is also referred to as the principal claim (*Hauptforderung),* is the claim against which the right of set-off is directed.[28] The passive claim is, therefore, the claim against which the creditors seek to assert the set-off in bankruptcy and which they are also at the same time the debtors in relation to the debtor in bankruptcy or the bankruptcy estate.[29]

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24. *See, e.g.*, Lawrence Kalevitch, *Setoff and Bankruptcy*, 41 CLEV. ST. L. REV. 599, 611-613 (1993) (noting that "[s]etoff in bankruptcy has traditionally provided the setoff holder with a right to cancel its liability to the bankrupt estate . . .") [hereinafter Kalevitch].

25. *See* 11 U.S.C. § 553(a) (2018) ("[T]his title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor . . . against a claim of such creditor against the debtor.").

26. *See, e.g.*, MARTIN SCHLÜTER, MÜNCHENER KOMMENTAR ZUM BÜRGERLICHEN GESETZBUCH § 387 ¶ 1 (C.H. Beck, ed., 8th ed. 2019) [hereinafter SCHLÜTER].

27. *Id.*

28. *Id.*

29. *Id.*

III. SET-OFF RULES IN U.S. INSOLVENCY PROCEEDINGS

A. Set-off and Recoupment

As in the European Union and its member states, the right of set-off is an important and powerful state law remedy in the United States.[30] In the U.S., the right of set-off arises automatically and is grounded in the principles of equity.[31] As such, the right of set-off exists independently from the U.S. Bankruptcy Code; it is created entirely outside of bankruptcy law and is therefore not an insolvency-specific remedy.[32] In addition to principles of equity, the right of set-off may also be established and is regulated under state law as a statutory remedy.[33]

However, when it comes to set-offs in more general terms, U.S. bankruptcy law allows two distinct but similar options: the right of set-off and the right of recoupment.[34] A clear distinction between both of these options is important because the right of set-off is limited after a petition for bankruptcy has been filed.[35] For example, the right of set-off is immediately subject to the automatic stay under U.S. law.[36] Conversely,

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30. Interestingly, in colonial America the right to set-off predates the English statutes. *See, e.g.*, Sepinuck, *supra* note 22, at 52-53 (noting that "[a]s early as 1645, the colony of Virginia permitted civil defendants to set off debts due to and debts owing from a plaintiff.").

31. *See* ROY R. GOODE, LEGAL PROBLEMS OF CREDIT AND SECURITY 154 (Sweet & Maxwell, 2d ed. 1988).

32. *See, e.g.*, *In re* B.F. Goodrich Employees Federal Credit Union v. Fred C. Patterson, Jr. and Mary L. Patterson, 967 F.2d 505, 510 (11th Cir. 1992) (showing an unmatured creditor's claim at the time of the debtor's bankruptcy) [hereinafter *In re* Patterson].

33. *See, e.g.*, William H. Loyd, *The Development of Set-Off,* 64 U. PA. L. REV. 541, 557 (1916) [hereinafter Loyd]; *see also* 810 Ill. Comp. Stat. § 5/9-340 (2001); Mich. Pub. Acts § 440.9340 (1962); *see also* Randall L. Dunn, *Banker's Lien and Equitable Set-off: Constitutional and Policy Considerations for Protecting Bank Customers*, 27 STAN. L. REV. 1149, 1152 (1975) (noting that the right of setoff may also be derived from the Roman Law of compensation); in practice only "very few states significantly regulate equitable setoff by statute." *See* DAVID G. EPSTEIN ET AL., BANKRUPTCY 360 (1992) [hereinafter EPSTEIN ET AL., BANKRUPTCY]. However, statutory restrictions may be found in the U.S. under states' consumer protection statutes. *See, e.g.*, 3 BARKLEY CLARK & BARBARA CLARK, THE LAW OF BANK DEPOSITS, COLLECTIONS, AND CREDIT CARDS § 18.02, ¶ 4 (LexisNexis, 2014); *see also* The Fair Credit Billing Act, 15 U.S.C. § 1666h(a) (2018) ("A card issuer may not take any action to offset a cardholder's indebtedness arising in connection with a consumer credit transaction under the relevant credit card plan against funds of the cardholder held on deposit with the card issuer, unless . . .").

34. *See, e.g.*, TABB, *supra* note 6, at 259-262.

35. *See In re* Gardens Regional Hospital and Medical Center, Inc. v. State of California, 975 F.3d 926 (9th Cir. 2020) ("Recoupment is not subject to all of the same strictures in bankruptcy as is exercise of right of setoff.").

36. *See* EPSTEIN ET AL., BANKRUPTCY, *supra* note 33, at 362.

the right of recoupment may be exercised without any such limitations and is not subject to the stay, allowing enforcement post-petition.[37]

The different treatment of these two options is based on the underlying type or character of the debt that exists between a creditor and debtor.[38] Similarly to the right of set-off in the European Union, in the United States, if the debt between creditor and debtor is mutual, the only available remedy is set-off.[39] Indeed, a debt is considered mutual if it is owed "in the same right and between the same parties, standing in the same capacity, and [are] of the same kind or quality."[40]

On the other hand, if the debt arose out of a single integrated transaction[41] in the United States, the creditor may further rely on the doctrine of recoupment to reduce or satisfy his claim. To be sure, recoupment is very powerful, but at the same time, it is a narrow and fact-specific remedy.[42] It is defined as "the setting up of a demand arising from the same transaction as the plaintiff's claim or cause of action, strictly for the purpose of abatement or reduction of such claim."[43] For example, if a debtor started performance under an existing contractual agreement with the creditor and that creditor later claims rights under the agreement for the delivery of non-conforming or defective goods, the creditor may have the right of recoupment due to the fact that his claim arose out of the same transaction with the debtor.[44]

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37. Gabriel A. Morgan, *The Devil is in the Details . . . The Doctrine of Recoupment*, WEIL RESTRUCTURING (May 10, 2019), https://restructuring.weil.com/automatic-stay/devil-in-the-details-doctrine-of-recoupment/#page=1 [hereinafter Morgan].

38. *See, e.g.*, Westinghouse Credit Corp. v. D'Urso, 278 F.3d 138 (2d. Cir. 2002).

39. *See id.*

40. *See* Boston & Maine Corp. v. Chicago Pac. Corp., 785 F.2d 562, 566 (7th Cir. 1986); *see also* Sepinuck, *supra* note 22, at 71.

41. *See, e.g.*, *In re* Univ. Med. Ctr. v. Louis W. Sullivan, 973 F.2d 1065, 1081 (3d Cir. 1992) [hereinafter *In re* Univ. Med. Ctr.].

42. Morgan, *supra* note 37.

43. *See, e.g.*, Newbery Corp. v. Fireman's Fund Ins. Co., 95 F.3d 1392, 1400 (9th Cir. 1996); *In re* Univ. Med. Ctr., 973 F.2d at 1079. Note that not all courts uniformly apply the same standard to define what constitutes a debt from the same transaction. For example, the 9th Circuit applies the so-called "logical relationship." *See, e.g.*, *In re* Barbra Williamson v. Public Agency Retirement System, No. CC-17-1375-LSF, 2018 WL 4926430, at *2 (B.A.P. 9th Cir. Oct. 10, 2018) (citing Newbery Corp. v. Fireman's Fund Ins. Co., 95 F.3d at 1399); On the other hand, the 3rd Circuit rejects this test. *See In re* Univ. Med. Ctr., 973 F.2d at 1081 (noting that "a mere logical relationship is not enough: the fact that the same two parties are involved, and that a similar subject matter gave rise to both claims, does not mean that the two arouse from the same transaction.").

44. *See* TABB, *supra* note 6, at 261 (noting that "in the Medicare context, involving health care providers whose relationship with the federal government involves ongoing Medicare reimbursements and credits").

B. Set-offs in Bankruptcy

Because the right of set-off is established independently and outside of the U.S. Bankruptcy Code, U.S. bankruptcy law simply recognizes and preserves that right by providing certain rules that address its effect and execution pre and post-bankruptcy petition. The Code specifically provides that bankruptcy proceedings do "not affect any right of a creditor to offset a mutual debt"[45] that arose between creditor and debtor prior to a petition for bankruptcy.[46]

Most notably, the right of set-off grants the creditor a secured claim in bankruptcy.[47] After a bankruptcy petition has been filed, it has the effect of providing a set-off creditor with senior priority over any unsecured claim or any other estate assets.[48] At the same time, while secured claims are broadly protected in bankruptcy,[49] this protection is not unlimited. For example, as with most secured claims, the right of set-off is also subject to the automatic stay, which restrains the creditor from taking immediate enforcement actions against the debtor or his estate.[50] Despite that limitation, a creditor may nevertheless assert the right of set-off as a defense against a turnover order by the trustee.[51] As a third party in possession of any property of the bankruptcy estate, creditors are generally required to turn over possession of any such property to the trustee or the debtor in possession.[52] In addition, a trustee may bring an action to compel the creditor to turn over any property of the bankruptcy estate that is under his/her control.[53]

Under U.S. bankruptcy law, a creditor with a right of set-off is also in an ideal position and is effectively treated as if he holds a preference

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45. *See* 11 U.S.C. § 553 (2018).
46. *See id.*
47. *See* 11 U.S.C. § 506(a)(1) (2018).
48. *See id.*
49. *See, e.g.*, Dewsnup v. Timm, 502 U.S. 410, 419 (1992) (addressing the effect of the Takings Clause of the Fifth Amendment to the U.S. Constitution); *see also* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 589 (1935) ("The bankruptcy power, like the other great substantive powers of Congress, is subject to the Fifth Amendment.").
50. *See* 11 U.S.C. § 362(a)(7) (2018).
51. *See* 11 U.S.C. § 542(b) (2018).
52. *See* 11 U.S.C. § 542(a) (2018). It is important to note that property only needs to be turned over, if the property has some value under 11 U.S.C. § 363 (2018), and if the trustee could use, sell, or lease the property. Property must also be turned over if the debtor may be able to claim an exemption under 11 U.S.C. § 522 (2018).
53. *See id.*; *see also* JEFFREY T. FERRIELL & EDWARD J. JANGER, UNDERSTANDING BANKRUPTCY 197 (LexisNexis, 3d ed. 2013) [hereinafter FERRIELL & JANGER].

over any other secured or unsecured creditor.[54] Specifically, the set-off creditor will always be paid in full and up to the extent of his right, while all general creditors must share any proceeds pro rata.[55] As the United States Supreme Court noted, the right of set-off in bankruptcy "can be asserted as a defense or by the voluntary act of the parties, because it is grounded on the absurdity of making A pay B when B owes A."[56]

C. Limitations of Set-off Rights in Bankruptcy

Exercising the right of set-off is not particularly difficult in the U.S. and may not even require the consent of the obligor.[57] As in European jurisdictions, set-off may be exercised extra-judicially between two mutually indebted parties.[58] Only one of the parties needs to determine that his/her obligation to the other party is offset, thereby reducing the amount the other party owes the first party.[59] Effectively, this functions as the cancelation of cross-demands.[60] In other words, all or part of a debt owed between two parties is netted out; it is discharged or forgiven and may be viewed as part or full performance.[61]

1. Mutual and Mature

The most important limitation of the right of set-off in bankruptcy is mutuality.[62] Only mutual debts may be offset and are explicitly mentioned in the U.S. Bankruptcy Code.[63]

A mutual debt under U.S. law is generally understood as a debt that must be owed "in the same right and between the same parties, standing

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54. *See generally* McCoid II, *Setoff: Why Bankruptcy Priority*, *supra* note 23 (arguing that the preferential treatment of set-offs in bankruptcy is questionable).

55. *See id.*; *see also*, Kalevitch, *supra* note 24 (noting that "[u]sing the face amount of the creditor's claim against the estate may be correct, but only if that is the real value of the setoff right. As in the matter of liens, any difference between the face amount of the creditor's claim and its value as an offset constitutes an unsecured claim against the estate, that is, a deficiency claim in the vocabulary of liens.").

