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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 108 – ADMINISTRATION SET-OFF AND EXPENSES

ADDENDUM

The "Cut-Off Date Amendment": a route to solve legal and practical uncertainties identified in the FMLC 108 Paper entitled

"*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*"

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FINANCIAL MARKETS LAW COMMITTEE

ISSUE 108 – ADMINISTRATION – SET-OFF AND EXPENSES

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1. 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 In November 2007, the FMLC published a paper entitled "*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*" (the "108 Paper").

1.3 The 108 Paper identified a number of legal and practical issues with the administration regime and in particular the set-off provisions (pursuant to r.2.85 of the Insolvency Rules 1986) and provisions relating to administration expenses (in Paragraph 99 of Schedule B1 to the Insolvency Act 1986 and r.2.67). It concluded that the application of the administration set-off rules and their 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 administration expenses) gave rise to legal uncertainties, which may discourage counterparties from dealing with a company in administration, and undermine attempts to rescue the company. These uncertainties have affected the financial markets, as illustrated by the recent and ongoing administration of Lehman Brothers International (Europe) ("LBIE").

1.4 In the context of the Insolvency Service's review of the administration regime following the administration of LBIE, the FMLC was asked by the Insolvency Service to carry out further work on one of the options which may solve the uncertainties

identified in the 108 Paper—namely the Cut-Off Date Amendment (as defined in Section 2 below).

1.5 The purpose of this addendum to the 108 Paper is to assist the Insolvency Service in detailing the Cut-Off Date Amendment, in particular:

(a) How r.2.85 and r.4.90 of the 1986 Rules should be amended to reflect the Cut-Off Date Amendment (Section 2, Appendix 1 and Appendix 2);

(b) Whether the new statutory set-off (pursuant to the Cut-Off Date Amendment) should be mandatory and self-executing or whether administrators should be given discretion to exercise it (Section 3 and Appendix 3);

(c) How the doctrine of administration expenses would interact with the Cut-Off Date Amendment (Section 4); and

(d) How contractual and equitable set-off would apply in the context of the Cut-Off Date Amendment (Section 5).

1.6 The FMLC wishes to note that the Cut-Off Date Amendment is one of the several options identified by the FMLC to solve the legal and practical uncertainties highlighted in the 108 Paper, but this option has been explored further in this Addendum at the request of the Insolvency Service.

2. The Cut-Off Date Amendment

2.1 As set out in the 108 Paper, 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 company that has gone into administration, 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).

2.2 For insolvency set-off purposes, the Cut-Off Date is currently linked to the date on which the company goes into administration (the "Administration Date").[1] The Set-Off Date is the date on which (having obtained the leave of the court to do so under Paragraph 65(3) of Schedule B1 to the Act) the administrator gives notice (under r.2.95) that he is proposing to make a distribution to creditors (where it is intended to refer to the Set-Off Date in this respect, the term the "Notice Date" will be used: see, in particular, Appendix 3).

2.3 The Cut-Off Date Amendment would involve the Cut-Off Date being pushed forward to coincide with the Set-Off Date, with the result that:

(a) All debts/claims arising out of obligations incurred by either party after the commencement of administration but before the Set-Off Date would not be excluded from set-off;[2]

(b) Where a counterparty has a right of set-off (contractual, equitable or independent) under arrangements existing on the Administration Date, that counterparty would be free, if it chose to do so:

[1] Rule 2.85(2)(a), although cut-off would operate on an earlier date if r.2.85(b),(c),(d), or (e) applied.

[2] For the avoidance of doubt, any debts acquired by the solvent companies from third parties and/or associated companies would be excluded so as to prevent the unfair build up of set-offs.

(i) To exercise that right up to the point when administration set-off under r.2.85 is triggered (i.e. the Set-Off Date); and

(ii) To exercise its pre-existing right of bilateral set-off against such of the pre-administration and/or post-administration debts owing to it as it may select, or to rely on recovering a post-administration debt as an administration expense (where it is eligible to do so);[3]

(c) After r.2.85 is triggered:

(i) Administration set-off is automatic, mandatory and self-executing;

(ii) Administration set-off only applies to sums arising out of mutual dealings and does not permit extended, "triangular" or cross-affiliate set-off;

(iii) Where a balance was expected to be owed to the solvent counterparty, the inter-relationship between set-off and unpaid administration expenses would be relevant and different options for dealing with such expenses are examined in section 4 below;

(d) R.2.85 set-off is capable of being triggered only in circumstances where an administrator intends to make a distribution to creditors; further consideration could, however, be given to permitting the administrator flexibility in choosing the precise trigger point for set-off in special administration regimes such as the regime for investment banks;

[3] Mandatory and self-executing set-off would only impact the Set-Off Date to the extent that the creditor had not been discharged by that date as an expense. In other words, the creditor could only chose to be paid as an expense until the Set-Off Date and, if the post-administration debts remained outstanding at that point, they would be included in the automatic set-off

(e) The interpretation of the Court of Appeal in *Kaupthing Singer and Friedlander Ltd (in administration)* [2010] EWCA Civ 518 is applied as regards the discounting of future debts.

2.4 The suggested redraft of r.2.85 set out in Appendix 1 provides wording for the above approach.

2.5 The right to set-off in these circumstances should be limited to bilateral set-off in cases where the requirement for mutuality is satisfied, otherwise these changes indirectly would damage the interests of creditors and permit multilateral set-off indirectly.

2.6 The consequential changes which would need to be made to the 1986 Rules in order to reflect the above are set out in Appendix 1. An explanatory note on the proposed changes is set out at Appendix 2.

3. Mandatory Set-Off and the Power to Disclaim

3.1 The relationship between statutory set-off and set-off arising from other sources has been addressed in a number of cases, three key authorities being the decisions of the House of Lords in *National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] 1 All ER 641 that statutory set-off could be neither modified nor excluded by the parties involved, in *Stein v Blake* [1995] 2 All ER 961 where it was held that set-off was mandatory and self-executing, with the result that "the original chose in action [i.e. each cross claim] ceases to exist and is replaced by a claim to a net balance", and in *Re Bank of Credit and Commerce International SA* (No 8) [1997] 4 All ER 568, which appeared to affirm the Court of Appeal's view[4] that the operation of

[4] See the judgment of Rose LJ at [1996] Ch. 245, 255 (CA).

insolvency set-off was "mandatory, automatic and immediate on the bankruptcy or liquidation taking place".[5]

3.2 Various commentators have questioned whether this outcome, i.e. the finding that statutory set-off is mandatory in character and cannot be excluded by contract, is justified. They do so largely on the grounds that the value of respecting the contractual bargain made between two parties, who may wish to exclude or modify statutory set-off, would be better observed by a different rule. Theory aside, the approach taken in the decisions may have a negative impact in reducing the overall size of the insolvent company's estate, and lowering the return for its creditors. On the positive side, the conclusion that administration set-off is mandatory and self-executing has the merit of providing administrative certainty in the insolvency process.

