

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London, EC4M 9QQ
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isda@isda-eur.org
website: www.isda.org

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The Insolvency Service
21 Bloomsbury Street
London WC1B 3QW

Attention: Alistair Kennard and Stephen Leinster

Dear Sirs,

Enterprise Act 2002 - Draft Insolvency (Amendment) Rules 2003

We refer to the draft Insolvency (Amendment) Rules 2003 relating to England and Wales (the **Rules**) published by The Insolvency Service on 11th June, 2003. We also refer to the meeting of 26th June 2003 convened by Lord Browne-Wilkinson on behalf of the Financial Markets Law Committee (**FMLC**) after we raised our concerns with the FMLC. A note of the meeting is available on the website of the FMLC (<http://www.fmlc.org>).

As mentioned in that meeting, we have concerns relating to certain set-off provisions of the Rules and we thought it might be helpful to record these concerns in writing following the meeting. We were very pleased to hear that you indicated, in the meeting, that the Insolvency Service would be prepared to consider an amendment to draft Rule 2.85 of the Rules (**draft Rule 2.85**) which would track the existing wording of Rule 4.90 of the Insolvency Rules 1986 (**Rule 4.90**) and we hope to hear from you shortly as to whether this amendment will be made before the Rules are implemented.

The International Swaps and Derivatives Association, Inc. (**ISDA**) is the global trade association representing leading participants in the privately negotiated derivatives industry, a business that includes interest rate, currency, commodity, credit, and equity swaps, options, and forwards, as well as related products such as caps, collars, floors, and swaptions. ISDA was chartered in 1985 and today numbers over 600 member institutions from 46 countries on six continents. These members include most of the world's major institutions who deal in, and leading end-users of, privately negotiated derivatives as well as associated service providers and consultants.¹

ISDA is involved on an ongoing basis in promoting law reform, participating in consultations and lobbying on legislative and regulatory developments affecting the financial markets (for example, ISDA actively participated with the European Commission on the text of the European Union directive on financial collateral arrangements). Ensuring legal certainty for cross-border financial transactions is one of ISDA's key missions. A considerable proportion of the resources of ISDA and its members is devoted to acquiring legal opinions from a wide range of jurisdictions on netting and collateral arrangements.

¹ For further information on ISDA, please consult our website at <http://www.isda.org>.

Our specific concern in relation to the Rules relates to the possible uncertainty that may arise in the interpretation of Rule 4.90, as amended by the Rules, by the adoption of draft Rule 2.85. Draft Rule 2.85 establishes the framework for mutual credit and set-off during an administration in circumstances where an administrator gives notice of his intention to make a distribution to creditors. We understand that draft Rule 2.85 is based, both in form and substance, upon the existing framework relating to mutual credit and set-off upon the liquidation of a company, as provided in Rule 4.90, but with certain deliberate differences (such as the inclusion of references to sums due *to* the company, as well as references to sums due *from* the company) which you consider need to be made as a matter of public policy.

Rule 4.90 and draft Rule 2.85 differ, however, with respect to the language used to describe which mutual credits, debts or other dealings are available for set-off. Rule 4.90 provides with respect to a liquidation that sums due to a solvent party shall not be available for set-off if the solvent party had notice "*at the time they became due*" that a section 98 meeting of creditors of the insolvent party had been summoned or a winding up petition was pending. Rule 4.90 has also been amended by the Rules so that sums due to the solvent party shall not be available for set-off if the sums "*became due*" during an administration immediately preceding the liquidation or if the solvent party had notice "*at the time they became due*" of an administration application or a notice to appoint an administrator.

Prior to 1995 there was academic discussion of the meaning of the word "due" in this context, the prevailing view, on strong grounds, being that it means "owing" or "outstanding" rather than "accrued and payable". This view was confirmed by the House of Lords in *Stein v Blake*² in the context of section 323 of the Insolvency Act 1986 (section 323). A sum does not have to be matured due and payable prior to the notice of the petition or section 98 creditors' meeting to qualify for set-off under Rule 4.90. Therefore any amount arising out of a transaction entered into prior to the solvent party's having the notice referred to above should be included in the mandatory set-off provided in Rule 4.90.

