Hilary Term
[2013] UKSC 13
On appeal from: [2011] CSIH 61

JUDGMENT

Joint Administrators of Heritable Bank plc (Respondent) *v* The Winding-Up Board of Landsbanki Islands hf (Appellant) (Scotland)

before

Lord Hope, Deputy President
Lord Walker
Lord Kerr
Lord Reed
Lord Carnwath

JUDGMENT GIVEN ON

27 February 2013

Heard on 4 and 5 February 2013

Appellant
David Alexander QC
Stephen Robins
Paul O'Brien

(Instructed by Morrison
and Foerster (UK) LLP)

Respondent
Gabriel Moss QC
Martin Pascoe QC
Sarah Wolffe QC
Georgina Peters
(Instructed by Freshfields
Bruckhaus Deringer LLP)

LORD HOPE (with whom Lord Walker, Lord Kerr, Lord Reed and Lord Carnwath agree)

1. Iceland is one of the most productive countries per capita in the world. It ranks high in economic and political stability. But the global financial crisis of 2008 exposed its dependence on the banking sector, and in the autumn of that year the nation's entire banking system failed. The dispute which has given rise to this appeal is one of the products of that crisis. It has its origin too in the fact that Iceland is a party, as are all the Member States of the European Union, to the Agreement on the European Economic Area ("the EEA Agreement") which was established on 1 January 1994.

2. On 6 December 2002 Annex IX (Financial Services) to the EEA Agreement was amended by the incorporation of Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding-up of credit institutions ("the Directive"). Landsbanki Islands hf ("Landsbanki") and its wholly owned subsidiary Heritable Bank plc ("Heritable") are both credit institutions for the purposes of article 1(1) of the Directive. Landsbanki is a company incorporated under the laws of Iceland with its registered office in Reykjavik. Heritable is a company incorporated under the Companies Act 1985 with its registered office in Glasgow.

3. Both companies are the subject of proceedings resulting from insolvency which were commenced on 7 October 2008. On that date the Financial Services Authority of Iceland, in the exercise of emergency powers conferred on it the previous day by the Icelandic Parliament, took control of Landsbanki, which was later granted a moratorium on its liabilities. On 29 April 2009, under provisions by which financial undertakings which had been granted a moratorium were deemed to be in a winding-up proceeding subject to the ordinary rules, the District Court of Reykjavik appointed a winding-up board to the company. Landsbanki's winding-up board is the appellant in this appeal. On 7 October 2008 the Court of Session appointed joint administrators to Heritable under paragraph 13 of Schedule B1 to the Insolvency Act 1986 on the application of the Financial Services Authority. The joint administrators of Heritable are the respondents to the appeal.

4. The Directive was implemented in the United Kingdom by The Credit Institutions (Reorganisation and Winding up) Regulations 2004 ("the Regulations"). Landsbanki is an EEA credit institution for the purpose of Part 2 of the Regulations. Heritable is a UK credit institution for the purposes of Parts 3 and

4. The issue before the court concerns claims submitted by Landsbanki in the administration of Heritable and claims by Heritable against Landsbanki. It relates to the effect in the administration of Heritable of a decision made by Heritable not to pursue its claims in the winding-up of Landsbanki. Its resolution depends on the proper construction of the Regulations and the Directive.

The competing claims

5. On 8 December 2008 Landsbanki submitted three claims in the administration of Heritable: (1) a claim for about £86m in respect of a revolving credit facility dated 31 May 2002 which was governed by English law ("the Landsbanki rcf claim"); (2) a contingent claim for £50m under a subordinated loan agreement ("the subordinated debt claim"); and (3) a contingent claim of £1,011,817,245 in respect of liabilities under a guarantee of Heritable's liabilities ("the guarantee claim").

6. On 6 November 2009 the administrators of Heritable rejected the Landsbanki rcf claim under section 49(2) of the Bankruptcy (Scotland) Act 1985 ("the 1985 Act"), as applied to administrations by rules 2.41(1) and 4.16 of the Insolvency (Scotland) Rules 1986. This was on the ground that Heritable had claims against Landsbanki which equalled or exceeded the amount of the Landsbanki rcf claim which served to extinguish it. This decision was based on the application of the rule of Scots law on the balancing of accounts in bankruptcy. On 26 November 2009 the administrators accepted the subordinated debt claim and the guarantee claim, but valued them at nil under paragraph 3(1) of Schedule 1 to the 1985 Act on the basis that there was no prospect of the relevant contingencies being satisfied. On 4 May 2010 a fourth claim was submitted by the winding-up board of Landsbanki for £17,122,221.92 under a master participation agreement ("the Landsbanki mpa claim"). It also was rejected by the administrators of Heritable.

7. On 20 November 2009 Landsbanki appealed to the Court of Session against the decision by the administrators of Heritable to reject the Landsbanki rcf claim. This was commenced by way of a note in the petition for the making of an administration order in respect of Heritable. The note was later amended to include an appeal against the decisions to value the subordinated debt claim and the guarantee claim at nil. It has not yet been amended to include an appeal against the rejection of the Landsbanki mpa claim. The issue in the appeal to this court is concerned only with the rejection of the Landsbanki rcf claim by the administrators.

