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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 108 – ADMINISTRATION SET-OFF AND EXPENSES

Legal assessment of rule 2.85 of the Insolvency Rules 1986 and its interplay with other insolvency provisions in respect of post-administration liabilities owed to counterparties

c/o Bank of England
Threadneedle Street
London EC2R 8AH
www.fmlc.org

FINANCIAL MARKETS LAW COMMITTEE

ISSUE 108 WORKING GROUP

Samantha Bewick	KPMG
Peter Bloxham	
Philip Hertz	Clifford Chance LLP
Jennifer Marshall	Allen & Overy LLP
Stephen Parker	Cadwalader, Wickersham & Taft LLP
Richard Tett	Freshfields Bruckhaus Deringer
Dermot Turing	Clifford Chance LLP
Joanna Perkins	FMLC Secretary
Kate Morris	FMLC Legal Assistant
Rory Conway	FMLC Legal Assistant

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1. Introduction and Executive Summary

A) Introduction

1.1 The role of the Financial Markets Law Committee ("FMLC") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed.

1.2 On 15 September 2003, a number of important changes were made to the administration regime including the introduction of a new power, exercisable by the administrator with the leave of the court, to make distributions to unsecured creditors. This meant that various rules (similar to the rules that apply in a liquidation) had to be introduced into Part 2 of the Insolvency Rules 1986 (the "Rules") to allow creditors to prove their debts in the administration in circumstances where the administrator obtains the leave of the court to make distributions. The new rules include set-off provisions (pursuant to r.2.85 of the Rules) and provisions relating to administration expenses (in para.99 of Schedule B1 to the Insolvency Act 1986 (the "Act") and r.2.67 of the Rules).

1.3 The FMLC considers that the application of the new administration set-off rule and its interplay with other insolvency provisions relating to the payment of post-administration liabilities owed to counterparties by a company in administration (including the concept of an administration expense) could give rise to potential legal uncertainties, as discussed in this paper. Some of these are merely drafting concerns which could be clarified through an amendment to the Rules, case law or guidance (from either the Insolvency Service or R3 as the professional body regulating insolvency practitioners). Others are more substantial and would require more significant changes to the legislation. The FMLC considers that these uncertainties may discourage counterparties from dealing with a company in administration, thus harming attempts to rescue the company through administration. Although these uncertainties are of general application, they could affect the financial markets if the insolvent company entered into swap or other derivative transaction (either prior to or following the administration) or was itself in the financial sector. At the end of this paper, a number of proposals are set out which would, in the FMLC's opinion, help to resolve some of these uncertainties.

1.4 The FMLC has been assisted in its consideration of this issue by a Working Group, the members of which are listed above and which has prepared this paper. This paper sets out the views of the FMLC, as well as those of the Working Group.

B) Executive Summary

1.5 Any counterparty dealing with a company which goes into administration will want to know how the post-administration liabilities owed by that company will be treated. Where there is already a course of dealing between that

counterparty and the company in administration (so that the counterparty is a debtor of the company at the moment of administration), additional complications may arise. The worst outcome for the counterparty would be to find itself obliged to pay in full the amount owed to the insolvent company in respect of pre-administration dealings, but to be left unable to recover in full the amount owed to it in respect of transactions with the insolvent company during the administration (either by way of set-off or as an expense of the administration).

1.6 The need for clarity and certainty will be reinforced by the regime proposed to be adopted for the capital treatment of Credit Risk Mitigation under Basel II[1] and the Capital Requirements Directive.[2] Given the stress on legal certainty in order to benefit from the reduced weighting ascribed to collateralised transactions, there is a risk that it will be difficult to establish which set-off or netting structures meet the requisite standard.

1.7 The FMLC considers that there are two main areas of uncertainty in respect of the administration set-off rule and two subsidiary areas where express clarification of the relevant provisions would be helpful. The key areas of uncertainty (each of which is discussed further below) are as follows:

(a) It may not be possible for a counterparty to determine, at the time the company with which it is dealing goes into administration, whether the administration set-off rule will come into play (the "**uncertainty of outcome**" issue). This will make it difficult for the counterparty to determine which set-off rules will apply to it and whether any liabilities incurred by the insolvent company post-administration will be available for set-off.

(b) If a right of set-off is not available, the counterparty may wish the post-administration liabilities owed to it to be treated as expenses of the administration so that they are paid in priority to unsecured, pre-administration claims[3]. If the post-administration liabilities are treated as expenses of the administration, such liabilities may not be paid in full if the administration is an "insolvent" one (i.e., where there are insufficient available assets to meet the administration expenses in full) (the "**shortfall**" issue). This could be the case in circumstances where the administration expenses are substantial (for example because the post-administration funding is paid as an expense). Even absent such an insolvent administration, there may be circumstances (discussed below) in which the counterparty may prefer to set-off pre- and post-administration liabilities rather than relying on the expense doctrine.

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1 International Convergence of Capital Measurement and Capital Standards – A Revised Framework (issued by Basel Committee on Banking Supervisions - June 2006).

2 2006/48/EC and 2006/49/EC.

3 Concerns had previously been raised regarding what post-administration liabilities would be treated as expenses of the administration. Although there are some areas which remain to be clarified in this respect, the decision of the High Court in *Re Trident Fashions plc* [2007] EWHC 400 ("**Trident**") has confirmed that the same approach will be taken, in respect of administration expenses, as is taken in relation to liquidation expenses, notwithstanding the differences in objectives of the two regimes.

