14 March 2014

FINANCIAL MARKETS LAW COMMITTEE

Dean Beale
The Insolvency Service
Fourth Floor
4 Abbey Orchard Street
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Dear Mr Beale

Issue 108: Administration set-off and expenses

The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") 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.

In September 2013 the Insolvency Service invited the FMLC to respond to its consultation on The Modernisation of Rules Relating to Insolvency Law (the "Consultation"); in particular, in light of concerns previously raised by the FMLC regarding the exercise by counterparties of rights of set-off against companies in administration. These concerns were the subject of papers published in 2007 (the "Issue 108 paper") and 2011 (the "Addendum") and letters addressed to the Insolvency Service dated 18 August 2009, 9 November 2010 and 6 January 2012 ("first letter", "second letter", and "third letter", respectively), all of which are relevant to the Consultation.[1]

This letter restates briefly three issues raised by the FMLC in the course of its correspondence with the Insolvency Service and considers the extent to which they have been addressed by proposals in the Consultation and/or by draft Insolvency Rules annexed to it. These issues concern the application of Rules 2.81, 2.85, 2.95 and 2.105 of the Insolvency Rules 1986 (the "Rules"). They comprise:

1. The effect of the hiatus (the "interim period") between the "cut-off date" (i.e. the date by which claims against the company must be incurred if they are to be the subject of set-off) and the "set-off date" (i.e. the date on which the administrator gives notice to creditors under Rule 2.95 that he proposes to make a distribution to them and thereby brings into play mandatory administration set-off). During this interim period, solvent counterparties who wish to trade with the company in administration may be deterred from doing so by uncertainties arising from the law on administration expenses and/or by a concern that the administration may itself prove to be insolvent and unable to meet its expenses. The FMLC termed this the "shortfall issue".

2. The lack of clarity, which preceded the Court of Appeal's decision in *Re Kaupthing Singer & Friedlander Ltd (in administration) [2010] EWCA 518*, about how future debts are to be discounted and valued for the purposes of set-off.

3. The question of what rights of "non-insolvency" set-off (contractual, equitable or independent set-off) can be exercised by counterparties in the interim period and the degree to which such rights are constrained by the requirements for mutuality referred to in the Rules.

The Cut-Off Date Amendment

Following publication of the Issue 108 paper, the FMLC was approached by the Insolvency Service to carry out further work on one of the options for law reform (the "cut-off date amendment") which the FMLC had suggested could mitigate the harsher effects of the shortfall issue. The cut-off date amendment was intended to align the cut-off date with the set-off date so that counterparties could exercise contractual and other rights of set-off in respect of debts incurred by the company before or during administration. The FMLC proposed

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detailed amendments to Rule 2.85 to achieve this reform, which it published in the Addendum.

Rule 14.24 of the draft Insolvency Rules 2015 in Annex 1 of the Consultation ("draft Insolvency Rules") which restates Rule 2.85 does not implement these proposed amendments but rather maintains the *status quo.* This means that the shortfall issue remains.

The FMLC believes that it is clearly in the interests of counterparties and the financial markets that this issue is addressed. The considerable uncertainty that followed the appointment of administrators in the insolvency of Lehman Brothers International (Europe) ("LBIE") owing to the duration of the interim period (15 months) materially affected counterparties that dealt with LBIE after its collapse.

Contingent/Future debt

The FMLC is pleased to note that the Court of Appeal's decision in *Kaupthing* has been incorporated in the draft rules. As you know, the question whether the discounting formula in Rule 2.105 of the Rules should be applied to the balance of a future debt after insolvency set-off claims has been exercised had been the subject of considerable uncertainty. In *Kaupthing*, the Court of Appeal held that the balance of a future debt owed to the insolvent company, which for the purposes of making a distribution to creditors has been the subject of set-off, shall be payable at its full value and not at the discounted value when the payment falls due.

Rule 14.24(5) of the draft Insolvency Rules now codifies the decision in *Kaupthing* and this is a welcome development. Nonetheless, it would assist practitioners who have to interpret and apply this rule if the purpose of the new wording could be made clearer so that there is no doubt as to how Rule 14.45 (discounting formula) interacts with Rule 14.24(5). It is, therefore, suggested that Rule 14.24(5) be amended thus:

> 14.24(5). However if all or part of the balance owed to the company results from a contingent or prospective debt owed by the creditor then the balance (or that part of it which results from the contingent or prospective debt) must be paid in full (without ~~reduction under rule 14.45~~ **applying Rule 14.45 to that part of the debt which is not discharged by set-off**) if and when the debt becomes due and payable.

If the above suggestion is adopted, it should similarly be applied to Rule 14.25(5) of the draft Insolvency Rules cross-referring to Rule 14.46.

"Non-insolvency" set-off rights

The need for clarity as to whether it is possible for creditors to exercise a contractual right of set-off during the interim period, even where these rights go beyond the requirements for strict mutuality in Rule 2.85, was raised in the FMLC's second letter. The administration of LBIE has highlighted uncertainty as to whether or not the mutuality requirement in Rule 2.85 operates so as to prevent creditors from exercising in the interim period contractual set-off rights in respect of claims owed to their affiliates by the company in administration.

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 claims of itself and its affiliates 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 right of set-off if a notice is given under Rule 2.95, there is nothing in the express terms of Rule 2.85 (or elsewhere in the insolvency legislation) which would appear to prevent this during the interim period (or, if no Rule 2.95 notice is given, during the course of the administration) unless the extended right of set-off were recharacterised as a registrable charge.

The assertion by the Insolvency Service that there is no legal impediment to the exercise of equitable and contractual set-off taking place during the interim period,[2] although welcome, does not give clarity on the question of whether non-mutual debts are capable of set-off in the interim period. This uncertainty continues to trouble market participants.

In the Fifth progress report for the administration of LBIE, the administrators revealed that they were preparing in 2011 to seek directions on the assertion of post-administration non-mutual contractual set-off. By the time of the Eighth progress report, the LBIE administrators had decided that no proceedings should in fact be commenced. Although it is explained that this was, in part, owing to the strengths of LBIE's legal arguments, it is also acknowledged that this was in equal part "assisted by the seemingly robust secondary market in LBIE unsecured claims". In other words, because LBIE claims started trading at above par, there was no longer any commercial reason to assert a set-off rather than paying the amounts due to LBIE and selling (at or above par) the amounts due from LBIE. The important point to note for the Consultation is that there was sufficient legal uncertainty to prompt the administrators to prepare to seek court directions on this issue.

It is, of course, fortunate that the LBIE administrators expect to repay unsecured creditors in full but there is no guarantee that this will be the case in the next insolvency of a major corporate or financial institution. Given the shades of legal uncertainty that exist in this area, this is an issue that would benefit from attention now. The FMLC included in Appendix 1 to the Addendum a suggested new Rule 2.85(11) to illustrate how this might be done and the alternative approaches as to scope.

I and members of the Committee remain open to discussing the issues raised in this letter and would be delighted to assist the Insolvency Service in the on-going reform of the Insolvency Rules 1986. Please do not hesitate to contact me should you require any further information or assistance.

Yours sincerely

Joanna Perkins

Joanna Perkins
Chief Executive

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1. All of these documents are available at: http://www.fmlc.org/Pages/papers.aspx
2. Letter from Nick Howard, Director of Policy, Insolvency Service, to Joanna Perkins dated 7 June 2013.