The Clearing House Arrangement

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1. Introduction: Multilateral Netting, Clearing and Settlement

In its narrow sense, “clearing system” is a mechanism for the calculation of mutual positions within a group of participants (“counterparties”) with a view to facilitate the settlement of their mutual obligations on a net basis. In its broad sense, the term further encompasses the settlement of the obligations, that is, the completion of payment discharging them. In that respect, “clearing system” is sometimes used to describe a process of multilateral netting by novation¹ and the settlement of the consequential payments.² In this broad sense, “clearing system” thus covers both “clearing” (denoting netting of obligations) as well as “settlement” (denoting payment of obligations).

The organization operating a clearing system is known as a “clearing house”.³ Participants in the “clearing system” are

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¹ “Multilateral netting by novation”, side by side with other forms of netting, is discussed below in Part 2.
² The terminology used in this article borrows heavily from Group of Experts on Payment Systems of the central banks of the Group of Ten countries, Report on Netting Schemes (Basle, Bank for International Settlements, February, 1989). Policy objectives and implications of netting were expanded in a follow-up report, which appeared between the submission of this article and its publication: Bank for International Settlements, Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries (Basle, November 1990).
³ In connection with collection of cheques and the payment system, a clearing house was judicially defined as “an association composed of a number of banks for convenient and expeditious handling of certain claims and credits against and in favor of members”: Security Commercial & Savings Bank of San Diego v. Southern Trust & Commerce Bank, 241 P. 945 (Cal. App., 1925) at p. 945. In Banque Nationale v. Merchants Bank of Canada, [1891] Montreal L.R. 336 (Que. S.C.), Davidson J. spoke of the Montreal clearing house for banks as “a purely voluntary association [whose] purposes are to provide simple and
members of the “clearing house” and are counterparties to the transactions to be netted and settled. Agreed-upon rules, mainly in the form of clearing house rules and procedures contractually bind participants bilaterally and multilaterally with the clearing house.

Clearing systems may exist in foreign exchange transactions, commodity and securities markets and bank collections of payment items. Such systems purport to economize on the number payments and thereby promote efficiency. Instead of making and receiving individual payments for numerous routine transactions, counterparties settle periodically in bulk, through the clearing house which acts as a central counterparty. Depending on the market and its requirements, settlement can take place monthly,\(^4\) daily,\(^5\) or at the end of any other agreed-upon period. As well, the machinery for clearing and settlement can utilize diverse technologies and operate in various speeds. The distribution of responsibilities between the central counterparty and the bilateral participants may also vary.\(^6\)

This article is designed to explore fundamentals relating to the legal nature of the clearing house arrangement. It is primarily concerned with the impact of a default by a counterparty on the multilateral netting by the clearing house and the resulting settlement. The question is specially important where the defaulting counterparty is insolvent.

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\(^5\) As a rule, this is the practice for cheque clearing; see definitions listed in footnote 3, * supra*, as well as large value electronic payment systems such as CHIPS and CHAPS; see B. Geva, “International Funds Transfers — Performance by Wire Payment” (1990), 4 B.F.L.R. 111.

\(^6\) For example, in some systems, the netting is centralized by the central counterparty at the clearing house. In others, counterparties net for themselves, and use the clearing house machinery only for settlement of netted amounts agreed upon among themselves. Even then the clearing house may facilitate inter-counterparty communication.
To keep the discussion relatively simple, this article is limited to the clearing and settlement of mature money debts. This bypasses complications arising both where an obligation is not yet due or where it relates to a specific quantity of fungible goods and not a sum of money.7

Following this introduction, Part 2 deals with the operation of bilateral and multilateral netting schemes. Part 3 examines the right of set-off and its application to bilateral and multilateral netting. Part 4 uses the House of Lord’s judgment in British Eagle8 as a focal point for discussing multilateral netting in insolvency. It demonstrates the importance of “mutuality” achieved by “substitution” for an effective insolvency set-off. Concluding Part 5 puts British Eagle in perspective, by examining its impact and highlighting subsequent developments. It is ultimately suggested that British Eagle is adequately flexible to accommodate the efficient operation of clearing houses.

2. Netting Schemes9

“Netting” is the process of establishing the amount owed by one counterparty to another by adjusting the mutual claims of each one on the other. In that process, the net amount owed by one counterparty to another is established by subtracting the gross amount owed by the latter to the former, from that owed by the former to the latter. Thus, where K owes L $10 and L owes K $6, the net amount owed by K to L is $2.

Netting arrangements are in the form of either “position netting” or “netting by novation”. “Position netting” is an arrangement which facilitates the discharge of two bilateral gross obligations between two counterparties by one payment of the net amount. This is also known as “payments netting” or “bulking of payment”. It can be carried out either on the basis of a pre-existing

8 Supra, footnote 4.
10 To demonstrate the generality of the ensuing discussion, amounts to be netted will not refer in this article to any specific currency. As discussed in the text at footnote 7, supra, so far as legal principles are involved, this article is limited to netting of mature money debts.
agreement ("binding payments netting") or by the actual acceptance of the net amount in discharge of the two debts. Either way, until payment is made, each party remains legally obligated for the gross amounts.

"Netting by novation is a species of "novation". In general, "novation amounts to the extinction of [an] old obligation, and the creation of a new one."\textsuperscript{11} Stated otherwise:\textsuperscript{12} Novation is a transaction by which, with the consent of all the parties concerned, a new contract is substituted for the one that has already been made. The new contract may be between the original parties ... or between different parties, e.g. where a new person is substituted for the original debtor or creditor ...

Where substitution is involved, novation is thus "a contract between debtor, creditor and a third party that the debt owed by the debtor shall henceforth be owed to [or by] the third party".\textsuperscript{13} "Netting by novation" is the replacement of two mutual gross obligations by one single net obligation for the net amount. In effect, the original gross obligations are discharged. Thus, to pursue the previous example, where K owes L 8 and L owes K 6 so that the net amount is 2, in a "position netting", until payment of 2 from K to L, K remains indebted to L in the amount of 8 and L remains indebted to K in the amount of 6. That is, the gross obligations of 8 and 6 remain effective and are not discharged until payment of 2 by K to L. On the other hand, under a "netting by novation" arrangement, the effect of the netting establishing the net amount of 2 owed by K to L is to discharge the two gross obligations of 8 and 6 and replace them with one net obligation of 2. Payment by K to L of 2 thus discharges the novated obligation and not the gross obligations which were already discharged in the course of netting.

Netting, whether position or by novation, can be either bilateral or multilateral. As discussed, bilateral netting involves solely two counterparties and establishes the net amount owed from one to another. Multilateral netting involves more than two counterparties and establishes the net amount owed between each one and all others. This amount is referred to as a "net net"\textsuperscript{14} and is

\textsuperscript{14} In multilateral netting, net debtors and net creditors are to be referred to either as such,
reached by transforming all bilateral debts between a pair of counterparties to multilateral net nets between each counterparty and all others. The mutuality between two of the counterparties in a bilateral netting is thus replaced by the mutuality between each counterparty and all others. Multilateral netting underlies the operation of the clearing house arrangement.