8. On 30 October 2009 Heritable submitted four claims in the winding-up of Landsbanki: (1) a claim for £661,673,236 as damages for breach of the revolving credit facility dated 31 May 2002 ("the Heritable rcf claim"); (2) a claim of £234,850,801 as damages under the master participation agreement ("the Heritable mpa claim"); (3) a claim for £7,665,032 under certain interest swap transactions in connection with an ISDA Master Agreement dated 23 December 2004 ("the swap claim"); and (4) a claim for £1,099,978 as reimbursement of payments made by Heritable in connection with Landsbanki's Icesave accounts in the United Kingdom ("the Icesave claim"). In each claim letter it was stated that, subject to the extent to which Heritable was required or permitted by the law governing Heritable's administration to set-off any liabilities it owed to Landsbanki against amounts owed by Landsbanki to Heritable, Heritable's claims were to rank as unsecured claims in the winding-up of Landsbanki.

9. By notices dated 14 January 2010 Landsbanki's winding-up board rejected the Heritable rcf claim, the Heritable mpa claim and the Icesave claim. The swap claim was accepted, but only to the extent of £7,247,284.

The proceedings in Iceland

10. The administrators of Heritable objected to the decision by the winding-up board of Landsbanki to reject their claims by a notice of objection dated 22 February 2010. As Landsbanki had already commenced proceedings in the Court of Session, the administrators asked that no further steps be taken in relation to their objection until Landsbanki's appeal before the Court of Session had been finally determined. By letters dated 8 March and 19 March 2010 the winding-up board of Landsbanki declined to accede to this request. On 23 March 2010 the winding-up board referred the administrators' objections to the District Court of Reykjavik under article 120 of the Icelandic Bankruptcy Act 1991 ("the BA 1991"). On 14 April 2010 the administrators sought a stay of the proceedings before that court pending a final determination of the preliminary issues that had been identified in relation to Landsbanki's appeal before the Court of Session. On 17 May 2010 the District Court of Reykjavik declined to grant a stay of those proceedings.

11. On 12 August 2010 the administrators of Heritable formally withdrew the Heritable claims, including the swap claim, from Landsbanki's winding-up. On 2 September 2010 the winding-up board of Landsbanki issued a counterclaim in the District Court of Reykjavik in which it sought a declaration that the Heritable claims had been extinguished by article 118 of the BA 1991. On 14 September 2010 the administrators applied to discontinue the article 120 proceedings before that court in relation to the rejection of Heritable's claims by the winding-up board. Their application was granted on 20 September 2010. The winding-up

board appealed against that decision to the Icelandic Supreme Court, but it was affirmed by the Supreme Court on 21 October 2010. It concluded that there was no need to rule on the counterclaim by Landsbanki's winding-up board because it was incompetent.

The proceedings in Scotland

12. The argument for Landsbanki's winding-up board in the note which they lodged in the proceedings in the Court of Session was that the decision to reject the Heritable claims in the Icelandic proceedings had effect and was binding in the United Kingdom in terms of regulation 5(1) of the Regulations. The administrators of Heritable were therefore bound to hold that Heritable had no claim against Landsbanki which could operate by way of set-off. It was averred that, as there were no other defences to the Landsbanki rcf claim, the administrators were bound to allow that claim in full. In their answers to the note the administrators took a plea to the relevancy of the note in so far as it relied on the decision in the winding-up of Landsbanki.

13. A debate took place on the relevancy of the Landsbanki winding-up board's averments before the Lord Ordinary, Lord Glennie, in June 2010. There were two issues. The first was whether, under regulation 5(1) of the Regulations, the decision by the winding-up board to reject the Heritable claims had effect and should be recognised in the United Kingdom. The second was whether any future determination by the District Court of Reykjavik of the winding-up board's rejection of Heritable's claims would found a plea of res judicata in the Court of Session.

14. On 20 July 2010 the Lord Ordinary rejected the arguments which had been submitted by the administrators in support of their plea to the relevancy on both grounds: [2010] CSOH 100, [2011] 2 BCLC 437. He held, having regard to the terms of the Directive, that a ruling by Landsbanki's winding-up board in the Icelandic winding-up proceedings should, to the extent that it was final and binding in Iceland, be recognised and given effect in the United Kingdom, and that effect should also be given to the extinguishment of a claim under Icelandic law if not presented within a particular time: para 65. He was not persuaded that there was any limit on the recognition to be given to a ruling in the Landsbanki proceedings in Iceland as to the validity of Heritable's claims against Landsbanki. So if the Icelandic court were to decide that there was no valid claim, its decision would have effect in the United Kingdom as if it were part of the general law of insolvency of the United Kingdom and would have to be given effect in the administration of Heritable: para 81.

15. The administrators of Heritable reclaimed against the Lord Ordinary's interlocutor. By the time of the hearing in the Inner House res judicata was no longer a live issue, as Heritable had withdrawn its claims in the Landsbanki winding-up. On 6 July 2011 Landsbanki's winding-up board was given permission to amend its pleadings to enable it to argue that, as the effect of the withdrawal of Heritable's claims and the discontinuance of the article 120 proceedings in Iceland was that the winding-up board's determination of those claims was final and binding under Icelandic law, Heritable's claims had been extinguished as a matter of the insolvency law of Iceland and that they had also been extinguished by reason of not having been submitted within the prescribed time.