56. *See* Studley v. Boylston Nat'l. Bank of Bos., 229 U.S. 523, 528 (1913).

57. *See, e.g.*, TABB, *supra* note 6, at 565.

58. *See id.* ("If mutual debt exists between the same parties, acting in the same right and capacity, the right of setoff arises automatically.").

59. *See, e.g.*, EPSTEIN ET AL., BANKRUPTCY, *supra* note 33.

60. *Id.* at 359.

61. *See, e.g.*, Sepinuck, *supra* note 22, at 51.

62. *See, e.g.*, FERRIEL & JANGER, *supra* note 53, at 367.

63. 11 U.S.C. § 553(a) (2018) ("Except as otherwise provided in this section and in section 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arouse before the commencement of the case." (emphasis added)). *See* FERRIELL & JANGER, *supra* note 53, at 45.

in the same capacity, and the same kind or quality."[64] Additionally, any right to offset by and available to a creditor may not exceed the creditor's existing non-bankruptcy right.[65] In other words, if a creditor "would be denied setoff outside of bankruptcy, in whole or in part, then to that extent"[66] the creditor's right to set-off is also not recognized and cannot be preserved under the U.S. Bankruptcy Code.[67]

To be sure, a mutual debt preserved under the U.S. Bankruptcy Code is a single debt between two counterparties. It is a debt between one debtor and one creditor, which explicitly excludes any triangular or multilateral offset or netting.[68] However, a mutual debt does not need to be owed out of a single integrated transaction and may be unrelated, but it must be owed between the same two identical parties.[69] Related corporate entities, such as a holding company and its subsidiaries, generally are not recognized as the same party and are prohibited from exercising the right of set-off under U.S. bankruptcy law.[70] On the other hand, the Internal Revenue Service, the Small Business Administration, and the Environmental Protection Agency may be recognized as a single creditor for purposes of mutuality and allowed to exercise the right of set-off under U.S. law.[71] Many U.S. courts specifically consider government agencies to be part of the "United States" as a unitary entity or unitary creditor.[72]

As part of mutuality, both counterparties must also act and stand in the same capacity.[73] This so-called capacity requirement is based on the

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64. *See* Boston & Maine Corp. v. Chicago Pac. Corp., 785 F.2d 562, 566 (7th Cir. 1986); *In re* Hawaiian Airlines, Inc. and West Maui Airport, Inc. v. United States, 196 B.R. 159, 161-62 (B.A.P. 9th Cir. 1996) [hereinafter *In re* HAL, Inc.]; *see also* Sepinuck, *supra* note 22, at 71.

65. *See, e.g.*, Kalevitch, *supra* note 24, at 617-18.

66. *See id.*

67. *See id.*

68. *See, e.g.*, *In re* Elcona Homes Corp. v. Green Tree Acceptance, Inc, 863 F.2d 483, 486 (7th Cir. 1988) [hereinafter *In re* Elcona Homes Corp.]; *see also In re* Lehman Bros., 458 B.R. 134, 136-37 (Bankr. S.D.N.Y. 2011) (noting that allowing for multilateral netting by agreement is unenforceable or that "[c]ontractual provisions [which] purport to create synthetic mutuality are not a substitute for the real thing.").

69. *See, e.g.*, TABB, *supra* note 44, at 565 ("If the mutual debts between the parties do arise out of the same transaction, the governing doctrine is called *recoupment*, not setoff.").

70. *See* TABB, *supra* note 6, at 569.

71. *See id.*

72. *See, e.g.*, United States v. Maxwell, 157 F.3d 1099, 1102 (7th Cir. 1998); *In re* Hawaiian Airlines, Inc. and West Maui Airport, Inc. v. United States, 196 B.R. 159, 164 (B.A.P. 9th Cir. 1996); *In re* Curtis Lawayne Turner and Rita Gail Turner v. Small Business Association, 84 F.3d 1294, 1296 (10th Cir. 1996).

73. *See* Boston & Maine Corp. v. Chicago Pac. Corp., 785 F.2d 562, 566 (7th Cir. 1986); *In re* Hawaiian Airlines, Inc. and West Maui Airport, Inc. v. United States, 196 B.R. 159, 161-62 (B.A.P. 9th Cir. 1996).

principle of fairness, commanding that debtor and creditor must act at arm's length when they demand set-off and act in the same role.[74]

Fiduciary roles and the right of set-off against trust accounts are often used as examples to explain the capacity requirement of mutuality more clearly.[75] For example, if a debtor holds multiple accounts with a bank to whom she owes money on a personal loan or credit card, the bank may not demand any set-off against the debtor's account, if the only liquid account of the debtor is held by the debtor as a fiduciary or corporate officer and not in any personal or individual capacity.[76] The same is true if the account is owned by more than one person jointly, between partners of a partnership, or if the account is held by the debtor as the trustee of a trust or the executor of an estate.[77] In each of these examples, no mutuality exists between creditor and debtor. This is because the relationship between these counterparties is based on entirely different roles and not established between identical parties in the same capacity.

In addition to mutuality, any mutual and unitary debt must generally also be mature before it may be offset.[78] This is only the case when the debt is due at the time when a creditor initiates set-off.[79] Any future payments or debt that has not yet matured, including future installments of rent, may not be set-off.[80] The only exception may be any debt that is payable on demand, which becomes immediately due and payable upon such demand by the creditor.[81]

2. Pre-Petition Claims

Another limitation under the U.S. Bankruptcy Code to exercising the right of set-off is that the debt owed and subject to the right of set-off must

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74. *See, e.g.*, TABB, *supra* note 6, at 569.

75. *See id.*; *see also* FERRIELL & JANGER, *supra* note 53, at 45.

76. *See id.*

77. *See id.*

78. *See, e.g.*, Barkley Clark, *Bank Exercise of Setoff: Avoiding the Pitfalls*, 98 BANKING L.J. 196, 206-213 (1981) (noting that it is generally recognized or "fundamental law" that banks may not offset debt against a customer account unless the debt is mature.); *see also* John TeSelle, *Banker's Right of Setoff-Banker Beware*, 34 OKLA. L. REV. 40, 61-62 (1981).

79. *See, e.g.*, FERRIELL & JANGER, *supra* note 53, at 46.

80. *See, e.g.*, Wenneker v. Physicians Multispecialty Grp., Inc., 814 S.W.2d 294, 297 (Mo. 1991) (dealing with an attempt by a bank to claim a right of set-off for rent accruing after the service of a garnishment).

81. *See, e.g.*, Marion Ins. Agency, Inc. v. Fahey Banking Co., 572 N.E.2d 124, 127 (Ohio Ct. App. 1988) (noting that it is not necessary that creditor formally demand payment); Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 518 P.2d 734, 738 (Wash. Ct. App. 1974) (arguing that maturity exists upon delivery of the demand for payment).

be one "that arose before the commencement of the case."[82] A creditor's pre-petition claim cannot be set off[83]

While this timing rule appears straightforward *per se*, the definition of what qualifies as a claim under the Code is very expansive and, for example, includes the "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured."[84]

As a result, the determination of when a creditor's right arose is much more complicated and confusing. There is no consistent approach and, to make things worse, U.S. courts have applied many different tests, such as the accrual test,[85] the conduct or transaction test,[86] the relationship test,[87] and the foreseeability test.[88]

Under the accrual test, which is not broadly accepted,[89] the courts determine the question of when a right to payment arises based on state law.[90] The conduct and transaction test, on the other hand, simply focuses on when the conduct that gave rise to the claim took place and views it as irrelevant whether the claim was contingent, unliquidated, or unmatured at the time the debtor files for bankruptcy.[91] As its name suggests, the

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82. *See, e.g.*, Pennsylvania Dep't of Pub. Welfare v. Davenport, 495 U.S. 552, 558 (1990), *superseded by statute*, Criminal Victims Protection Act of 1990, Pa. Laws 101-581, § 3, 104 Stat. 2865, *as recognized in* Johnson v. Home State Bank, 501 U.S. 78, 83 n.4 (1991); 11 U.S.C. § 553(a) (2018). *See, e.g.*, Kalevitch, *supra* note 24, at 658.

83. *See, e.g.*, FERRIELL & JANGER, *supra* note 53, at 368.

84. 11 U.S.C. § 101(5)(A) (2020).

85. *See, e.g.*, Cooper-Jarrett, Inc. v. Cent. Transp. Inc., 726 F.2d 93, 96 (3d Cir. 1984).

86. *See, e.g.*, Braniff Airways, Inc. v. Exxon Co., 814 F.2d 1030, 1037 (5th Cir. 1987).

87. *See, e.g.*, *In re* Pettibone Corp. v. Edwin R. Ramirez, 90 B.R. 918, 925-26 (Bankr. N.D. Ill. 1988) [hereinafter *In re* Pettibone Corp.].

88. *See, e.g.*, FERRIELL & JANGER, *supra* note 53, 368.

89. *See, e.g.*, *Getting to Know Your Two Best Friends: The Rights of Setoff and Recoupment*, K&LNG ALERT, https://files.klgates.com/files/publication/56da8ca6-ba6a-4973-8fa4-3b2d8aaf05a5/presentation/publicationattachment/77554d2e-5845-481f-9f1c-4f3a7f161e4d/ba1205.pdf (last visited Oct. 28, 2021) ("The accrual test is disfavored and seldom used.").

90. *See, e.g.*, Matter of Avellino & Bienes v. M. Frenville Co., 744 F.2d 332, 337 (3d Cir. 1984), *overruled by In re* Grossman's Inc. & Jeld-Wen, Inc. v. Gordon Van Brunt, 607 F.3d 114, 121 (3d Cir. 2010) (noting that "while federal law controls which claims are cognizable under the Code, the threshold question of when a right to payment arises, absent overriding federal law, 'is to be determined by reference to state law.'"); *In re* Grossman's Inc., 607 F.3d at 121; *see* Matter of M. Frenville Co., 744 F.2d at 337 (citing Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 161 (1946)); *In re* David McMeekin & Joan Shoreman, 16 B.R. 805, 808 (Bankr. D. Mass. 1982); *In re* Thomas, 12 B.R. 432, 433 (Bankr. S.D. Iowa 1981).

91. *See, e.g.*, Braniff Airways, Inc. v. Exxon Company, U.S.A., 814 F.2d 1030, 1036; Matter of Nickerson & Nickerson, Inc., 62 B.R. 83, 85 (Bankr. D. Neb. 1986); *In re* Morristown Lincoln-Mercury, Inc. & Richard Stair, Jr. v. Hamilton Bank of Morristown, 42 B.R. 413, 417-18 (Bankr. E.D. Tenn. 1984).

relationship test requires some type of pre-petition relationship between the parties as a basis for any right of set-off.[92] Specifically, a right to payment is established at the "earliest point in the relationship"[93] between creditor and debtor.[94] Finally, under the foreseeability test, the determination of when the right of set-off arose depends on the happening of a future event that was "within the actual or presumed contemplation of the parties at the time the original relationship between the parties was created."[95]

3. Disallowed Claims

Disallowed Claims may not be offset during an insolvency proceeding in the United States.[96] This limitation corresponds with the basic rule that after a creditor files a claim against the debtor in a U.S. bankruptcy filing, and after an objection is raised, the validity and amount of that claim has to be determined by the court.[97]

The reasons for disallowance may be divided into three basic categories.[98] First, the right of set-off will only be allowed if the right in the amount of the demand for set-off existed "as of the date of the filing of the petition."[99] The fact that the right was unmatured, contingent, or disputed is irrelevant as long as the right existed at the time of the petition.[100]

Second, the right of set-off may also be disallowed if the debtor is able to raise a substantive non-bankruptcy objection or defense against the enforceability of the claim that is the basis of the creditor's demand for

92. For German law *see, e.g.*, HANS-PETER KIRCHHOF ET AL., MÜNCHENER KOMMENTAR ZUR INSOLVENZORDNUNG 301 (C.H. Beck, ed., 2013) [hereinafter KIRCHHOF ET AL.].

