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Insolvency set-off in the reinsurance context in different jurisdictions

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In the reinsurance context, a usual query that arises in almost any single reinsurance transaction or contract where some money is advanced or handed over between the parties is whether it is possible to set-off mutual debts within an insolvency proceeding.

Set-off is an equitable right that allows the parties to a contract to cancel or offset mutual debts to each other by asserting the amounts owed, subtracting one from the other and paying only the balance.

The interest of the parties to set-off amounts arises, for example, in VIF (Value in Force) transactions, which imply monetizing the value in force of an insurer's individual life risk portfolio to allow such insurer to exchange the expectation of future cashflows for an upfront amount of capital. These VIF transactions, quite frequent in Europe in the last years, are structured through a reinsurance treaty whereby the cedant cedes the defined book to the reinsurer in exchange of an upfront reinsurance commission reflecting the assessment of the future profits expected to arise from such defined book of business. At the signing date of a VIF, the reinsurer shall pay a (usually) very high reinsurance commission, whereas the cedant pays an initial premium.

The right of set-off is particularly relevant in those cases where the cedant transfers the reserves to the reinsurer to enable the reinsurer to pay the reinsured claims. In these cases, the reinsurer is usually interested in being able to offset the reserves against amounts due by the cedant, especially in case of insolvency of the cedant.

This same problem arises in those cases where a reinsurance treaty provides for a premium withheld account, whereby the insurer withholds the periodic premiums collected from the policyholders up to the end of the period foreseen in the reinsurance contract in order to guarantee the fulfilment of the reinsurer's obligations. In such case, it is the cedant who needs to be entitled to offset the infringements of the reinsurer (unpaid reinsured claims) with the funds withheld.

The possibility for the parties to a reinsurance contract to offset mutual debts when one of the parties is insolvent is dealt with differently in the different European jurisdictions. Please find a brief description of the situation in Spain, the United Kingdom, France and Italy.

Spain

The possibility of offsetting payments is expressly regulated under articles 1195 to 1202 of the Spanish Civil Code. According to these articles, set-off is permitted when two persons or entities are reciprocally creditors and debtors of each other, provided that the following requirements (set out under Article 1196 of the Civil Code) are met:

(a) Each of the persons is a creditor of the other.

(b) Both debts consist of a sum of money or, when things owed are fungible, that they are of the same kind and also of the same quality, if the quality has been designated.

(c) Both debts must have matured.

(d) They are liquidated and enforceable.

(e) None of them is subject to any retention or dispute brought by a third party and of which due notice has been given to the debtor.

In light of the aforesaid, as a general rule set-off is permitted under Spanish law, provided that certain requirements are met.

However, the problem arises when one of the parties to the contract becomes insolvent. Under the Spanish Insolvency Act, the general rule is that it is not possible to set-off obligations once the insolvency of a contractual party is declared, unless the requirements for the set-off established under Article 1196 of the Civil Code are complied with before the insolvency proceedings are declared open.

Nevertheless, a large number of Scholars consider that the prohibition established under article 58 of the Insolvency Act does not apply when the credits and debts to be offset have the same origin or cause *("ex eadem causa")*. That is, when the credits and debts derive from the same contract which foresees such set-off. According to this interpretation, the set-off that is carried out in those cases is not the general legal set-off of credits and debts

of the insolvent company due to the whole number of contracts in which it is a party (situation to which article 58 of the Insolvency Act refers, according to the aforesaid Scholars) but instead, the set-off is the way of performance of the contract agreed by the parties.

The Supreme Court has also given some light on this issue very recently. In its Ruling of 13 March 2017 it says:

> *"Actually, we are not before a compensation per se (…). We find ourselves before a liquidation scenario of one single contractual relationship where obligations have arisen for both parties involved. In the rulings 188/2014, of 15 April, and 428/2014 of 24 July we have considered that in scenarios like this one, even in the case where the loans arise amongst a bankruptcy procedure, we are before a contract liquidation mechanism and not before compensations where Section 58 of the Bankruptcy Act is applicable".*

This position of the Supreme Court has been held by the Barcelona High Court of Appeal in several judgments (for instance, rulings of 9 October 2014, 26 March 2014 and 6 March 2014), where it is expressly concluded that the set-off of mutual debts arising from the same contract shall be permitted upon the insolvency of one of the parties to such contract.

However, other courts (for example, the Madrid High Court of Appeal –judgment of 8 July 2008-) and other Scholars defend the opposite interpretation: insolvency set-off is only permitted if the requirements established under article 1196 of the Civil Code are met, regardless of whether the debts to be offset derive from the same title or contract. According to the High Court of Madrid, if the possibility to set-off is extended, the principle *''par condition creditorum''* (equal treatment of creditors) would be infringed. In addition, the Scholars who defend this position (a minority) understand that if the legislator had intended to exclude from the set-off prohibition credits ''ex eadem causa'', he would have expressly stated in article 58 of the Insolvency Act.