16. On 28 September 2011 the First Division (Lord President Hamilton, Lord Mackay of Drumadoon and Lord Marnoch) recalled the Lord Ordinary's interlocutor: [2011] CSIH 61, 2012 SC 209. It held that, in accordance with the principles of unity and universality required by the Directive, the affairs of Heritable, a United Kingdom credit institution which was itself in insolvency, should be wound up with the defences available under its own general law to protect the interests of its creditors, and in particular that effect should be given to regulation 22(3)(d) of the Regulations under which the law of the United Kingdom was to determine the conditions under which set-off might be invoked in Heritable's winding-up: para 38. Landsbanki's winding-up board now have appealed against that decision to this court.

The legal framework

(a) Icelandic law

17. In paragraph 17 of its note Landsbanki's winding-up board made averments about Icelandic law in relation to the winding-up of Landsbanki to the following effect, which the Lord Ordinary accepted as well founded for the purposes of the debate before him: para 21. The winding-up of a financial undertaking such as Landsbanki is subject to the same rules as apply to bankruptcy proceedings generally. Article 116 of BA 1991 provides that legal action cannot be brought against a bankrupt estate unless expressly permitted by law. An action for payment cannot be commenced against a bankrupt, although an action which is still pending can be continued. Article 117 provides that a party who is unable to pursue his claim by action but wishes to maintain a claim against a bankrupt's estate must submit a statement of his claim to the trustee in bankruptcy. The claim must be submitted within the period stated in the trustee's notice issued to creditors under article 85. It will have the same effects as if a legal action had been filed in respect of it at the point in time when the trustee receives the statement.

18. Article 118 provides that, if a claim which is not the subject of a pending action is not submitted to the trustee in bankruptcy within the prescribed time, it is cancelled with respect to the bankrupt's estate. This is a more rigid system than that which applies to the adjudication of claims in Scotland under sections 48-53A of the 1985 Act. But every system has to set a timetable for the submission of claims, and the Icelandic system has the merit of certainty and of minimising the risk of delay.

19. Article 119 provides that, once the period for stating claims is over, the trustee in bankruptcy is required to prepare a list of the submitted claims and a statement of how he thinks each claim should be recognised. An opportunity is given by article 120 to a claimant who is unwilling to accept the ruling of the trustee in bankruptcy as to the recognition of his claim to state his objection at a meeting of the creditors held to consider the stated claims, or to notify his objection by letter no later than the date of the meeting. If the trustee is unable to settle the issue, he is required to refer the matter to the district court. If his position on the claim is not challenged, it is to be regarded as finally approved during the bankruptcy proceedings.

20. Applying the law as so described to the claims by Heritable, it was averred for Landsbanki's winding-up board that the submission of claims by Heritable was the equivalent of the bringing of a legal action against Landsbanki. Any claim that was not submitted in the winding-up had been extinguished, and those claims that were submitted had been adjudicated upon. The administrators of Heritable had objected to the determination of the winding-up board and the matter had been referred to the district court in Reykjavik. The question whether or not Heritable's claims could be maintained against Landsbanki would depend on the result of the proceedings in Iceland.

21. On 12 August 2010, following the decision of the Lord Ordinary that the arguments for the winding-up board were well founded, the administrators of Heritable withdrew Heritable's claims from the winding-up. In their notice of withdrawal the administrators said that this was being done without prejudice to Heritable's right to rely on its claims against Landsbanki for the purpose of insolvency set-off under Scots insolvency law. On 21 October 2010 (as already narrated in para 11, above) the Icelandic Supreme Court refused the winding-up board's appeal against the decision of the district court to discontinue the article 120 proceedings in relation to the winding-up board's rejection of the Heritable rcf claim, the Heritable mpa claim, the Icesave claim and the balance of the swap claim.

22. Landsbanki's winding-up board submits that, according to Icelandic insolvency law, the effect of these developments is that there was a rejection of the Heritable claims which was never overturned and that their withdrawal has served to extinguish them under article 118 of BA 1991. So they are no longer maintainable against Landsbanki, and the administrators' attempt to reserve Heritable's rights was meaningless and ineffective as the consequences of Icelandic law have effect in Scotland under regulation 5(1). The meaning and effect of that regulation is at the heart of the winding-up board's argument.

(b) the Directive

23. The primary EU instrument dealing with cross-border insolvency is Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings ("the 2000 Insolvency Regulation"). But article 1(2) of the 2000 Insolvency Regulation provides that it shall not apply to insolvency proceedings concerning credit institutions and a number of other undertakings in the financial sector. The reorganisation and winding-up of credit institutions is provided for instead by the Directive, which required national implementation by the Member States and by non-EU countries in the EEA, including Iceland, by 5 May 2004.

24. Among the recitals to the Directive are the following:

> "(6) The administrative or judicial authorities of the home Member State must have sole power to decide upon and to implement the reorganisation measures provided for in the law and practices in force in that Member State. Owing to the difficulty of harmonising Member States' laws and practices, it is necessary to establish mutual recognition by the Member States of the measures taken by each of them to restore to viability the credit institutions which it has authorised.
>
> …
>
> (14) In the absence of reorganisation measures, or in the event of such measures failing, the credit institutions in difficulty must be wound up. Provision should be made in such cases for mutual recognition of winding-up proceedings and of their effects in the Community.
>
> …

(16) Equal treatment of creditors requires that the credit institution is wound up according to the principles of unity and universality, which require the administrative or judicial authorities of the home Member State to have sole jurisdiction and their decisions to be recognised and to be capable of producing in all the other Member States, without any formality, the effects ascribed to them by the law of the home Member State, except where this Directive provides otherwise.

