

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

CHAIRMAN:
THE RT.HON. LORD HOFFMANN

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Stephen Leinster
Director of Policy
The Insolvency Service
21 Bloomsbury Street
London W1B 3QV

Dear Stephen

Administration set-off: clarification of position prior to Rule 2.95 notice

Further to the ongoing discussions between yourself and the FMLC regarding administration set-off, we are writing to ask for the Insolvency Service's views as to the types of set-off that might be available prior to an administrator giving notice, under Rule 2.95 of the Insolvency Rules 1986 (the "Rules"), of his or her intention to make a distribution to creditors (the "Rule 2.95 notice").

As you will be aware, in a liquidation, mandatory insolvency set-off (under Rule 4.90) comes into play as soon as the company goes into liquidation and the account is taken on that date. There is therefore very little difference in timing between the "cut-off date" (i.e. the date after which claims incurred or acquired by the solvent counterparty, or incurred by the insolvent counterparty, can no longer be included in the account for set-off purposes)¹ 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 any 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).

The position is very different in an administration.² Mandatory insolvency set-off under Rule 2.85 only comes into play if and when an administrator gives a Rule 2.95 notice. Alternatively, mandatory insolvency set-off under Rule 4.90 may come into play if the company subsequently goes into liquidation. In each case, the cut-off date is back-dated to the date of administration but the set-off date (on which the account is taken for set-off purposes) will be the date on which the relevant rule comes into play (i.e. the date of the Rule 2.95 notice or the subsequent liquidation).

This raises the question as to what rights of set-off can be exercised, in an administration, between the company going into administration and the relevant mandatory insolvency set-off rule coming into play (referred to in this letter as the "interim period"). The interim period could be substantial. In the administration of Lehman Brothers International (Europe) ("LBIE"), there were some 15 months between LBIE going into administration and the administrators giving a Rule 2.95 notice. It is clearly in the interests of the financial markets that there is certainty regarding the operation of set-off in the interim period.

¹ In the case of a liquidation that has not been preceded by an administration, this will be the date of notice of a winding up petition or meeting of creditors under section 98 of the Insolvency Act 1986.

² This is for good reasons – as set out in the FMLC 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* dated November 2007.

Although the Rules do not deal with this interim period, the FMLC working group focusing on Administration (the “**108 Working Group**”) considers that, subject to the statutory moratorium that arises on administration, creditors can continue to exercise “non-insolvency” set-off rights (such as contractual, equitable or independent set-off rights) during the interim period, *even if the claims have arisen post administration*.

What creditors cannot do, however, is build up claims for the purposes of exercising a right of set-off under Rule 2.85 in the future (for example, if no other right of set-off is available). The impact of the statutory moratorium on set-off rights in the interim period will depend on the nature of the set-off rights being exercised. The moratorium should not prevent the exercise of a self-help remedy (such as a contractual right of set-off, an equitable set-off right or a right to combine accounts (see by analogy *Electro Magnetic(s) Ltd v Development Bank of Singapore Ltd* [1994] 1 SLR 734). If, on the other hand, the set-off right can only be exercised through legal proceedings (as is generally the case with independent set-off), the consent of the administrator or the leave of the court may be required, pursuant to paragraph 43(6) of Schedule B1 to the Insolvency Act 1986, to commence or continue any proceedings in order to allow the company in administration to raise an independent set-off or possibly even for a creditor to raise the set-off by way of a defence in any proceedings brought by the company in administration.

What is slightly less clear, however, is whether it is possible for a creditor to exercise a contractual right of set-off during the interim period that goes beyond the requirements for mutuality referred to in Rule 2.85.

As you may be aware, some contractual rights of set-off are, on their terms, very broad and purport to allow a creditor to set off cross-affiliate claims (for example) or claims that may have been acquired from a third party since the date of administration. While the effect of Rule 2.85 is that a creditor will not be able to exercise such a wide contractual set-off right *following* the giving of the Rule 2.95 notice (as the insolvency set-off rule will override any contractual provisions which are inconsistent with the requirements for mutuality in Rule 2.85), there is nothing in the express terms of Rule 2.85 (or elsewhere in the insolvency legislation) which would appear to prevent this (as the account of “mutual dealings” is only taken as at the date of the Rule 2.95 notice) prior to this date, i.e. in the interim period.

Given the shades of legal uncertainty that may exist in this area, the FMLC would be grateful for your confirmation (on behalf of the Insolvency Service), that “non-insolvency” set-off rights are available to a creditor in the interim period, even if the claims have arisen post-administration. The FMLC would also be grateful for clarification as to whether such “non-insolvency” set-off rights would be limited to claims and cross-claims which satisfy the requirements for mutuality set out in Rule 2.85 and, if so, the legal basis for any such limitation.

Ultimately, unless any litigation which might be commenced in the context of the LBIE administration were to put the matter entirely beyond doubt, it might be worth clarifying the position through revisions to Rule 2.85.

Please do not hesitate to contact the FMLC Acting Secretary (Anne-Laure Condat) at fmlc.actingsecretary@bankofengland.co.uk or 020 7601 5950 if you would like to discuss this issue further.

Yours sincerely



Joanna Perkins³
FMLC Director

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The FMLC would like to thank Jennifer Marshall (Partner at Allen & Overy LLP) for her help in drafting this letter, which is being sent on behalf of the FMLC.