93. *In re* Pettibone Corp. v. Edwin R. Ramirez, 90 B.R. 918, 926 (Bankr. N.D. Ill. 1988); *In re* Michael Wayne Edge and Frances S. Roach v. Michael Wayne Edge and Thomas Anderson Roach, 60 B.R. 690, 705 (Bankr. M.D. Tenn. 1986).

94. *See In re* Pettibone Corp., 90 B.R. at 926 (referring to a tort case and the claim of a victim against a wrongdoer).

95. *In re* National Gypsum Co. and Aancor Holdings, Inc., 139 B.R. 397, 406 (N.D. Tex. 1992) (citing *In re* Chateaugay Corp. and United States v. The LTV Corporation, The Committee of Equity Security Holders of the LTV Corporation, and The State of New York v. LTV Steel Company, Inc. and The Committee of Unsecured Creditors of the LTV Steel Company, Inc., 944 F.2d 997, 1004 (2d Cir. 1991)); *see also In re* Chateaugay Corp., 944 F.2d at 1004.

96. *See* 11 U.S.C. § 553(a)(1) (2018).

97. *See* 11 U.S.C. § 502(b) (2020).

98. *See, e.g.*, TABB, *supra* note 6, at 659.

99. 11 U.S.C. § 502(b) (2020).

100. *See* 11 U.S.C. § 502(c) (2020).

set-off.[101] For example, if the underlying contract between the counterparties is unenforceable because of usury, unconscionability, or the lack of consideration,[102] the right of set-off will be disallowed. Another often-used example is the lack of compliance with form requirements such as the statute of frauds.[103]

Third and finally, the right of set-off may also be disallowed for bankruptcy-specific reasons or policies which are expressly mentioned in the U.S. Bankruptcy Code.[104] Examples are claims for unmatured interest,[105] specific landlord rent claims,[106] and certain employee's termination claims.[107]

4. Prohibition of Creditor's Preferences

One of the basic tenets of U.S. bankruptcy law is the equal distribution of assets among creditors.[108] No creditor should receive any preference or preferential treatment over a similarly situated creditor.[109] A preference is a transfer that favors one creditor over another and is most often executed as a pre-bankruptcy transaction.[110] To be sure, "[a]ny creditor that received a greater payment than others of his class is required to disgorge so that all may share equally."[111]

For the right of set-off, any offset demand may be set aside if a creditor gained an unfair advantage over any other creditor during ninety days prior to any debtor's petition for bankruptcy.[112]

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101. *See* 11 U.S.C. § 502(b)(1) (2020); *see also* Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156, 161 (1946) (citing Bryant v. Swofford Bros. Dry Goods Co., 214 U.S. 279, 290-9 (1909); Security Mortgage Co. v. Powers, 278 U.S. 149, 153-54 (1908)) (noting that "[w]hat claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed, is a question which, in the absence of overruling federal law, it to be determined by reference to state law").

102. *See, e.g.*, S. REP. NO. 95-989, at 62 (1978); *see also* H.R. REP. NO. 95-595, at 352 (1978).

103. *See, e.g.*, TABB, *supra* note 6, at 570.

104. *See, e.g.*, 11 U.S.C. § 502(b)(2)-(9) (2020); 11 U.S.C. § 502(d), (e) and (k) (2020); 11 U.S.C. § 523(a)(5) (2020).

105. *See* 11 U.S.C. § 502(b)(2) (2020).

106. *See* 11 U.S.C. § 502(b)(6) (2020).

107. *See* 11 U.S.C. § 502(b)(7) (2020).

108. *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, 2-4 (1986); Elizabeth Warren, *A Principled Approach to Consumer Bankruptcy*, 71 AM. BANKR. L.J. 483, 483 (1997); *see also*, Howard Delivery Services, Inc. v. Zurich American Inc. Co., 547 U.S. 651, 669 (2006).

109. *See id.*

110. *See* 11 U.S.C. § 547(b) (2020).

111. H.R. REP. NO. 95-595, at 177-78 (1978).

112. *See* 11 U.S.C. § 547(b)(4)(A) (2020).

Overall, there are three main restrictions on any offset request in insolvency proceedings in the United States. First, in order to prevent any creditor to purchase claims at a discounted rate before a debtor may file for bankruptcy, and to then turn these claims into full value claims during the insolvency proceeding by demanding a set-off, creditors are restricted from exercising any set-off of claims acquired within ninety days before the debtor filed his bankruptcy petition.[113] This is not the case, however, if the claims involve complex financial instruments, such as securities, commodities, swaps, repurchase agreements, or derivative master netting agreements.[114]

Second, a creditor may not build up the debt he owes to any debtor ninety days before the filing of a bankruptcy petition, if that debtor was already insolvent during that time.[115] This restriction follows the general approach of preference law under the U.S. Bankruptcy Code in preventing a buildup of collateral to secure a debt.[116] However, the restriction of a demand for offset in this context is only sanctioned if it can be proved that the creditor's intent for the buildup was to obtain a right to offset.[117]

Third, a demand for set-off is also prohibited if a creditor exercised the demand in order to improve his position before the debtor has filed for bankruptcy but does so on the day of or within 90 days of the demand.[118] Under these circumstances, the trustee may recover from the offset creditor the amount by which he improved his position on the date or at the point of the set-off.[119]

5. Fraudulent Transfers or Conveyances

Traditionally, the law of fraudulent transfers is rooted in the assumption that some debtors may try to remove some of their assets out of the reach of their creditors.[120] Unlike the law of preferences in

113. *See* 11 U.S.C. § 553(a)(2)(b)(i) (2018) ("[A]fter 90 days before the date of the filing of the petition.").

114. *See* 11 U.S.C. § 362(b)(6) (2020); 11 U.S.C. § 362(b)(7) (2020); 11 U.S.C. § 362(b)(17) (2020); 11 U.S.C. § 362(b)(27) (2020); 11 U.S.C. § 555 (2005); 11 U.S.C. § 556 (2005); 11 U.S.C. § 559 (2005); 11 U.S.C. § 560 (2005); 11 U.S.C. § 561 (2005).

115. *See* 11 U.S.C. § 553(a)(3) (2018).

116. *See, e.g.*, 11 U.S.C. § 547(b)(5) (2020).

117. *See* 11 U.S.C. § 553(a)(3)(c) (2018).

118. *See* 11 U.S.C. § 553(b) (2018).

119. *See id.*; *see also* 11 U.S.C. § 547(c)(5) (2020); *see* TABB, *supra* note 44, at 571 (noting that "[s]ection 553(b), like § 547(c)(5), utilizes a two-point improvement-in-position test.").

120. *See, e.g.*, John C. McCoid II, *Constructively Fraudulent Conveyances: Transfers for Inadequate Consideration*, 62 TEX. L. REV. 639, 656 (1983); *see also* Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829 (1985).

bankruptcy, the law of fraudulent transfers focuses more directly on the rights and the relationship between creditors and debtors, rather than the equal relationship between similarly situated creditors.[121]

It is generally recognized today that any transfer by the debtor that has the potential of harming the creditor's right of recovery may be avoided under the law of fraudulent transfers or conveyances.[122] It is no surprise that this avoidance power may also be relevant in the context of the right of set-off. For example, a debtor may transfer a claim to an unsecured creditor in order to provide that creditor with a right to offset his claim and, in turn, essentially provide him with a secured claim despite his failure to perfect such a claim.

To be clear, the right of set-off itself does not qualify as a fraudulent transfer; as noted, it is based on the principle of equity, common law, and stipulations in many state statutes.[123] However, a fraudulent transfer or conveyance cannot and should not be offset during an insolvency proceeding.[124] Allowing a demand for offset would undermine and potentially totally preempt the overall goal of the U.S. Bankruptcy Code's fraudulent transfer rules.[125] It would allow creditors to offset the value of property "fraudulently" transferred to them by the amount of their unsecured or non-enforceable claim against the debtor.[126]

As a result, U.S. courts generally deny the set-off of a creditor's obligation to return monies obtained through any fraudulent transfers or conveyances.[127] Specifically, courts argue that allowing a set-off under these circumstances would defeat the right to recover the conveyance, deplete the estate, and that the underlying transaction is single, rather than mutual, which, in turn, prevents preservation in bankruptcy.[128] Thus, any claim that is fraudulently transferred or conveyed lacks mutuality and cannot be set-off in the United States.

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121. *See, e.g.*, Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 777 (1984).

122. *See, e.g.*, TABB, *supra* note 6, at 572.

123. *See id.*

124. *See, e.g.*, *In re* United Energy Corp. v. C.H. Rider & Family, 944 F.2d 589, 597 (9th Cir. 1991).

125. *See, e.g.*, *In re* J.R. McConnell, Jr. and Vincent Bustamonte v. Peter Johnson, 934 F.2d 662, 667 (5th Cir. 1991); Mack v. Newton, 737 F.2d 1343, 1366 (5th Cir. 1984). *In re* Acequia, Inc. v. Vernon B. Clinton and Rosemary Haley and Acequia, Inc. v. Vernon B. Clinton, 34 F.3d 800, 817 (9th Cir. 1994).

126. *See, e.g.*, Mack v. Newton, 737 F.2d at 1366.

127. *See, e.g.*, *In re* Acequia, Inc., 34 F.3d at 817.

128. *See id.*

6. Automatic Stay and Freezes

A discussion of set-off rights in U.S. insolvency proceedings would not be complete without addressing the role and impact of the automatic stay on any demand for set-off.[129]

The automatic stay is an integral part of U.S. bankruptcy law[130] and operates like a statutory injunction, becoming automatically effective upon the filing of a bankruptcy petition.[131] The automatic stay's main function is to preserve the bankruptcy estate on a temporary basis for the duration of the insolvency proceeding.[132] It is the overall goal of the stay to allow for the equitable treatment of all of the debtor's creditors while, at the same time, providing the debtor with a viable opportunity to get a fresh start.[133] The stay is also an effective tool to ensure that the bankruptcy proceeding advances in a much-needed, orderly fashion and prevents any creditor from a run on the debtor's assets or any attempt to collect on any claim outside of the insolvency proceeding.[134]

The right of set-off is not exempt from the effect of the stay. The automatic stay prevents any creditor from exercising or demanding the set-off of a debt that arose prior to the commencement of the debtor's insolvency proceedings.[135] As such, the set-off creditor is treated equally to any other secured creditor under the U.S. Bankruptcy Code.[136] Because a secured creditor retains his claim after the debtor petitioned for bankruptcy, the set-off creditor also retains his right of set-off and is only restricted from executing his set-off right until it has been properly examined.[137]

The automatic stay certainly has an interim character and is not meant to last forever. For example, the stay terminates automatically when a discharge is granted[138] or once the property is no longer property of the

129. *See* 11 U.S.C. § 362(a) (2018).

130. *See, e.g.*, H.R. REP. NO. 95-595, at 340 (1978).

131. *See id.*

132. *See, e.g.*, TABB, *supra* note 6, at 235-37.

133. *See, e.g.*, DAVID G. EPSTEIN & STEVE H. NICKLES, PRINCIPLES OF BANKRUPTCY LAW 48 (1st ed. 2007); *see also* TABB, *supra* note 6, at 235-36.

134. *See id.*

135. *See* 11 U.S.C. § 362(a)(7) (2020) (the creditor is stayed from "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor").

136. *See, e.g.*, TABB, *supra* note 6, at 260-62.

137. *See, e.g.*, WILLIAM M. COLLIER, 4 COLLIER ON BANKRUPTCY ¶ 553.05[2], at 553-35 (15th ed. 1996). *See also* Matter of Corland Corp., James L. Stephenson, and United Bank, N.A. v. Duke Salisbury, 967 F.2d 1069, 1077 (5th Cir. 1992).