(17) The exemption concerning the effects of reorganisation measures and winding-up proceedings on certain contracts and rights is limited to those effects and does not cover other questions concerning reorganisation measures and winding-up proceedings such as the lodging, verification, admission and ranking of claims concerning those contracts and rights and the rules governing the distribution of the proceeds of the realisation of the assets, which are governed by the law of the home Member State.

…

(23) Although it is important to follow the principle that the law of the home Member State determines all the effects of reorganisation measures or winding-up proceedings, both procedural and substantive, it is also necessary to bear in mind that those effects may conflict with the rules normally applicable in the context of the economic and financial activity of the credit institution in question and its branches in other Member States. In some cases reference to the law of another Member State represents an unavoidable qualification of the principle that the law of the home Member State is to apply."

25. Article 2 of the Directive defines the expression "reorganisation measures" as meaning measures which are intended to preserve or restore the financial situation of a credit institution and which could affect third parties' pre-existing rights, including among other things reduction of claims. It defines "winding-up" proceedings as meaning proceedings whose aim is to realise assets under the supervision of the administrative or judicial authorities of a Member State, including where the proceedings are terminated by a composition or other similar measure.

26. Article 3 provides that the administrative or judicial authorities of the home Member State shall alone be empowered to decide on the implementation of one or

more reorganisation measures in a credit institution, including branches established in other Member States. These reorganisation measures are to be applied in accordance with the laws, regulations and procedures applicable in the home Member State, unless otherwise provided in the Directive, and they are to be fully effective in accordance with the legislation of that Member State throughout the Community without any further formalities, including as against third parties in other Member States.

27. Article 9, which deals with winding-up proceedings, is to a similar effect. It provides that the administrative or judicial authorities of the home Member State which are responsible for the winding-up shall alone be empowered to decide on the opening of the winding-up proceedings concerning a credit institution, including branches established in other Member States. A decision to open winding-up proceedings taken by the administrative or judicial authority of the home Member State is to be recognised without further formality within the territory of all other Member States and shall be effective there when the decision is effective in the Member State in which the proceedings are opened.

28. Article 10, which is headed "Law applicable", provides in paragraph 1 that a credit institution is to be wound up in accordance with the laws, regulations and procedures applicable in its home Member State insofar as the Directive does not provide otherwise. Paragraph 2 of this article states that the law of the home Member State shall determine in particular, among other things –

> "(c) the conditions under which set-offs may be invoked;
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> …
>
> (g) the rules governing the lodging, verification and admission of claims;
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> (h) the rules governing the distribution of the proceeds of the realisation of assets, the ranking of claims and the rights of creditors who have obtained partial satisfaction after the opening of insolvency proceedings by virtue of a right *in re* or through set-off;
>
> …
>
> (l) the rules relating to the voidness, voidability or unenforceability of legal acts detrimental to all the creditors."

29. Article 21 is headed "third parties' rights *in re*". It provides that the adoption of reorganisation measures or the opening of winding-up proceedings shall not affect the rights in re of creditors or third parties in respect of tangible or intangible, moveable or immoveable assets belonging to the credit institution which are situated within the territory of another Member State at the time of the adoption of such measures or the opening of such proceedings.

30. Article 23 is headed "Set-off". It provides:

> "(1) The adoption of reorganisation measures or the opening of winding-up proceedings shall not affect the right of creditors to demand the set-off of their claims against the claims of the credit institution, where such a set-off is permitted by the law applicable to the credit institution's claim.
>
> (2) Paragraph 1 shall not preclude the actions for voidness, voidablity or unenforceability laid down in article 10(2)(l)."

(c) the Regulations

31. As the Lord President observed, the structure of the Regulations which were made to implement the Directive as from 5 May 2004 does not mirror exactly that of the Directive which they transpose: 2012 SLT 247, para 9. But it has not been suggested that the Directive has not been properly implemented by the Regulations. Their effect, as described in the Explanatory Note, is that no winding-up proceedings or reorganisation measures in respect of EEA credit institutions can be undertaken in the United Kingdom except in the circumstances permitted by the Regulations, and that EEA reorganisation measures and winding-up proceedings are to be recognised in the United Kingdom. An EEA credit institution is defined in regulation 2 as meaning an EEA undertaking, other than a UK institution, of a description which applies to Landsbanki. A UK credit institution means an undertaking whose head office is in the United Kingdom of a description that applies to Heritable.

32. The provisions dealing with the matters as so described are set out in regulations 3 and 5 in Part 2 of the Regulations, which is headed "Insolvency Measures and Proceedings: Jurisdiction in Relation to Credit Institutions". Regulation 3(1) provides that on or after 5 May 2004 a court in the United Kingdom may not, in relation to an EEA credit institution or any branch of an EEA credit institution, make a winding-up order, appoint a provisional liquidator or

make an administration order. It gives effect to the principle of mutual recognition referred to in recital 14 of the Directive.

33. Regulation 5(1), the meaning and effect of which (as mentioned earlier: see para 22, above) lies at the heart of the argument for Landsbanki, provides:

> "An EEA insolvency measure has effect in the United Kingdom in relation to –
>
> (a) any branch of an EEA credit institution,
>
> (b) any property or other assets of that credit institution,
>
> (c) any debt or liability of that credit institution,
>
> as if it were part of the general law of insolvency of the United Kingdom."