3.3 In contrast, giving administrators greater discretion in relation to the timing of set-off could increase the size of the insolvent estate and the Insolvency Service may wish at least to consider this possibility in the course of reviewing all possible options for the reform of set-off in an administration. However, conferring discretion on the administrators in this way could only be achieved at the cost of creating significant administrative uncertainty, and the FMLC considers that cost to be too high. Although this is not an option that the FMLC favours, we have considered the option further in Appendix 3 for the sake of completeness. An alternative proposal, also explored in Appendix 3, would be to give administrators a power to disclaim onerous contracts so as to prevent post-administration liabilities from arising if such liabilities would be included in the account for set-off purposes. Again, however, there are

[5] However, since these cases were decided, the FMLC notes that *Manning v AIG Europe UK Ltd* [2004] EWHC 1760 (Ch) has upheld the principle that there is no policy objection to a creditor agreeing that his contractual claim should be subordinated to the claims of other creditors. In theory, it may therefore be possible for a creditor to abandon any claim it may have in the insolvency so as effectively to deprive itself of the benefit of a right of set-off.

issues as to whether a power of disclaimer is appropriate in an administration context, particularly given its ability to create uncertainty for creditors.

4. Administration Expenses

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 Paragraph 99(3) and (4) of Schedule B1 to the 1986 Act are designed to achieve this result,[6] providing that the administrator's "remuneration and expenses" and "a sum payable in respect of a debt or liability arising out of a contract" entered into by the administrator 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).[7]

4.2 For the purpose of this section:

(a) The "set-off amount" shall mean the balance (due to the counterparty or the company, as the case may be) of all mutual dealings between the counterparty and the company until the Set-Off Date (i.e. mutual dealings pre- and post-administration);

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[6] There is currently an issue regarding the meaning of administration expenses, as identified by the *Trident*, *Goldacre* and *Nortel* / *Lehman* cases (among others). The FMLC would strongly encourage the Insolvency Service to clarify the meaning of administration expenses and resolve this significant legal uncertainty through legislative amendments.

[7] 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.

(b) The "pre-administration balance" shall mean the balance (due to the counterparty or the company, as the case may be) of all mutual dealings between the counterparty and the company pre-administration; and

(c) The "post-administration balance" shall mean the balance (due to the counterparty or to the company, as the case may be) of all mutual dealings between the counterparty and the company post-administration.

4.3 If, pursuant to the Cut-Off Date Amendment, mutual dealings taken into account in calculating the insolvency set-off were to include debts with respect to obligations incurred after the Administration Date, to what extent should the set-off amount due to the counterparty, if any, be paid as an administration expense?

4.4 To treat the set-off amount due to the counterparty as an expense up to the value of the counterparty's post administration gross indebtedness (the "post-administration debt expense option") would benefit the counterparty at the expense of unsecured creditors. The counterparty would be encouraged to trade with the company because it would enjoy the benefit of (1) insolvency set-off inclusive of post-administration debts and (2) the payment of the set-off amount as an expense up to the amount of that gross indebtedness.

4.5 The FMLC has identified two alternative approaches to the treatment of administration expenses under the Cut-Off Date Amendment for the Insolvency Service to consider. Each alternative is set out in further detail below and illustrated by numerical examples.

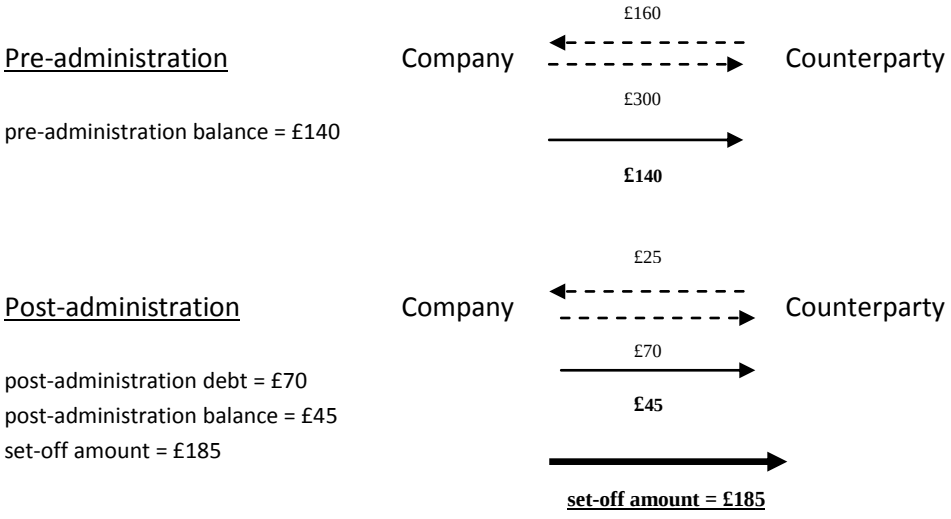
4.6 The first alternative is that only that part of the set-off amount equal to the post-administration balance should be paid as an expense. The counterparty would enjoy the benefit of insolvency set-off, but it would only be entitled to payment of the set-

off amount as an administration expense to the extent of the balance of all mutual dealings owed to the counterparty after the Administration Date (i.e. the post-administration balance), not to the extent of the counterparty's post-administration gross indebtedness (as would be the case pursuant to the post-administration debt expense option).

4.7 The second alternative is to apportion the set-off amount due to the counterparty *pro rata*, taking into account the relative sizes and compositions of the pre-administration balance and the post-administration balance. The basis for such an approach is *Unit 2 Windows Ltd, Re* [1985] 3 All ER 647, in which Walton J recognised that the mere taking of an account involving debts of differing priorities involved no appropriation and itself made no selection such that a rateable apportionment of the set-off amount was the only available solution.

