THE CITY OF LONDON LAW SOCIETY'S FINANCIAL LAW COMMITTEE:

RESPONSE TO PROPOSED AMENDMENTS TO THE INSOLVENCY RULES 1986 FOLLOWING THE INSERTION OF SECTION 176ZA INTO THE INSOLVENCY ACT 1986

1. The City of London Law Society (CLLS) represents approximately 12,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

2. The CLLS responds to Government consultations on issues of importance to its members through its 17 specialist Committees. A working party of the CLLS Financial Law Committee, made up of solicitors who are experts in their field, have prepared the comments below in response to the draft Insolvency (Amendment) Rules 2008 (the "draft Rules") circulated for consultation by the Insolvency Service with its letter of 16 August 2007. The members of the working party comprise:

Geoffrey Yeowart	-	Lovells LLP (Chairman of the working party)
Mark Evans	-	Travers Smith
David Ereira	-	Linklaters LLP
Dorothy Livingston	-	Herbert Smith LLP (Chairman of the Financial Law Committee)
Sarah Paterson	-	Slaughter and May
Robin Parsons	-	Sidley Austin LLP

3. We welcome the proposals set out in the draft Rules subject to the comments and suggestions below.

Exception for security financial collateral arrangements

4. We continue to consider that an exception is necessary to preserve the existing legal position established by the decision of the House of Lords in *Buchler v Talbot (Re Leyland Daf Ltd)* [2004] BCC 214 where a floating charge constitutes a "security financial collateral arrangement" under the Financial Collateral Arrangements (No 2) Regulations 2003 (the "FCA Regulations"). As explained in our Note of 22 September 2006 and repeated in our note to H M Treasury of 27 September 2007 on the working of the FCA Regulations, it would be contrary to the spirit of Directive 2002/47EC (which the FCA Regulations implemented into English law) and to the natural expectations of participants in the financial markets to permit liquidation expenses to be paid by a liquidator out of the assets subject to a "security financial collateral arrangement". The EC Treaty provides that a Directive is binding, as to the result to be achieved, on each Member State, and that a Member State must abstain from any measure which could jeopardise the attainment of the objectives of the Treaty.

5. The FCA Regulations already include exceptions in relation to section 176A of the Insolvency Act 1986 ("IA 86") (*Share of assets for unsecured creditors*) and section 196 of the Companies Act 1985 ("CA 85") (*Payment of debts out of assets subject to floating charge*). It would be inconsistent if an exception were not also made for liquidation expenses.

Exception for market charges, system-charges and collateral security charges

6. We suggest that the draft Rules also be amended to clarify that section 176ZA does not apply to a floating charge which constitutes a "market charge" within the meaning of Part VII of the Companies Act 1989, a "system-charge" within the meaning of the Financial Markets and Insolvency Regulations 1996 or a "collateral security charge" within the meaning of the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 (the "Settlement Finality Regulations"). It is already provided that the claim of a participant or central bank to collateral security is payable in priority to winding up expenses: regulation 14(6) of the Settlement Finality Regulations. It should be made clear that the same principle applies in relation to market charges and system-charges in the interests of ensuring legal certainty and reducing systemic risk in the London financial markets.

7. The special regime applicable to market charges, system-charges and collateral security charges is recognised in other provisions of the IA 86: see section 72F and paragraph 2(2) (c) and (d) in Schedule AI.

Prior distributions

8. We suggest that the draft Rules be amended to clarify that prior distributions of floating charge realisations made at a time when no liquidator was appointed cannot be subsequently challenged by a liquidator (even if a winding up petition had been presented at the time of the distribution): *Re Demaglass Holdings Ltd (No 2)* [2003] 1 BCLC 412. As stated in our previous Note, if a receiver felt unable to make a distribution because of uncertainty on this question, this could have a serious impact generally. To give one example, it would adversely affect securitisations, whether they were entered into before 15 September 2003 or are excepted from the prohibition on the appointment of an administrative receiver by section 72B, 1A 86 (*Capital market arrangement*), where the nature of the assets and the structure are such that, in the event of enforcement, receivership and liquidation might have to run in parallel for many years.

9. We suggest that sub-paragraph (c) in the proposed new version of Rule 4.218(1) be amended to read:

> "(c) subject as provided below, property comprised in or subject to a floating charge created by the company (excluding realisations of property distributed by a receiver to the holder of the floating charge prior to the date on which an order was made for the winding up of the company or a resolution was passed for its voluntary winding up)."