Regulation 5(2) provides that a competent officer may exercise in the United Kingdom in relation to a credit institution which is subject to an EEA insolvency measure any function which he is entitled to exercise in relation to that credit institution in the relevant EEA State. Regulation 5(6), read together with the definition of the expressions it uses in regulation 2, provides that an EEA insolvency measure means, as the case may be, a reorganisation measure or winding-up proceeding as defined in article 2 of the Directive (see para 25, above) which has effect in relation to an EEA credit institution by virtue of the law of the relevant EEA State. The winding-up of Landsbanki would appear to be an insolvency measure for the purposes of regulation 5(1).

34. Part 3 of the Regulations is headed "Modifications of the Law of Insolvency: Notification and Publication". Regulation 7, which is in that Part, provides:

> "The general law of insolvency has effect in relation to UK credit institutions subject to the provisions of this Part."

There then follow provisions dealing with various procedural matters, such as consultation with the Financial Services Authority prior to a voluntary winding-up, notification to the Financial Services Authority by the court of any decision, order or appointment that it makes, notification by the Financial Services Authority to the EEA regulator of any EEA state in which the UK credit institution has a branch, notification to creditors, submission of claims by EEA creditors, reports to creditors, service of notices and documents and disclosure of confidential information received from an EEA regulator.

35. Part 4 of the Regulations is headed "Reorganisation or winding up of UK Credit Institutions: Recognition of EEA Rights". Regulation 19(1)(b) provides that this Part applies where an administration order made under paragraph 13 of Schedule B1 to the 1986 Act on or after 5 May 2004 is in force in relation to a UK credit institution. It applies therefore to the administration of Heritable. Regulation 21(1) provides that for the purposes of Part 4 "affected credit institution" means a UK credit institution which is the subject of a relevant reorganisation or winding-up. It also provides that "relevant reorganisation" or "relevant winding-up" means any voluntary arrangement, administration, winding-up, or order referred to in regulation 19(1) to which Part 4 applies. Heritable is an affected credit institution within the meaning of that expression as defined in this article.

36. Regulation 22 is headed "EEA rights: applicable law in the winding-up of a UK credit institution". It provides, so far as material to this case, as follows:

> "(1) This regulation is subject to the provisions of regulations 23 to 35.
>
> (2) In a relevant winding up, the matters mentioned in paragraph (3) are to be determined in accordance with the general law of insolvency of the United Kingdom.
>
> (3) Those matters are –
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> …
>
> (d) the conditions under which set-off may be invoked;
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> …
>
> (g) the claims which are to be lodged against the estate of the affected credit institution;
>
> …
>
> (i) the rules governing –
>
> (i) the lodging, verification and admission of claims,
>
> (ii) the distribution of proceeds from the realisation of assets,
>
> (iii) the ranking of claims,
>
> (iv) the rights of creditors who have obtained partial satisfaction after the opening of the relevant winding up by virtue of a right in rem or set-off."

37. Regulation 26 deals with third parties' rights in rem in a way that gives domestic effect to article 21 of the Directive. A relevant reorganisation or winding-up is not to affect the rights in rem of creditors or third parties in respect of assets belonging to the affected credit institution which are situated within the territory of

an EEA state at the relevant time. Regulation 28 deals with creditors' rights to set-off in a way that gives domestic effect to article 23 of the Directive. It provides:

> "(1) A relevant reorganisation or a relevant winding up shall not affect the right of creditors to demand the set-off of their claims against the claims of the affected credit institution, where such a set-off is permitted by the law applicable to the affected credit institution's claim.
>
> (2) Paragraph (1) does not preclude actions for voidness, voidability or unenforceability of legal acts detrimental to creditors under the general law of insolvency of the United Kingdom."

The issue

38. As will be apparent from what has been said so far, the issue in this case is how cross-claims between two credit institutions are to be dealt with in insolvency proceedings in two different EEA States. As at the date when each EEA proceeding was opened, there were claims by Landsbanki against Heritable in Scotland and claims by Heritable against Landsbanki in Iceland. The winding-up board of Landsbanki rejected Heritable's claims, and Heritable later withdrew them. The result is that they are no longer provable in Landsbanki's winding-up under Icelandic law. The administrators of Heritable have rejected the Landsbanki rcf claim by the application of set-off. This was done by applying the principle known to Scots law as the balancing of accounts in bankruptcy. If this principle is available to the administrators under regulation 22(3)(d), it will determine how much if anything will be recoverable by Landsbanki in satisfaction of its claim from the administration of Heritable.

39. Scots law has long recognised that it would be inequitable for a debtor of a bankrupt to be required to pay his debt in full, while he could only get a dividend for the debt due to him by the bankrupt: *Bell*, *Commentaries* 7th ed, (1990) pp 118 et seq; Goudy, *Bankruptcy* 4th ed, (1914) p 550. Bell expresses the principle in this way at p 118:

> "It is not only expedient, but required by the plainest principles of equity, that where one of the parties becomes unable to pay his debt to the other, he should not be entitled to require payment from that other of an equal debt that is due to him. Thus, the settlement of mutual debts may be referred to two distinct principles: the one is

> virtual payment and extinction; the other, retention till counter performance."

At p 119, having noted that the latter operates only in bankruptcy, he observes:

> "The former is known by the name of Compensation (in England Set-off), and is amply discussed by our authors; the latter, sometimes vaguely, called Retention, but which may be distinguished as the Balancing of Accounts in Bankruptcy."

The latter he describes as the more important branch of the doctrine. It is not merely an arrangement of convenience, but is an equitable adjustment of mutual debts and credits, to avoid manifest injustice.