The FMLC has set out two proposals in section 7 of this paper regarding how these issues might be resolved.

1.8 In addition to these key areas of uncertainty, the FMLC considers that there are two areas where the drafting of the relevant provisions could usefully be clarified:

(a) The administration set-off rule will only come into play if the administrator gives notice of his intention to make a distribution to creditors. There is some uncertainty, however, as to what will be treated as a distribution for these purposes (the "**meaning of distribution**" issue). This will make it difficult for a counterparty to determine whether or when the administration set-off rule has come into play.

(b) Issues also arise in relation to contingent claims which are owed to the insolvent company (the "**contingent claims**" issue). Although it is helpful that r.2.85 clarifies how these should be dealt with for set-off purposes, it is unclear what will happen if the claim (once it matures) turns out to be more or less than the value given to it by the administrator.

2. Background

A) The operation of set-off in a liquidation

2.1 Set-off, in the context of insolvency, is a mechanism whereby a party who is both a creditor and a debtor of an insolvent company has an account taken of his mutual dealings with the company. The net amount after set-off then becomes the amount owed to the party by the company (if the party is a net creditor) or by the party to the company (if the party is a net debtor).

2.2 The key feature of the operation of set-off is that a creditor of a company can make use of amounts owed to it by the company to reduce or extinguish amounts that creditor owes the company. The amount owed by the company to the creditor is set-off for its full value against the amount owed by the creditor to the company. In comparison, if the creditor were to receive a distribution from the company's estate, it would only receive a dividend on the amount owed (assuming of course that the amount was not an administration expense). Therefore, the operation of set-off means that a creditor will effectively see the benefit of the full value of some or all of the amount owed by the company instead of receiving only part of the amount owed by the company in a distribution. Set-off is an important and well established mechanism of creditor protection in English law. The benefit to a creditor who owes money to a company is justified by the confidence it promotes between parties in their dealings with each other and is also the bedrock on which dealings between counterparties in the financial markets are based.

2.3 Various legal issues arise out of set-off. In particular, it is necessary in certain circumstances to have a point after which debts incurred by the insolvent

company or the counterparty, or acquired by the counterparty, cannot be taken into account in any set-off calculation (referred to as the "cut-off date" in this paper). In the context of liquidation, r.4.90 of the Rules provides that the mutual credits and debts between the company and the creditor subject to set-off are those which were incurred before the company went into liquidation. Furthermore, r.4.90 provides that any debt arising out of an obligation incurred at a time when the creditor had notice of a winding-up petition or creditors' meeting under s.98 of the Act (or, in circumstances where the liquidation is immediately preceded by an administration, notice of an administration application or notice of intention to appoint an administrator) shall not be available for set-off. The basic policy behind the cut-off date is to prevent the creation of claims, or the trafficking in claims, after the creditor knew (or should have known) that liquidation was imminent. After this point, it is then up to the creditor whether it should extend credit to the company (although the nature of liquidation is such that little, if any, trade with the company is likely to occur once a winding-up has commenced).

B) Administration set-off rule

2.4 R.2.85 of the Rules sets out the provisions that deal with the operation of set-off in administration if the administration becomes a liquidating one (as described below). R.2.85 provides that the mutual dealings taken into account when calculating set-off do not include debts arising out of an obligation incurred after the company entered administration. Further provisions exclude debts arising out of obligations incurred when a creditor had notice of an administration application or notice of intention to appoint an administrator (or, in circumstances where the administration is immediately preceded by a liquidation, the date of the commencement of the liquidation or the earlier date of notice of the winding-up petition or creditors' meeting). Debts acquired by a creditor (by assignment or otherwise) pursuant to an agreement entered into after these events are also excluded for set-off purposes. In other words, absent a preceding liquidation, the cut-off date is the date of administration or earlier date of notice of the administration.

2.5 The wording of r.2.85 follows very closely the wording of r.4.90 subject to one key difference between the two rules (see table at Appendix 1). In a liquidation, r.4.90 will automatically come into play as soon as the company goes into liquidation whereas an account only needs to be taken for the purposes of r.2.85 if the administrator gives notice (pursuant to r.2.95 of the Rules) that he proposes to make a distribution to creditors (the meaning of this expression is considered below). Until this point in time, a creditor will only be able to exercise a right of set-off if another form of set-off (such as a contractual right of set-off, an equitable right of set-off or an independent right of set-off) is available. It will not usually be known, at the date on which the company goes into administration, whether the administrator will be making distributions to creditors (and so whether r.2.85 will come into play). This is considered further below. If the administration set-off rule does come into play, however, no claims incurred or acquired after the cut-off date will be available for set-off.

C) Reasons for difference between liquidation and administration set-off rules

2.6 When the concept of a mandatory and self-executing administration set-off rule was first raised in the consultations regarding the Enterprise Act 2002, some concern was expressed at the idea that such a rule might apply from the commencement of the administration. This would have had the effect of freezing positions (for example, under running accounts or hedging agreements) and could have prevented the administrator from being able to continue to trade. While such a set-off rule may have been appropriate in the case of a liquidation (where there is unlikely to be significant trading activity), it was hardly in keeping with the emphasis on rescue in respect of the new administration provisions (where the administrator may well want to encourage counterparties to continue to deal with the company in administration in order to achieve the rescue or the continuation of the business as a going concern). It was agreed that the administration set-off rule was only necessary once the administrator had concluded that a rescue of the company was not possible and that the administration should be used, instead, to make distributions to creditors (i.e. a liquidating administration). This is why r.2.85 does not apply automatically from the moment of administration (as r.4.90 does in a liquidation). The rule only applies if and when the administrator gives notice under r.2.95 that he proposes to make a distribution (the meaning of which is considered below). Up to that point, the usual contractual, transaction or independent set-off rights will continue to apply.