138. *See, e.g.*, 11 U.S.C. § 524(a) (2019).

estate.[139] This is also the case if the petition is dismissed[140] or if the case is closed.[141] However, because some insolvency proceedings, such as reorganizations, may last over many years, the automatic stay may also remain in place for a very long time.[142] To avoid any long-term negative impact, the U.S. Bankruptcy Code requires adequate protection of the creditors' claims and U.S. courts may decide to grant individual relief from the stay.[143] Relief may be granted if maintaining the stay is no longer necessary as it relates to the creditor's claims or if the creditor's interests outweigh those of the debtor.[144]

As a result, the set-off creditor remains stayed from executing a set-off until the insolvency proceeding terminates or the creditor petitions the court and obtains relief from the stay.[145]

It is important to note that administrative freezes do not violate the automatic stay under U.S. bankruptcy law.[146] A freeze is an administrative hold by a bank or payment processor on an account whereby the account is not debited, and the debtor is prevented from utilizing any of the funds in the account.[147]

Any administrative freeze by a set-off creditor does not *per se* qualify as a set-off demand because the debtor's account is not permanently reduced by the set-off amount.[148] Rather, the debtor is merely prevented from accessing or withdrawing the funds in his account.[149] The temporary refusal to pay the debtor as depositor is "neither a taking of possession of [the debtor's] property nor an exercising of control over it, but merely a refusal to perform its promise."[150]

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139. *See, e.g.*, 11 U.S.C. § 362(d)(2) (2020).

140. *See, e.g.*, 11 U.S.C. § 362(c)(2)(B) (2020).

141. *See, e.g.*, 11 U.S.C. § 362(c)(2)(A) (2020).

142. *See, e.g.*, 11 U.S.C. § 1141(d)(1) (2020); *see also*, TABB, *supra* note 6, at 285.

143. *See, e.g.*, 11 U.S.C. § 361 (2020).

144. *See* 11 U.S.C. § 362(d)(1) (2020).

145. *See* 11 U.S.C. § 362 (d) (2020); *see also In re* Metropolitan Hospital, 131 B.R. 283, 288 (E.D. Pa. 1991); *In re* Albany Partners, Ltd. v. W.P. Westbrook, Jr. et al. v. Albany Partners, Ltd., 749 F.2d 670, 675 (11th Cir. 1984).

146. *See* Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 19 (1995).

147. *See* James H. Wynn, *Freeze and Recoupment: Methods for Circumventing the Automatic Stay?*, 5 BANKR. DEV. J. 85, 107 n.1 (1987); Scott T. Silverman, *The Administrative Freeze and the Automatic Stay: A New Perspective*, 72 WASH. U. L. Q. 441, 474 n.2 (1994) (citing James H. Wynn, *Freeze and Recoupment: Methods for Circumventing the Automatic Stay?*, 5 BANKR. DEV. J. 85 n.1 (1987)).

148. *See* Strumpf, 516 U.S. at 19 ("Petitioner refused to pay its debt, not permanently and absolutely, but only while it sought relief under § 362(d) from the automatic stay.").

149. *See id.* at 18.

150. *See id.* at 22.

The U.S. Supreme Court concluded that this interpretation of the freeze is also a necessary understanding of U.S. bankruptcy law because the determination of whether a set-off has occurred and whether it violates the automatic stay is a federal, not a state law, question.[151] The Court further pointed out that any other conclusion would draw the effect of other sections of the U.S. Bankruptcy Code into question, namely the rule that a set-off creditor may be exempt from a turnover order by the trustee.[152] Other Code provisions that support the Court's finding are the rules that a debtor is prohibited from using or accessing cash collateral without permission[153] and that the right of set-off is treated as a secured claim under the Code.[154]

What remains unclear under U.S. law is whether an indefinite or permanent freeze is permitted[155] and which role the set-off creditor's intent plays in finding a violation of the automatic stay. The U.S. Supreme Court has not clearly addressed these questions, but it appears that in its only decision denying that a freeze violates the automatic stay,[156] the Court heavily relied on the fact that the set-off creditor in that case also had petitioned the bankruptcy court to obtain a relief from the stay.[157]

Specifically, the Court noted that "because—as evidenced by [the creditor's] 'Motion for Relief from Automatic Stay and for Setoff'— [the creditor] *did not purport* permanently to reduce respondent's account balance by the amount of the defaulted loan."[158] And, further continued to find that "[a] requirement of such *an intent* is implicit in the rule followed by a majority of jurisdictions addressing the question . . . "[159]

Because of these unanswered questions, U.S. courts have found that only a temporary or short-term administrative freeze is permitted and that an indefinite freeze "constitutes forbidden self-help in violation of the

151. *See id.* at 19.

152. *See id.*; *see also* 11 U.S.C. § 542(b) (2018).

153. *See* 11 U.S.C. § 363 (2019); *see also* John R. Coogan et al., *Central European Law*, 31(2) INT'L L. 495, 496-98 (1997).

154. *See* 11 U.S.C. § 506 (2005).

155. *See, e.g.*, *In re* Michael D. Kleinsmith v. Alcoa Employees & Community Credit Union, 361 B.R. 504, 508 (Bankr. S.D. Iowa 2006) (arguing that a hold over a year and a half in length violated the automatic stay).

156. *See* Citizens Bank of Maryland v. Strumpf, 516 U.S. 16, 19 (1995).

157. *See id.*

158. *Id.* (emphasis added).

159. *Id.* (emphasis added).

automatic stay."[160] Any such violation may subject the creditor to actual or punitive damages.[161]

Finally, it is important to note that the stay only applies to any set-off creditor for a debt that arose prior to the commencement of an insolvency proceeding.[162] A set-off creditor may not be restricted by the stay when demanding a set-off against any debt that arose post-petition.[163] It may be possible that creditors try to argue that a specific debt should be considered a post-petition rather than a pre-petition debt, in order to avoid the impact of the automatic stay. However, under U.S. bankruptcy law, any unliquidated, contingent, unmatured, or disputed claim may qualify as a pre-petition claim in this context.[164] Only claims that can be clearly identified as having arisen between both counterparties after a petition for bankruptcy was filed, may not be impacted by the automatic stay.[165] To be clear, this is different from the scenario in which a creditor attempts to offset a post-petition debt with a pre-petition debt, which is not permissible.[166]

IV. EUROPEAN UNION INSOLVENCY SET-OFF RULES

A. The European Union Recast Regulation

The need to increase the competitiveness of the economy in the European Union also increased the need for European businesses to cooperate more closely across borders and between EU member states.

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160. *See, e.g.*, *In re* Chris E. Cullen and Beth A. Cullen, 329 B.R. 52, 58 (Bankr. N.D. Iowa 2005); Town of Hempstead Emps. Fed. Credit Union v. Wicks, 215 B.R. 316, 319 (E.D.N.Y. 1997) (finding that a credit union violated the stay through an administrative freeze because it did not seek relief from the stay for four month); *In re* Roy A. Glenn, 198 B.R. 106, 109 n.2 (Bankr. E.D. Pa. 1996), *rev'd* 207 B.R. 418 (Bankr. E.D. Pa. 1997).

161. *See, e.g.*, *In re* Richard Timothy Anderson and Ethel M. Anderson, 430 B.R. 882, 889 (Bankr. S.D. Iowa 2010).

162. *See, e.g.*, 11 U.S.C. § 362(a)(7).

163. *See id.*; *see also* FERRIELL & JANGER, *supra* note 53, at 368 (noting that "[n]o provision is made for setoff pf post-petition claims [in the Bankruptcy Code].").

164. *See* 11 U.S.C. § 101 (2020).

165. *See, e.g.*, *In re* Kenneth Norton, No. 17-129130-JNF, 2018 WL 4005432 (Bankr. D. Mass. 2018) (noting that "[t]he determination of when claims arise ... has generated considerable controversy in bankruptcy case law."); Epstein v. Official Committee of Unsecured Creditors of Piper Aircraft Corp., 58 F.3d 1573, 1576 (11th Cir. 2005) (referencing that prepetition claims may be determined based on "the accrued state law claim test, the conduct test, and the prepetition test."); *In re* Robert Burns Jensen and Rosemary Tooker Jensen v. California Dept. of Health Services, 127 B.R. 27 (B.A.P. 9th Cir. 1991) (applying the conduct test).

166. *See* FERRIELL & JANGER, *supra* note 53, at 368; *see also* Se. Bank N.A. v. Grant (*In re* Apex Int'l Mgmt. Servs., Inc. and Southeast Bank, N.A. v. Charles W. Grant), 155 B.R. 591, 594-95 (Bankr. M.D. Fla. 1993).

Needless to say, as an economy of scale, the European Union has a comparative advantage to provide European businesses with a more efficient and less costly way of conducting their business. The right of set-off plays a crucial role in this context by significantly reducing transaction costs among counterparties.

In the regular course of daily business, the right of set-off may be exercised countless times between two businesses or counterparties residing in two different EU member states, or between parties in the EU and the United States.[167] It is not uncommon in any cross-border transaction to encounter insolvency. The impact of an unforeseen international crisis, such as the COVID-19 pandemic,[168] may cause severe economic distress and force one of the counterparties to fail. It is in this context that the remaining solvent counterparty may need to consider exercising the right of set-off during insolvency proceedings. However, being forced to deal with numerous jurisdictional distinctions throughout the EU or in the United States on how to exercise this important right may, again, increase transaction costs and significantly increase business uncertainty. This uncertainty is counterproductive and may, in turn, not only reduce overall market competitiveness but also cause financial distress for the creditor and solvent counterparty while potentially disadvantaging other creditors of the debtor in bankruptcy.[169]

The determination of whether the requirements for set-off are met and whether the right may be utilized during an insolvency proceeding, requires a fairly high level of cooperation and mutual recognition among the different EU member states, often including an impact analysis on other creditors.[170] This is of particular importance in cross-border

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167. *See, e.g.*, Christian A. Johnson, *At the Intersection of Bank and Finance Derivatives: Who has the Right of Way?* 66 TENN. L. REV. 1, 86 (1998) (noting that "[participants] in the derivatives market take great comfort from their ability to set off."); *see also In re* Sivec SRL, 476 B.R. 310 (Bankr. E.D. Okla. 2012) (preserving creditors' setoff rights even in cases in which foreign law may not grant creditors setoff rights); *In re* Awal Bank, BSC and Charles Russell, L.L.P., London v. HSBC Bank USA, N.A. 455 B.R. 73, 90 (Bankr. S.D.N.Y. 2011) (holding that a foreign representative in a Chapter 15 case may bring an action to avoid and recover an amount set off by a creditor during the 90-day preference period).

168. Johanna Hoekstra, *Regulating International Contracts in a Pandemic: Application of the Lex Mercatoria and Transitional Commercial Law*, COVID-19, Law and Human Rights 117-125 (Ferstman, C. and Fagan, A., eds., 2020).

169. *See, e.g.*, McCoid, *supra* note 23, at 15-16; *see also In re* Elcona Homes Corp. v. Green Tree Acceptance, Inc., 863 F.2d 483 (7th Cir. 1998).

