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Project **Offsetting of financial assets and liabilities**

Topic **Legal enforceability of unconditional right of offset**

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## **Background**

1. At the January 2010 IASB meeting, the IASB asked the staff to organise an education session on netting in general and in particular the netting provisions under Master Netting Agreements, to help the Boards in any future deliberations that address the accounting for right of offset.
2. In response to the Board's request in January, the staff organised and invited representatives from banks, industry groups (International Swaps and Derivatives Association) and legal experts (in international financial law) to participate in an education session for the joint board in February 2010.
3. At the June 2010 meeting, some Board members requested more information on the legal enforceability of the offsetting provisions in ISDA and other similar master netting agreements. In response to that request the staff presented, at the October 2010 meeting, an analysis of issues relating to the legal enforceability of the right of set off pursuant to ISDA Master Netting Agreements and other situations where financial institutions have the right of set off.

## **Purpose of this Paper**

4. At the November 2010 meeting, the Boards tentatively decided that to meet the offset criteria, an entity should have an unconditional right of offset and that right

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should be enforceable in all circumstances (both in the normal course of business and in bankruptcy) for the relevant positions to be offset.

5. The staff noted at the November 2010 meeting that there is diversity in practice as to whether the 'legally enforceable criterion means the right of offset (unconditional right of offset) should be enforceable only in the normal course of business (currently enforceable) or the right of offset should be enforceable both in the normal course of business and in the default or bankruptcy of the counterparty.
6. At the November 2010 meeting, the Boards tentatively decided an unconditional right of offset refers to a right of offset that is enforceable in all circumstances (including default by or bankruptcy of a counterparty).
7. This paper discusses the legal enforceability of an unconditional right of offset. This is in response to a request by some Board members to provide more information on the legal enforceability of such arrangements.
8. This paper is for informational purposes only as several staff papers and the legal experts that attended the February education session have addressed the issue in detail. **It is not the intention of the staff to discuss this paper and hence if Board members have questions on this paper, please ensure you contact the staff before the meeting.**

**Unconditional right of set-off**

9. The right to set off is a legal right and therefore to understand the economic implications of offsetting, it is necessary to understand the legal rules that provide and underpin those rights.
10. The right to set off is a legal right, and the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships between the parties need to be considered (to ascertain whether the right of set-off is enforceable).
11. Set off is the right of a debtor who is owed money by his creditor on another account or transaction to secure payment for what is owed to him by setting this off in reduction of his own liability.

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12. There are two legal foundations for offsetting of contracts – *court set-off* and *contractual set-off*. Although contractual and court set-off are conceptually equivalent (and equivalent in effect), their legal treatments are different. Court set-off is offsetting effected by a court whereas contractual set-off is offset on the basis of a contract (where there would otherwise not be reason for court set-off).<sup>1</sup>
13. Court set-off is a legal technique whereby cross-claims are discharged to produce a net claim. It represents the right which one party has against another to use his asset in full or partial satisfaction of what he owes to the other. This netting is not based on a contract, but results directly from law and thus is always governed by national law.
14. We have not analysed court set off (set off at common law or in equity or by statute) further as, in virtually every situation in which that form of set-off is available there would be an automatic set-off both under the rules of insolvency and outside insolvency.

***Contractual set-off***

15. This is a set-off right created by contract and governed by the terms of the contract. The parties to the contract stipulate for themselves the criteria for set-off, such as whether mutuality is required whether contingent debts may be set off, and when the set-off takes effect.
16. The simple form of contractual set-off is a clause in a contract providing that one party is entitled to set-off against any amounts it owes and all amounts owed to it by the other party. Other contractual relationships which are not of this character require a process that leads, automatically or by unilateral action by one party, to consolidation of the mutual claims into a single net balance. This process may involve the conversion into one net asset(s) or obligation(s) between the parties resulting from the issue and receipt of transfer orders between them.

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<sup>1</sup> Wood, Philip., Title Finance, Derivatives, Securitisations, set-off and Netting, 1st ed, London, Sweet & Maxwell (1995)

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17. There are two types of contract set off rules: those that apply in the course of ordinary business among solvent counterparties - *(a) netting by novation (b) payment or settlement netting*, and those that apply in resolutions of insolvent firms - (c) close-out netting. Close out netting is a conditional right so given the decision of the Boards at the November meeting is not relevant for this analysis.
18. Novation netting involves the amalgamation of two or more executory contracts into a single new contract to be performed at a future time. Novation netting may be effected by a provision for bilateral consolidation of contractual obligations or by clearing house rules. Here each contract may provide for automatic consolidation of contracts as and when these come into existence, so that no set-off situation ever arises.<sup>2</sup>
19. Whereas novation netting involves the combination of rights and obligations underlying executory contracts, payment netting is the process by which matured claims are netted out and paid. It is only the act of payment of the net balance which extinguishes the claims on both sides and such netting may be effected either by bilateral arrangements or by multilateral arrangements through a clearing house.

**Staff Comments**

20. The right to set off is a legal right, and the conditions supporting the right may vary from one legal jurisdiction to another. The laws applicable to the relationships between the parties need to be considered (to ascertain whether the right of set-off is enforceable).
21. The staff notes that contractual set off may, generally, be available both outside and within bankruptcy.
22. Prior to a bankruptcy, the limits on contractual set-off are for the most part practical rather than legal. Generally, parties to a contract are free to agree on terms for set-off of their liking and these will be effective so long as they are not displaced by

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<sup>2</sup> The law on financial derivatives –Alastair Hudson

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bankruptcy. Most countries allow contractual set-off or netting prior to bankruptcy of a party.

23. On bankruptcy, however, the bankruptcy rules become mandatory; displacing all other forms of set-off not exercised prior to bankruptcy.
24. Thus there is a possibility that on bankruptcy of a contractual party the non defaulting party may not be permitted to exercise any contractual right to net all obligations owed under the agreement.
25. The effect of bankruptcy on contractual rights of set off varies by jurisdiction. Hence the importance of considering jurisdictional and cross-border differences because different countries have different legal environments and local laws in some countries may not recognise some contractual set-off provisions in bankruptcy of one of the parties. Some countries are known to be debtor-friendly while others are creditor-friendly with respect to set-off on insolvency.
26. In some jurisdictions, contractual set-off arrangements would survive in bankruptcy of the counterparty. In those jurisdictions, set-off is treated as having taken place automatically on the bankruptcy date. The original claims are thus extinguished and only the net balance remains owing one way or the other. The creditor is thus exposed to insolvency risk only for the net balance<sup>3</sup>.
27. Many jurisdictions have developed protective statutes ('carve-outs') which allow for set-off and netting only in financial markets and or obligations and claims arising from clearing or payment systems. The carve-outs, however, protect only some types of financial contracts or only contracts between particular counterparties or only if the contract is a specified market contract or the clearing or payment system meets specified criteria. Where the criteria are met, the carve-out legislation will preserve the validity of netting arrangements in insolvency and provides that any netting arrangement operate according to their terms even within insolvency.

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<sup>3</sup> Re BCCI (No.8) and Stein v Blake [1996]

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28. Whether an entity's right of offset meets the right of offset criterion will depend on the governing law of the contract and the bankruptcy regime that will govern the insolvency of the counterparties.
29. An entity would meet the unconditional right of offset criterion (as decided by the Boards) if based on applicable laws the right of offset can be enforced both in and outside bankruptcy of the counterparties.
30. The staff notes that based on the Boards decision to limit the right of offset to circumstances when the unconditional right of offset is enforceable even in bankruptcy, not all contractual rights of set off will meet the criterion.