The operation of multilateral netting can be demonstrated by the following example. Suppose X owes Y 100, Y owes Z 100, and Z owes X 60. In this setting, X owes all others 40 (that is, 100 – 60); Y neither owes to, nor is owed by all others (since 100 – 100 = 0); and Z is owed by all others 40 (made of 100 – 60). Namely, X’s net net is –40, Y’s net net is 0, and Z’s net net is 40. Multilateral netting thus produces 40 owed by X for the benefit of Y. In a “netting by novation” scheme, the establishment of this debt by multilateral netting discharges the respective bilateral debts among X, Y and Z. However, in a “position netting” arrangement, the respective bilateral debts remain binding until payment of 40 is actually made by X to Y.

Multilateral netting may not necessarily produce a single actual payment. Thus, suppose G owes H 40, H owes J 20, and G owes J 10. Upon multilateral netting G owes all others 50, H is owed by all others 20, and J is owed by others 30. The proceeds of G’s payment of 50 ought thus to be distributed between H and J, receiving 20 and 30 respectively. Depending on the scheme, G may either pay H and J separately, or will make one payment to an agent who will distribute the proceeds between H and J. Where there are more than three counterparties so that the position of any net creditor need not necessarily mirror that of any net debtor, the existence of a common counterparty or agent (“central counterparty”) which receives individual payments from net

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15 "Mutuality" is premised on the principle that "one man's money shall not be applied to pay another man's debt": *Jones v. Mossop* (1844), 3 Hare, 568 at p. 574, 67 E.R. 506, per Wigram V.C. In connection with the set-off required for netting (as discussed in Part 4, below), mutuality means that "the two claims must be between the same parties in the same right." See R.M. Goode, *Legal Problems of Credit and Security*, 2nd ed. (London, Sweet & Maxwell, 1988), p. 154. For an extensive discussion on principles of mutuality see Chapter 14 of Wood, supra, footnote 9.

16 Such an example (among A-B-C) is set out by Wood, ibid., p. 186; and graphically worked out at pp. 187 and 189.

17 For more on the discharge, see the text around footnotes 27 to 28, infra.
debtors and distributes them to net creditors is thus quite indispensable. This can be demonstrated in the following example. Suppose Q owes P 8, P owes R 3, S owes R 2, R owes Q 10, Q owes S 12 and S owes P 7. Upon multilateral netting, Q's net net is -10, P's net net is 12, R's net net is -5 and S's net net is 3. Both Q and R are net debtors. Both P and S are net creditors. Payments made by Q (10) and R (5), total 15, and are distributed between P (12) and S (3). An effective method carrying out such payments requires the employment of a central counterparty acting as a common agent receiving payments from net net debtors and distributing the proceeds to net net creditors.

For each participant, the central counterparty represents the joint interest of all other participating counterparties. The interaction between each participant and the central counterparty is facilitated at the clearing house where multilateral netting is confirmed and through which settlement is carried out. The central counterparty is thus the central figure of the clearing system, linking transacting counterparties and transforming their bilateral relations into a multilateral one. Thus, the use of a central counterparty enables a multilateral netting scheme to maintain the requirement of mutuality between parties. It is in this sense that the central counterparty is the embodiment of the clearing house organization.

The mechanism facilitating multilateral netting can be described as follows: all obligations due to or from each participant are novated by substituting a central counterparty for each counterparty of the participant. In the previous example, Q owed P 8, was owed by R 10, and owed S 12. Under the novation process, the central counterparty substitutes P, R and S, so that Q owes the central counterparty 8 and 12 and is owed by the central counterparty 10. Each participant ends up with a gross amount owed by him to the central counterparty, being the sum of all net amounts owed by him to his net creditor counterparties, ("gross net

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18 Needless to say, multilateral netting can also be worked out (and not only confirmed) in the clearing house, and in fact, bilateral netting can also take place there. Compare footnote 6, supra.

19 For each counterparty the central counterparty may not necessarily be a separate legal entity but rather all other counterparties jointly. See footnote 23, infra.

20 See Wood, supra, footnote 9, p. 188. Earlier (at p. 186) Wood explains the mechanics also on the basis of assignment, but this seems to work only in a situation such as described around footnote 15, supra.
debts”) and a gross amount owed to him from the central counterparty, being the sum of all net amounts owed to him by his net debtor counterparties (“gross net credits”). For Q, the gross net debit is 20 (being the sum of 8 to P and 12 to S), and the gross net credit is 10 (being the amount owed by R). Ultimately, these gross amounts are netted to produce the overall net net for the participant. In our example, Q’s net net is –10.

The same exercise takes place with respect to all other counterparties (P, R and S). Ultimately, as discussed, receipts from net net debtor participants (Q and R) are disbursed to net net creditor counterparties (P and S). The entire process is set out in the following tables.21

Table 1
Bilateral Nets of Counterparties

<table>
<thead>
<tr>
<th>Participants</th>
<th>P</th>
<th>Q</th>
<th>R</th>
<th>S</th>
<th>Owed by Participant (debts)</th>
<th>Owed to Participant (credits)</th>
<th>Net Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>P</td>
<td>–8</td>
<td>8</td>
<td>–3</td>
<td>7</td>
<td>–3</td>
<td>15</td>
<td>12</td>
</tr>
<tr>
<td>Q</td>
<td>–10</td>
<td>10</td>
<td>–12</td>
<td>2</td>
<td>–20</td>
<td>10</td>
<td>–10</td>
</tr>
<tr>
<td>R</td>
<td>3</td>
<td>–10</td>
<td>2</td>
<td></td>
<td>–10</td>
<td>5</td>
<td>–5</td>
</tr>
<tr>
<td>S</td>
<td>–7</td>
<td>12</td>
<td>–2</td>
<td></td>
<td>–9</td>
<td>12</td>
<td>3</td>
</tr>
</tbody>
</table>

Table 2
Central Counterparty

<table>
<thead>
<tr>
<th>Receipts</th>
<th>Disbursements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q</td>
<td>P 12</td>
</tr>
<tr>
<td>R</td>
<td>S 3</td>
</tr>
<tr>
<td>Total</td>
<td>Total 15</td>
</tr>
</tbody>
</table>

Multilateral netting raises the further question as to what is

21 However, for clarity sake, bilateral gross amounts and their transformation to bilateral nets, have been omitted.
discharged by either the net netting (in netting by novation) or the actual payment (in position netting). Does the discharge apply to the various bilateral net amounts owed between each pair of counterparties, or to the bilateral gross amounts owed between each pair?

The answer depends on the nature of the bilateral netting which produced the nets. If at the bilateral netting stage, "netting by novation" was used, then the net debt would be discharged as the bilateral gross debts would have been discharged when the net debt was established. If, on the other hand, at the bilateral netting stage, "position netting" was used, then the net netting (in multilateral netting by novation) or payment (in a multilateral position netting) would discharge the bilateral gross debts.