Statutory right of recoupment and priorities

10. We consider that a floating charge holder should have a statutory right to recoup, out of any assets of the company becoming available for payment to general creditors, liquidation expenses previously paid out of floating charge assets. The right of recoupment should extend to the proceeds of any recovery in the legal proceedings, the cost of which has been borne by the floating charge holder. This would ensure consistency with a floating charge holder's existing right of recoupment, under section 40(3), IA 86 (*Payment of debts out of assets subject to floating charge*), and section 196(4) of CA 85 (*Payment of debts out of assets subject to floating charge*), in respect of preferential debts paid out of the floating charge assets.

11. It is also necessary to deal with priorities where a company has created floating charges in favour of two or more creditors, particularly if the liquidator needs to pay liquidation expenses only out of part of the floating charge assets. The question is then how the

expenses should be borne between the floating charge holders. It is suggested that this question be dealt with in accordance with general law or as otherwise expressly agreed between the relevant floating charge holders. So, if there are two floating charges, the liquidator should have recourse, first, to the assets subject to the junior floating charge and, to the extent that these are insufficient, to the assets subject to the senior floating charge. If both floating charges relate to the same assets, liquidation expenses should be paid out of the common pool but the recoupment claim, if any, of the senior floating charge holder should have priority over the recoupment claim of the junior floating charge holder.

12. We suggest that the draft Rules be amended to include a recoupment provision to the following effect:

> "Payments of any expenses of the liquidation made under section 176ZA out of property comprised in or subject to a floating charge shall be recouped, as far as may be, out of the assets of the company (including the proceeds of any legal proceedings to which the company or its liquidator is a party) available for the payment of general creditors."

The above wording is based on that used in section 40(3), IA 86 and section 196(4), CA 85, which do not attempt to deal with the question of priorities. It may be better to deal with the question of priorities in general terms in Rule 4.218C instead.

Preferential creditors

13. We suggest that a liquidator may dispense with the requirement under Rule 4.218C(2) to send a request for approval to preferential creditors where the amount owed to them falls below a prescribed minimum or the cost of sending a request to preferential creditors would be disproportionate to the benefits: a similar approach applies under section 176A(5), IA 86 (*Share of assets for unsecured creditors*).

14. It may also be appropriate to provide that a request need not be sent to either preferential creditors or a floating charge holder where the amount of the litigation expenses falls below a prescribed minimum. A floating charge holder is unlikely to be concerned about small claims unless the cumulative expenses of litigating them is likely to prove substantial.

15. We suggest that, to the extent that the Secretary of State will be entitled, by virtue of the Employment Rights Act 1996, to be subrogated to preferential rights of employees in respect of payments made to them out of the Redundancy Fund, it should be sufficient to obtain consent under Rule 4.218C only from the Secretary of State.

16. The Rules should also provide that, where the liquidator has already obtained the approval of a majority in value of preferential creditors, he need not send out a formal request under Rule 4.218C(2).

Inter-relationship with section 176A, IA 86

17. We suggest that the new Rules expressly state, in the interests of clarity, that the company's net property referred to in section 176A(6) (*Share of assets for unsecured creditors*) be calculated after deduction of floating charge assets applied under section 176ZA (*Payment of expenses of winding up*) in funding liquidation expenses (subject only to adding back any recovery made by the floating charge holder under the recoupment right suggested in paragraphs 10 to 12 above).

18. **Scope of legal proceedings**

We suggest that, in the definition of "litigation expenses" and elsewhere, it be made clear that legal proceedings include:

(a) arbitration proceedings; and

(b) pre-action processes such as mediation or an application for pre-action disclosure pursuant to CPR Rule 31.16, which can involve substantial costs.

It should also be made clear that the liquidator should seek consent before incurring any significant costs in taking any pre-action steps of the kind referred to in sub-paragraph (b) above.

Guiding principles to be followed by the court in exercising its discretion

19. Proposed Rule 4.218E(6) indicates that the court will be given a wide discretion in deciding whether to grant approval and, if so, on what terms. If this approach is adopted, the court will need to lay down, as the Court of Appeal did in *Re Atlantic Computer Systems plc [1990] BCC 859*, guiding principles to follow when exercising its discretion.