4.8 As against the treatment of the set-off amount due as an expense up to the amount of the counterparty's post-administration indebtedness (i.e. the post-administration debt expense option referred to in paragraph 4.4 above), the first alternative may, *prima facie*, seem to be the better view. The counterparty has already had the benefit of insolvency set-off in relation to post-administration debts (as post-administration debts have been taken into account in the calculation of the set-off amount). To treat the set-off amount due to the counterparty as an expense up to the value of the counterparty's post-administration gross indebtedness would be to convert part of the unsecured debt due to the counterparty to an administration expense. The categories of administration expenses (r.2.67(1)) and other priority payments (see for example Schedule B1 99(3), (4) and (5) of the Act) are closed and each is supported by different underlying reasons which do not apply to pre-administration debts which would otherwise rank as unsecured claims.

4.9 The following example illustrates the above: if, in relation to pre-administration mutual dealings, the company were owed £160 by the counterparty to whom it owed £300 (a pre-administration balance due to the counterparty of £140) but, in relation to post-administration mutual dealings, the company were owed £25 by the same counterparty to whom it owed £70 (a post-administration balance due to the counterparty of £45), the counterparty would be entitled, pursuant to the post-administration debt expense option, to be paid £70 (i.e. full amount of the post-administration debt) as an expense of the administration which would clearly be detrimental to other creditors. By contrast, the counterparty would be entitled, pursuant to the first alternative, to be paid £45 of the set-off amount of £185 as an expense of the administration. The counterparty has, in effect, already been paid £25 (i.e. its post-administration gross indebtedness to the company) by way of set-off. To pay £70 as an expense of the administration (as per the post-administration debt option) would be, indirectly, to convert £25 of the pre-administration unsecured claim of £140 to an administration expense with any statutory underpinning to prioritise that debt.



4.10 However, although the first alternative seems to be the better view, the above illustrates that it is flawed insofar as it relies on notional separate accounts in relation to pre- and post- administration mutual dealings to assert that somehow some part of an otherwise unsecured claim is inappropriately converted to an administration expense. The proposed rule change however contemplates no such division, transplanting the existing Cut-Off Date to the Set-Off Date, with the consequence that the part of the set-off amount due to be paid as an expense cannot be identified except by rateable division. The second alternative is therefore the better approach. The suggested redraft of r.2.85 set out in Appendix 1 provides wording for this approach.

4.11 Applying the second alternative using the same figures as the above example, £35 of the balance due would be paid as an expense, being 50 per cent of £70. The 50 per cent proportion reflects 100 per cent less the proportion of the total pre- and post-administration debt owed to the company (£185, being £160 plus £25) as against the total pre- and post-administration debt owed to the counterparty (£370, being £300 plus £70). This proportion is then applied to the post-administration debt owed to the counterparty (i.e. £70).

Expressed as a mathematical formula, the part of the set-off amount which constitutes an Administration Expense under the second alternative is equal to:

[1 – (Counterparty Debt / Company Debt)] x Admin Company Debt

Or, expressed in percentages:

[100% - (100 x Counterparty Debt / Company Debt)%] x Admin Company Debt

Where:

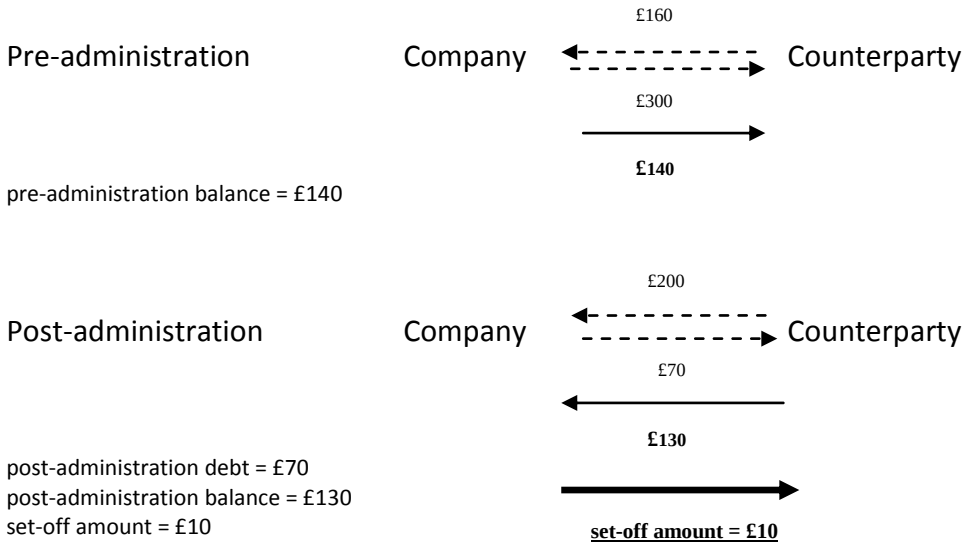
"Counterparty Debt" means the total pre- and post-administration debt owed by the counterparty to the Company;

"Company Debt" means the total pre- and post-administration debt owed by the Company to the counterparty; and

"Admin Company Debt" means the post-administration debt owed by the Company to the counterparty.

4.12 A related question is whether, in circumstances in which a notional separate account in relation to pre- and post-administration mutual dealings would result in a post-administration balance due to the company that is less than the pre-administration balance due to the counterparty, the set-off amount due to the counterparty is to be paid as an expense or merely to be treated as an unsecured claim.

4.13 The following numerical example illustrates this particular scenario: if, in relation to pre-administration mutual dealings, the company were owed £160 by the counterparty to whom it owed £300 (a pre-administration balance due to the counterparty of £140) but, in relation to post-administration mutual dealings, the company were owed £200 by the same counterparty to whom it owed £70 (a post-administration balance due to the company of £130), the set-off amount owed to the counterparty would be £10, i.e. £140 (the pre-administration balance due to the counterparty) less £130 (the post-administration balance due to the company)).



4.14 To treat the set-off amount due as something to be paid as an administration expense (i.e. applying the post-administration debt expense option) would, again, benefit the counterparty at the expense of unsecured creditors.

4.15 Applying the first alternative to this example, the set-off amount would be treated as an unsecured claim (as the post-administration balance is owed to the company rather than to the counterparty). Applying the second alternative would involve a *pro rata* identification of that part of the balance due to be paid as an expense.