2.7 However, if the administrator does decide that he is going to make a distribution (thus bringing the administration set-off rule into play), the cut-off date (preventing the build-up of set-off rights) is back-dated to the date of the commencement of the administration (or earlier date of notice as referred to above). Any claims incurred or acquired after this date will not be available for set-off under r.2.85. This has a number of important consequences and gives rise to many of the concerns referred to below.

3. Uncertainty of Outcome

3.1 Many of the uncertainties regarding the operation of the administration set-off rule arise from the difference between the **cut-off date** (i.e., the date after which claims incurred or acquired by the solvent counterparty, or incurred by the insolvent company, can no longer be included in the account for set-off purposes) and the **set-off date** (i.e., the date on which the account of what is due from each party to the other in respect of mutual dealings is to be taken and the sums due from one party are to be set-off against the sums due from the other). In the case of most liquidations, the set-off date (i.e., the date the company goes into liquidation) is likely to occur shortly after the earliest cut-off date (i.e., the date of notice of a winding-up petition).[4] In the case of an

[4] The period could be longer if, following the presentation of the winding-up petition, a provisional liquidator is appointed.

administration, however, the set-off date is the date on which (having obtained the leave of the court to do so under para.65(3) of Schedule B1 to the Act) the administrator gives notice (under r.2.95 of the Rules) that he is proposing to make a distribution to creditors. This date may never arise (for the reasons given below) or could occur some months after the commencement of the administration. The problem for creditors is that, if the administrator does give the r.2.95 notice (thus triggering the set-off date for the purposes of the administration set-off rule), any claims that were incurred or acquired after the (much earlier) cut-off date (including claims incurred during any trading period by the administrator) will not be included in the account for set-off purposes. This could include claims arising out of post-administration derivative transactions entered into between a counterparty and the company acting by its administrator or changes to a credit balance post-administration.

3.2 To give a topical example, if (under the current regime) a bank were to go into administration, and a customer had a deposit account with a balance of £1,000 at the time of the administration, the customer would be able to set off that balance against any amount owing by the customer to the bank (for example in relation to a mortgage loan) even following a r.2.95 notice[5]. However, if the customer were to make a further deposit of £500 following the date of the administration (or earlier notice referred to in paragraph 2.4), so that the balance of the deposit account was now £1,500, the customer would not be entitled (under r.2.85) to set off the additional £500 against his or her mortgage loan but would be obliged to pay the extra £500 of the mortgage loan and then claim in the administration for a dividend in respect of that part of his or her deposit. This may discourage customers from making further deposits (or otherwise dealing with the bank) post administration[6].

3.3 In a liquidation, it is clear to counterparties what the outcome will be (i.e., a realisation of the assets and the distribution of the proceeds to creditors in accordance with the statutory order of priorities)[7] and, as stated above, the liquidation set-off rule comes into play from the moment the liquidation is commenced. However, in an administration, various outcomes are possible. The three-fold purpose of administration is set out in para.3 of Schedule B1 to the Act:

(a) The primary purpose of the new administration regime is to rescue the company as a going concern and, if the administrator is successful in achieving this purpose, the administration will come to an end,[8] and the administrator will hand the management of the company back to the directors, without the administration set-off rule ever coming into play.

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5 In practice, the chances of a bank being wound up through an administration are, perhaps, remote but this depends on the meaning of "distribution" referred to below and whether the administrator would feel it necessary to give a r.2.95 notice before making any payments (including an interim payment) to unsecured creditors.

6 In October 2007, HM Treasury, the FSA and the Bank of England published a discussion paper considering reforms to the insolvency procedures in respect of banks and so the position outlined in this paragraph might change. However, the principles apply to any party dealing with a company in administration including for example hedging counterparties.

7 Even if the proceeds are distributed through a scheme of arrangement rather than pursuant to the liquidation rules in the Rules, the terms of the scheme are likely to reflect in broad terms the liquidation entitlements.

8 Either automatically on the expiry of the 12 month administration period pursuant to para.76(1) of Schedule B1 to the Act or upon an application of the administrator (under para.79(3) of Schedule B1) if the administrator has been appointed by order of the court or upon the filing of the requisite documents with the court (under para.80(2) of Schedule B1) if the administrator has been appointed by one of the out-of-court routes into administration.

Other forms of set-off (including contractual rights) will continue to be available to the counterparty.

(b) Alternatively, the administrator may pursue the second objective of achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration). There are various ways in which this could be achieved but this may well involve a sale of the business as a going concern. If pursuing this objective results in realisations which need to be distributed to the creditors, again, there are various ways in which this can be done. The administrator could propose a scheme of arrangement or voluntary arrangement in order to make the distributions (in which case the administration set-off rule will not come into play but the contractual set-off provisions in the scheme or arrangement are likely to follow the same or similar principles subject to the scheme or arrangement specifying any relevant cut-off date). Alternatively, the administrator could place the company into compulsory[9] or voluntary liquidation[10] so that the liquidator can make the distributions (in which case the liquidation set-off rule would come into play, with the cut-off date being back-dated to the date of the administration). The third option is for the administrator himself to make the distributions to creditors, having obtained the leave of the court (pursuant to para.65(3) of Schedule B1) in the case of distributions to unsecured creditors. It is only in this third scenario that the administration set-off rule would come into play.