40. As Lord Hodge pointed out in *Integrated Building Services Engineering Consultants Ltd v PIHL UK Ltd* [2010] CSOH 80, [2010] BLR 622, para 23, there is no consensus as to whether this principle is a species of retention, as Lord McLaren in *Ross v Ross* (1895) 22 R 461, 465 suggests, or an extension of compensation by which one claim may be set-off against another, resulting in the extinction of the former claim. In many contexts, such as the present, this question is of no practical importance. What the administrators are seeking to do in this case is to strike a balance between the competing claims for the purpose of working out how much, if anything, is due to Landsbanki by way of a dividend in the administration of Heritable. This procedure is, in essence, no different from that which is referred to in articles 10(2)(c) and 23 of the Directive and regulations 22(3)(d) and 28 as set-off.

41. Landsbanki submits that the issue is to be determined by construing regulation 5(1) in accordance with the Directive. So construed, the effects of Icelandic insolvency law on the claims that Heritable lodged in Landsbanki's winding-up must be held to apply automatically in the United Kingdom. If and to the extent that they have been rejected or extinguished under Icelandic insolvency law, that rejection or extinction applies automatically to EEA insolvency proceedings in the United Kingdom. The rejection or extinction of claims in the main proceedings takes effect throughout the EEA in accordance with the laws of the State in which these proceedings are opened. It follows that these claims have no part to play in the administration of Heritable. They may not be raised by way of a defence to Landsbanki's claims against Heritable.

42. Heritable submits that the effect of the Directive is that each Member State has exclusive jurisdiction to open proceedings with respect to credit institutions

with head offices within its territory and to make legal rulings applying its own law. In a case such as this, where a parent credit institution has its head office in one Member State and its wholly owned subsidiary has its head office in another, each Member State must recognise the other Member State's proceedings. The Regulations, transposing the Directive into United Kingdom law, allocate the proceedings relating to Heritable to the Scottish courts. Scots law is the law governing all issues arising in and with respect to its administration. They include the determination and quantification of Landsbanki's proof in the administration, questions as to whether Heritable is able to rely on its cross-claims against Landsbanki to reduce its liabilities to Landsbanki and questions as to the amount for which Landsbanki is to be admitted in the administration as a creditor.

43. The question, in short, is whether Icelandic law binds the administrators of Heritable. Does it govern the question whether the claim that Heritable wishes to maintain in its administration against Landsbanki by way of set-off against Landsbanki's claim against it still subsists for this purpose? Must it be taken to have been extinguished for this purpose because it can no longer be maintained against Landsbanki in the winding-up proceedings in Iceland? The parties are agreed that there is no previous case law which addresses this issue.

Some preliminary observations

44. The position at common law was explained in the Inner House by Lord President Hamilton: 2012 SC 209, para 29. A debt under a contract whose proper law is the law of another jurisdiction may, for the purposes of Scots law, be discharged by insolvency proceedings in that other jurisdiction: *Rochead v Scot* (1724) M 4566. But such proceedings will not, for the purposes of Scots law, discharge a debt where the proper law of the contract is not the law of the jurisdiction in which the proceedings are taking place: *Adams v National Bank of Greece SA* [1961] AC 255, where the proper law of the contract was that of England: St Clair and Drummond Young, *The Law of Corporate Insolvency in Scotland* 4th ed, (2011) para 22.31. The position under the common law of England is the same: *Antony Gibbs & Sons v La Société Industrielle et Commerciale des Métaux* (1890) LR 15 QBD 339. The question whether an obligation has been extinguished is governed by its proper law: *Wight v Eckhardt Marine GmbH* [2003] UKPC 37, [2004] 1 AC 147, para 11, per Lord Hoffmann; *Dicey, Morris & Collins, The Conflict of Laws* 14th ed, (2006) vol 2, para 31R-092, Rule 200.

45. The proper law of the revolving credit facility is English law. So, if the matter were to be regulated by the common law, the position would be that what happened to Heritable's rcf claim in Iceland would have no bearing on the question whether it could be used by way of set-off against Landsbanki's rcf claim

in the administration of Heritable in Scotland. The effect of the Directive, however, is that the common law must give way to the law under which proceedings resulting from the insolvency of credit institutions must be conducted by the Member States to the extent, if any, that it directs. The question is whether it, and the Regulations which give it effect, contains such a direction. The answer is to be found by construing the Directive and the Regulations which implement it, and applying that construction to the facts.

46. The principle of mutual recognition on which the scheme of the Directive proceeds is indicated by recitals (6) and (16). The administrative or judicial authorities of the home Member State must have sole power to decide upon and to implement the reorganisation measures provided for by the law and practices in force in that Member State. Equal treatment of creditors requires that the credit institution is wound up according to the principles of unity and universality. Those principles require the administrative or judicial authorities of the home Member State to have sole jurisdiction for the conduct of such proceedings. They also require that the decisions of those authorities will be recognised and be capable of producing in all the other Member States, without any further formality, the effects ascribed to them by the law of the home Member State. There is no indication here that any one home Member State is to have priority over the others. On the contrary, the insolvency proceedings in each Member State are to be conducted solely in accordance with the laws and procedures of that Member State.