Multilateral netting can produce either one or more payments through the use of either "position netting" or "netting by novation". In each case, the obligations discharged between each pair of counterparties are either net or gross, depending on the nature of the bilateral netting establishing respective nets. As stated above, in multilateral position netting schemes, such respective obligations, whether net or gross, are discharged by actual payment. In netting by novation arrangements they are discharged by the mere establishment of net net positions.\textsuperscript{22}

Discharge of obligations in netting schemes is set out in the table which follows.

\textsuperscript{22} In theory, multilateral netting, bilateral obligations may be discharged already at the gross netting stage. However, in practice, the gross netting is unlikely to occur separately from the net netting. Hence, for simplicity, the possible discharge of bilateral obligations at the gross netting stage will not be pursued here.
By its nature, netting by novation is thus characterized by the replacement of old obligations by a new netted obligation. This replacement is the distinguishing feature between netting by novation and position netting which does not generate any new substitute netted obligation prior to payment. In a bilateral netting by novation, the new obligation is between the same counterparties to the original obligation. This is not so in multilateral netting by novation.

Indeed, for each counterparty, multilateral netting by novation entails the replacement of each of the original contracting counterparties as contracting parties, to or by whom payment is owed by a central counterparty. Such a central counterparty may be the one

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* In multilateral netting schemes.

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Table 3

<table>
<thead>
<tr>
<th>Netting by Novation</th>
<th>(net)* Netting Discharges</th>
<th>Payment Discharges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bilateral Position Netting</td>
<td>–</td>
<td>gross</td>
</tr>
<tr>
<td>Bilateral Netting by Novation</td>
<td>gross</td>
<td>net</td>
</tr>
<tr>
<td>Multilateral Position Netting</td>
<td>–</td>
<td>Bilateral Obligations net – if bilateral by novation gross – if bilateral position netting</td>
</tr>
<tr>
<td>Multilateral Netting by Novation (and Substitution)</td>
<td>Bilateral Obligations net – if bilateral netting by novation gross – if bilateral position netting</td>
<td>net net</td>
</tr>
</tbody>
</table>
operating the clearing system, or one related to it. Alternatively for each participating counterparty, the central counterparty may be all other participating counterparties jointly rather than a distinct entity.23

To pursue the previous example, Q’s net net debt of 10 is either to P, R and S jointly or to the central counterparty to whom Q actually pays. Either way, in a multilateral netting by novation Q’s net net debt of 10 discharges Q’s bilateral debts to P and S (of 8 and 12 respectively), as well as R’s debt to Q of 10.24 It is however the replacement of each of Q’s counterparties, either by all of them collectively, or by the new central counterparty, which turns multilateral netting by novation into “multilateral netting by novation and substitution”.

By its nature, multilateral netting by novation is also by substitution. At the same time, in multilateral position netting, there is no substitution; the novation with the central counterparty is merely hypothetical in order to facilitate the calculation of amounts payable.

As well, there is the intermediate possibility of “multilateral position netting and substitution”. Thereunder, bilateral obligations are novated by the substitution of the central counterparty for individual counterparties but beyond that bilateral obligations remain intact25 so that no netting by novation follows.26

23 For the nature at common law of “the joint promise of several persons” as “the single obligation of all jointly and the individual obligation of none” so that “there is but one obligation and one cause for action for its breach”: see Williston on Contracts, 3rd ed., W.H.E. Jaeger, ed. (Mount Kisco, N.Y., Baker, Voorhis & Co. Inc., 1959), vol. 2, § 327, p. 668. As well, “at common law, a single joint contractual right belongs to all of obligees taken together.” Ibid., § 326, p. 664. Compared to a scheme based on one contract for each participating counterparty with a central counterparty, such a scheme of a joint obligation by all net net debtors to each net net creditor and a joint right of all net net creditors against each net net debtor is quite awkward. However, it is utilized either where the clearing house is not operated by a distinct legal entity, or as one means for a central counterparty to avoid personal liability (though, as discussed in Part 3, infra, a central counterparty may limit its liability regardless).

One manifestation of the joint right as not a summary of individual rights is the rule under which an obligor sued by joint creditors cannot set off an individual debt owed to him by one of the plaintiff-creditors: see, e.g., Gordon v. Ellis (1846), 2 C.B. 821, 135 E.R. 1167, and McDougall v. Cameron (1893), 21 S.C.R. 379 at p. 381, per Strong J.

24 Discharge by multilateral netting by novation is discussed in text around footnotes 27 to 28, infra.

25 In theory there are even more variations. First there is the possibility of multilateral novation by gross netting and substitution. This is an intermediate position between (a) multilateral position netting and substitution, and (b) multilateral netting by novation. It consists of (i) novation by substitution, and (ii) novation by gross netting only: see the
Indeed, while multilateral netting by novation requires substitution and, in general, substitution is itself a form of novation, the novating substitution is compatible with either position netting (and in fact, no netting at all) or netting by novation. As it involves novation by substitution but no netting by novation, multilateral position netting and substitution is thus an intermediate concept bridging between multilateral netting by novation and multilateral position netting. It is, however, better regarded as a form of position netting, since it does not involve netting by novation.

It is thus important to distinguish between novation by substitution and netting by novation and substitution. In each case, a series of bilateral obligations among pairs of participants is replaced. In the former, replacement is by novated obligations by bilateral net debtors to the central counterparty and corresponding novated obligations of the central counterparty to bilateral net creditors ("position netting and substitution"). In the latter, replacement is by one set of net net debtor's novated obligations to the central counterparty, and another set of obligations of the central counterparty's own novated obligations to net net creditors ("multilateral netting by novation"). In both cases, the novated central counterparty's obligation need not be absolute and unconditional. In fact it is likely to be on a "non-recourse" basis, so as to be conditional upon and limited to funds provided by net net debtor participants.\(^2\) None the less, a net net creditor may be satisfied to relinquish any recourse to either original or novated net net debtors' bilateral obligations, provided he is assured of enforcement by the central counterparty against net net debtors, as well as that net net debtors' funds transmitted via the central counterparty may be completely outside the reach of the central counterparty's own creditors.\(^2\) Indeed, such assurances are quite common in clearing systems. However, as will be seen in Part 4 below, default procedures in a clearing system may provide for the repudiation of multilateral netting and the restoration of original interparty bilateral obligations upon the default of a net net debtor.

\(^2\) text which follows footnote 20, supra. Second, there is the possibility of substitution followed by bilateral netting by novation.

\(^2\) Multilateral position netting and substitution does not look like an attractive option but it works quite well: see Parts 4 and 5 below.

\(^2\) For a similar situation (trustee's obligation solely out of trust funds) see *De Vigier v. Inland Revenue Comrs.*, [1964] 2 All E.R. 907 (H.L.).