(c) Finally, if neither the first nor the second objective can be achieved, the administrator may realise the property of the company in order to make a distribution to secured or preferential creditors. If this does not involve a distribution to unsecured creditors, it does not appear that the administration set-off rule would come into play although this is not entirely clear (see Section 5 below).

3.4 Because of the difference between the cut-off date and the set-off date in an administration, post-administration but prior to a r.2.95 notice, creditors can continue to exercise "non-insolvency" set-off rights (such as contractual, transaction or independent set-off rights) even if the claims have arisen post-administration but creditors cannot build up claims for the purposes of exercising a right of set-off under r.2.85 in the future (for example, if no other right of set-off is available to them). Furthermore, if the non-insolvency set-off right is inconsistent with the provisions of r.2.85, the creditor will need to exercise that non-insolvency set-off right prior to notice being given under r.2.95; if it fails to do so, the non-insolvency set-off right will be lost.

3.5 Unfortunately, it may not always be clear from the outset whether a distribution to creditors might ultimately be made: even if the administrator states in his proposals that he is seeking to rescue the company or to sell the business as a going concern, the circumstances might subsequently change and

[9] This is not dealt with expressly as an exit from administration in Schedule B1, but it is believed that the administrator has the same power as under the old administration regime to present a winding-up petition in respect of the company in order to ensure that a compulsory liquidation commences immediately upon the administration coming to an end.

[10] Pursuant to para.83 of Schedule B1.

the administration may become a liquidating one. The prudent advice to a creditor who wishes to preserve its rights of set-off must therefore be to exercise any non-insolvency set-off right as soon as possible (rather than to risk losing it) even though such advice is unlikely to assist with the rescue or continued trading of the company in administration. The advice to depositors in the example given above may be to withdraw those deposits as soon as possible in case any r.2.95 notice is given (which would hardly be in the interests of promoting customer confidence). The uncertainty as to whether or not the administration set-off rule will come into play makes it difficult for counterparties to take definitive legal advice regarding their set-off rights. Ultimately, this uncertainty, when coupled with the uncertainties regarding whether a counterparty will recover any post-administration liabilities as an expense of the administration (as discussed below), could discourage a counterparty from continuing to deal with a company post-administration.

4. Administration Expenses and the Shortfall Issue

A) Meaning of administration expense

4.1 The main purpose of administration is to allow a business to continue to operate while a rescue or restructuring is put in place. In these circumstances, it is necessary for the insolvent company to be able to continue to incur liabilities and also to be able to pay these creditors in priority to certain pre-administration liabilities; otherwise creditors will not be prepared to deal with the company post-administration. The provisions of para.99(3) of Schedule B1 to the Act are designed to achieve this result, providing that the administrator's "remuneration and expenses" shall be charged on and payable out of property in the custody or control of the administrator in priority to any floating charge security (and therefore also any unsecured claims).[12]

4.2 If a counterparty's claim is paid in full as an expense of the administration, the need for that counterparty to rely on a right of set-off will be reduced. However, this assumes that there are sufficient assets to pay the administration expenses in full.

4.3 There are three relevant provisions in the insolvency legislation which provide for how administration expenses are to be dealt with and this expression has also been clarified by the *Trident* decision referred to above:

(a) In addition to providing that the administration expenses shall be charged on and payable out of property in the custody or control of the

[12] Section 175 of the Act, which is incorporated into the administration regime by para.65(2) of Schedule B1 in the case of a distribution made by the administrator, has the effect that the expenses of the administration also have priority to preferential claims.

administrator in priority to any floating charge security, para.99(4) of Schedule B1 also gives super-priority to debts or liabilities arising out of contracts entered into by the administrator.[13] If the administrator enters into a new contract with the counterparty post-administration, any liabilities arising under such contract should therefore be treated as being super-priority expenses under para.99(4). In practice, an administrator (on a personal basis) is unlikely to enter into contracts with trading counterparties but rather will cause the company in administration, acting by the administrator as agent and without personal liability, to enter into such a contract. Although para.99(4) refers to contracts entered into "by the administrator", it seems likely that this would include contracts entered into by the company acting by its administrator. For the avoidance of any doubt, though, the FMLC considers that the counterparty should require the contract to state expressly that any liabilities under it are to charged on the company's property in accordance with para.99(4). If, rather than entering into a new contract with the counterparty, the administrator merely causes the company to continue to perform an existing contract, para.99(4) will not apply in relation to any post-administration liabilities arising from that pre-existing contract (e.g., in respect of services performed or goods delivered post-administration). Furthermore, as para.99(4) only refers to contractual liabilities, it will not apply to non-contractual liabilities such as those arising in tort. It is therefore necessary to consider whether these types of liability fall within the general meaning of "expenses" in para.99(3).

