c/o Bank of England
Threadneedle Street
London
EC2R 8AH

Telephone: (+44) (0)20 7601 3918
Fax: (+44) (0)20 7601 5226

Email: fmlc@bankofengland.co.uk
Website: www.fmlc.org

6 January 2012

Mr Nick Howard
Director of Policy
The Insolvency Service
Room 511
21 Bloomsbury Street
London
WC1B 3QW

nick.howard@insolvency.gsi.gov.uk

Dear Mr Howard

ISSUE 108: Set-off and Administration Expenses in the Administration Regime

The Financial Markets Law Committee (the "FMLC") is grateful to you for your email to the FMLC Director, Joanna Perkins, of 5 August 2011 in connection with the Addendum to the FMLC Issue 108 Paper: Administration Set-off and Expenses (the "Addendum"), which was sent to you by letter dated 25 March 2011. The Addendum, amongst other things, proposes an amendment to the cut-off date under Rule 2.85 of the Insolvency Rules 1986 (the "Insolvency Rules"). The FMLC has considered with interest the points made in your email and addresses them below.

The FMLC understands that the resources of the Insolvency Service's policy team are limited but strongly believes that the suggested changes in the Addendum are important and deserving of attention alongside the current review of administration expenses. Indeed, the FMLC considers it sensible to review both issues at the same time because of the interplay between administration set-off and the treatment of administration expenses.

The FMLC would suggest that a combined review of set-off and administration expenses should not involve a substantial extra commitment of resources by the Insolvency Service given that any changes made to administration expenses would seem likely to necessitate a review of the consequential effect on the rest of the administration regime and notably the aspects thereof in respect of set-off. Moreover, the FMLC would argue that any increased expenditure by the Insolvency Service should be weighed against the savings to be made by those dealing with insolvent parties and those considering, in advance, counterparty risks. The proposed changes to Rule 2.85 and Rule 4.90 of the Insolvency Rules (to be found in Appendix 1 to the Addendum) and the explanatory notes on the changes to the aforementioned rules (to be found in Appendix 2 to the Addendum) are intended to assist the Insolvency Service by illustrating how the changes might be made.

The existing version of Rule 2.85 is a source of serious legal uncertainty for the wholesale financial markets for the reasons explained in the Addendum, including the following:

1. After a company goes into administration, there is often serious uncertainty for a significant period as to whether or not set-off under Rule 2.85 will be brought into play because this

will depend on whether the administrator decides to serve a Rule 2.95 notice for a proposed distribution to creditors.

2. Even though a debt arising out of a contract entered into by the administrator will normally rank as an administration expense, the creditor may be concerned that full payment will not be possible if it proves to be the case that there are insufficient assets available to the administrator out of which to pay his remuneration and administration expenses. The prospect of such an "insolvent" administration occurring is now a very real one as a result of the decision in *Nortel*.[1]

3. There may also be doubt as to whether a post-administration debt is an administration expense where, for instance, it arises out of the continued performance of an existing contract or arises out of a non-contractual obligation.

The FMLC notes that the Insolvency Service would like to receive more information as to the financial benefits expected to result from any change to Rule 2.85. As with many other issues of legal uncertainty, it is difficult to produce such figures and statistics without the legal uncertainty having actually led to a major problem or litigation which is, of course, what the FMLC is trying to avoid. Nevertheless, the FMLC considers that the removal of legal uncertainty through amendments to Rule 2.85 would produce a number of identifiable benefits which are discussed below:

a) There are few provisions of English insolvency law which are more important to debtors and creditors than the statutory set-off rules which apply in administration and liquidation. The removal of legal uncertainty surrounding Rule 2.85 would save considerable time and costs for the financial markets and industry generally in assessing this uncertainty and its implications in numerous different situations.

b) The removal of legal uncertainty arising from Rule 2.85 would promote the rescue culture and help ensure solvent businesses are not discouraged from trading, or continuing to trade, with a company in administration.

c) The removal of legal uncertainty surrounding Rule 2.85 would help to reduce the amount of costly litigation. The case of *Kaupthing*[2] provides an example of such costs in that the parties concerned had to go through the expensive process of going to the Court of Appeal in order to obtain guidance on the interpretation of the discounting rule under Rule 2.105 of the Insolvency Rules because of ambiguities in its drafting.

d) By way of a further example, the latest progress report of the administrators of Lehman Brothers International (Europe), dated 13 October 2011, reveals that the administrators are finalising their "litigation strategy for resolution of other issues relating to non-mutual set-off and preparation for court proceedings against two significant counterparty groups" (page 15). This litigation appears necessary only because of the uncertainty regarding Rule 2.85. It would seem that the reason it has taken the administrators so long to initiate proceedings is because of the complexity of the issues and their concerns about whether a single set of proceedings would be binding on all creditors who have purported to assert cross-affiliate set-offs. It would therefore appear preferable that such issues be dealt with by way of legislation, rather than through costly and uncertain litigation.

e) The removal of legal uncertainty surrounding Rule 2.85 might reduce the risk of flight to a jurisdiction offering more certainty, which would entail the loss of business to the UK. However, it should be noted that it is not clear that flight to a less uncertain jurisdiction is currently a significant problem.

The FMLC believes that the proposed amendment to Rule 2.85 would not add to the burden of regulation on business but would, instead, remove an unwelcome complication for business. When the law has unexpected or undesirable consequences, it would seem in the interest of all concerned to review and clarify it. It is in the interest of both debtors and creditors that administration set-off should operate clearly and smoothly, without unpredictable consequences.

---

1 *Bloom and others v Pensions Regulator and others* [2011] EWCA Civ 1124

2 *Re Kaupthing Singer & Friedlander Ltd (in administration)* [2010] EWCA Civ 561

The FMLC notes your query as to whether alteration of Rule 2.85 might create an opportunity for counterparties to find ways to engineer a more advantageous position for themselves. The FMLC believes that the purpose of statutory set-off is, in many ways, to achieve "rough justice" between debtor and creditor. The FMLC believes that the scope for abuse can be avoided, for instance, by continuing to exclude from set-off debts acquired by the creditor from a third party after the commencement of the administration (see paragraph 1.8 in Appendix 2 to the Addendum).

The FMLC would be delighted to discuss the issues raised in this letter at a meeting. Please do not hesitate to contact the FMLC Secretariat should you wish to organise such a meeting or if you require any further information or assistance.

Yours sincerely

Lord Hoffmann
FMLC Chairman