France

Unlike in Spain, the situation under French law is clearer. Pursuant to Article L. 622-7 of the French Commercial Code, the debtor is prohibited from paying debts incurred prior to the commencement of the proceedings, subject to specified exceptions.

The set-off of connected debts (*''dettes connexes''*) is actually one of these exclusions.

Debts are considered as connected when the credits and debts derive from the same contract, or from different contracts but within the same operation (same *"ensemble contractuel"*). Since the mutual debts to be offset in the context of a reinsurance transaction would derive from the same contract or operation, the parties would be allowed to set-off such mutual debts.

In order to be able to set-off their claims, the creditors must file a proof of claim first. It is an efficient mechanism which is used quite often and allows a payment of the creditor outside the restructuring plan and without being in competition with the other creditors.

United Kingdom

Under English law, the position is also more straightforward than that under Spanish law.

The key authorities regarding insolvency set-off are Rule 14.24 (in respect of administration) and Rule 14.25 (in respect of liquidation) of the Insolvency (England and Wales) Rules 2016 (SI 2016/1024). In a liquidation, insolvency set-off applies where, *"before the company goes into liquidation, there have been mutual dealings between the company and a creditor of the company… and the sums due from the one must be set off against the sums due from the other"*. In the case of an administration, insolvency set-off only applies where the administrator has delivered notice of an intended distribution to creditors - apart from this, it also applies to mutual dealings between parties in a similar way as in liquidation.

As the name suggests, *"mutual dealings"* must be *"mutual"*. The meaning of this has developed through case law, but in brief, the parties' relationship to each other is key - the dealings must be between the same parties, acting in the same capacity, right or interest in respect of the various debts being claimed, although the debts do not need to arise from the same transaction. Therefore, if the debts are jointly owned with another party, arise by way of assignment or attachment by a creditor, or are subject to a security interest, they may not be *"mutual"* and so would not be subject to set-off.

Further, *"mutual dealings"* between two companies do not include any debts incurred or acquired where the non-insolvent party was in any way aware of the company's pending or current insolvency. For example, this includes (amongst other things) where a debt was incurred after the company went into administration or liquidation.

Subject to the above restrictions, the sums which must be set-off include broad types of amounts. It is irrelevant whether the amounts in issue are certain or less so, and the sums which must be set-off include (i) both future and presently payable sums; (ii) sums payable under either a certain or a contingent obligation; or (iii) *"fixed or liquidated"* amounts, or amounts which can be ascertained by either fixed rules or those which are a matter of opinion.

Where a sum is uncertain (because it is contingent or otherwise), it is up to the liquidator or administrator to estimate the value and inform the creditor of this value.

In the case of any future debts (i.e. sums payable by either party after the date of the declaration of the dividend that an administrator or liquidator pays to creditors) which are

being balanced as part of the insolvency set-off, they must be discounted under Rule 14.44 of the Insolvency Rules, which provides a formula to calculate the value of such future debts.

Lastly, insolvency set-off in liquidation is in theory an automatic process, which applies at the date on which the liquidation commences, with assets being treated as realised and distributed on that date (although, in practice, it will be a longer process for any set-off to be calculated and then for the liquidators to either collect or pay the outstanding relevant balance). In contrast, an administration is not an automatic process: insolvency set-off only applies from the date that the administrator has delivered notice of an intended distribution to creditors.

Italy

Finally, Italian law does not contemplate specific provisions as far as set-off in relation to reinsurance operations.

The general rule on set-off established by the Italian Civil Code allows the automatic set-off of mutual debts existing between two parties to the extent that such debts are enforceable, certain and due at the time of set-off. Even in the absence such legal requirements, mutual debtors may contractually agree to set-off their debts and the conditions thereof.

The situation is slightly different in an insolvency scenario. As a general principle, according to Article 56(1) of the Italian Insolvency Act - which also applies to compulsory administrative liquidation and extraordinary administration proceedings to which insurance and reinsurance companies may be subject - creditors of a bankrupt company are entitled to set-off their receivables with their debts vis-à-vis such company, even if not yet due.

However, pursuant to Article 56(2) of the Italian Insolvency Act, with reference to those receivables that were not yet due at the time of the opening of the insolvency proceedings, set-off is not allowed if the claims vis-à-vis the insolvent entity were purchased after the opening of the insolvency proceedings, or in the preceding year. According to Italian case law and scholars, such provision not only applies to the purchase of receivables but also to debt assumptions aimed at extinguishing debts by offsetting them with the receivables. It should be noted that no set-off is allowed between receivables arisen after the opening of the insolvency proceedings with pre-existing receivables.

In light of the above, in the context of reinsurance agreements, according to Italian law it should generally be possible to set-off debts and receivables vis-à-vis the insolvent entity, provided that both were existing prior to the opening of the relevant insolvency procedure.

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