(b) R.2.67 of the Rules deals with the order of priority in which administration expenses are to be paid as between themselves. There is no indication in the statute as to how these provisions fit with para.99 of Schedule B1 but Mr Justice David Richards in the *Trident* case stated that the introduction of this rule and the wording of para. 99(3) of Schedule B1 meant that the construction of "expenses" in the old s.19(4) of the Act (as established by *Centre Reinsurance Co v Freakley*[15]) would not be applicable to the new provisions with the result that the confinement of administrator's expenses to those for which he made himself personally liable for was now incompatible with the list in r.2.67(1) for which, in many cases, the administrator would have no personal liability. The court held that a policy decision had been made in drafting r.2.67 to bring the framework regarding administration in line with that of liquidation, by framing the new rule in much the same terms as r.4.218 of the Rules. As a result the old-style administration case law was no longer applicable, and the drafters had intended that the courts instead follow the case of *re Toshoku Finance UK plc*[16], a r.4.218 liquidation case.

(c) R.2.68 of the Rules deals with distributions to any class of creditors. The administrator is required to defray any amounts (including any expenses) which would be payable, at the end of the administration, in accordance

13 Para.99(5) provides that this includes certain employment liabilities arising out of contracts of employment adopted by the administrator.
15 [2006] 1 WLR 2863
16 [2002] 1 WLR 671

with the provisions of para.99. By referring to the payment of expenses at the end of the administration, para.99 is drafted in similar terms to former s.19 of the Act. In *Re Paramount Airways Ltd (No. 3)*,[17] it was held that, despite the wording of s.19, it was understood that administrators would, in the ordinary way, pay expenses of the administration as they arise during the continuance of the administration and this practice was recognised, albeit obiter, by Mr Justice David Richards in the *Trident* case. R.2.68 only applies where an administrator makes a distribution (which is subject to the difficulties of interpretation discussed below).

B) The Shortfall Issue

4.4 The *Trident* decision will mean that a greater category of post-administration claims will rank as expenses of the administration, even where there is no benefit to the insolvent estate. Such claims could include post-administration tax liabilities and rates liabilities including potentially on unoccupied properties[19]. There may be circumstances in which there are insufficient monies to pay those expenses in full. This will happen if the administration turns out to be an insolvent one (meaning that there are insufficient unsecured or floating charge assets to pay all of the expenses of the administration in full). In such a case, the administrator will be required to pay the expenses in the order of priority set out in r.2.67. If there are insufficient assets to pay in full the sub-category of expenses which includes the creditor's claim, the creditor may only receive a *pro rata* share of the assets (or no payment at all if the prior sub-categories of expenses exhaust all the available assets). If, on the other hand, the creditor were able to exercise a right of set-off, and the amount it owed the company was greater than the amount that it was owed, it would be able to set-off the full amount of the liability owed to it (rather than receiving a partial payment in this regard).

4.5 The risk of an administration turning out to be an insolvent one may seem a remote one because officeholders will behave cautiously and are unlikely to incur liabilities as administrators in circumstances where they consider there is a risk of a shortfall. They are also likely to pay liabilities as they go during the administration rather than letting them accumulate. Furthermore, because of the subordination (by virtue of paras.99(3) and (4) of Schedule B1 to the Act) of the administrators' fees, they have a personal incentive to avoid a situation where a shortfall arises.

4.6 However, circumstances could arise where a supervening event reduces the assets (or the value of the assets) available to the administrator with which to defray administration expenses or where it is not clear at the outset what the realisations will be (and therefore whether there will be sufficient unsecured or floating charge assets out of which the expenses can be paid). Furthermore, the

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17 [1994] 2 All ER 513

19 There is not currently a statutory exemption for companies in administration in respect of empty property rates (as there is for a company in liquidation) but such an exemption has been proposed in the consultation paper "Modernising Empty Property Relief" in respect of the Rating (Empty Properties) Bill which was introduced into the House of Commons on 10 May 2007.

quantum of the administration expenses could end up being more than anticipated (and more than the value of the floating charge and unencumbered assets). Three scenarios are particularly relevant in this context.

(a) If there is significant post-administration financing, this will generally be repayable as an administration expense. In certain cases, a lender may choose to fund the administration even if it is not clear that there will be sufficient floating charge realisations or unencumbered assets to repay that funding (for example if it is in the best interests of the borrowing group, and therefore to any lender that has financed that group, that the business of a particular company is rescued or its affairs dealt with in an orderly manner).

(b) In the case of a retail company with a number of trading premises, the rates liability across the portfolio of properties could be substantial (in the *Trident* case, it was estimated that the liabilities were in excess of £2.7 million). If there are also substantial tax liabilities[20], this could soon delete the floating charge realisations and unencumbered assets.

(c) There could be cases where the floating charge and unencumbered assets, out of which expenses are to be paid, are limited (for example in the case of a company holding real property or investments where the majority of those assets are subject to fixed charge security).

4.7 To give a real-life example, in the recent administration of a major furniture chain (which it is not possible to name for client-confidentiality reasons), it was necessary for the administrators to borrow extensively from the existing secured lenders in order to continue the business while potential sale options were explored. The post-administration financing constituted a significant expense of the administration. Due to various factors that it was not possible to anticipate at the commencement of the administration, it has now turned out that there will be insufficient proceeds of realisation to pay the (fixed) secured debt and the expenses of the administration (including the post-administration financing) in full. Other potential examples include the following:

(a) if the company has assets such as commodities which fluctuate in value, a sudden market movement could create a shortfall;

(b) it may be discovered during the course of the administration that the company's title to a particular asset is defective; and

(c) in a group context, it may not be immediately apparent which company owns which assets. Service companies, which may have the primary liability to pay salaries and other outgoings, may not have any assets at all.