47. These recitals indicate that the separate regime of the Directive for credit institutions is modelled on the principle which is set out in article 16(1) of the 2000 Insolvency Regulation. The basic rule of jurisdiction which article 3(1) of the 2000 Insolvency Regulation lays down is that the courts of the Member State within the territory of which the centre of a debtor's main interests is situated has jurisdiction to open insolvency proceedings. There is to be a single forum for this purpose, except where the debtor possesses an establishment within the territory of another Member State, in which case article 3(2) provides that the other Member State has jurisdiction restricted to the assets of the debtor situated in that other Member State. Article 16(1) of the 2000 Insolvency Regulation states:

> "Any judgment opening insolvency proceedings handed down by a court of a Member State which has jurisdiction pursuant to Article 3 shall be recognised in all the other Member States from the time that it becomes effective in the State of the opening of the proceedings."

The effects of that recognition are set out in article 17(1). It states that the judgment opening the proceedings referred to in article 3(1) shall, with no further formalities, produce the same effects in any other Member State as under the law of the State of the opening of proceedings. Articles 3, 9 and 10 of the Directive

(see paras 26-28, above) carry the principles referred to in the recitals forward into the provisions of the Directive, except that the home Member State alone is empowered to take measures with regard to branches of a credit institution established in other Member States: article 3(1).

48. It follows that the fact that Heritable's claims against Landsbanki have been extinguished for all the purposes of the winding-up of Landsbanki in Iceland cannot be questioned in the administration of Heritable in Scotland. Iceland, as Landsbanki's home EEA State, has sole jurisdiction for this purpose, and the effects of the insolvency proceedings in Iceland must be recognised in Scotland. But does it follow that the administrators of Heritable must treat Heritable's rcf claim as having been extinguished here too because of the effects on that claim of what has happened in Iceland? The answer indicated by article 10(2) suggests the contrary. It states that the law of the home Member State shall determine, among other things, the conditions under which set-offs may be invoked, the rules governing the admission of claims and the distribution of the proceeds of the realisation of assets, the ranking of claims and the rights of creditors who have obtained partial satisfaction after the opening of insolvency proceedings.

49. Landsbanki's argument, however, is that the meaning and effect of regulation 5(1) is that the extinction of Heritable's claim that results from the fact that the claim is no longer being pursued in Iceland has effect in the United Kingdom as if the EEA insolvency measure in Iceland in respect of Landsbanki was part of the law of insolvency of the United Kingdom too. It starts from the position that there is nothing in the Directive to prevent the relevant body of the home Member State of an insolvent credit institution from adjudicating upon the validity of claims lodged by creditors who are also the debtors of the credit institution or to prevent the law of that Member State from extinguishing claims by creditors who have themselves become insolvent. It takes this to mean that it is the insolvency law of that credit institution's home Member State that has effect also in the place where the insolvency proceedings in respect of its creditor were opened. This, it says, is made clear so far as the law of the United Kingdom is concerned by regulation 5(1). That regulation states that an EEA insolvency measure has effect in the United Kingdom in relation to any debt or liability of an EEA credit institution "as if it were part of the general law of insolvency of the United Kingdom."

50. Mr Alexander QC for Landsbanki submitted that the insolvency measure for the purposes of that regulation, as defined by regulation 5(6), is the winding-up of Landsbanki in Iceland. The words "as if it were part of the general law of insolvency of the United Kingdom" meant that the effects of that insolvency measure were automatically incorporated into that law and must be given effect here. Everything turned on the meaning of that phrase. It gave effect to the collective nature of insolvency proceedings and the principle of equality among

creditors. There was a level playing field, with one set of rules for all. Each creditor must lodge his claim in the credit institution's home Member State. That was what Heritable did when the proceedings were opened in Iceland. But there were no longer any rival cross-claims, as Heritable had withdrawn its claim in the winding-up of Landsbanki.

51. It is a striking feature of this argument, well presented though it was, that it is based entirely on regulation 5(1). Mr Moss QC for Heritable had no quarrel with the proposition that, according to the principles of unity and universality, the Directive required that insolvency proceedings in respect of a credit institution should proceed on a strict entity basis in the home Member State of that institution, irrespective of where it had its branches. He was willing to assume too that Iceland had implemented the Directive correctly into its own law. He submitted that, if Heritable and Landsbanki had both been Scottish companies and were both being wound up in Scotland, it would not have been open to doubt that Heritable could assert a set-off against Landsbanki in its own winding-up even though it had not claimed in Landsbanki's winding-up. This was simply a matter of common sense. The liability of the debtor company was still an asset for the purposes of the creditor's winding-up. The question was whether that position was fundamentally altered by regulation 5(1) in the case of a winding-up in another EEA State. He submitted that, when that regulation was examined in its context and regard was had to the consequences of Landsbanki's argument, it was not.

Discussion

52. There is much more to the Regulations than regulation 5(1). The first point to notice is that Part 2, as its heading indicates, is concerned with jurisdiction in relation to EEA credit institutions. One can, of course, take from the provisions of this Part that the Regulations are designed to adopt the strict entity approach, based upon the principle which is to be found in article 9 of the Directive, that it is the administrative or judicial authorities of the credit institution's home Member State that shall alone be responsible for the opening of proceedings for its winding-up. Seen in that context, there is nothing remarkable about what regulation 5 sets out. Even if that credit institution has branches in the United Kingdom, the entire process of winding-up must be conducted in the home Member State.