170. Council Regulation 1346/2000, 2000, O.J. (L 160) 1, Recital 11-12.

insolvencies that involve the collapse of multinational corporations, such as Lehman Brothers in the United States[171] and Parmalat in Italy.[172]

There are currently twenty-seven different applicable national insolvency laws in force throughout the European Union, all of which may potentially compete with one another and create inconsistent results.[173] In turn, transaction costs for companies conducting business throughout the European Union are increasing. With many of these national distinctions in place, the EU needed to adopt rules that could help avoid conflict and instead provide clear rules for cooperation among national government authorities administering insolvency proceedings.[174]

Finding a common solution was not easy and took over a decade to complete.[175] The first tangible result was the insolvency regulation that entered into force in 2002.[176] As a regulation, this first Union instrument on insolvency proceedings immediately applied directly to all Union member states,[177] except Denmark.[178] Denmark chose not to take part in the adoption of the regulation and to opt out. As a result, Denmark is not bound by the regulation.[179]

While the EU's first insolvency regulation is widely viewed as a success and offered some good solutions, it immediately became clear that with the increasing number of cross-border insolvency filings throughout the Union, the single market required additional and more complete cross-border insolvency rules.[180] This included better rules regarding the right of set-off and its application in insolvency proceedings.[181] Because of the shortcomings of the first EU insolvency regulation, the regulation was

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171. *See, e.g.*, David N. Crapo, *Lehman Brothers Dismantles in Bankruptcy*, 4 PRATT'S J. BANKR. L. 702, 707-08 (2008).

172. *See, e.g.*, Samuel L. Bufford, *International Insolvency Case Venue in the European Union: The Parmalat and Daisytek Controversies*, 12 COLUM. J. EUR. L. 429, 438 (2006); Djuro Djuric & Vladimir Jovanovic, *"Too Big to Fail"?: The Agrokor Case and Its Impact on West Balkan Economies*, 28 INT. INSOLV. REV. 22, 23 (2019).

173. Council Regulation 1346/2000, 2000, O.J. (L 160) 1, Recital 11, 22.

174. *See, e.g.*, Recast Regulation, *supra* note 8, at Recital 22.

175. *See* Bob Wessels, *The European Union Regulation on Insolvency Proceedings (Recast): The First Commentaries*, 13(4) EUR. COMP. L. 129 (2016) [hereinafter Wessels].

176. Council Regulation 1346/2000, 2000, O.J. (L 160) 1, 18 (EC).

177. *Id.* at 4.

178. *Id.* at 18. This Regulation was also the first documant regulating insolvency at the EU level.

179. *Id.* at Recital 88.

180. *Id.* at Recital 27.

181. For more on the reasons for the revision of the old regulation, *see* Wessels, *supra* note 175, at 129; *see also* Samantha Bewick, *The EU Insolvency Regulation, Revisited*, 24 INT. INSOLV. REV. 172 (2015).

recast in 2017 as Regulation (EU) 2015/848[182] (the "Recast Regulation"). The Recast Regulation now applies to all insolvency proceedings initiated in any EU member state on or after June 26, 2017.[183] Once again, Denmark is the exception and the only member state opting not to adopt the new regulation.[184]

To be sure, the purpose of the Recast Regulation is not to replace any of the national insolvency rules of individual EU member states, including national set-off rules in insolvency proceedings.[185] Rather, the EU recognized that because "of widely differing substantive laws it is not practical to introduce insolvency proceedings with [a] universal scope throughout the Union."[186] All national substantive insolvency rules and regulations remain untouched and continue to be an exclusive power of each member state.[187]

Among others, the Recast Regulation provides administrative and common core rules that also apply to cross-border set-off in insolvency proceedings.[188] In particular, the Recast Regulation functions as a platform to facilitate both better recognition of, and cooperation in, insolvency proceedings among Union member states.[189] This, in turn, also aims at reducing future conflicts between national laws and preventing any negative effects on the single market.[190]

The right of set-off is expressly addressed multiple times in the Recast Regulation.[191] For example, Recital 70 of the regulation's preamble

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182. The documents accompanying the Recast Regulation state that its purpose is the creation of effective administrative rules which will apply to natural persons and legal entities in the case of opening insolvency proceedings with a cross-border element. *See, e.g.*, Commission Implementing Regulation (EU) 2017/1105 of June 12, 2017, O.J. (L 160) 1 (establishing the forms referred to in Regulation (EU) 2015/848 of January 26, 2020, O.J. (L 160), 1-26) [hereinafter Regulation 2017/1105].

183. *See* Recast Regulation, *supra* note 8, at Recital 22.

184. *See* Recast Regulation, *supra* note 8, at Recital 88 (stating that Denmark exercised its right to adopt the Regulation based on the Treaty on European Union and the Treaty on the Functioning of the European Union).

185. *See, e.g.*, Bewick, *supra* note 181, at 172-73.

186. Recast Regulation, *supra* note 8, at Recital 22.

187. *Id.* at Art. 9.

188. *See, e.g.*, Regulation 2017/1105, *supra* note 182.

189. *See* Recast Regulation, *supra* note 8, at art. 41; *see also* Wessels, *supra* note 175, at 775.

190. *See* Dubravka Aksamovic, *EU Insolvency Law—New Recast Regulation on Insolvency Proceedings*, 1 ECLIC 69, 90-91 (2017); *see, e.g.*, Catherina Balmond & Katharina Crinson, Freshfields Bruckhaus Deringer, *Restructuring and Insolvency: European Union, Getting the Deal Through*, Law Business Research Ltd. 160, https://www.freshfields.com/4a3f80/globalassets/what-we-do/regulatory/restructuring-and-insolvency-2020-getting-the-deal-through.pdf (last visited Jan. 17, 2022) [hereinafter Balmond & Crinson].

191. *See, e.g.*, Recast Regulation, *supra* note 8, at Recital 70-71, art. 7, 9, 55.

stipulates that regardless of whether the right of set-off is allowed or not, under the law of any member state in the European Union in which an insolvency proceeding was initiated, a creditor shall have the right of set-off if that right is generally available under the law that applies to the claim of the insolvent debtor.[192] The reference of the right of set-off in the Recast Regulation clearly proves that the European Union intended to extend the recognition of the right of set-off and to allow the right even if the rules of a member state in which an insolvency proceeding is initiated does not allow set-off.[193] In addition, it may also be fair to argue that based on this fact, the European Union endorsed the guarantee function of the right of set-off in insolvency.[194] As with American creditors, a European Union creditor raising a mutual and compensable claim who initiates a set-off against an insolvent debtor is in a much more favorable position than any other creditor. The set-off creditor is able to receive compensation up to the extent of his right of set-off against the insolvent debtor, while any other creditor is in a much more unpredictable situation and may only be compensated *pro rata*.[195]

1. Applicable Law and Conflicts

The Recast Regulation determines the question of which law applies to cross-border insolvency proceedings based on the principle of territoriality in private international law and the concept of the debtor's center of main interests.[196]

The center of main interests, also called COMI requirement, establishes the proper jurisdiction for the filing of any insolvency proceeding in the European Union.[197] The Recast Regulation clarifies and revamps the existing COMI requirement by defining that the proper venue for any insolvency petition in the European Union is "the place where the debtor conducts the administration of its interests on a regular basis, and which is ascertainable by third parties."[198]

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192. *See id.* at Recital 71.

193. *See id.* at art. 7(2)(m) (The Recast Regulation provides that set-off cannot lead to the invalidity of legal acts, such void, voidable or impossible legal acts).

194. *See, e.g.*, Laura Carballo Piñeiro, *'Brexit' and International Insolvency Beyond the Realm of Mutual Trust: Brexit and International Insolvency,* 26 INT'L INSOLVENCY REV. 3, 284-85 (2017).

195. *See* Aksamovic, *supra* note 190 at 79.

196. *See* Recast Regulation, *supra* note 8, at art. 3.

197. *See* Recast Regulation, *supra* note 8, at art. 3(1).

198. *See id.*

Unless proven otherwise, COMI is generally presumed to be the debtor's registered office involving companies or the habitual residence for any individual.[199] Regardless of this presumption and considering the free movement of goods, capital, services, and persons in the European Union as well as the high level of mobility for business entities and natural persons in the Union, the determination of the COMI of any particular debtor may often prove more difficult, however.[200]

For example, the habitual residence of an individual may change more often and involve different locations in different member states. New establishments and undertakings may also be formed in different member states and business operations, supply chains, or parts of an undertaking may move to yet another member state.[201] Complicating things further, for logistics, tax, or corporate governance reasons, many European Union business entities operate establishments in several member states at the same time and may also be connected to other companies that operate in a different set of EU member states or the European Economic Area.[202] It may also be possible that debtors are part of an international holding company or consortium with corporate entities located outside the Union.[203]

Because of these facts, any presumption of the COMI may not apply if the registered office or the habitual residence of the debtor has been moved to another member state within three or six months prior to the opening of any insolvency proceeding.[204] In addition, rather than where a debtor's center of main interests actually is, the main factors to determine the proper venue and jurisdiction may be the creditor's understanding and perception of where that center of main interests is located.[205] As a result, the debtor may often carry the burden of proof on where his COMI is located. In addition, the debtor may also be required to directly inform any creditor in due course of a new location from which he is carrying out any of his activities, or, in the alternative, the debtor may need to make his new location public by any appropriate means.[206]

It is also noteworthy that, despite the default rule of the COMI requirement, the Recast Regulation includes a number of exceptions to

199. *See id.*
200. *See id.* at Recital 24.
201. *See id.* at Recital 30.
202. *See* Aksamovic, *supra* note 190, at 79.
203. *See* Recast Regulation, *supra* note 8, at Recital 31.
204. *See id.* at Recital 30.
205. *See id.* at Recital 28.
206. *See id.*

this rule and distinguishes between the law of the "main insolvency proceeding"[207] and the law of the "State of the opening of proceedings."[208] It may therefore be appropriate to argue that, in some cases, the member state's jurisdiction in which the petitioner simply decides to file his petition first and where the proceedings are opened, may be the competent jurisdiction.[209] This is important because the applicable law also serves as the basis for establishing the requirements to exercise the right of set-off and its overall legal effect. Moreover, the applicable law also defines the scope of the right of set-off, including any possible temporary or permanent limitation.[210]

Overall, the Recast Regulation provides only for a few exceptions from the COMI requirement. The primary proceeding is always the main proceeding based on the debtor's center of main interests and, as such, also functions as the opening proceeding.[211] Any insolvency proceeding that is not the main proceeding is considered a secondary proceeding, which may only become the opening proceeding if expressly permitted by the Recast Regulation.[212] Secondary insolvency proceedings run in parallel to the main insolvency proceedings and are limited to assets of the debtor that are located outside the territory of the main proceeding.[213]

Generally, any secondary proceeding is a proceeding in a member state in which the debtor does not maintain his center of main interest, but in which he owns and operates some form of an establishment.[214] As such, a "secondary insolvency proceeding [is] limited to the assets located in that [member] State."[215] After the main insolvency proceedings are opened, any other prior opened proceeding automatically becomes a secondary proceeding.[216]

In sum, the Recast Regulation stipulates that the applicable law or the so-called *lex fori concurcus* is the law of the member state in which the insolvency proceedings are initiated or opened.[217] By default, this is meant to be the member state in which the debtor has his COMIs and the place

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207. *Id.* at art. 3(1).
208. *Id.* at art. 7(1).
209. *See id.* at art. 7(2)(i).
210. *See* Balmond & Crinson, *supra* note 191.
211. *See* Recast Regulation, *supra* note 8, at 3(1).
212. *See, e.g.*, Wessel, *supra* note 175, at 774.
213. *See* Recast Regulation, *supra* note 8, at Recital 24.
214. *See id.* at Recital 23.
215. *See id.*
216. *Id.* at art. 3(4) ("When main insolvency proceedings are opened, the territorial insolvency proceedings shall become secondary insolvency proceedings.").
217. *See, e.g.*, Interedil Srl v. Fallimento Interedil Srl, 2011 ECJ, C-396/09, 48.

of her regular business operations, known to and verifiable by any creditor.[218]

2. The Right of Set-off

Despite their differences, most commentators agree that the right of set-off in insolvency proceedings in the European Union is established in both the common and civil law systems.[219] That said, the application of the right of set-off is not uniform in either system, which may often result in some diverse outcomes, and also increases the likelihood of forum shopping.[220] This is a real concern because even after Brexit, the European Union includes at least two member states and jurisdictions—Ireland and Malta—with a common law legal tradition.[221]

The majority of civil law jurisdictions only permit the use of set-offs in insolvency if certain requirements are met. This is regardless of whether the right is generally acknowledged by statute or based on a contractual agreement between two counterparties.[222] On the other hand, claiming a set-off during insolvency proceedings appears easier and more straightforward in most common law jurisdictions, including the United States.[223]

The Recast Regulation aims to avoid the impact of these differences and distinctions by providing for a much broader and more uniform recognition of the right of set-off across the Union.[224] The Regulation does so by taking account of the widely differing substantive laws in the member states and separating the questions of the applicable substantive law for the establishment of the right of set-off from the question of which procedural law applies during the insolvency proceeding and how the right of set-off may be executed.[225]

The Regulation recognizes that any "particularly significant rights and legal relationships" between debtors and creditors granted on a

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218. *See* Recast Regulation, *supra* note 8, at art. 3.

