FINANCIAL MARKETS LAW COMMITTEE
ISSUE 74: SET-OFF IN ADMINISTRATION

Note of a meeting 26 June 2003

Present:

Lord Browne-Wilkinson, Chairman, Financial Markets Law Committee
Stephen Leinster, Insolvency Service
Alistair Kennard, Insolvency Service
Ed Murray, Allen & Overy and acting for ISDA
Jennifer Marshall, Allen & Overy and acting for ISDA
Dorothy Livingston, Herbert Smith, CLLS Financial Law Sub-Committee and FMLC member
Geoffrey Yeowart, Lovells and CLLS Financial Law Sub-Committee
Chris Hanson, Lovells and CLLS Insolvency Law Sub-Committee
Antony Beaves, Bank of England
Peter Bloxham, Freshfields Bruckhaus Deringer
Dermot Turing, Clifford Chance
Martin Thomas, Secretary, Financial Markets Law Committee

Background

Implementation of the Enterprise Act, which received Royal Assent on 7 November 2002, requires a substantial amount of secondary legislation, including changes to the Insolvency Rules. Draft rules were published by the Insolvency Service on 11 June following consultation with the Insolvency Rules Committee. They include rules proposed to establish automatic set-off when an administrator decides to make a distribution. The draft rules use phrasing which differs from that applicable to set-off in a liquidation. Some of the differences are intended to achieve a different effect as a matter of policy. However, one particular change of wording is not intended to achieve a different effect.

The Insolvency Rules 1986 (SI 1986/1925) provide at rule 4.90 that,

> *"(1) This rule applies where before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.*
>
> *(2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other.*
>
> *(3) Sums due from the company to another party shall not be included in the account taken under paragraph (2) if that other party had notice <u>at the time they became due</u> that a meeting of creditors had been summoned under s.98 or (as the case may be) a petition for the winding up of the company was pending.*
>
> *(4) Only the balance (if any) of the account is provable in the liquidation. Alternatively (as the case may be) the amount shall be paid to the liquidator as part of the assets."*

Rule 2.85 of the draft Insolvency (Amendment) Rules 2003 reads,

> *"(1) This Rule applies—*
>
> *(a) where the administrator, being authorised to make the distribution in question, has pursuant to Rule 2.95 given notice that he proposes to make it; and*
>
> *(b) only for the purposes of determining the claims to be taken into account for the purposes of calculating that distribution.*
>
> *(2) In this Rule "mutual dealings" means mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the administration.*
>
> *(3) An account shall be taken as at the date of the notice referred to in paragraph (1) of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other.*
>
> *(4) A sum due either to or from the company shall not be taken into account under paragraph (3) if—*
>
> *(a) the liability to pay the sum due was incurred after the company has entered administration;*
>
> *(b) the other party had notice <u>at the time the liability to pay the sum due was incurred</u> that—*
>
> *an application for an administration order was pending; or*
> *any person had given notice of intention to appoint an administrator;*
>
> *(c) the administration was immediately preceded by a winding up and the liability to pay the sum due was incurred during the winding up; or*
>
> *(d) the administration was immediately preceded by a winding up and the other party had notice at the time the liability to pay the sum due was incurred that—*
>
> *(i) a meeting of creditors had been summoned under section 98; or*
> *(ii) a petition for the winding up of the company was pending.*
>
> *(5) Only the balance (if any) of the account is provable in the administration. Alternatively the amount shall be paid to the administrator as part of the assets."*

The two underlined phrases are intended to mean the same as each other. However, it had been noted by ISDA, the CLLS specialist sub-committees for financial and insolvency law, and others, that the difference of wording might create legal uncertainty.

The issue having been raised with the FMLC, Lord Browne-Wilkinson convened an exploratory meeting to discuss what might be done about this issue.

Discussion

In considering the drafting of rule 2.85 no challenge was being made to the policy it represents, that the streamlining of administration procedures should include automatic set-off (subject to a cut-off date) when a distribution of assets is decided upon. The issue under discussion related only to the linguistic inconsistency between rules 4.90 and 2.85.

The rule 4.90 phrase "at the time they became due" is imperfect. Its meaning (which is to read "due" in the sense of "owing" or "incurred" rather than "currently payable") had been elucidated through academic and practitioner analysis and in 1995 was confirmed by the House of Lords in *Stein v Blake* [1995] 2 All ER 961.

Rule 4.90 had been seen as the natural starting point for drafting a rule establishing set-off in administration. However, in rule 2.85 the new *phrase "at the time the liability to pay the sum due was incurred*" had been proposed in substitution for the 4.90 phrase "*at the time they became due*", without altering 4.90 itself in that respect. It was felt that this could give rise to fresh problems, namely that the courts would interpret the difference between the language adopted in the two rules as intentional, so that it would be uncertain what meaning should be given to rule 2.85. It was also suggested that courts might infer that the broader language in rule 2.85 requires rule 4.90 to be construed restrictively and no longer consider Stein v Blake authoritative precedent with respect to rule 4.90, with the result that courts may consider that a sum must be matured due and payable prior to the notice of the petition to qualify for set-off under rule 4.90. Nor was it beyond doubt that the new wording has the same meaning as the old, for example in relation to the moment when contingent liabilities are "incurred" and whether "incurred" refers to the time when the debtor first became liable or the creditor first acquired the claim.

Overall there was a real risk that judges would take the inconsistency between 4.90 and 2.85 to signify a difference of effect.

It was therefore suggested that the better approach would be for rule 2.85 to track the 4.90 wording, for the sake of consistency. This approach is now being considered by the Insolvency Service. And this approach would resolve the concern the meeting had been convened to address.

In addition, it was mentioned that there may be an opportunity in the near future for a review of both rules. Such a review would be able to take into account draft wording of the type suggested by the CLLS. Such a review would also need to consider whether to seek alteration to the wording of the relevant part of Insolvency Act 1986 s 323 and, if it is not possible to alter a statute (as is likely), to consider how best to cater for a remaining difference between the Act on the one hand and the two rules on the other. It was noted that, whilst ideally section 323 should be amended at the same time as Rules 2.85 and 4.90, *Stein v Blake* would still be authority for the proper interpretation of section 323 even if it were left unamended. Amendment of section 323, which deals with individuals' bankruptcies, is peripheral to the interests of wholesale financial markets.

Lord Browne-Wilkinson expressed on behalf of the FMLC his sincere thanks to those attending for giving up their time and welcomed the potential resolution of the issue that had come out of the discussion.

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