In contrast, draft Rule 2.85 provides with respect to an administration (in the circumstances set out in draft Rule 2.85) that sums due from or to a solvent party shall not be available for set-off if the solvent party had notice "*at the time the liability to pay the sum due was incurred*" that, among other things, an application for an administration order was pending.

We understand that The Insolvency Service has indicated to members of the City of London Law Society Banking Sub-committee that the intention behind draft Rule 2.85 is that it should have the same effect as the reference in Rule 4.90 to the time at which sums become "*due*", as clarified in *Stein v Blake*. As such, a sum would not have to be matured due and payable prior to the relevant notice to qualify for set-off under either Rule 4.90 or draft Rule 2.85.

We consider, however, that, unless the two Rules use the same language in this regard, there is a significant risk that the courts will interpret the difference between the language adopted in the Rules as intentional. In ISDA's view, the danger is that the courts may erroneously infer that the broader language in Rule 2.85 coupled with a failure to amend this aspect of Rule 4.90 (which we understand was outside the ambit of the Insolvency Rules Committee's role on this occasion as it was not deemed to be an Enterprise Act related amendment to the Rules) reflects the view that Rule 4.90 is to be construed restrictively. There is therefore a danger that *Stein v Blake* will no longer be considered authoritative precedent with respect to Rule 4.90 and that the courts may consider that a sum must be matured due and payable prior to the notice of the petition to qualify for set-off under Rule 4.90.

Furthermore, although the new wording is intended to address some of the concerns which arose, prior to *Stein v Blake*, out of the existing "sums due" wording, the reference to when a liability is "incurred" may give rise to uncertainties in the case of acquired debts or contingent liabilities. For example, in relation to contingent liabilities, it is not clear whether the contingent liability to pay the sum due would be "incurred" at the time the company entered into the arrangement that gave rise to the contingent liability or whether the liability would be "incurred" at the time that the contingent liability crystallised. In relation to acquired debts, it could be argued that the insolvent company's liability to pay the sum due was "incurred" at the time it entered into the original agreement under which the debt arose, rather than at the time the purchaser acquired the debt; if this analysis is correct, the new wording

² [1996] 1 AC 243; [1995] 2 All ER 961 (House of Lords).

will not prevent the build-up of set-off rights by the acquisition of claims against the insolvency company after the relevant cut-off dates set out in draft Rule 2.85.

The enforceability of close-out netting and collateral arrangements is fundamental to the soundness of the international financial markets. A large proportion of these arrangements are entered into under an ISDA Master Agreement governed by English law, often between financial market participants where at least one of the parties, particularly if it is a derivatives dealer, is based, or has significant operations, in London. It is therefore of particular international importance that the enforceability of close-out netting under English law be beyond question as to Transactions entered into, but not fully matured prior to, commencement of liquidation (or, where relevant, administration) proceedings.

Currently, the financial markets rely, to a substantial extent, on the interpretation placed on Rule 4.90 by the House of Lords in *Stein v Blake*. ISDA feels strongly that legal certainty in relation to enforceability of close-out netting and collateral arrangements under English law could be seriously and adversely affected by the proposal to adopt differing language in Rules 4.90 and 2.85.

We would strongly urge The Insolvency Service to take this opportunity to amend draft Rule 2.85 to ensure that it is consistent with Rule 4.90 in relation to the "sums due" language. We understand that The Insolvency Service intends, in the near future, to carry out a more detailed review of the insolvency set-off provisions (including both Rule 2.85 and Rule 4.90 and ideally also section 323) and we hope that this will provide an opportunity to revise or clarify the "sums due" language, particularly in relation to contingent liabilities and acquired debts. Until this review takes place, we would strongly recommend that the existing "sums due" language, as clarified in *Stein v Blake*, is used for both Rule 2.85 and Rule 4.90.

We are copying this letter to the Financial Markets Law Committee in view of their role in arranging the meeting to discuss with you the issues raised above.

Any questions or comments regarding our comments on the Rules may be addressed to the undersigned at the address above (tel. +44 20 7330 3550; fax +44 20 7330 3555; e-mail pwerner@isda-eur.org).

Yours faithfully,

Peter Werner