\(^2\) The most obvious device is a separate expressly designated trust account.
3. The Right to Set Off Mutual Debts

Netting avoids the multiplicity of reciprocal payments (in position netting) as well as of reciprocal obligations (in netting by novation) through the exercise of the right of set-off. For example, in bilateral netting, two reciprocal gross obligations are discharged either by one payment of their differences (in position netting) or by merely striking its amount (in netting by novation). In the latter case, the exercise of the right of set-off discharges the reciprocal gross obligations by establishing their net. In the former case, the right of set-off can be used after payment of the net in order to defend an action by either counterparty for the amount of the smaller obligation.29

“Set-off” is defined as “the discharge of reciprocal obligations to the extent of the smaller obligation”. Accordingly, “where a creditor claims a debt from his debtor and the debtor has a cross-claim on the creditor, then, if the debtor can reduce or extinguish the amount of the creditor’s claim by his cross-claim, the debtor is said to set off”.30

At common law,31 the right of set-off “is generally characterized as being, not a modification of an obligation, but an incident of its enforcement”.32 It is “merely a convenient mode of settling mutual accounts or preventing multiplicity of actions between the same parties”.33 In contrast to the civil law “compensation” which operates automatically by the sole operation of law to extinguish mutual obligations,34 set-off at common law is “a personal privilege, and not an incident or an accompaniment of the debt”.35 It “is not a defense, but a cross action [which] concedes the validity of the plaintiff’s claim, and is founded upon an independent cause

29 See Part 2, the text following footnote 9, supra.
30 Wood, footnote 9, supra, p. 5.
33 Falconbridge on Banking and Bills of Exchange, 7th ed., A.W. Rogers, ed. (Toronto, Canada Law Book Ltd., 1969), p. 671. This quote does not appear in the current edition (see footnote 32). Instead, the author states, “[t]o prevent circuity, mutual debts taking the form of liquidated demands may be set off, the one against the other, with judgment being rendered for the net balance”. Ibid., vol. 1, p. 786.
35 Lincoln v. Grant, 47 D.C. App. 475 (1917-18) at p. 483.
of action in favor of the defendant, who may at his election assert it
by way of set-off, or enforce it by a separate suit". 36

By statute, the right of set-off can be asserted by the defendant
by way of defence. 37 The right is available only in an action for
payment of a debt due from the defendant to the plaintiff and can
be used solely in relation to a debt due from the plaintiff to the
defendant; 38 that is, both reciprocal claims must be in liquidated
amounts due by one to the other. 39 The right exists in England by
statute since 1729 40 and is currently provided for in Ontario in s.
124 of the Courts of Justice Act, 1984. 41 It is called "statutory set-
off", or alternatively, "independent set-off", "legal set-off", "court set-off" or "procedural set-off". 42

Statutory set-off is effective only from the time judgment is
given. 43 That is, until judgment it produces position netting. As of
judgment, it generates netting by novation.

Statutory set-off is classified as a procedural right. 44 In effect,
this is another way of describing it as generating position netting
before judgment, and not netting by novation. Thus, where A
owes B 8 and B owes A 6, the scope of each reciprocal debt
remains unchanged. However, where B sues A, the effective
exercise of set-off by A will generate a judgment of 2. Alterna-
tively, if A pays 2 prior to being sued, the effective exercise of set-
off by A against B’s subsequent action will extinguish A’s liability
altogether. It is only in this sense, that is via the intermediation of
legal proceedings, that set-off can be said to extinguish or
discharge an obligation. However, in practice, the mere avail-
bility of the right may eliminate the creditor’s action in the first

36 Ibid.
37 See Geva, supra, footnote 31, at p. 132.
38 Against a plaintiff suing as an assignee of a debt, set-off is also available to the defendant
in relation to a debt due to him from the plaintiff’s assignor and accruing prior to the
notification of the assignment: see, e.g., Cavendish v. Geaves (1857), 24 Beav. 163, 53
E.R. 319; s. 40(1)(b) of the Personal Property Security Act, 1989, S.O. 1989, c. 16, and
for a critical discussion, Geva, supra, footnote 31, at pp. 134-7.
39 Goode, supra, footnote 15, at p. 135. This reciprocity is the "mutuality" requirement
referred to in footnote 15 and the text supra.
40 "Act for the Relief of Debtors with Respect to the Imprisonment of their Persons", 1729,
2 Geo. II, c. 22, s. 13.
41 S.O. 1984, c. 11, as amended.
42 Wood, supra, footnote 9, at p. 7. This "statutory set-off" is thus distinguished from
"equitable" or "transaction" set-off, relating to matters arising from one transaction and
discussed by Wood in Chapter 4.
43 Wood, ibid., at pp. 17 and 84-6.
44 Goode, supra, footnote 15, at p. 132.
place, so that the intermediation of legal proceedings may be hypothetical.

Against a bankrupt debtor, set-off was allowed by common law courts and courts of equity as of the 17th century. The codification of the right to set-off in bankruptcy goes back to 1705. The right is currently provided for in insolvency legislation in England as well as in Canada.

Set-off in insolvency is procedural "in the sense that it is part of the process of proof and requires the taking of an account". None the less, unlike statutory set-off between solvent parties, bankruptcy set-off is mandatory and cannot be excluded by contract.

The specific rationale for bankruptcy set-off which distinguishes it from statutory set-off between solvent parties was explained by Park B. in Forster v. Wilson. Accordingly, while the latter "is given by ... statutes ... to prevent cross actions", the object of the former "is not to avoid cross actions ... but to do substantial justice". This can be demonstrated in the following examples.

Suppose A owes B 8 and B owes A 6 and both are in default. Where they are solvent, in the absence of the right of set-off, each will have to bring a separate action against the other. B will recover 8 and A will recover 6. A will thus end up paying 2 more than received by him, but only as a result of two actions. At the same time, where set-off is available, A is allowed to use it in B's action so as to produce one judgment in B's favour for the amount of 2. In this setting, statutory set-off avoided circuity of action.

45 Goode, ibid., at p. 134.
46 "Act to Prevent Frauds frequently committed by Bankrupts", 1705, 4 & 5 Anne, c. 17, s. 11.
47 Though technically "insolvency" is broader than "bankruptcy", unless otherwise indicated, the two terms will be used in this article interchangeably.
49 Bankruptcy Act, R.S.C. 1985, c. B-3, s. 97(3); Winding-up Act, R.S.C. 1985, c. W-11, s. 73. The proposed Insolvency Act, Bill C-17, an Act respecting bankruptcy and insolvency, 2nd Sess., 32nd Parl., 32 Eliz. II, 1983-84, s. 246, purported to supersede them. For the application of these pieces of legislation to banks, see Crawford, footnote 32, supra, at pp. 641-2.
50 Goode, supra, footnote 15, at pp. 177-8.
52 (1843), 12 M. & W. 191, 152 E.R. 1165.
53 Ibid., at p. 203.
54 Ibid., at p. 204.
55 See the paragraph containing footnote 44, supra.
However, it did not alter the allocation of resources between the parties.