53. So an EEA insolvency measure in another EEA State must, as regulation 5(1)(a) says, have effect in the United Kingdom in relation to any of its branches here as if it were part of the general law of insolvency of the United Kingdom. Regulations 5(1)(b) as to the credit institution's property or other assets, and 5(1)(c) as to its debt and liabilities, are mirror images of each other. They are to be dealt with in the proceedings in the other EEA State. Property or assets located in Scotland are not to be disposed of in accordance with the rules of diligence that are

available under Scots law, and steps by a creditor to enforce a claim against the credit institution are to be pursued solely in the proceedings in the other EEA State. Regulation 5(2) provides that, for the purposes of those proceedings, decisions taken by a person entitled to exercise any function which he is entitled to exercise in those proceedings are to be given effect in this country. In this way the integrity of the exclusive jurisdiction that is given to the home EEA State is preserved.

54. But these provisions are concerned only with an EEA insolvency measure in relation to a credit institution which is located in another EEA State. It is only for that purpose that an EEA measure is to have effect as if it were part of the general law of insolvency in the United Kingdom. They apply to the winding-up of Landsbanki in Iceland. But they do not apply to the administration of Heritable in Scotland. The rules which apply to Heritable, which is a UK credit institution, are set out in Parts 3 and 4 of the Regulations.

55. Mr Alexander submitted that the effect of the phrase "as if it were part of the general law of insolvency of the United Kingdom" was that the winding-up proceedings in Iceland had to be regarded as having been incorporated into the general law of insolvency of the United Kingdom, and that the reference to the general law of insolvency in regulation 7 had to be read in the same way. But in my opinion this reads too much into this phrase. It has the effect for which he contended in relation to the winding-up of Landsbanki. But it does not extend to the proceedings relating to Heritable. The phrase as used in regulation 7 is a reference to the laws, regulations and procedures applicable in the UK credit institution's home Member State, as article 10(1) of the Directive indicates.

56. The rules which are most directly in point for the purposes of this appeal are set out in regulations 7 and 22. Regulation 7, which is in Part 3, gives effect to article 10(1) of the Directive. It provides that the general law of insolvency has effect in relation to UK credit institutions subject to the provisions of that Part. The general law of insolvency must be taken for this purpose to be the general law of insolvency of the part of the United Kingdom in which the credit institution is located: see the definition in regulation 2(3). The modifications that Part 3 makes to the general law of insolvency are summarised in para 34, above. Regulation 22, which is in Part 4, deals with the applicable law in relation to EEA rights in the winding-up of a UK credit institution. Regulation 22(1) states that its provisions are subject to the provisions of regulations 23 to 35. Regulation 22(2), which gives effect to article 10(2) of the Directive, states that the matters mentioned in regulation 22(3) are to be determined in accordance with the general law of insolvency of the United Kingdom. They include the conditions under which set-off may be invoked and the rules governing, among other things, the admission and ranking of claims: regulations 22(3)(d) and (i).

57. Regulation 28 preserves the right of creditors to demand the set-off of their claims against the claims of the affected credit institution, where set-off is permitted by the law applicable to the credit institution's claim. This is the other side of the application of the principle of set-off that is referred to in regulation 22(3)(d). It reinforces the point that issues of set-off are to be determined in the home EEA State, as the common law of Scotland requires, according to the proper law of the contract. It is conceived in the interests of creditors in other EEA States, bearing in mind that exclusive jurisdiction is given to the United Kingdom as the home Member State. Their right to claim set-off is put onto the same basis as creditors in the United Kingdom. This gives effect to article 23(1) of the Directive, and it respects the principle of unity and universality on which the Directive's provisions are based.

58. The key to a proper understanding of regulation 5(1), therefore, lies in an appreciation of the fact that, while it is designed to give effect to the mandatory choice of the law of insolvency of the EEA State in which the foreign credit institution is located, it is not concerned in the least with the effects of the mandatory choice of Scots law for the administration of Heritable in Scotland. Those effects are provided for in Part 3 and 4 of the Regulations, which have nothing to do with the effects of the mandatory choice of the law of Iceland for the winding-up of Landsbanki.

59. I would therefore reject the argument for Landsbanki, on the ground that it fails to take account of the scheme of the Directive and the Regulations. But I think that there is also much force in Mr Moss's argument, which built on points made by the Lord President in his opinion at 2012 SC 209, paras 32 and 40, that Landsbanki's argument produces an arbitrary and unprincipled outcome.

60. As the Lord President observed in para 32, the logic of Landsbanki's argument is that Heritable's claims against Landsbanki would have been extinguished even if Heritable had been a wholly solvent company. It might have decided that there was no point in pursuing a claim in Landsbanki's winding-up because the prospects of a dividend were remote and the costs of doing that outweighed any possible advantage. However sound that assessment might have been, its effect would have been that Heritable would have been unable to set-off its claim by way of a defence to a claim pursued against it in Scotland by Landsbanki. The only way for a creditor to avoid that result would be to lodge and maintain its claim in the insolvency proceedings in the other Member State, even if the prospects of recovering anything were nil. This would also be, as the Lord President said in para 40, to give universal priority to the process in which a decision happened to be made first. That would encourage forum shopping, especially where there was a prospect of inconsistent findings as to the validity of a claim in different Member States. It is hard to believe that this was intended by the framers of the Directive.

61. These arguments do not, of course, provide an answer in themselves to Landsbanki's case. But they do suggest that it is crucial to pay close attention to the scheme of the Directive to which the Regulations give effect. When this is done the answer is, in my opinion, entirely clear.

Conclusion

62. For these reasons I would dismiss the appeal and affirm the First Division's interlocutor.