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Dear Steve,

Administration Set-off and Expenses

The remit 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.

You may recollect receiving a paper in late 2007, which was subsequently published on the FMLC website, headed "Issue 108 – Administration Set-off and Expenses". The FMLC Paper offers a 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. In particular, it highlights certain areas of legal uncertainty in respect of the administration set-off rule. For example, it is difficult for a counterparty to determine, at the time the company with which it is dealing goes into administration, 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 or will otherwise be repaid in full. This may, in turn, discourage counterparties from dealing with a company after it has entered administration and it creates an unwelcome element of uncertainty. The paper also touched briefly on issues relating to the build-up of set-off rights post administration (see paragraphs 3.4 and 7.4(b) of the FMLC Paper). You will find a copy of the FMLC Paper enclosed for ease of reference.

It appears to the members of the FMLC that the issues of legal uncertainty identified in the FMLC Paper have materially affected market participants in their dealings with Lehman Brothers International (Europe) Limited ("LBIE") after its collapse and that this offers direct evidence of the need for these issues to be addressed. In fact, the FMLC Paper did not anticipate the full extent of the uncertainty that these issues might cause because the paper did not consider the administration of a financial institution. Where parties are discouraged from dealing with a systemically important financial institution after it has entered insolvency, it exacerbates an already difficult situation and the consequences for the financial markets may be severe. The ability of the company to continue trading will be immediately affected and this may cause undesirable market uncertainty as to whether the financial institution in question will be able to satisfy its contractual commitments as they are performed in the administration. To a certain extent, these issues were not as severe as they may otherwise have been in respect of LBIE because the administrators announced from the outset that their intention was to wind down the business of LBIE rather than to cause it to continue to trade. However, even in such a case, there have been issues in relation to the application of set-off as referred to below. These issues would be even more problematic in the case of a trading

administration where the administrators may well want hedging and other derivative contracts (for example) to remain in place.

It is self-evidently important for the purpose of facilitating an orderly administration of such companies that administrators are not impeded from incurring new financial obligations on behalf of the company, which may include the renewal or continued performance of any contracts that are vital to the company's operations. The FMLC's original proposals in relation to set-off were made with the objective of resolving legal uncertainty. The optimal resolution seemed to the Committee to be one which would recognise the importance of facilitating an orderly administration by removing any unnecessary impediments. However, the overall balance of policy considerations remains, of course, a matter for the Insolvency Service.

The LBIE administration has also raised a number of issues regarding set-off, such as the interplay between contractual set-off and insolvency set-off under Rule 2.85 (including whether claims can be acquired for the purpose of exercising non-insolvency set-off rights), the order in which set-offs are to be applied and whether rights of set-off can be exercised against proprietary claims for the return of client assets and monies. Some of these issues are to be considered in the LBIE client asset scheme of arrangement (the "LBIE Scheme") which will be considered by the Court in the coming months, assuming it is determined later this month that the Court has jurisdiction to sanction such a Scheme. As many of these issues were beyond the scope of the FMLC Paper, the FMLC is considering whether to convene the same or another working group to address these further issues.

The FMLC Paper identified a number of additional uncertainties in relation to administration expenses, such as the categories of post-administration claims that such expenses might include and the possibility that expenses will not be repaid in full if the administration is an "insolvent" one. It would appear that there is much that has yet to be resolved regarding the payment of expenses in the LBIE administration; and the FMLC expects that the issues of concern identified in the FMLC Paper will be highlighted during this process. In particular, some of the concerns around administration expenses are to be considered in the LBIE Scheme.

The FMLC would therefore urge you to review the proposals made in the FMLC Paper which, in the opinion of the FMLC, would help resolve the issues of legal uncertainty considered above. The FMLC would welcome further discussion with you on this issue and will consider the situation further when the outcome of the LBIE proceedings is clearer.

Yours sincerely

Joanna Perkins