Suppose now that B is bankrupt. A cannot sue him. Nor can he exercise his statutory right of set-off against the action of B’s trustee in bankruptcy, since no cross-action would lie against a trustee in bankruptcy for a debt due from the bankrupt. Indeed, A may prove his claim in bankruptcy, in which case he will receive a dividend on the debt of 6 due to him. Accordingly, in the absence of bankruptcy set-off, A will end up paying the full amount of 8 to B’s trustee in bankruptcy, and receive only a dividend on the 6 owed to him by B! Instead of paying 2 (8 less 6), A ends up paying an amount of 8 less the dividend on 6, which altogether is greater than 2. It is by allowing A to set off the debt of 6 owed to him by B against the claim of B’s trustee in bankruptcy for the 8, that bankruptcy set-off does “substantial justice between the parties”. Its effective exercise gave A the equivalent of a security interest in B’s debt to him so as to affect the allocation of resources between the parties, effectively to the detriment of B’s other unsecured creditors.

Bankruptcy set-off is retroactive to the insolvency date. That is, until claim approval, bankruptcy set-off produces position netting. Once a balance is struck and approved, it generates netting by novation as of the bankruptcy date.

Contractual set-off is created by contract, independently of any rule of law. The contract may be express, implied or arise from custom or usage. The contract may confer on the debtor an option to set off his cross-claim, or the set-off may be mandatory so as to produce a net balance (“account stated”). Whether contractual set-off produces netting by novation as of the emergence of any cross-claim, from the time a balance is struck, at any other time, or even at all, is a matter to be governed by the counterparts’ contractual arrangement.

Contractual set-off is important only in circumstances where no other type of set-off is available. So far as reciprocal liquidated claims are concerned, its prime importance is in situations where it operates to give an effective earlier date for the novated obligation.

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56 Forster v. Wilson, supra, footnote 52, at p. 204.
57 Ibid. See the text at footnote 54, supra.
58 Wood, supra, footnote 9, at pp. 17 and 292-3.
59 Wood, ibid., at pp. 11 and 147-8.
resulting from the netting than would have been produced by other types of set-off.

4. **Multilateral Netting and Insolvency: *British Eagle***

In multilateral netting, where the default of a net net debtor results in a shortfall in the amount available for distribution to net net creditors, settlement cannot be completed. According to the default procedures applicable in the pertinent clearing system, multilateral netting may either be repudiated or upheld. Where it is repudiated, settlement is rescinded. Rescission of settlement can be carried out by the return of funds to net net debtors and the full restoration of all original intercounterparty bilateral obligations which are then settled directly outside the clearing house. Alternatively, a new multilateral netting is calculated without the defaulter, settlement amounts are adjusted, and only the original bilateral obligations to and of the defaulter are restored and settled directly outside the clearing house. 60

Where, upon default, multilateral netting is upheld and settlement is carried out, the deficiency resulting from the default is borne by either the central counterparty, by all or some counterparties according to a loss sharing formula, or by resort to insurance, collateral, guarantees, letters of credit or other such securities.

As will be seen below, 61 the effect of repudiation is to divert funds owed by bilateral net debtors of the defaulter from the clearing house (for the benefit of all net net creditors) to the defaulter's trustee in bankruptcy or liquidator (for the benefit of the general non-clearing house creditors of the defaulter) and thereby to increase the deficiency. However, upholding multilateral netting upon default requires a detailed scheme designed to implement the execution of settlement and may involve legal uncertainties.

Indeed, the choice of procedure is a matter to be agreed upon by counterparties as part of the contractual arrangements setting up the clearing system. However, counterparties may enforce an agreed upon scheme upholding multilateral netting against a reluctant liquidator or trustee in bankruptcy of an insolvent net

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60 Where default by one counterparty generates a chain of defaults, the exercises may be repeated.
61 See footnotes 75 to 76 and text, *infra.*
net debtor, only where such a scheme is effective under the governing insolvency law. Novation and the conditions facilitating insolvency set-off must be set up in a way that will assure that applicable insolvency law will accommodate the agreed-upon scheme.

More specifically, inasmuch as set-off requires mutuality, it can only work on a bilateral basis. Indeed, multilateral netting is effective only as a co-ordinated series of bilateral nettings between each participating and a central counterparty. Accordingly, in the absence of an agreement establishing such mutuality, multilateral set-off is ineffective in insolvency. Furthermore, where novation by substitution has not preceded insolvency, an agreed-upon multilateral netting under a clearing house arrangement is not effective in insolvency. As a result, the usefulness of multilateral netting rests largely on its legal enforceability.

These observations were confirmed by the House of Lords in British Eagle International Airlines Ltd. v. Compagnie Nationale Air France, the single leading authority on the impact of insolvency on multilateral netting.

The International Air Transport Association ("IATA") ran a clearing house whose object was to provide the facility for the settlement of debts between international airlines which carried passengers and freight on behalf of each other. A debit eligible for clearance arose when the debtor, that is, an airline ("the issuing party") issued a ticket for transportation over the routes of the creditor, that is, by another airline ("the carrying party").

The setting up of the clearing house was designed to eliminate the need for an individual inter-airline payment of each debt. Instead of making and receiving numerous payments, the airlines devised the clearing house system. Thereunder, debts resulting from eligible services would be cleared monthly and would result in a settlement involving either one payment by a member (in a net net debit position) to the clearing house or one payment by the clearing house to a member (in a net net credit position) but never in payments being made to or by members inter se.

Clearing house rules and regulations were binding on all members inter se and towards IATA. By multilateral agreements all agreed that:

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62 See footnote 15, supra.
63 As discussed in Part 2, supra.
64 [1975] 2 All E.R. 390 (H.L.). The judgments of the trial judge and the Court of Appeal are cited in footnotes 81 and 82, infra.
65 IATA was incorporated in 1945 by an Act of the Canadian Parliament with the object of
(i) Each issuing airline agrees to pay to each carrying airline the transportation charges applicable to the transportation performed by such carrying airline.

(ii) Settlement of amounts payable ... between ... members of the IATA Clearing House shall be in accordance with applicable rules and regulations of the IATA Clearing House.

Clearances were effected on a monthly basis under the following procedure.

(a) Each airline submitted a separate Form I for each other airline setting out claims of the former as a carrying party creditor against the latter as an issuing party debtor. The original was sent to the clearing house and a copy was sent to the debtor airline.

(b) In addition, each airline submitted one Form 2, containing summaries of accounts, including all claims against issuing parties respectively in the sterling zone and the dollar zone.

(c) On the basis of the information provided in Forms 1 and 2, the clearing house prepared and sent to each airline a statement (Form 3) setting out its credits, debits and net balance (the net net) for the month under clearance.