4.16 Pursuant to the Cut-Off Date Amendment, the counterparty has the benefit of insolvency set-off in the amount of £360, leaving a set-off amount due to the counterparty of £10. If the entirety of the £10 set-off amount were to be treated as an administration expense, this would substantially eliminate the insolvency risk (1) which the counterparty had exposed itself to by its pre-administration dealings with the company and (2) in circumstances in which the counterparty had in fact increased its exposure in the post-administration period.

4.17 The forgoing analysis however, again, relies on notional separate accounts in relation to pre- and post-administration mutual dealings. But for the transplanting of the existing Cut-Off Date to the Set-Off Date, and using the above figures, the counterparty would be required to pay £200 to the company and would be paid £70 as an expense.

4.18 The Cut-Off Date Amendment should therefore recognise that the counterparty has a right to priority payment for the post-administration debt due from the company when calculating the set-off amount due. Applying the second alternative to the above example, the part of the set-off amount due to be paid as an expense would be:

[100% - (100 x Counterparty Debt / Company Debt)%] x Admin Company Debt

[100% - (100 x £360 / £370)%] x £70 = [100% - 97.30%] x £70 = £1.89

Where:

Counterparty Debt = £360 (total pre- and post-administration debt owed by the counterparty to the Company)

Company Debt = £370 (total pre- and post-administration debt owed by the Company to the counterparty; and

Admin Company Debt = £70 (post-administration debt owed by the Company to the counterparty

Therefore, £1.89 of the balance of £10 would be paid as an expense and £8.11 would rank as an unsecured claim, reflecting the fact that insolvency set-off reduced the debt owed by the Company by some 97 per cent.

5. Contractual / Equitable Set-Off

5.1 Under the current administration regime, there is uncertainty as to the types of set-off that might be available prior to the Notice Date (i.e. the date on which

administrators give notice, under r.2.95, of their intention to make a distribution to creditors (the "r.2.95 notice")). The FMLC previously wrote to the Insolvency Service to seek clarification on this point (the "Insolvency Service Letter").[8]

5.2 As set out in the Insolvency Service Letter, the current regime raises uncertainty as to what rights of set-off can be exercised, in an administration, between the Administration Date and the r.2.95 notice (the "Interim Period"). Broadly, the Working Group considers that, although the 1986 Rules do not deal with the Interim Period, counterparties can continue to exercise "non-statutory" set-off rights (such as contractual, equitable or independent set-off rights) during that period, even if the claims have arisen after the Administration Date (subject to the statutory moratorium that arises on administration).

5.3 However, the Working Group considers that it is less clear whether it is possible for a counterparty to exercise a contractual, equitable or independent right of set-off during the Interim Period that goes beyond the requirements for mutuality referred to in r.2.85 (some contractual rights of set-off are very broad and purports to allow, for example, cross-affiliate or third party claims set-off).

5.4 Pursuant to the Cut-Off Date Amendment (with the Cut-Off Date being pushed forward and merged with the Set-Off Date), mutual dealings between the company and its counterparties for the purpose of r.2.85 will include all debts/claims incurred up to and including the Notice Date. The new Rules would make it clear that, prior to the Notice Date (i.e. during the Interim Period), counterparties will also be able to exercise any "non-statutory" bilateral set-off rights (i.e. contractual, equitable or independent set-off rights) that might be available to them.

[8] Letter from the FMLC to Stephen Leinster, Director of Policy at the Insolvency Service, dated 9 November 2010 (Administration set-off: clarification of position prior to Rule 2.95 Notice).

5.5 The Insolvency Service should consider whether the new Rules provide that such "non-statutory" set-off rights should be limited to claims and cross-claims which satisfy the requirements for mutuality set out in r.2.85. In other words, there are two options in this regard:

(a) **Option 1**: "non-statutory" set-off rights are not limited to claims and cross-claims which satisfy the requirements for mutuality set out in r.2.85; or

(b) **Option 2**: "non-statutory" set-off rights are limited to claims and cross-claims which satisfy the requirements for mutuality set out in r.2.85.

5.6 Although Option 1 would promote contractual certainty between the parties, permitting extended rights of set-off going beyond the limits of mutuality, it may not be legally possible even without any restrictions in the new Rules. Equitable rights of set-off, for example, tend to be limited to mutual dealings in any event. Furthermore, a contractual right of set-off which purports to enable a counterparty to set off against a non-mutual amount owed by the company to another counterparty (albeit the counterparties being affiliated) may (depending on the drafting) be characterised as a floating charge, which will be void if not registered (*Re Tudor Glass Holdings Limited* [1984] 1 BCC 98,982). Even if the charge has been registered, it is likely to be treated as security, the enforcement of which is subject to the administration moratorium. However, there are ways in which the contractual provision might be drafted so that it was not characterised as a floating charge. Hence, one option might be to adopt Option 1 but only to allow the set-off if it is effective as a matter of contract (or on the basis of another non-insolvency set-off right.)

5.7 On the other hand, it may be considered that an extended right of set-off under Option 1 is inconsistent with the fundamental *pari passu* rule in section 107 of the

Insolvency Act 1986 in which case Option 2 might be the preferred route.[9] The counter-argument is that the *pari passu* rule only comes into play once the r.2.95 notice is given (i.e. once the administration becomes a distributing one) and so there is no reason to restrict the operation of contractual, equitable and independent set-offs prior to this point. The suggested redraft of r.2.85 set out in Appendix 1 provides wording for each option.

6. Conclusion

6.1 The FMLC suggests that the Cut-Off Date Amendment, as described in Section 2 and illustrated by the suggested amendments to the 1986 Rules set out in Appendix 1, be considered by the Insolvency Service as an option to improve legal certainty in the application of set-off in the context of administration.

6.2 Many of the uncertainties identified by the FMLC in the 108 Paper regarding the operation of the administration set-off rule arise from the lapse of time between the Cut-Off Date and the Set-Off Date. In this context, practical uncertainty is created for creditors because, if an administrator triggers the Set-Off Date by issuing a r.2.95 notice, any claims that were incurred or acquired after the 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. As there are often circumstances in practice where it is not clear from the outset of an administration whether a distribution to creditors might ultimately be made, even if an administrator states in his proposals that he is seeking to rescue the company or to sell the business as a

[9] It is also worth noting, by way of comparison, that under the US Bankruptcy Code, debts need to be mutual (i.e. owed by the same parties in the same capacities) in order to be eligible for set-off under Section 553 of the Code.

going concern, the circumstances might subsequently change and the administration may become a liquidating one.