4.8 In any event, even if there is no shortfall, a creditor may prefer, for its own internal reasons, to rely on a right of set-off rather than receiving a payment as

[20] If the administrator or a secured creditor disposes of a fixed charge property and this results in capital gains tax being payable, this tax liability is payable as an administration expense (out of the floating charge or unencumbered assets) rather than out of the proceeds of the fixed charge asset. If there is a disposal of a substantial property portfolio, the CGT liabilities could be significant.

an expense of the administration. Take the example of a number of derivative transactions (some pre- and some post-administration) entered into under a single ISDA Master Agreement. The counterparty may wish (for its own credit-risk purposes) to be able to set-off credit and debit balances in respect of all outstanding transactions under the Master Agreement (rather than being required to treat pre- and post-administration liabilities separately). The uncertainty as to whether or not such contractual set-off may be prevented following a r.2.95 notice is undesirable.

5. Meaning of Distribution

5.1 As referred to above, the administration set-off rule only comes into play when the administrator, being authorised to make the distribution in question, has given notice (pursuant to r.2.95) that he proposes to make it. "Distribution" is not defined in either r.2.85 or r.2.95 and this gives rise to the question of what "distribution" means for these purposes. For the reasons given below, the FMLC is of the view that this expression should be construed as a distribution only to unsecured creditors but it would be useful if the expression could be clarified (either though an amendment to the Rules or by case law).

5.2 The expression "distribution" is used in a number of places in Schedule B1 to the Act. For example, the third objective in para.3(1) of Schedule B1 is to realise property in order to make a "distribution" to one or more secured or preferential creditors. Para.65(3) also refers (impliedly) to distributions to secured and preferential creditors when providing that a distribution may not be made to a creditor who is neither secured nor preferential unless the court gives permission. The expression is also referred to in the heading of Chapter 10 of Part 2 of the Rules which applies when the administrator makes, or proposes to make, a distribution to any class of creditors (r.2.68). Secured creditors are not expressly excluded from the expression "creditors" for the purposes of r.2.68. Hence the question arises as to whether a "distribution" (for the purposes of r.2.85) is limited to a distribution to unsecured (including preferential) creditors or whether it could include any payments made to secured creditors.

5.3 It seems clear that a payment made to a fixed charge creditor pursuant to the condition of a court order under para.71(3) of Schedule B1 would not constitute a "distribution" to that secured creditor. Furthermore, if the secured creditor is able to obtain the leave of the court (under para.43(2) of Schedule B1) to enforce its security outside of the administration process, any recoveries will not be "distributions" for the purposes of the administration provisions. What is more problematic, however, is the categorisation of payments made to the floating charge-holder in respect of floating charge assets realised by the administrator (after the necessary deductions have been made for the administration expenses, the preferential creditors and the s.176A prescribed part). Does the secured creditor have to go through the proving process in order to recover the floating charge element of its security and, if so, is this to be treated as a "distribution" for the purposes of Chapter 10 of Part 2 of the

Rules[21] including r.2.85? This requirement would seem inconsistent with the provisions of r.2.83(1) (whereby a secured creditor is entitled to prove for the balance of its claim, after deducting the amount that has been realised in respect of its security) and rr.2.90 – 2.94 (whereby a secured creditor can disclose its security in its proof of debt, put a value on this security and prove for the balance, allowing the administrator to redeem the security at the value put upon it in the creditor's proof); these provisions appear to envisage that, to the extent that the claim is secured, it will not be part of the proof of debt process.

5.4 Furthermore, in the notice that is to be given pursuant to r.2.95, the administrator is required to state whether the distribution in question is to preferential creditors or preferential creditors and unsecured creditors (r.2.95(2)(b)); the rule makes no reference to secured creditors.

5.5 For these reasons, it would appear that r.2.85 (and the other provisions of Chapter 10 of Part 2 of the Rules) only come into play if the administrator proposes to make a distribution to unsecured (including preferential) creditors or secured creditors in respect of any unsecured element of their claims; the non-insolvency set-off rules will continue to apply if the administrator makes any payments to secured (including floating charge) creditors. Any uncertainty in this regard, however, could have a detrimental effect on the financial markets and the willingness of counterparties to continue to trade with a company in administration.

6. Contingent Claims

6.1 The position in relation to the set-off of contingent claims (such as a claim under a guarantee of a loan where no demand has been made on the loan or where no default has yet occurred in respect of the loan) and future claims (such as a claim to pay money on a date which is not yet due) owing by or to the insolvent company has recently been clarified and affected by The Insolvency (Amendment) Rules 2005.[22] Contingent and future debts owing *to* and *by* the insolvent company are now to be set-off provided they arise out of obligations incurred prior to the cut-off date (referred to above). R.2.85(4) now specifically provides that a sum shall be regarded as being "due" to or from the insolvent company for the purposes of set-off whether: (a) it is payable at present or in the future; (b) the obligation by virtue of which it is payable is certain or contingent; or (c) its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion. In the FMLC's view, it is very helpful that the rule has been clarified in this way.