The timetable for clearance and settlement was described by Lord Morris as follows:67

Clearance of accounts for one month will close on the 30th day of the following month. Thus “claims” in respect of any transportation effected in the month of September must be received by 30th October. Then the clearing house must complete the processing of members' claims within five working days. On completion of such clearance, the clearing house will send telegraphs or telegrams ... to members telling them the balances either owed to or by the clearing house and within three days of the sending of these telegrams the clearing house will dispatch, inter alia, Form 3 [showing in detail how the sum mentioned in the telegram has been arrived at]. Then, seven days after the sending of the clearing house cable there is what is called “call day”. “Settlement by debtors” (meaning settlement by debtors to the

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66 British Eagle, ibid., at p. 404. As for the applicable law, “[t]he clearing house regulations provide that they are to be construed according to the law of the Province of Quebec but it was no [sic] suggested in argument that there were any special rules of construction applicable under Quebec law which would lead to a different meaning being put on them than they would bear under English law” ibid., at p. 408, per Lord Cross. The case was decided under English law.

67 Ibid., at pp. 397-8.
clearing house) must be made before the close of banking business on call day. Then, on completion of "debtor settlements" the clearing house settles "creditors" (meaning creditors of the clearing house) ... The clearing house is allowed seven days after the date when those who are its debtors must pay before it need discharge the accounts of those who are its creditors. (In practice it has been found that the use by the clearing house of amounts that it will have in hand enables interest to be earned which covers the cost of running the clearing house).

Under the clearing house regulations, the financial responsibility of the clearing house was limited to the sum it collected from net net debtor members.

British Eagle and Air France were two airline members of the clearing house. British Eagle ceased to carry on business on November 6, 1968. On November 8 ("liquidation date"), a resolution for creditors' winding-up was passed by its members. Liquidation date thus was subsequent to October 30, that is after the closing of clearing for September 30, but prior to November 12, which was the "call day" for the overall amount due from debtor members for the closed period.

For the period ending on September 30 ("cleared period") British Eagle was a net net debtor to the clearing house. Eligible debits were further created by and to British Eagle after September 30, in fact until the day of cessation of business (the "uncleared period"). The activity of British Eagle during the entire "cleared" and "uncleared" period, that is between September 1 and November 6, produced a net net debit position to the clearing house.

The bilateral netting of the mutual claims between Air France and British Eagle for the "cleared" as well as "uncleared" period produced a net credit in favour of British Eagle. Unlike British Eagle, Air France remained solvent at all relevant times.

In the facts of the case, payment from the insolvent British Eagle for the "cleared" period was not forthcoming. This generated a shortfall in the funds to be disbursed by the clearing house to net net creditor members. As well, with the cessation of business by British Eagle in the course of the "uncleared" period, at a point where it had been in a net net debit position, the occurrence of shortfall was destined to repeat itself in the next clearance. British Eagle was thus in default for the entire amount of its net net debit position for the entire "cleared" and "uncleared" period.

The applicable clearing house procedure, as applied in the facts of the case, purported to effect settlement of the multilateral

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68 Ibid., at pp. 406-7.
netting, leaving the defaulter liable to the clearing house for the deficiency in the amount of its net net debit position, and allocating the loss resulting from unsettled clearance onto the bilateral net creditors of the defaulter. Accordingly, bilateral net credits in favour of bilateral net creditors of the defaulter (that is, the sum of the gross net multilateral debits of the defaulter) were reversed. Sums paid by bilateral net debtors of the defaulter, that is the amount of the gross net credits of the defaulter, were apparently held by the clearing house for the benefit of bilateral net creditors, to whom they would be paid together with the defaulter's deficiency, once collected. The report does not tell us what happens to amounts held by the clearing house for the benefit of bilateral net creditors if default itself remains uncollectible. One can assume that such amounts are ultimately paid to the bilateral net creditors in a way that the loss resulting from the deficiency is apportioned among them.

69 See opening paragraphs to this Part, supra.
70 See Table I in Part 2, supra.
71 A bilateral net debtor who is not a net net debtor pays by reducing his net net credit.
72 See, supra, footnote 64. As the explanation at p. 407 of British Eagle is not entirely complete or clear, this may reflect my own understanding as to the specifics of the default procedure.
73 Thus, in reference to Tables 1 and 2, Part 2, supra, and upon the default of Q,

**Revised Table 1**

<table>
<thead>
<tr>
<th></th>
<th>P</th>
<th>Q</th>
<th>R</th>
<th>S</th>
<th>Net Net</th>
<th>Resulting Deficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>P</td>
<td>8</td>
<td>-3</td>
<td>7</td>
<td>4</td>
<td>8</td>
<td></td>
</tr>
<tr>
<td>Q</td>
<td>-8</td>
<td>8</td>
<td>7</td>
<td>4</td>
<td></td>
<td></td>
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<tr>
<td>R</td>
<td>3</td>
<td>-10</td>
<td>2</td>
<td>-5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>S</td>
<td>-7</td>
<td>12</td>
<td>-2</td>
<td>-9</td>
<td>12</td>
<td></td>
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</tbody>
</table>

**Revised Table 2**

<table>
<thead>
<tr>
<th>Receipts</th>
<th>Disbursements</th>
</tr>
</thead>
<tbody>
<tr>
<td>R 5</td>
<td>P 4</td>
</tr>
<tr>
<td>S 9</td>
<td>Q 10*</td>
</tr>
</tbody>
</table>

* Amount is not paid to Q but is rather kept by the clearing house for the benefit of P and S (Q's bilateral net creditors). Once Q's original deficiency of 10 is collected, the combined amount of 20 is distributed to P (8) and S (12) to compensate them for the original deficiency.

74 To pursue Tables 1 and 2 examples, the 10 held by the clearing house will be distributed to P (4) and S (6).
British Eagle’s liquidator sued Air France for the amount of the bilateral net credit position resulting from the two airlines’ mutual dealings over the entire “cleared” and “uncleared” period. His object was to repudiate the multilateral netting of the clearing house and divert funds payable by British Eagle’s bilateral net debtors (that is, the gross net credits of British Eagle)\textsuperscript{75} from the clearing house (for the benefit of airline creditor members) to British Eagle (for the benefit of all creditors of British Eagle and not only member airlines). This would have increased the shortfall to the clearing house resulting from the default by British Eagle, by adding (a), the amount of the bilateral net debits of British Eagle’s counterparties (which are British Eagle’s own bilateral or gross net credits) to (b), the amount defaulted by British Eagle (that is, its net net debit position for the entire “uncleared” and “cleared” period), so as to be equal to (c), the gross (bilateral) net debits of British Eagle.\textsuperscript{76}

There was no dispute as to the liability of British Eagle’s bilateral net debtors including Air France.\textsuperscript{77} Rather, at stake was the entitlement to their bilateral net claims. Can they be a part of the multilateral netting, as claimed by the clearing house, or are they part of British Eagle’s estate?