6.3 Although it is not within the FMLC's remit to comment on matters of policy, it is noted that 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, may discourage counterparties from dealing with a company in administration, thus harming attempts to rescue the company and undermining the amendments for this purpose in the 2003 changes to the 1986 Rules.

6.4 The Cut-Off Date Amendment is one of the several options identified by the FMLC to solve this legal and practical uncertainty. The FMLC considers that this option is one that the Insolvency Service could efficiently and effectively implement as part of its review of the administration regime following the administration of LBIE. However, the solution adopted should be capable of operating satisfactorily in a wide range of situations and not just in the insolvency of an investment bank.

Appendix 1

PROPOSED CHANGES TO THE INSOLVENCY RULES 1986

1.1 In order to implement the Cut-Off Date Amendment set out in the body of the Addendum, r.2.85 would need to be amended and consequential changes would need to be made to r.4.90(2) and Regulation 12(2) of the Financial Collateral Arrangements (No 2) Regulations 2003.

1.2 Suggested drafting for r.2.85 and r.4.90 is set out below. An explanatory note to the suggested changes below is set out in Appendix 2.

2.85 Mutual credit and set-off

2.85(1) **[Application of r.2.85]** This Rule applies 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.

2.85(2) **["Mutual dealings"]** 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 but does not include any of the following-

(a) any debt arising out of an obligation incurred after the date of the notice referred to in paragraph (1) above;

(b) [any debt arising out of an obligation where-

(i) the administration was immediately preceded by a winding up; and

(ii) at the time the obligation was incurred the creditor had notice that a meeting of creditors had been summoned under section 98 or a petition for the winding up of the company was pending;]

(c) any debt arising out of an obligation incurred during a winding up which immediately preceded the administration; or

(d) any debt which has been acquired by a creditor by assignment or otherwise, pursuant to an agreement between the creditor and any other party where that agreement was entered into-

(i) after the company entered administration;

(ii) at a time when the creditor had notice that an application for an administration order was pending;

(iii) at a time when the creditor had notice that any person had given notice of intention to appoint an administrator;

(iv) where the administration was immediately preceded by a winding up, at a time when the creditor had notice that a meeting of creditors had been summoned under section 98 or that a winding up petition was pending; or

(v) during a winding up which immediately preceded the administration.

2.85(3) [Account of mutual dealings and set-off] 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.

2.85(4) **[Sums regarded as due]** A sum shall be regarded as being due to or from the company for the purpose of paragraph (3) 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.

2.85(5) **[Application of r.2.81]** Rule 2.81 shall apply for the purposes of this Rule to any obligation to or from the company which, by reason of its being subject to any contingency or for any other reason, does not bear a certain value.

2.85(6) **[Application of rr.2.86-2.88]** Rules 2.86 to 2.88 shall apply for the purposes of this Rule in relation to any sums due to the company which-

(a) are payable in a currency other than sterling;

(b) are of a periodical nature; or

(c) bear interest.

2.85(7) **[Application of r.2.105]** Rule 2.105 shall apply for the purposes of this Rule to any sum due to or from the company which is payable in the future.

2.85(8) **[Only balance provable]** Only the balance (if any) of the account owed to the creditor under paragraph (3) above is provable in the administration. Alternatively the balance (if any) owed to the company shall be paid to the administrator as part of the assets except where all or part of the balance results from a contingent or prospective debt owed by the creditor and in such a case the balance (or that part of it which results from the contingent or prospective debt) shall be paid if and when that debt becomes due and payable and, for this purpose, without applying Rule 2.105 to that part of the debt which is not discharged by set-off under paragraph (3) above.

2.85(9) **[Rateable application]** Where the sums due from the company to the creditor include preferential debts, debts eligible for payment as administration expenses and/or any other unsecured debt or liability, then any sum due from the creditor to the company (which is less in amount than the total of such debts and liabilities) shall be set off rateably against such debts and liabilities for the purpose of the account to be taken under paragraph (3) above. [***NB: This wording assumes that the second alternative referred to in paragraph 4.7 of this Addendum is adopted.***]

2.85(10) **["Obligation", "distribution" and "administration expense"]** In this Rule "**obligation**" means an obligation however arising, whether by virtue of an agreement, rule of law or otherwise; "**distribution**" means a distribution to one or more unsecured (including preferential) creditors; and "**administration expenses**" means a debt or liability charged on and

payable out of property of which the administration has custody or control pursuant to Paragraph 99 (4) and (5) of Schedule B1 of the Act.

2.85(11) **[Pre-existing set-off rights]** This Rule 2.85 is without prejudice to the right of a creditor of the company to exercise, at any time after the company entered into administration but before the date of the notice referred to in paragraph (1) above and to the extent otherwise permitted by law, any right of set-off [arising out of arrangements existing at the date when the company entered into administration] (whether by virtue of contract, equity or otherwise) in or towards the discharge of all or such part as the creditor may select of the sums due or becoming due to the creditor by the company [but only in respect of mutual dealings between the company and the creditor at any time before the date of such notice]. [***NB: Wording in square brackets to be included if Option 2 in paragraph 5.5 above is preferred***]

4.90 Mutual credits and set-off

4.90(1) **[Application of Rule]** 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.

4.90(2) **[Excluded debts]** The reference in paragraph (1) to mutual credits, mutual debts or other mutual dealings does not include-

(a) any debt arising out of an obligation incurred at a time when the creditor had notice 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;

(b) any debt arising out of an obligation where-

(i) the liquidation was immediately preceded by an administration; and

(ii) at the time the obligation was incurred, the administrator had given notice (pursuant to Rule 2.95) that he proposed to make a distribution to creditors;

(c) any debt which has been acquired by a creditor by assignment or otherwise, pursuant to an agreement between the creditor and any other party where that agreement was entered into-

(i) after the company went into liquidation;

(ii) at a time when the creditor had notice that a meeting of creditors had been summoned under section 98;

(iii) at a time when the creditor had notice that a winding up petition was pending; or

(iv) where the liquidation was immediately preceded by an administration, after the administrator had given notice (pursuant to Rule 2.95) that he proposed to make a distribution to creditors.