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[21] Not only would this have an impact on whether r.2.85 comes into play but it would also affect payments of interest to the secured creditor (as r.2.88 provides that, unless there are surplus assets, interest is only provable up to the date of the administration or earlier liquidation whereas a secured credit agreement will usually give the secured creditor the right to default interest until payment) and the conversion of foreign currency claims (as r.2.86 provides that any foreign currency claim will be converted into Sterling at the official exchange rate (defined as the middle exchange rate on the London Foreign Exchange Market at the close of business) prevailing on the date when the company entered administration (or liquidation if earlier) whereas a secured credit agreement will usually contain its own provisions for the exchange of foreign currency claims). There were no suggestions, during the consultations and debates regarding the Enterprise Act 2002 that the new provisions were intended to have such a significant impact on secured claims and it therefore seems inconceivable that this is the effect of the provisions.

[22] SI 2005/527 which came into force on 1 April 2005.

6.2 Contingent debts (including contingent debts owing to the insolvent company) are to be estimated in accordance with r.2.81 and future debts are to be valued in accordance with r.2.105 (debts payable at a future time). The formula for the discounting of future debts has also been changed by The Insolvency (Amendment) Rules 2005 in response to defects in the original drafting noted by Lord Millett in the House of Lords' decision in *Re Park Air Services Limited*.[23]

6.3 By way of contrast, if the balance of the claim, after set-off, is a sum owing to the insolvent company and all or part of that balance results from a contingent or prospective debt owed by the solvent counterparty, then the balance (or such part of it as results from the contingent or prospective debt) only becomes payable by the counterparty when the debt actually becomes due and payable. In other words, the set-off provisions do not accelerate the payment of contingent or future debts payable by a solvent counterparty otherwise than for the purposes of set-off.

6.4 Although not expressly stated in the revised insolvency set-off rules, it is thought that the normal rules allowing an "appeal" against the admission or rejection of a proof in whole or in part would be available to any creditor wishing to challenge the valuation (for set-off purposes) by the administrator of any incoming contingent claim. However, it is not clear what would happen if, having valued the incoming contingent claim for set-off purposes, the circumstances changed (so that, for example, the contingent claim crystallised at more than its valuation or it became apparent that the contingent claim could never, in fact, arise).

(a) If the change of circumstance results in a greater amount being due to the creditor, and the administrator still has assets available for distribution, an adjustment could be made in subsequent distributions to take into account the change of circumstances in accordance with r.2.101(1). This rule suggests that there could be no claw-back of distributions already made if there were no such available assets. However, r.2.101(1) may not apply if no proof has been made in respect of the net claim (on the basis of the administrator's original assumption that no amounts would be due from the company in administration) and so it would be useful if this rule could be extended to cover such a scenario.

(b) If the change of circumstance results in a lesser amount being due to the creditor, and a dividend has already been paid in this regard, the rules do not currently state whether the creditor would be obliged to repay the difference to the company in administration. By analogy with r.2.102(2) (regarding secured creditors and revaluations of the security that result in a reduction of the unsecured portion of those creditors' claims), it is possible that the creditor would be obliged to repay the difference but it would be useful if this could be clarified.

[23] [2000] 2 A.C. 172

6.5 The FMLC does not consider that any of these issues regarding contingent claims are particularly significant as, in practice, they would be negotiated and resolved by the administrator and the relevant creditors. However, if changes were being made to the rules for other purposes, it may be helpful to clarify these points.

7. Proposals

7.1 As discussed above, the primary concern with the current r.2.85 regime arises in an insolvent administration, and the prohibition of set-off between administration expenses and pre-administration debts in circumstances where a r.2.95 notice is given. In an insolvent administration, this gives rise to the potential injustice that a counterparty may be required to pay into the estate for pre-administration liabilities, but only be paid a proportion of its administration expenses claim. The paper discussed above why this risk is higher in an administration than perhaps might have been thought.

7.2 *Proposal 1*: The simplest answer would be to allow administration expenses, incurred before a r.2.95 notice is given, to be treated as mutual dealings for the purposes of r.2.85.[24] This would avoid the potential injustice mentioned above. Further, as administration expenses would be the only post-administration liabilities eligible for set-off, there would be no concern that debt trafficking might be encouraged. (Debts *acquired* post-administration would not be administration expenses, and so would not be capable of being set-off against pre-administration debts owed to the company.)

7.3 A counterparty may be owed pre- and post-administration amounts by the company. In such a situation, the FMLC suggests that set-off is applied against the *pre*-administration amounts first, with any resulting balance then applied against the counterparty's administration expenses claim. This promotes justice to the counterparty.

7.4 *Proposal 2:* A second answer would be to amend r.2.85 to provide different cut-off dates for debts arising out of obligations *incurred* by the company in administration, and debts *acquired* by a counterparty pursuant to an agreement entered into after the relevant cut-off date:

(a) If the cut-off date for debts arising out of obligations *incurred* by either the counterparty or the insolvent company were to be the same as the set-off date (i.e. when the administrator gives a r.2.95 notice), any post-administration liabilities entered into by the company, acting by its administrator, in the course of the administration would still be available for set-off up to the point at which the counterparty had the r.2.95 notice that the administration set-off rule had come into play. If the post-administration liability owed to the counterparty exceeded the amount due

[24] An amendment would also be needed to r.4.90 such that administration expenses incurred up to the r.2.95 notice (if any) or the end of the administration are eligible for set-off under r.4.90.

to the insolvent company by the counterparty, the excess amount would be treated as an expense of the administration.[25]

(b) However, the FMLC considers that the cut-off date for debts *acquired* by a creditor pursuant to an agreement entered into after a particular date should continue to be back-dated to the date of the administration (or, in certain circumstances, an earlier date).[26] This would prevent the trafficking of claims, post-administration, by parties wishing to improve their set-off position if or when r.2.85 came into play.