In arguing for the repudiation of the settlement for both the “cleared” and “uncleared” periods, the liquidator of British Eagle relied on s. 302 of the Companies Act, 1948, providing that “the property of a company shall, on its winding up, be applied in satisfaction of its liabilities \textit{pari passu}.”\textsuperscript{78} In effect, the contention was that bilateral net amounts owed by bilateral debtor members (including Air France) were “property” of British Eagle to be applied in satisfaction of its liabilities \textit{pari passu} among all creditors and not only in reduction of British Eagle’s indebtedness to \textit{some} creditors, that is, the clearing house creditor members.\textsuperscript{79}

\textsuperscript{75} Again, in the setting of Table 1, this means that upon Q’s default, his liquidator claimed the 10 owed by R and diverted this sum from S and P to the benefit of Q’s general creditors, beyond the reach of clearing house members, thereby increasing the overall deficiency in clearing.

\textsuperscript{76} That is, in the setting of Table 1, the shortfall resulting from Q’s default would have increased by adding (a) 10 to (b) 10 so as to be equal to (c), 20.

\textsuperscript{77} Consequently, “Air France [had] no personal interest in the result of the proceedings since it is on any footing liable to account for the sum claimed either to the clearing house or to the liquidator of British Eagle”: \textit{supra}, footnote 64, at p. 407, \textit{per} Lord Cross.

\textsuperscript{78} \textit{Ibid.}, at p. 409.

\textsuperscript{79} For the inability to contract out of the statutory scheme for distribution of assets in insol-
From a legal perspective, the issue was the effective time of substitution. That is, the effectiveness of insolvency bilateral netting was not challenged. Nor was there any dispute as to the effectiveness of multilateral netting, provided mutuality, that is substitution, had been established prior to liquidation.

The liquidator did not purport to challenge the binding effect of multilateral netting but instead challenged the timing as to when the central counterparty's obligation came into force. In his view, this coincided with the time when clearance had become effected. Having failed to convince the trial judge and the Court of Appeal, the liquidator was partly successful in the House of Lords. A majority of the law lords accepted in principle this view as to substitution by clearance, though disagreed with the liquidator as to the time clearance had been effected. The dissent regarded the substitution as occurring not as late as on the completion of clearance, but rather as taking place as soon as each inter-airline bilateral obligation had arisen. The dissent would have dismissed the liquidator's appeal (and, hence, his action). The majority allowed the appeal in part and held for the liquidator as to the "uncleared" period.

Thus, the liquidator contended that clearance was not "effected" until net net debts became due and payable on "call day", that is, November 12, which was after the date of the November 8 resolution to wind up. Speaking on the point for the entire court, Lord Cross rejected this view altogether: "clearance is effected or completed when the clearing house has ascertained — as it must do within five days of the 'closure' of a clearance — the balances due to or from members and informs them telegraphically of the amounts due to or from them". Accordingly, in the facts of the case, September clearance was "effected" on November 4, before the winding up resolution was passed:

On that date . . . the right of British Eagle to have its claims against [net bilateral debtor members] brought into clearance and the right of [net

vency, see National Westminster Bank v. Halesowen Presswork, supra, footnote 51, cited with approval in British Eagle by the dissenting Lord Simon, supra, footnote 64, at p. 403.
80 British Eagle, ibid., at p. 401.
83 Lord Cross, with Lords Diplock and Edmund-Davies concurring.
84 Lord Morris joined by Lord Simon.
85 Supra, footnote 64, at p. 408.
bilateral creditor members] to have their claims against British Eagle brought into clearance were all satisfied and were replaced by an obligation on British Eagle to pay the clearing house [its net debit].

On the accrual of clearance prior to "call day", Lord Morris was in general agreement: "Services rendered before the end of September 1968 were . . . the subject of 'clearances' within the scheme before the date of the liquidation. 'Clearance' differs from 'settlement' . . . and 'clearance' in regard to the September items was complete before 8th November." 

Thus, a unanimous House of Lords dismissed the liquidator's action in relation to the "cleared" period and upheld the effectiveness of the pertinent multilateral netting. No similar consensus emerged with respect to the "uncleared" period.

The majority judgment was given by Lord Cross (Lords Diplock and Edmund-Davies concurring). In his judgment, Lord Cross referred to the argument "as to whether the right of British Eagle to have any given claim against Air France settled through the clearing house system could properly be called a debt due by Air France to British Eagle notwithstanding that British Eagle could not bring legal proceedings against Air France to enforce payment of the sums due from it". In that respect, he was "prepared to assume in favour of Air France that the legal rights against Air France which British Eagle acquired when it rendered the services in question were not strictly speaking 'debts' owing by Air France but were innominate choses in action having some, but not all, the characteristics of 'debts' ". None the less, he saw this question as "simply a dispute as to the proper use of words which has no bearing on the decision of the case". 

In effect, the two opposing arguments were as follows: the clearing house, through Air France, contended that "what passes into the control of the liquidator on a winding-up is the property of the company subject to any rights over it created by the company in favour of others in good faith while it was a going concern". On the other hand, the liquidator argued that "the court can always refuse to give effect to provisions in contracts which achieve a distribution of the insolvent's property which runs counter to the principles of our insolvency legislation". Effectively, the contro-

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86 Ibid., at pp. 408-9.
87 Ibid., at p. 401.
88 Ibid., at p. 409. See the text preceding footnote 65, supra.
89 Ibid., at p. 409.
90 Ibid.
versy related to the time the central counterparty's novated obligation arose.

Specifically rejecting any suggestion that the parties to the clearing house arrangement intended to give one another an unregistered charge on each other's book debts, Lord Cross nevertheless accepted the latter argument of the liquidator. The fact that there had been neither a preferential payment nor a deliberate scheme to avoid the statutory formula for distributing assets on insolvency did not matter.

Thus, allowing the liquidator's appeal concerning clearance for the period from October 1 to November 6, while dismissing his appeal concerning the September clearance, Lord Cross stated:

But what Air France are saying here is that the parties to the "clearing house" arrangements by agreeing that simple contract debts are to be satisfied in a particular way have succeeded in "contracting out" of the provisions contained in s. 302 of the 1948 Act for the payment of unsecured debts "pari passu". In such a context it is to my mind irrelevant that the parties to the "clearing house" arrangements had good business reasons for entering into them and did not direct their minds to the question how the arrangements might be affected by the insolvency of one or more of the parties. Such a "contracting out" must ... be contrary to public policy. The question is, in essence, whether what was called in argument the "mini liquidation" flowing from the clearing house arrangements is to yield or to prevail over the general liquidation ... I would therefore hold that, notwithstanding the clearing house arrangements, British Eagle on its liquidation became entitled to recover payment of the sums payable to it by other airlines for services rendered by it during that period and that airlines which had rendered services to it during that period became on the liquidation entitled to prove for the sums payable to them.

A powerful dissent (relating to the "uncleared" period alone) was given by Lord Morris. In his view, "central to the contract [between British Eagle and Air France] was a term ... that no amount was to become payable by Air France [as a net bilateral debtor] to British Eagle." In his view, as soon as they arise, bilateral debts incurred between members are instantaneously novated and become debts due to or from the clearing house:

The essence of the scheme was that instead of there being debts as between members there should be either debits or credits in an account with IATA but no debts as between members. An operator might be in overall [net net]...
debit with the clearing house even though, had there been no scheme, the operator would have been entitled to receive payments from various other operators.