4.90(3) **[Account of mutual dealings and set-off]** 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.

4.90(4) **[Sums regarded as being due]** A sum shall be regarded as being due to or from the company for the purposes of paragraph (3) 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.

4.90(5) **[Application of r.4.86]** Rule 4.86 shall also apply for the purposes of this Rule to any obligation to or from the company which, by reason of its being subject to any contingency or for any other reason, does not bear a certain value.

4.90(6) **[Application of rr.4.91-4.93]** Rules 4.91 to 4.93 shall apply for the purposes of this Rule in relation to any sums due to the company which-

(a) are payable in a currency other than sterling;

(b) are of a periodical nature; or

(c) bear interest.

4.90(7) **[Application of r.11.13]** Rule 11.13 shall apply for the purposes of this Rule to any sum due to or from the company which is payable in the future.

4.90(8) **[Only balance provable]** Only the balance (if any) of the account owed to the creditor is provable in the liquidation. Alternatively the balance (if any) owed to the company shall be paid to the liquidator as part of the assets except where all or part of the balance results from a contingent or prospective debt owed by the creditor and in such a case the balance (or that part of it which results from the contingent or prospective debt) shall be paid if and when that debt becomes due and payable and, for this purpose, without applying Rule 11.13 to that part of the debt which is not discharged by set-off under paragraph (3) above.

4.90(9) **[Rateable application]** Where the sums due from the company to the creditor include preferential debts and/or any other unsecured debt or liability, then any sum due from the creditor to the company (which is less in amount than the total of such debts and liabilities) shall be set off rateably against such debts and liabilities for the purpose of the account to be taken under paragraph (3) above.

4.90(10) **["Obligation"]** In this Rule "**obligation**" means an obligation however arising, whether by virtue of any agreement, rule or law or otherwise.

Appendix 2

EXPLANATORY NOTE ON PROPOSED CHANGES TO RULES 2.85 AND 4.90 OF THE INSOLVENCY RULES 1986

Implementing the Cut-Off Date Amendment

1.1 In order to implement the Cut-Off Date Amendment as set out in Appendix 1, r.2.85 could be changed by amending sub-paragraph (a) of r.2.85(2) and deleting existing sub-paragraph (b), so that a debt arising out of an obligation incurred after the commencement of administration but before the administrator gives notice (pursuant to r.2.95) that he proposes to make a distribution to creditors (a "r.2.95 notice") be treated as a "mutual dealing" and eligible for set-off under r.2.85(3).

1.2 It is questionable whether existing sub-paragraph (e) of r.2.85(2) serves a useful purpose. However, it has not been removed from the draft text as the Rule may be intended to ensure symmetry with r.4.90(2)(b) and it is unlikely that there are cases where an administration has been preceded by a winding up.

1.3 Existing sub-paragraph (d) has been retained as suggested in paragraph 2.4 of the 108 Paper, in order to avoid trafficking in claims post-administration.

1.4 In order to ensure consistency with these changes, consequential amendments have been made to r.4.90(2). In particular, where a liquidation is preceded by an administration, the cut-off for debts to be eligible for set-off would be the date when a r.2.95 notice should be given by the administrator and not the commencement of the administration (or events preceding it).

Pre-existing contractual and other rights of set-off

1.5 Pursuant to the Cut-Off Date Amendment, where a creditor has a right of set-off under arrangements existing at the commencement of administration, it should be entitled to exercise that right up to the point when a r.2.95 notice is served. New rule 2.85(11) has been added for this purpose. It would cover contractual, equitable and independent set-off.

1.6 It had originally been contemplated that it would be sufficient simply to recast r.2.85(2)(a) and (b), so that debts arising out of "mutual dealings" after the company entered into administration and before the administrator gave a r.2.95 notice, could be taken into account for set-off under r.2.85(3) if and when set-off under r.2.85(3) came into operation. However, this approach would still have two drawbacks: -

(a) There would be serious uncertainty for a significant period whether or not set-off under r.2.85 would be brought into play, since this would depend on whether the administrator decided to serve a r.2.95 notice for a proposed distribution to creditors.

(b) Even though a debt arising out of a contract entered into by the administrator would rank as an administration expense, the creditor might be concerned that full payment would not be possible if there were insufficient assets available to the administrator out of which to pay his remuneration and administration expenses. There might also be doubt whether a post-administration debt was an administration expense where, for instance, it arose out of the continued performance of an existing contract or arose out of a non-contractual obligation.

1.7 These uncertainties could discourage a creditor from dealing with a company after it had entered into administration as explained in the FMLC's letter to the Insolvency Service, dated 18 August 2009. The above concerns would be substantially reduced if a creditor could continue to rely on a pre-existing right of set-off in relation to debts arising out of obligations incurred before the administrator gave a r.2.95 notice.

1.8 The question arises whether a pre-existing right of set-off permitted by proposed r.2.85(11) should be exercisable only in relation to amounts arising out of "mutual dealings" (within the meaning of r.2.85(2)) or whether it could be exercised more widely to include, for instance, debts acquired by the creditor from another creditor after the administration commenced but before a r.2.95 notice was given. This involves a policy decision for The Insolvency Service. For the present, a reference to mutual dealings has provisionally been included in square brackets.

Administration expenses and preferential debts

1.9 When an account is taken for the purposes of r.2.85(3), debts due from the company to the creditor which are eligible for payment as administration expenses should be set off rateably in the same way as preferential debts. It was held by Walton J in *Re Unit 2 Windows Limited*[10] that, where a creditor had both preferential and non-preferential claims, any sum owed by the creditor to the company should be set off rateably against the preferential and non-preferential claims. Set-off in that case arose in a liquidation and was governed by section 31 of the Bankruptcy Act 1914 and section 612 of the Companies Act 1985 (now replaced by r.4.90). In the FMLC's view, the principles applied in that case are also relevant when applying statutory set-off in an administration under r.2.85. Like section 31, r.2.85 gives no right, either to the

[10] [1985] 1 W.L.R. 1383.

creditor or the company, to appropriate the amount to be set-off against any particular debt or debts. Rule 2.85 is not intended to confer any particular benefit on either debtor or creditor but to achieve substantial justice between them. It involves an accounting exercise.