219. Loyd, *supra* note 33, at 557.

220. *See, e.g.*, Carballo Piñeiro, *supra* note 194, at 283 (referring to the Heidelberg Vienna Report on the external evaluation of Regulation 1346/2000 on Insolvency Proceedings).

221. *See id.* at 283.

222. *See id.* For the requirements of set-off in insolvency proceedings *see, e.g.*, INSOLVENZORDNUNG, *supra* note 15, at § 94; Stečajni zaknon [SZ] [Bankruptcy Act] Official Gazette Narodne novine art. 174 (Croat.) both of which belong to civil law systems.

223. *See* PHILIP WOOD, PRINCIPLES OF INTERNATIONAL INSOLVENCY 403 (London: Sweet & Maxwell, 2nd ed. 2007).

224. *See* Recast Regulation, *supra* note 8, at Recital 22.

225. *See id.* (noting that "[t]he Regulation acknowledges the fact that as a result of widely differing substantive laws it is not practical to introduce insolvency proceedings.").

national level should be dealt with differently than the issue of when a debtor's assets are simply located in more than one member state.[226] More specifically, the Regulation mandates that for these significant rights, particular "[rules] should be made."[227]

While the Regulation does not provide for any specific examples of what rights may be considered significant in this broader context,[228] it seems fair to argue that the right of set-off qualifies as such a right because the Regulation specifically provides that "the opening of insolvency proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of a debtor, when such a set-off is permitted by the law applicable to the insolvent debtor's claim."[229]

As such, the drafters of the Recast Regulation clearly recognized the importance of the right of set-off in private ordering and extended the right's overall recognition in insolvency proceedings in the Union. This is because the law applicable for a set-off demand of can be independent or separate from the applicable law of the main proceeding and the debtor's COMIs.[230]

While this approach may have been well-thought-out, it appears poorly formulated. At the very least, the territorial definition of the application of the right of set-off in the Recast Regulation is ambiguous. When the Regulation refers to "the law applicable to the insolvent debtor's claim"[231] it is unclear whether the applicable law for the right of set-off may be limited to the law of a European Union member state or if the rules of the Regulation also allow and refer to the application of the laws of a third, non-EU member state, such as the United States.[232] To be sure, even if the prevailing opinion is that the Recast Regulation only refers to the laws of Union member states,[233] the provisions of the Regulation should be more clearly drafted to provide better legal certainty.[234]

B. National Legislation: Germany, Austria, and Croatia

The Recast Regulation is limited to set-offs in insolvency proceedings that include, at a minimum, one cross-border element. The

226. *See id.*
227. *Id.*
228. *Id.* (providing for examples of legal relationships).
229. *See id.* at art. 9.
230. *See id.* at Recitals 23, 70, and 71.
231. *See* Recast Regulation, *supra* note 8, at art. 9.
232. *See* Carballo Piñeiro, *supra* note 194, at 284-85.
233. *See id.*
234. *See id.*

Regulation may therefore be more appropriately described as a private international law instrument or simply a conflict of laws framework for cross-border insolvency proceedings. The Regulation provides general rules that are intended to improve the cooperation in these proceedings throughout the European Union and among all of its member states.[235] As a result, all national insolvency laws in the member states remain generally applicable and relevant in determining the applicable law for a creditor's right of set-off.[236] This, of course, may continue to create significant uncertainty about the enforceability of the right of set-off during any cross-border insolvency proceeding.

To further this point and highlight the different characteristics of the right of set-off, it may be helpful to compare the national rules in some European Union member states. Germany, Austria, and Croatia serve as good examples in this context. All of these jurisdictions primarily follow the German legal tradition, which continues to exert significant influence across the European Union.[237] German law is also often relied on as a paradigm for European Union legislation and may often be adopted with minimal changes by smaller member states, such as Croatia, or any country that aspires to become a European Union member in the future.[238]

Since its independence in 1991,[239] Croatia has followed German law and legal developments very closely.[240] The country did so particularly during its application process for membership to the European Union starting in 2003[241] and continues to do so today.[242]

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235. *See id.* at Recitals 48, 49, and art. 41.

236. *See id.* at Art. 7.

237. Lidija Šimunović, Prijeboj, Novi informatory, Zagreb, 2020 at 9 [hereinafter Šimunović, Prijeboi].

238. For a broader comparison of set-off models other than the Germanic model, such as the Anglo-Saxon and Romanic models, *see* Lidija Šimunović, *Rethinking the European Model Law of Set-Off in the Era of Brexit and the Recent Reform of the French Civil Code*, 15(1) CROATIAN YEARBOOK OF EUROPEAN L. & POL'Y 145, 149-153 (2019) [hereinafter Šimunović].

239. *See* John R. Coogan et al., *Central European Law*, 31(2) INT'L L. 495, 496-98 (1997).

240. *See* Jasnica Garašić, *Regulation of Personal Insolvency in Croatia*, 61 ZBORNIK PFZ 1487, 1513 (2010); Domagoj Sajter, *Challenges for a Mature Insolvency System in a Transitional Economy: Lessons from Croatia*, 19-2 NBR. INT'L INSOLVENCY REV. 133, 138 (2010).

241. *See* Kalin P. Schlueter, *Digitalizing its Land Register: Croatia's e-Ticket to the EU*, 18 IND. INT'L & COMPAR. LAW REVISED 511, 511 (2008).

242. Croatian law does not entirely mirror German law, but it follows its example to the extent possible considering the social and economic conditions in Croatia. *See* Garašić, *supra* note 240, at 1513. It may also be noteworthy that until the end of the First World War, Croatia was under the control of the Habsburg Empire and followed the Swiss and Austrian Civil Code. The process of the codification of civil law in the Habsburg Monarchy had a gradual course. It started in 1753 and ended in 1811, when the Austrian Civil Code was introduced by the patent of the Emperor into the legal systems of the Austrian descendant countries (including Croatia) as the General Civil

A comparison between set-off rules that follow the German legal tradition and the common law approach in the United States also seems appropriate because of the similar economic role that both countries play regionally and globally.[243] German and U.S. law have long been viewed as exemplary by many other countries and the two countries share similar social and economic conditions.[244]

In order to clearly compare and identify the different characteristics of the right of set-off during insolvency proceedings in the United States and the European Union, it is necessary to focus on two main issues: (1) the requirements for when the right of set-off may be effectuated or demanded by a creditor, and (2) the point in time when a creditor may be permitted to claim the right of set-off during insolvency proceedings. Specifically, it is important to clearly distinguish between cases in which the right of set-off arose pre-petition or post-petition, and when creditors claimed their right of set-off against the debtor in bankruptcy.[245] In this context, it is not only essential to determine when the right of set-off became enforceable, but also to distinguish between the status of a creditor of the debtor as a pre-petition creditor or a creditor of the bankruptcy estate (post-petition).

1. Pre-Petition Set-off

As discussed in the U.S. context, allowing and preserving the right of set-off in insolvency proceedings may be viewed as a preferential treatment of the set-off creditor, which challenges the concept of equal

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Code. The ABGB was the applicable code in the entire Monarchy until 1861. After its rescission it was not removed from the Croatian legal system, but it was further developed as the Croatian Civil Code independent from the original. Leksikografski Zavod Miroslav Krleza, HRVATSKA ENCIKLOPEDIJA (2020) https://www.enciklopedija.hr/natuknica.aspx?ID=45220. As such, it seems reasonable to assume that the Austrian and Swiss Civil Code should have a greater influence on Croatian law when compared to German law. Gerhard Köbler, *Zentrissimum Integrativer Europaischer Legistik*, 61 ZBORNIK PFZ 1487, § 567 (2011) *available at* https://www.koeblergerhard.de/Fontes/WestgalizischesGesetzbuch1797.pdf ("*Wenn gegenseitige Forderungen zusammentreffen, die nicht nur richtig und gleichartig, sondern auch so beschaffen sind, daß eben dieselbe Sache, die dem Einen als Gläubiger gebührt, von diesem auch als Schuldner dem Andern entrichtet werden kann; so entsteht eine gegenseitige Aufhebung der Verbindlichkeiten, (Kompensation) welche selbst von Rechtswegen die gegenseitige Zahlung bewirkt.*").

243. *See* Mher Arshakyan, *The Impact of Legal Systems on Constitutional Interpretation: A Comparative Analysis: The U.S. Supreme Court and the German Federal Constitutional Court*, 14 GER. L.J. 8, 1297, 1297 (2013).

245. For example, in Croatia, the Croatian Bankruptcy Code was inspired by the German InsO. *See* JASNICA GARAŠIĆ & SINIŠA PETROVIĆ, NATIONAL REPORT FOR CROATIA, EXECUTORY CONTRACTS IN INSOLVENCY LAW: A GLOBAL GUIDE, 173 (Jason Chuah & Eugenio Vaccari, 2019).

245. *See, e.g.*, Carballo Piñeiro, *supra* note 194, at 283.

treatment of all creditors. All of the compared jurisdictions in Europe equally endorse the policy goal of equal treatment among creditors.[246]

Without sharing in the proportional distribution of the property of the estate, the set-off creditor may no longer be considered an unsecured creditor because he receives at least full compensation of his claim up to the amount of the debtor's counterclaim. In addition, with regard to any part of his claim that exceeds the counterclaim, the claim is bifurcated. As such, the remainder of the set-off creditor's claim that exceeds the debtor's counterclaim becomes an unsecured claim against the estate of the debtor in bankruptcy. The result is that the set-off creditor then also shares in the distribution of the property of the bankruptcy estate by recovering *pro rata* with all other unsecured creditors. This advantage further reduces the overall available amount of the estate and disadvantages all non set-off creditors. But maybe even more importantly, this fact violates the goal of treating all creditors fairly and equally.

Germany, Austria, and Croatia are all civil law jurisdictions.[247] As such, the requirements to claim set-off prior to or independent from the initiation of insolvency proceedings are governed by the provisions of each country's law of obligations (BGB, ABGB, and COA, respectively).[248]

The basic requirements for the demand of a set-off right are very similar in all three jurisdictions. With only a few language and grammatical differences, initiating the right of set-off in Germany, Austria, and Croatia only requires that the claims are mutual, mature, and enforceable.[249]

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246. *See* Sepinuck, *supra* note 22, at 107.

247. For Germany and Austria *see* Časlav Pejović, *"Civil Law" I "Common Law": Dva Različita Puta Do Istoga Cilja, Poredbeno Pomorsko Pravo*, 4 (2001) No. 155, p.9. For Croatia *see* DALIBOR ČEPULO, HRVATSKA PRAVNA POVIJEST U EUROPSKOM PRAVNOM KONTEKSTU [CROATIAN LEGAL HISTORY IN THE EUROPEAN LEGAL CONTEXT] 95-96, 411 (2021).