Hence, no amount was "due and owing" from Air France or from any net debtor to British Eagle on November 8. By adhering to the clearing rules, all members agreed "not to enforce against each other any net claims for services". Rather, "they agreed that transactions which were governed by those rules should not give rise to any money claim by one party against another but should give rise to credits or debits in account with the clearing house which would result in money claims by or against IATA." Accordingly:

It followed that as between British Eagle and Air France no amounts were ever due or payable. When British Eagle went into liquidation the "property" of the company could not and did not include any claim to receive money from Air France for the reason that Air France did not owe any money to British Eagle. The property of the company included the contractual right to have a clearance in respect of all services which had been rendered on the contractual terms and the right to receive payment from IATA if on clearance a credit in favour of the company resulted.

Lord Morris explicitly rejected the liquidator's contention that IATA was merely the agent of each member to collect and to pay inter-member debts. The contention rested on the clearing house regulation providing that "[t]he liability of the Clearing House to any member at the date of any clearance is limited to the sums collected on behalf of such member from debtors in general clearance." In the opinion of Lord Morris, this refers to the simple fact that "what the clearing house does is done on behalf of its members." Yet "the sums collected by the clearing house are not the individual sums relating to the very numerous items arising from transactions between . . . members." Rather it is only respective overall debit positions which are collected.

Accordingly, the contractual arrangement delineated property rights and entitlements to sue as follows:

When one airline effects a transportation in respect of a contract entered into by another airline an obligation results. It might be called a debt owed by one operator to another but more accurately it is that which would be a debt but for the agreement made; by the scheme there is an agreement that

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94 Ibid., at p. 396.
95 Ibid., at p. 398, emphasis added.
96 Ibid., at p. 400.
in lieu of there arising a debtor/creditor relationship between members there will be debits or credits in account with the clearing house. Alternatively the effect of the scheme is that when a debtor/creditor relationship arises it is by agreement superseded so that only a debt to or from the clearing house can result. On either view the only "property" owned by British Eagle on 8th November 1968 was the right (if on balance they proved to be in credit) to receive a payment from the clearing house. In my view the effect of the scheme was that if on clearance a member proved to be in credit with the clearing house such member in default of receiving payment could sue IATA. Similarly IATA could sue a member who on clearance proved to be in debt and failed to pay the clearing house.

Lord Simon agreed with Lord Morris' dissenting speech. In his view, "British Eagle had long since deprived itself of the right to claim from Air France payment for the interline services British Eagle performed for Air France." Under the inter-airline agreement, "no party ... had any right to claim direct payment [from another party] for interline service: its right ... was to have the value of such service respectively credited and debited in the IATA clearing house settlement account." Consequently, "the 'property' of British Eagle (for the purpose of s. 302) did not include any direct claim against Air France for the value of interline services performed by British Eagle for Air France but merely the right to have the value of such services brought into the monthly settlement account."

Both dissenting law lords stressed that the clearing house arrangement was a bona fide commercial transaction and not a device to undermine the statutory scheme of the distribution of assets in liquidation. Therefore the arrangement was not to be set aside. Hence "It is a general rule that a trustee or liquidator takes no better title to property than that which was possessed by a bankrupt or a company. [Thus], the liquidator ... cannot remould contracts which were validly made."98

Ultimately, the liquidator won his claim as to the "uncleared" period but lost his claim as to the "cleared" period. The dissenting law lords would have dismissed the liquidator's action in its entirety.99 In the final analysis, multilateral netting withstood bankruptcy as of the substitution; however, in the majority's view substitution had not materialized as early as on the emergence of each bilateral obligation.100 Rather, the majority ruled that substi-

97 Ibid., at p. 403.
98 Ibid., at p. 401, per Lord Morris.
99 Thereby upholding the judgments of the two lower courts: see footnotes 81 and 82, supra.
100 As Lord Morris would have ruled.
tution occurred at the conclusion of clearance, but before payment by net debtors to the central counterparty became due.101

5. Conclusion: In the Aftermath of British Eagle

It is a basic tenet that insolvency as well as judgment transforms bilateral position netting to bilateral netting by novation; and that this transformation need not be supported by express contract.102 For mutual mature money debts set-off is not required in order to limit insolvency exposure but in producing net payable amounts it is helpful as long as solvent parties perform their respective contracts.

British Eagle should be seen as the application of these propositions to multilateral netting. Indeed, while multilateral netting was repudiated on insolvency, repudiation had been premised on the lack of mutuality and not on a belated netting by novation; that is, according to the majority, it was lack of pre-insolvency substitution and not lack of pre-insolvency netting by novation which resulted in the liquidator's victory as to the "uncleared" period.

Stated otherwise, in British Eagle the majority implicitly recognized the ability of intra clearing cycle insolvency to transform position netting to netting by novation, provided a pre-insolvency substitution had existed. The decision thus fully recognized the effectiveness of multilateral position netting and substitution.

On this point, there was no disagreement between the law lords. Their differences lay only in as to how counterparties should demonstrate the occurrence of substitution. The majority required an express, clear and unequivocal language in the contracts governing the clearing system. The dissent was prepared to be satisfied with the relationship that emerged from the basic nature of the clearing house arrangement, that is, from the forfeiture of a direct bilateral remedy as of the time when each bilateral obligation arose.

It is, however, noteworthy that private parties can live with the majority decision and effectively set up a scheme upholding multilateral netting on insolvency. Indeed, after British Eagle, systems were set up where instantaneous substitution was explicitly provided upon the emergence of each new bilateral obligation.103

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101 As the liquidator argued.
102 See Part 3, the text around footnotes 43 and 58.
103 See, e.g., the Talisman, the computerized system for settlement of accounts set by the
However, more recently the U.K. Companies Act 1989, in effect purported to follow the dissent in *British Eagle*. It did so by providing for the effectiveness of insolvency multilateral netting in order "to make provision for safeguarding the operation of certain financial markets". Thus, expressly recognizing the application of the general law of insolvency to clearing houses in s. 158, the statute goes on to provide in s. 159 that clearing house rules take priority over insolvency laws. This amounts to a statutory reversal of the part of *British Eagle* holding for the repudiation of the preclearing multilateral netting on the defaulter's insolvency. It effectively recognizes instantaneous "substitution" as inherent in the nature of a clearing system, irrespective of the exact language of pertinent clearing rules.

In the final analysis, in relation to mutual mature debts, counterparties may be satisfied by setting an early point of time for substitution. As this course of action is accommodated by current jurisprudence, no statutory revision on that point may have been required.

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104 Chapter 40.

105 The preamble to the Act. See also s. 154, being the introductory section for Part VII, entitled "Financial Markets and Insolvency".