20. The definition of "litigation expenses" in proposed Rule 4.218A(1) appears to be forward looking as it refers to expenses "chargeable", as well as backward looking as it refers to expenses to be "incurred". This may prompt a liquidator to seek to accumulate at the outset a "fighting fund" to include all prospective litigation costs and an allowance for any costs which may be awarded against the company if the liquidator loses the case. The creation of such a fund could adversely affect the amount and timing of distributions to creditors. If an application for approval is made to the court, it may be sensible in larger or more complex cases for the court to give approval in stages, so that the liquidator is required to report on progress at appropriate "milestones" and to seek confirmation that he may proceed to the next stage.

Costs of applying to court

21. We agree that the court should have a discretion, where there appears to be a proper case, to order that the costs of a floating charge holder incurred in applying to the court under Rule 4.218CE and/or any other party represented at the hearing be paid out of the company's assets.

Rights of waiver

22. We suggested in our previous Note that a floating charge holder or a preferential creditor be able to waive (either generally or specifically) its rights to approve litigation expenses if he thinks fit. This would be helpful and uncontroversial. A floating charge holder may be willing to give a waiver if, for instance, he is satisfied that either:

(a) there will be no surplus available to the floating charge holder after payment of preferential creditors and the "prescribed part" under section 176A, IA 86, even if the litigation expenses were not incurred; or

(b) the floating charge holder will be fully repaid (even if those expenses are incurred).

23. We suggest that a provision to the following effect be added at the end of the proposed new Rule 4.218C:

"The relevant creditor may, if he chooses, waive his rights under Rules 4.218B and 4.218C, either generally or specifically in relation to particular legal proceedings, and unconditionally or subject to such conditions as he may agree with the liquidator."

Confidentiality

24. The other party to legal proceedings being brought or defended by the liquidator may have a strong incentive to discover the amount of litigation expenses approved under Rules 4.218C to E, since, once the approved amount has been exhausted, the liquidator will presumably have to seek fresh approval or discontinue the proceedings. We suggest that the liquidator be entitled to require that reasonable precautions be taken to keep the approved amount confidential, including the right to apply for the sealing of the court file containing the order approving the amount of the litigation expenses.

Specific comments on the draft Rules

25. We have the following comments on the wording of the draft Rules:

(a) We suggest that, in line 3 of the definition of "litigation expenses", the words "or defend" should be added after "bring".

(b) In the new version of Rule 4.218(1), it seems sensible to provide that expenses will be paid out of assets coming into the liquidator's hands and proceeds of legal proceedings under sub-paragraphs (a) and (b) to the extent that such assets and proceeds are then available to him, before having recourse to floating charge assets under sub-paragraph (c).

(c) A floating charge holder should also have the right under Rule 4.218C to call for such other information as it may reasonably require in order to consider the request for approval received from the liquidator.

Review of rules relating to administration expenses

26. We suggested in our previous Note that serious thought be given to the possibility of introducing a similar, more balanced regime in relation to administrations, so that an administrator could not incur litigation expenses without the approval of a floating charge holder if those expenses would otherwise deplete the floating charge realisations available to the floating charge holder. At present an administrator is free to use floating charge assets in his custody or control, without reference to the floating charge holder or the court, to pay administration expenses out of those assets: paragraphs 70(1) (*Charged property: floating charge)* and 99(3) and (4) (*Vacation of office: charges and liabilities)*, Schedule B1, IA 86. We consider that, as a matter of principle, the same approach should apply in an administration, particularly in view of the substantial increase in the number of cases where administration is being used instead of liquidation. Again, we suggest that this issue be considered as part of the review of Part 10 of the Enterprise Act 2002.

Review of post-liquidation tax liabilities

27. As explained in our previous Note, post-liquidation tax liabilities are another type of expense which is of particular concern to lenders (and, in the context of securitisations, to rating agencies). For example, if a receiver is appointed pursuant to the capital market exception in section 72B, IA 86, and the receiver disposes of property triggering either a capital gains tax liability or a stamp duty de-grouping charge, that liability (following *Toshoku Finance UK plc* [2002] UKHL 6) is likely to be an expense of the liquidation. A

similar point might apply in relation to other necessary disbursements such as commercial property rates. Although they are separate from those addressed in the draft Rules, these issues should also be reviewed at the earliest practical opportunity.

28. We should welcome the opportunity to be consulted in relation to an amended draft of the Rules when this becomes available.

Financial Law Committee
The City of London Law Society
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