1.10 It is logical to extend the rateable application rule to administration expenses (in addition to preferential debts) if the other changes proposed in this Addendum are accepted. Rule 2.85(9) has been added for this purpose. A similar provision (but not covering administration expenses) has been added as r.4.90(9).

Pre-existing contractual set-off and administration expenses

1.11 The question arises whether the same rateable application rule should apply where the creditor exercises a pre-existing contractual right of set-off before a r.2.95 notice is served. A creditor should have the choice of (i) exercising a pre-existing right of set-off to discharge pre and/or post-administration debts arising out of obligations incurred before a notice is served under r.2.95, or (ii) seeking to recover a post-administration debt as an administration expense (where it is eligible as such) payable out of unencumbered and floating charge assets in the administrator's custody or control, or (iii) a combination of both. It would be left to the creditor to decide whether to exercise his right of set-off and, if so, against which debts, unless and until mandatory set-off came into operation under r.2.85(3).

1.12 This might well lead to a creditor exercising his right of set-off first against pre-administration debts, so that any post-administration debts not discharged by set-off could be recovered as an administration expense. This might enable a creditor to increase his recoveries where administration expenses were paid in full but unsecured claims were paid only in part. However, if a contractual right of set-off is to become

exercisable up to the point when a r.2.95 notice is given, it is unlikely that there is a reason in principle why the creditor should not be able to exercise that right to the extent permitted by its terms. This would not be inconsistent with the objectives of administration (as stated in paragraph 3(1), Schedule B1 of the 1986 Act), the primary objective being to rescue the company as a going concern. If a rescue is achievable, it is unlikely that the administrator will need to make a distribution to creditors under r.2.95. Up to the point when an administrator concludes that a rescue is not achievable, creditors should continue to be able to rely on their usual rights of set-off.

1.13 If a creditor did not exercise his pre-existing right of set-off before the administrator gave a r.2.95 notice, set-off under r.2.85 would then automatically operate instead and have mandatory, self-executing effect. This would supersede and override any pre-existing right of set-off. To the extent that a post-administration debt incurred by the company (acting by the administrator) was not discharged by set-off, the balance would be recoverable as an administration expense where it was eligible to be so treated (subject, where applicable, to the rateable application rule under new r.2.85(9).

Extent of non-insolvency set-off

1.14 There is a question whether r.2.85(11) should be limited to rights of set-off arising under arrangements existing at the time when the company entered into administration or whether it should extend to rights of set-off arising under arrangements coming into existence after that time but before the giving of a r.2.95 notice. If new r.2.85(11) is limited to pre-existing rights of set-off, this would be consistent with preserving the status quo as it exists at the commencement of administration. A creditor could still seek to recover a post-administration debt arising out of a contract entered into by the administrator as an administration expense.

1.15 If proposed r.2.85(11) were extended to rights of set-off under arrangements coming into existence after commencement of the administration, this would involve a policy decision for The Insolvency Service. This could lead to creditors without pre-existing rights of set-off insisting that they were given such rights if they were to continue trading with the company after it had entered into administration. While it might be argued that creditors should be able to protect themselves in this way, the question then arises whether this new right of set-off should be exercisable only in relation to post-administration debts or both pre and post-administration debts. The latter approach could alter the status quo as it existed at the time when the company entered into administration. For present purposes, the proposed drafting for r.2.85 (11) is on the basis that the Rule is limited to pre-existing rights of set-off.

Meaning of "distribution"

1.16 A definition of "distribution" has been added to r.2.85(10) as suggested in paragraph 7.6 (a) of the 108 Paper, in order to clarify that the expression "distribution" in r.2.85 means a distribution to unsecured (including preferential) creditors.

Extent to which future debts should be discounted

1.17 R.2.85(8) has been amended to clarify the extent to which the discounting rule under r.2.105 should apply to a future debt. A similar change to r.4.90(8) is proposed.

1.18 The approach suggested by the City of London Law Society in its letter to The Insolvency Service of 11 April 2005 and its reply of 18 April 2005 has been adopted. This is consistent with the approach subsequently taken by the Court of Appeal in *Kaupthing Singer and Friedlander Limited* [2010] EWCA Civ 518. Although this is clearly a helpful decision, it is based on giving the existing wording of r.2.85 a purposive of interpretation. It seems to us sensible to put matters wholly beyond doubt by adding

the suggested wording to the end of r.2.85(8) to confirm that the above interpretation is the one intended by the legislation.

1.19 It may be helpful if an example is provided to illustrate how the amended version of r.2.85(8) is intended to operate. An insolvent company (I) owes a debt which has matured to a solvent counterparty (C), while C owes a future debt to I. The face value of the debt owed by I is less than discounted value of the debt owed by C. The debt owed by I is extinguished in full and there is partial discharge of the debt owed by C. Mathematically the intended outcome is to calculate the percentage of the discounted amount which is not discharged by set-off and leave C liable to pay, on the original (future) due date, the same percentage of the gross undiscounted amount subsisting before set-off. Otherwise, in the scenario contemplated in the existing wording of the second sentence of r.2.85(8), the creditor would receive a double benefit: the future debt would be reduced to its net present value but the balance (after set-off) would not be payable until its maturity date.

Drafting approach

1.20 A "light touch" in amending r.2.85 and r.4.90 has been adopted, keeping the changes succinct and using language which is consistent with other language used in the Rule.

Financial Collateral Arrangements (No 2) Regulations 2003

1.21 If the suggested amendments to r.2.85(2) and r.4.90(2) are accepted, similar consequential changes will need to be made to the cut-off times specified in Regulation 12(2) of the Financial Collateral Arrangements (No 2) Regulations 2003[11] in order to ensure consistency.

[11] The Regulations are to be amended to implement Directive 2009/44/EC (the deadline for implementation being 30 December 2010).

Appendix 3

ALTERNATIVE PROPOSAL: GIVING ADMINISTRATORS A GREATER DEGREE OF DISCRETION AS TO WHEN STATUTORY SET-OFF SHOULD APPLY (SEE SECTION 3)

1.1 Although the linking of the application of cut-off under r.2.85 to the Notice Date, as contemplated by the Cut-Off Date Amendment, would clarify the current legal position, a rigid link between the Cut-Off Date and the giving of a r.2.95 Notice may hinder the administrator's efforts to maximise recoveries for creditors. An alternative approach to address this would be to give administrators a greater degree of flexibility when deciding when the Cut-Off Date should be.