248. *See* INSOLVENZORDNUNG, *supra* note 15, at § 94. If by force of law or on the basis of an agreement an insolvency creditor had a right to set-off a claim on the date when the insolvency proceedings were opened, such right shall remain unaffected by the proceedings. In the Croatian legal system the rules regarding set-off in insolvency law are set forth in Articles 174-176 of the Croatian Bankruptcy Act. Although legal treatment of rules regarding set-off within insolvency proceedings change with the commencement of insolvency proceedings according to the mentioned Bankruptcy Act, rights of set-off both statutory and contractual rights that existed prior to the commencement of insolvency remain unaffected. That is a very important change compared to the situation prior to the enactment of the Croatian Bankruptcy Act from 1996. In Germany it was the same before the enactment of the Insolvency Act in 1999. Under the old version of the Act the prior contractual set-off right was not explicitly included both in German and Croatian laws.

249. For German Law *see, e.g.*, BGB, *supra* note 14. For Austrian law *see* ABGB, *supra* note 14, at art. 141. For Croatian law *see* Zakon o obvenznim odnosima [ZOO] [Civil Obligations Act] § 195 (Croat.) (2005) [hereinafter COA].

The code provisions in the German, Austrian, and Croatian Civil Code stipulate the following:[250]

§ 87 of the German Civil Code (BGB):

"If two persons owe each other performance that is substantially of the same nature, each party may set-off his claim against the claim of the other party as soon as he can claim the performance owed to him and effect the performance owed by him;"[251]

§ 1438 of the Austrian Civil Code (ABGB):

"When claims are mutually dependent, valid, similar, and—provided that the property due to one party in her position as creditor may also be paid by her in her position as a debtor to the other party; the completion of performances between both parties may be effectuated and as long as the claims offset in a mutual manner may result in the mutual cancellation (compensation) of each party's claim, which by operation of law results in mutual payment redemption."[252]

§ 195 of the Croatian Obligation Act (COA):

"A debtor may set off a claim against the claim of the creditor provided that both claims are payable in money or other fungible property identical in kind or quality and both are due."[253]

In addition to these general set-off requirements, German, Austrian, and Croatian law also requires an explicit declaration of set-off. The right is not self-executing and needs to be explicitly claimed or demanded.[254]

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250. *See also* Fren CC, *supra* note 14, at art. 1347. "Set-off is the simultaneous extinguishment of reciprocal obligations between two persons. If it is invoked, it operates up to the value of the lower of the two obligations at the date when all the conditions for set-off are met." *See also* LA. CIV. CODE art. 1893 (2018) "Compensation takes place by operation of law when two persons owe to each other sums of money or quantities of fungible things identical in kind, and these sums or quantities are liquidated and presently due. In such a case, compensation extinguishes both obligations to the extent of the lesser amount. Delays of grace do not prevent compensation."

251. *See* BGB, *supra* note 14.

252. *See* ABGB, *supra* note 14, at art. 20 ("*Wenn Forderungen gegenseitig zusammentreffen, die richtig, gleichartig, und so beschaffen sind, daß eine Sache, die dem Einen als Gläubiger gebührt, von diesem auch als Schuldner dem Andern entrichtet werden kann; so entsteht, insoweit die Forderungen sich gegeneinander ausgleichen, eine gegenseitige Aufhebung der Verbindlichkeiten* (Compensation), *welche schon für sich die gegenseitige Zahlung bewirket.*"). It is important to note here that many member states of the European Union use the term "compensation" which is based on Roman Law. Austrian law uses this term as well as Louisiana law. However, because the term "compensation" has a different meaning in the United States and in most common law jurisdictions, the term "set-off" is used here in order to avoid confusion and misunderstanding. *See, e.g.*, ZIMMERMAN, *supra* note 1 at 21.

253. *See* COA, *supra* note 249.

254. *See, e.g.*, BGB, *supra* note 14, at § 388.

However, like in the United States,[255] all that is required is a unilateral action or an explicit request made by the creditor to the other party. The right of set-off cannot be conditioned or timed.[256] While the declaration of the right automatically has the legal effect of offset unless the right is found to be invalid,[257] this does not mean that set-off operates *ipso iure.* Instead, under the German legal tradition, "set-off has to be asserted by an extrajudicial, informal and unilateral declaration to the other party, whereupon it works retrospectively."[258] However, if the right was made under duress or by mistake, it may be invalid.[259] Yet, no available defense may be sufficient to prevent the enforcement of the right. For example, raising the statute of limitations as an affirmative defense does not automatically or necessarily invalidate the right of set-off post-petition.[260]

Indeed, with respect to the right of set-off in insolvency, the main characteristic in German, Austrian, and Croatian law is the requirement that a creditor's right of set-off must be a valid and enforceable right pre-petition, and only then, may a creditor attempt a set-off post-petition.[261] As such, the right of set-off and all of its legal effects are preserved after the commencement of any insolvency proceedings and the right may be claimed at any point by the creditor without any restrictions.[262] The right of set-off is also not subject to an automatic stay as in the United States. In practice, the creditor who obtained the right of set-off prior to the commencement of the insolvency proceedings, even if he has not yet claimed a set-off, is not required to file a proof of claim against the bankruptcy estate in Germany, Austria, or Croatia.[263] The only thing the creditor must do is to request the set-off from the trustee.[264] As long as the right is valid and enforceable, the trustee or debtor in possession has no

255. *See* Sepinuck, *supra* note 22, at 54. Outside of bankruptcy proceedings, "the precise actions necessary to effect setoff are unclear, setoff can now certainly be effected without judicial involvement."

256. *See id.*

257. *See* GAUCH ET AL., *supra* note 17, at 300.

258. *See* ZIMMERMAN, *supra* note 1 at 33; *see also* BGB, *supra* note 14.

259. *See, e.g.*, Šimunović, *supra* note 238, at 204.

260. *See* COA, *supra* note 249 art. 198.

261. *See* Stečajni zaknon [SZ] [Bankrupcy Act] Official Gazette Narodne novine no. 71/15, 104/17, art. 174 and 175 (Croat.) [hereinafter SZ].

262. This conclusion is based on the provisions of the German Insolvency Law. *See* INSOLVENZORDNUNG, *supra* note 15, at § 94; ABGB, *supra* note 14, at art. 19.

263. *See, e.g.*, GAUCH ET AL., *supra* note 17, at 300.

264. LOHMANN & REICHEL, MUNCHENER KOMMENTAR ZUR INSOLVENZDRDNUNG [Munich Commentary on the Insolvency Code] InsO § 96 (C.H. Beck, ed., 4th ed. 2019).

defense against the set-off creditor and cannot resist the set-off or order a turnover post-petition.[265]

Of course, set-off creditors are free to exercise their right of set-off[266] and they are not required to file a proof of claim against the bankruptcy estate. However, if they fail to do either, the creditors may at the same time and inadvertently waive their right to set-off.[267] Neither German, Austrian, nor Croatian law explicitly provide any examples for when such a failure qualifies as a waiver,[268] but failing to file a proof of claim may be interpreted as an indirect waiver of the right of set-off.[269] As a result, any diligent creditor in the European Union is well advised to either immediately demand or claim his right of set-off following a debtor's bankruptcy petition, or to file a proof of claim. Filing a proof of claim, as required under U.S. law, may at the very minimum ensure that the set-off creditor will be able to recover *pari passu*.[270]

2. Post-petition Set-off

The most notable difference between U.S. law and countries that follow the German legal tradition in the European Union is how differently these jurisdictions deal with the right of set-off post-petition.

German, Austrian, and Croatian law allow post-petition set-offs only under very limited circumstances.[271] The criteria for allowing any set-off post-petition, even if all substantive legal requirements are met, depends on when the right's underlying obligations became legally enforceable.[272]

Specifically, the provisions in German, Austrian, and Croatian insolvency laws stipulate the following:

§ 95 (1) of the German Insolvency Act (InsO):

"If on the date when the insolvency proceedings were opened one or more of the claims to be set off against each other were conditioned, immature or

265. *See* Šimunović, *supra* note 238.

266. So called the right of set-off is lat. facultas alternativa STAUDINGER ET AL., *supra* note 14, at 249; Oertmann, *supra* note 17, at 376.

267. STAUDINGER ET AL., *supra* note 14, at 251.

268. *See, e.g.*, INSOLVENZORDNUNG, *supra* note 15, at § 94-95.

269. For Germany, *see, e.g.*, INSOLVENZORDNUNG, *supra* note 15, at § 94-95. For Croatia, *see, e.g.*, SZ, *supra* note 261, at arts. 174 and 175.

270. *See* KIRCHHOF ET AL., *supra* note 92, at 80-216; INSOLVENZORDNUNG, *supra* note 15, at § 96[6].

271. *See* INSOLVENZORDNUNG, *supra* note 15; *see* ABGB, *supra* note 14, at art. 19.

272. *See, e.g.*, INSOLVENZORDNUNG, *supra* note 15. In Croatian law the COA explicitly requires that both counterclaims must be due. On the other hand, under German and Austrian law the claim of the person who declares set-off has to be due but the counterclaim of the other person in the set-off relationship does not.

> did not cover similar types of performance, such set-off may not be effected before its conditions are met. Sections 41 and 45 shall not apply. Set-off shall be excluded if the claim against which a set-off is to be effected will be unconditioned and mature before it may be set off."[273]
>
> § 19 of the Austrian Insolvency Act:
>
> "The fact that the creditor's or debtor's claim was subject to a condition or not yet due at the time of the opening of insolvency proceedings, or that such creditor's claim was a non-monetary payment, does not exclude a set-off. If the creditor's claim is subject to a condition, the court may make the permissibility of a set-off dependent on the posting of a security."[274]
>
> Art. 175 of the Croatian Bankruptcy Act:
>
> "(1) If, at the time of the initiation of the bankruptcy proceedings one or more claims which are subject to set-off are under a suspensive condition, or they are not due, or they are not aimed at the same acts, set-off will ensue once the requirements are met. (. . .) If the counterclaim in set-off becomes unconditional and due before set-off is possible, set-off is excluded."[275]

Most obviously, and in similarity to U.S. law, under German, Austrian, or Croatian law, it is not possible to offset any claims that were not mutual at the time the insolvency proceedings commenced.[276] However, if all of the requirements for a set-off are met in a contractual relationship before the commencement of an insolvency proceeding and the right of set-off has not been claimed or asserted at that time, the set-off may still become effective post-petition.[277] The rationale behind this rule is to protect the creditor's expectations and reliance on the general availability of the right of set-off even before the right is fully vested.[278] Indeed, the right of set-

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273. *See id.*

274. *See* ABGB, *supra* note 14, at art. 19.

275. *See* SZ, *supra* note 261.

276. *See, e.g.*, INSOLVENZORDNUNG, *supra* note 15, at 95(1). Section (1) sentence three states: "*Die Aufrechnung ist ausgeschlossen, wenn die Forderung, gegen die aufgerechnet werden soll, unbeding und fällig wird, bevor die Aufrechnung erfolgen kann.*" [Set-off shall be excluded if the claim against which a set-off is to be affected will be unconditioned and mature before it may be set off.].

277. *See* Hrvoje Markovinović & Martina Pušić, *Prijeboj u stečaju*, 57 PRAVO U GOSPODARSTVU 3, 577-578 (2018) [hereinafter Markovinović & Pušić].