7.5 In the view of the FMLC, either of the above proposals would encourage counterparties to continue to trade with a company in administration up to the point in time when the administrator concluded that a rescue was not possible and that the administration should become a liquidating one.

7.6 Separately, there are some more minor issues which, if one were revisiting the legislation, it would be helpful to amend/clarify:

(a) the expression "distribution" in r.2.95 could be clarified (either through an amendment to the Rules or by case law). Although the FMLC is of the view that this expression, when used in conjunction with r.2.85, should be construed as a reference to a distribution only to unsecured creditors or preferential creditors, there is a little uncertainty in this regard;

(b) it would be helpful if guidance could be given (either by the Insolvency Service or R3 as the professional body regulating insolvency practitioners) regarding how an administrator should deal with a contingent claim owing to the insolvent company which turns out to have a different value to the one given to it by the administrator for set-off purposes (and in particular whether r.2.101 is intended to apply in these circumstances, even if no proof has actually been made). Whilst perhaps not meriting an amendment to the Rules, clarification of this issue by guidance would provide a welcome higher level of certainty to the financial markets. In particular, clarification would be welcomed regarding whether any dividends already made by the administrator could be claw-back or whether a creditor who has been overpaid could be required to return some of its dividend.

7.7 Finally, now that the administration set-off regime has been in force for over two years, the FMLC considers that there would be merit in canvassing comments on the regime and how it has operated in practice. This could be done through a formal consultation exercise or by discussions with key market participants and would follow on from the consultation exercise which was

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[25] For similar reasons, the cut-off date under r.4.90 for debts arising out of obligations incurred by either the counterparty or the insolvent company should not be back-dated to the date of an immediately preceding administration but should be the date of the liquidation (or earlier date of notice of the winding-up petition or s.98 creditors' meeting). This would prevent counterparties from being discouraged to deal with a company in administration on the basis that it may, subsequently, go into liquidation; under r.4.90 as currently drafted, any right of set-off in respect of liabilities incurred by the insolvent company during the course of the administration would be lost in such a liquidation.

[26] The cut-off date in r.4.90 for debts acquired by a creditor should similarly be back-dated to the date of the administration – in other words, the provisions of r.4.90 should not be amended in this regard.

undertaken by the Insolvency Service when the administration set-off rule was first introduced (at which time the impact on the financial markets of the new rule was not yet known).

8. Conclusion

8.1 The FMLC has identified two main areas of concern that it believes arise out of the application of the new administration set-off rule and its interplay with other insolvency provisions. It has also outlined, as subsidiary issues, two areas where express clarification of r.2.85 would be helpful. These uncertainties arise primarily out of the difference between the cut-off date (after which claims incurred or acquired by the solvent counterparty, or incurred by the insolvent company, can no longer be included in the account for set-off purposes) and the set-off date (on which the account of what is due from each party to the other in respect of mutual dealings is to be taken and the sums due from one party are to be set-off against the sums due from the other).

8.2 It is considered that any uncertainty in respect of r.2.85 may detract from the new administration regime's ability to achieve its primary goal (of rescuing ailing companies as going concerns), by discouraging counterparties from dealing with companies who are subject to the regime. While these concerns are of general application, they could impact upon financial markets if the insolvent company has outstanding positions in the derivatives markets.

8.3 The proposals put forward in this paper in order to deal with these areas of uncertainty are:

- for the Insolvency Service to re-open the consultation exercise that was embarked upon when the new administration set-off rule was first introduced;

- for r.2.85 to be amended:

  - either so that administration expenses incurred before a r.2.95 notice are treated as mutual dealings for the purposes of r.2.85 (and thus such liabilities could be set off against any amounts owing by the counterparty to the insolvent company); or

  - so as to provide for different cut-off dates for debts arising out of obligations *incurred* by the parties and debts *acquired* by a creditor pursuant to an agreement entered into after the relevant cut-off date (so as to avoid discouraging counterparties from dealing with companies that are subject to the administration regime, without rendering that regime vulnerable to abuse through the trafficking of claims, post-administration, by parties wishing to improve their set-off positions if/when r.2.85 comes into play);

- for the uncertainty regarding the expression "distribution" to be eliminated (either through an amendment to the Rules or by case law); and

- for guidance to be given (either by the Insolvency Service or R3) as to how administrators ought to deal with contingent claims owing to insolvent companies which turn out to have different values to those originally attributed to them for set-off purposes.

Appendix 1

Can you set off pre administration versus post administration amounts?

Event	Contractual set-off	Insolvency set-off	Insolvency Set-off Cut off dates	Reference
Administrator distribution	No	No	• date of entry into administration • date of creditor having notice of petition pending or notice of intention to appoint administrator	Rule 2.85(2)(a) and (b)
Move to liquidation	No	No	• section 98 meeting summoned • petition pending • liquidation preceded by administration and creditor on notice of petition pending or notice of intention to appoint administrator	Rule 4.90(2)(a) and (b)
Move to dissolution	Yes	n/a		
Automatic	Yes	n/a		
Objective achieved	Yes	n/a		
Creditor application	Yes	n/a		

Notes: This assumes that an adequately drafted contractual set off provision exists in pre-administration documentation.

This ignores acquisition of debts so as to create set-offs.