1.2 Under the Cut-Off Date Amendment, cut off would occur on the Notice Date (or other date applicable under r.2.85(2)), meaning that creditors would be able to continue to exercise any available contractual or legal rights of set-off until that time. There are two consequences arising from this, which could destroy value in the company for the remaining creditors.

1.3 The first is where the administrator has decided that the process is effectively one of liquidation and seeks to trigger mandatory set-off provisions in order to ensure that the expected return for the company's creditors is at least equivalent to that which would have applied in a liquidation. An administrator may be unable to do this, however, if either (i) he is still some way from being in a position to make a distribution,[12] or (ii) it is envisaged that any distribution would be made using an alternative distribution mechanism, such as a scheme of arrangement.

1.4 Should such circumstances arise, the administrators may (depending on the

[12] It should be noted, however, that this did not prevent the administrators of LBIE from giving a r.2.95 notice.

interpretation of the relevant rules) have to wait until they are ready to make a distribution before seeking leave to give a r.2.95 notice, thereby bringing into effect the set-off provisions of r.2.85. Until such time (or, if earlier, the date on which the company enters liquidation), it would be open to the company's creditors to improve their position, to the detriment of the general body of creditors, through the exercise of any more extensive contractual rights of set-off that they may have.

1.5 A second consequence of linking the Cut-Off Date to the Notice Date might be to deter administrators from enforcing claims against debtors who have acquired debts since the commencement of the administration (or who may do so before a judgment has been obtained against them), as doing so could disadvantage the general creditor body.

1.6 To take a theoretical example, if a debtor owes £10m to the company, but has acquired £3m of claims against that company since the Administration Date, that debtor would (assuming no contractual rights of set-off) not be able, in the absence of any action by the company in administration, to set-off those amounts. If, however, the administrators brought proceedings in order to enforce the £10m claim, the debtor would be able to use the £3m debt acquired after commencement of the administration as a partial defence or counter-claim to the administrator's claim. Judgment would therefore be given for the company in administration in the amount of £7m, with the £10m claim and the £3m debt being merged in that judgment. The consequence would be that, by bringing the action to enforce the debt at an early stage in the process (rather than waiting until the insolvency set-off rules come into effect), the company would end up effectively repaying, or providing full value for, the £3m of acquired debt, rather than merely paying the creditor a distribution on that amount.

Giving Administrators a greater degree of discretion

1.7 There are a number of possible ways in which administrators could be granted greater discretion in this context:

(a) Linking the Cut-Off Date to the date on which the administrators notify the company's creditors that they are satisfied that there is no longer any prospect of saving the company as a going concern, and that a distribution will therefore, at a future date, be made to the company's creditors either by the administrators or any subsequent liquidators. This would allow the administrators to replicate the position in a liquidation directly if they conclude that the administration would effectively involve the liquidation of the company's business, thereby bringing into effect the set-off provisions of r.2.85;

(b) Allowing the administrators to decide what the Cut-Off Date should be. It could be argued that this remedy is already available to administrators under the existing legislation as the administrators may decide to give notice, under r.2.95, in order to bring into play the provisions of r.2.85 even though no distribution to creditors is imminent. The power to do this could be confirmed, however, by giving administrators discretion to choose a date, after the Administration Date and prior to the Notice Date, as the date after which mutual dealings will not be included for the purposes of statutory set-off. The main disadvantage with this approach is the risk of arbitrariness, and the fact that a Cut-Off Date could be selected at a time when saving the company as a going concern was still a viable option (thereby reducing the prospects of the company's survival). Should this approach be adopted, completely de-linking the Cut-Off Date from the distribution of the company's assets to its creditors, administrators might be put under pressure in cases where the company's

survival was doubtful to identify a Cut-Off Date very soon after their appointment, in order to minimise the risk of any loss to the estate, thereby effectively pushing the Cut-Off Date back to the Administration Date;

(c) Allowing administrators to decide whether or not the exercise of a particular right of set-off was consistent with their statutory objective. Creditors, it could be argued, would be protected from administrators exercising this discretion unreasonably as any creditor who considered that an administrator's decision in relation to a specific set-off was unfair or unreasonable could apply to the court for relief under Paragraph 74(1) of Schedule B1 to the Act. However, while recourse would be available in this way, some creditors may not regard the existence of such a right as being of sufficient comfort to balance a perceived unsatisfactory exercise of discretion by an administrator;

(d) Giving administrators a power to disclaim onerous contracts so as to prevent post-administration liabilities from arising if such liabilities would be included in the account for set-off purposes. This option is explored further under the sub-heading below. This paper does not consider whether such a power is appropriate in an administration context.

A power to disclaim onerous contracts

1.8 Granting administrators a power to disclaim onerous contracts may not in itself significantly alter the administrator's powers or, in most cases, result in any increase in the insolvent company's estate as long as creditors were still able either to exercise contractual rights of set-off and/or utilise the existence of a debt owed by the company in administration as a defence or counterclaim to any debt recovery action by the administrator. If such rights continued to be enforceable, set-offs would still

take place whether or not they had been approved by the administrator.

1.9 In order to make such a discretion effective, it would therefore be necessary to remove the availability of a contractual or debt-related defence or a right to counterclaim where based on a debt acquired after the commencement of the company's administration, and give the administrator an absolute discretion as to whether or not two claims could be set-off against each other. It is likely that the creation of an absolute discretion of this nature would result in increased litigation and lead to greater uncertainty as to whether a right of set-off would be available.

1.10 In addition to creating increased litigation risk, permitting the administrator effectively to opt out of any contractual provision allowing the exercise of set-off and/or denying a creditor the right to counterclaim without offering equivalent statutory protection could lead to inequitable results. This would be unfortunate in the context of a provision grounded, as noted by Lord Cross in dissent in *Halesowen*,[13] in the desire to prevent injustice.

1.11 Giving administrators discretion as to whether set-off should be permitted may therefore be likely to result in both (i) greater uncertainty as to the contracting parties' position in an administration and (ii) increased litigation, which would ultimately be funded (at least in part) out of the administration estate.

[13] [1972] A.C. 785, 813.