278. *See* LOHMANN & REICHEL, MUNCHENER KOMMENTAR ZUR INSOLVENZDRDNUNG [Munich Commentary on the Insolvency Code] InsO § 96 (C.H. Beck, ed., 4th ed. 2019) ("*Durfte der Gläubiger aber vor der Eröffnung des Insolvenzverfahrens darauf vertrauen, mit Rücksicht auf das Entstehen der bereits im Kern angelegten Aufrechnungslage seine Forderung durchzusetzen, soll er in dieser Erwartung auch im Insolvenzverfahren nicht entäuscht werden*." [Was the creditor, based on his reliance justified to believe that his claim can be set-off because the right's requirements were essentially all met prepetition then this reliance should also be honored post-petition.]).

off may be viewed as an alternative to perfect performance. Under German law, the right of set-off is considered a performance substitute (*Erfüllungssurrogat*), which fulfills a double function.[279] First, the right of set-off substitutes perfect performance such that a unilateral declaration is sufficient notice. Second, the right of set-off gives creditors the opportunity to enforce their rights without needing to sue. This is beneficial for the creditor who need not encumber the litigation risk nor related court costs.[280]

If two specific conditions are met before the set-off, a creditor is able to assert his right of set-off against the debtor, however, this rule does not apply, and the creditor's right of set-off fails post-petition.[281] To be sure, two conditions must be met before the creditor can assert its right of set-off against the debtor. First, the debtor's claim cannot be subject to a condition precedent or a condition subsequent before the set-off was demanded or claimed by the creditor.[282] Second, the debtor's claim cannot be or become due before the creditor asserted set-off. [283] If these conditions are not met, the creditor's right of set-off fails post-petition and cannot be enforced.[284] A large number of member states in the European Union already practice set-off by notice or are at least transitioning towards a notice system. In jurisdictions that follow German legal tradition, the right of set-off can only be created and executed by unilateral declaration or notice (*Gestaltungrescht*).[285] Notably, these jurisdictions do not permit set-off automatically or *ipso iure*. Similarly, the French legal system has amended its Civil Code to require notice before set-off.[286] This understanding seems well on its way to become the majority view in the European Union. Many member states in the Union either already practice set-off by notice or appear to converge towards that system.[287] This system is beneficial for the European Union because it provides greater flexibility and is more economically efficient for counterparties who can decide when they want to offset their obligations. [288]

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279. *See, e.g.*, SCHLÜTER, *supra* note, at ¶ 1.
280. *See id.*
281. *See* INSOLVENZORDNUNG, *supra* note 15; SZ, *supra* note 261, at no. 175(1)/1996; Markovinović & Pušić, *supra* note 277, at 581.
282. *See* INSOLVENZORDNUNG, *supra* note 15.
283. *See id.*
284. *See id.*
285. *See id.*
286. *See* SZ, *supra* note 261, at arts. 174, 175.
287. *See* COA, *supra* note 249, at arts. 196, 388.
288. *See* INSOLVENZORDNUNG, *supra* note 15.

To be clear, in all compared European Union jurisdictions, the right of set-off when declared post-petition may only be justified by the creditor's general expectation and reliance to utilize the right during the normal course of business.[289] As noted previously, this expectation implies that the creditor's right and ability to offset should not be eschewed in any way and, in particular, should not be restricted if the debtor fails to perform as promised and files for bankruptcy instead.[290] In Germany, Austria, and Croatia, the prevailing view is that this expectation should always be maintained and that it should not be negatively impacted simply because of the commencement of insolvency proceedings.[291]

In sum, the options for successfully asserting any right of set-off for valid claims post-petition in these three European Union jurisdictions may be best described as follows: (1) the counterclaims of both, debtors and creditors must have existed pre-petition; (2) at least the debtors claims, which became part of the bankruptcy estate post-petition, must still be pending and qualify as executory claims; or (3) if the creditors' claims were initially considered different in kind, but post-petition qualified as mutual claims before becoming due.

It is important to remember that these options are independent from the requirement that the creditor's set-off claim must have always been enforceable before the debtor's counterclaim.[292] In other words, the debtor's claim may remain executory post-petition, while the set-off creditor is required to have fully performed first.[293] At the same time, it is not necessary that the obligations of the debtor became due or were terminated through performance or otherwise after compliance with a condition precedent or subsequent.[294]

On the other hand, it should be evident that if the right of set-off between the insolvency creditor and the debtor arose post-petition, the right is generally prohibited under German, Austrian, and Croatian law and cannot be asserted.[295] The same is true if the set-off creditor obtained his claim from another creditor after the commencement of the insolvency proceedings or if the insolvency creditor obtained the claim through

289. Šimunović, *supra* note 238, at 187, 188.

290. For Croatia, *see, e.g.*, Markovinović & Pušić, *supra* note 277, at 595; KÜBLER ET AL., KOMMENTAR ZUR INSOLVENZORDNUNG, 89 EL, § 95 (Aug. 2021).

291. For German law, *see* KIRCHHOF ET AL., *supra* note 92, at 80-216.

292. For Croatian law, *see* Markovinović & Pušić, *supra* note 277, at 581-582.

293. *Id.*

294. *See* Šimunović, Prijeboj, *supra* note 238, at 187, 188.

295. *See* INSOLVENZORDNUNG, *supra* note 15, at § 96[6]; SZ, *supra* note 261, at no. 176/1996.

assignment up to six months pre-petition while the creditor knew or should have known that the creditor has either become insolvent or already filed for bankruptcy.[296] Finally, any creditor who obtained the right to set-off through an avoidable act is precluded from asserting a set-off claim.[297]

The exclusion of set-off in these examples aims to prevent the insolvency creditor from fulfilling the requirements of set-off through otherwise legal acts immediately before or after the initiation of insolvency proceedings in order to gain an unfair advantage and manipulate the system of equal and proportional compensation of all creditors' claims in bankruptcy.[298]

V. CONCLUSION

Among solvent and liquid parties, set-offs make good practical and commercial sense. However, in insolvency proceedings this seems less obvious. Why should set-off creditors be given preferential treatment in insolvency proceedings? Indeed, for many years a consensus on whether set-offs are beneficial and should be allowed in insolvency have been elusive and the discussions have mostly centered around the different characteristics of the right of set-off or how it is treated in a transnational context.[299]

The difference in characteristics, treatment, and outcome appear more incremental and less fundamental when comparing the law in the United States and the European Union. Yet, many differences remain, which, if unrecognized, may result in severe negative consequences for set-off creditors. The possibility of an inadvertent waiver of the right of set-off in the European Union may be the most important example.[300] Even if not required in European Union jurisdictions, set-off creditors are well advised to file a proof of claim with the bankruptcy court or administrator.

This is a major difference to U.S. law, which requires a set-off creditor to generally file a proof of claim after a petition for bankruptcy is filed.[301] After filing the proof of claim, the U.S. creditor is then further required to file a motion for relief with the bankruptcy court before the obligations may be discharged by set-off.[302] While this appears to require

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296. *See* ABGB, *supra* note 14, at art. 20.

297. *See* INSOLVENZORDNUNG, *supra* note 15, at § 96[6]; SZ, *supra* note 261, at no. 176/1996; ABGB, *supra* note 14, at art. 20.

298. *See* KIRCHHOF ET AL., *supra* note 92, at no. 1.

299. Similar to this conclusion, *see* Šimunović, Prijeboj, *supra* note 238, at 188.

300. Markovinović & Pušić, *supra* note 277, at 584.

301. *See, e.g.*, TABB, *supra* note 6, at 285-89

302. *See id.* at 260.

a set-off to be pleaded in court, this is not correct as a general conclusion. First, this characteristic is limited to insolvency proceedings and does not consider administrative freezes or recoupments. Second, the motion for relief is directly tied to the automatic stay and its protection purpose for other creditors. As such, the right of set-off is also subject to the automatic stay in the United States, which does not exist in Europe.[303]

Although many leading European commentators argue that the right of set-off in the United States is merely a procedural right,[304] this is a misconception. It is true that the doctrinal foundation of the right of set-off appears more clearly established in the European Union, which is accomplished through a more formalized and static approach. In the United States, the right of set-off is based on principles of equity and regulated on both the state and federal levels.[305] Contract law is, of course, state law in the United States and the U.S. Bankruptcy Code is federal law. Both sources of law address the right of set-off as a substantive right.[306]

Indeed, U.S. law may provide more predictability, and more consistent outcomes. The supranational rules of European Union law, and specifically the Recast Regulation, do not provide for a European-wide uniform and harmonized insolvency regime with one approach toward set-offs.[307] Rather, the Regulation functions as a private international or conflicts rule, retaining the primacy of the twenty-seven national contract law and insolvency rules, in all Union member states.[308] On the other hand, the U.S. Federal Bankruptcy Code, provides uniformity throughout the entire United States with one set of rules and no need to determine the debtor's center of main interest for purposes of the right of set-off. This approach eliminates any attempt of forum shopping and reduces transaction costs.[309]

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303. *See, e.g.*, Kevin M. J. Kaiser, *European Bankruptcy Laws: Implications for Corporations Facing Financial Distress*, 25(3) EUR. CORP. FIN., 67 (1996); *see also* David P. Stromes, *The Extraterritorial Reach of the Bankruptcy Code's Automatic Stay: Theory vs. Practice*, 33 BROOK. J. INT'L L. 277 (2007).

304. *See, e.g.*, STAUDINGER ET AL., *supra* note 14, Introduction to §§ 387 *et seq.*, ¶3 (noting that setoff is a procedural remedy); *see also*, WALTHER J. HABSCHEID, ZUR AUFRECHNUNG (VERRECHNUNG) GEGEN EINE FORDERUNG MIT ENGLISCHEM SCHULDSTATUT IM ZIVILPROCESS, FESTSCHRIFT FÜR KARL H. NEUMAYER 263, 267 (Werner Barfuß, Berhard Dutoit, Hans Forkel, Ulrich Immenga & Ferenc Majoros, eds., 1985).

305. *See* TABB, *supra* note 6 and accompanying text.

306. *See, e.g.*, Sepinuck, *supra* note 22, at 54 (noting that "[s]etoff has become a widely recognized area of substantive law.").

307. *See* Recast Regulation, *supra* note 8 and accompanying text.

308. *See, e.g.*, Recast Regulation, *supra* note 8, art. 7.

309. *See* Nadia Dried, *Corporations Are Cherry-Picking Ch. 11 Judges, House Told*, LAW360 (2021), https://www.law360.com/banking/art.s/1407153/corporations=are=cherry=

At the same time, European Union jurisdictions that follow the Germanic legal tradition and have adopted the notice requirement when asserting the right of set-off seem much more focused on private ordering and party autonomy.[310] This characteristic provides parties with much more flexibility to assert the right of set-off and offers better economic efficiencies when compared to the approach in the United States. The flip side of this advantage is an overall complex theoretical and formalist approach to the right of set-off, which some commentators even attempt to define as a lien on the creditor's own debt.[311]

In restricting commercial parties' access to the right of set-off pre and post-petition, the compared European legal systems address attempts to game the system and prevent creditors from gaining an unfair advantage during insolvency proceedings. The compared European legal systems' policy goal of equal treatment among creditors in insolvency proceedings is reflected in their restrictions on the right to set-off. These legal systems' policy-driven approach offers a practical example of why set-off creditors should be differentiated from and given preference in insolvency proceedings in the United States and EU member states.

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310. One of the fundamental principles of contract law in these countries is party autonomy. *See* ZOO, *supra* note 250, at art. 2.

311. *See* ERNST WEIGLIN, DAS RECHT ZUR AUFRECHNUNG ALS PFANDRECHT AND DER EIGENEN SCHULD 38-39 (1904) ("*Die Aufrechnung ist gleichzeitig Aufhebung einer dem Berechtigten zustehenden Forderung und einer gegen ihn bestehenden Schuld durch einseitige Erklärung gegenüber dem Gläubiger dieser Schuld. Hält man sich nun vor Augen, dass der Zweck des Rechts der Aufrechnung der ist, dem Gläubiger der Forderung, welcher zugleich Schuldner ist, durch die Möglichkeit der Befreiung von seiner Schuld für seine Forderung eine Sicherung, und durch die Schuldbefreiung selbst eine Befriedigung zu verschaffen, so erkennt man, dass der Begriff des Pfandrechts an der eigenen Schuld derjenige ist, unter welchen das Aufrechnungsrecht in zwanglose Weise gestellt werden kann*." [Set-off is the discharge of an obligation, usually by an obligee against an obligor through unilateral declaration. When considering the purpose of the right of set-off it is to provide a security for the obligee. This security allows him to discharge his own debt and to receive satisfaction for his counterclaim. As such, the right of set-off may be viewed as a lien against the obligee's own debt.]).