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31 August 2007

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Dear Stephen

Pre-appointment administration expenses

I write in my capacity as chairman of the Insolvency Law Committee of the City of London Law Society (the **Committee**).

This letter constitutes the response of the Committee to the consultation announced by the Insolvency Service in June 2007 on the draft rules for the recovery of pre-appointment administration expenses.

Summary of our response

We believe that there is a definite need for legislative amendments to correct the current uncertainty on the recoverability of pre-appointment administration remuneration and expenses, but we have a number of concerns about the drafting and scope of the proposed amendments.

In summary, our main concerns are as follows:

- In its scope and requirements, the proposed new subsection (ka) in Rule 2.33(2) goes too far and is in serious danger of colliding with the current, and as yet unresolved, debate around "pre-pack" administrations, including the recovery of costs in "pre-packs". There are also causes for concern in relation to commercial sensitivity and practicality in (ka)(vi) and the over-engineering of (ka)(viii).

- We recommend that a new Rule 2.67 paragraph is created instead of piggy-backing on existing paragraphs. The drafting of the rule must also be re-considered. At present, it is not sufficiently clear as to which expenses are being brought into the net. The rule must also not be framed in such a way as to deter insolvency practitioners (**IPs**) from recognising conflicts of interest in pre-pack cases.

- We recommend that the administrator be provided with recourse to the court if he is of the opinion that the remuneration figure is "insufficient", as is provided for by the existing regime in Rule 2.108.

- Rules 14 and 15 should include provisions dealing with the costs of court applications which follow the existing rules on post-appointment remuneration.

We expand on these points in more detail below.

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The disclosure statement (proposed amendment to Rule 2.33 on the administrator's proposals)

1 The proposed new subsection (ka) in Rule 2.33(2) would require an administrator to make a separate statement about pre-appointment costs and expenses as part of his statement on his proposals for achieving the purpose of administration.

2 This is necessary but, so long as the proposed (ka) is the only response of the Government to the wider issues concerning pre-packs, the disclosure statement should justify the pre-pack and not merely state the facts. A statement which deals only with what is to be recovered by the administrator under the new rules is inadequate because there should be disclosure of all remuneration and expenses which are directly or indirectly debited to the estate. For example, disclosure should pick up pre-packs where the purchaser has been contractually obliged to meet pre-appointment costs. Such costs may not come out of the estate but will have indirectly reduced it because the obligation will have been reflected in the price paid. There will also be cases where the costs are paid by third parties who will then add them to their own claims against the estate - particularly relevant in the case of secured creditors.

3 However, in other respects the proposed (ka) goes too far.

4 As drafted, (ka)(iv) to (vii) place this section on a collision course with "pre-pack" issues, where the requirements of these proposed provisions insist on a greater level of administrator disclosure regarding valuation, marketing and disposal strategy. Of particular concern is subsection (ka)(vi) which requires the administrator to disclose details of "all" offers received for the business or property of the company. Put simply, this requirement is impractical and commercially unviable. While we accept that the matters referred to in (ka)(iv), (v) and (vii) must be addressed, we believe that this is an area that requires a separate consultation and furthermore risks pre-empting the report on pre-pack administrations not due to be released until this autumn.

5 The commercial sensitivity that surrounds the sale of business or assets of companies in financial difficulties needs to be acknowledged and articulated in the legislation. Both successful and unsuccessful bidders have an interest in the price paid not entering the public domain (for example, through a creditor leak). It is our recommendation that what should be required is a sworn statement by the IP that the best price reasonably attainable for the business was, in his judgment, achieved in all the circumstances. (The alternative to such a declaration is that details of all offers received will be disclosed but only "as appropriate".)

6 The level of detail required by (ka)(viii) is over-engineered, particularly given that the requirement to set out "the circumstances giving rise to pre-appointment work" contained in (ka)(iii) provides more than sufficient clarity for creditors without burdening the administrator with additional hurdles.

7 Given our conclusions on the priority rule (see below), (ka)(i) would require amending.

8 With regard to the remaining subparagraphs (ka)(ii), (iii) and (ix), we are of the opinion that these provide the level of detail and disclosure reasonably required by the statement.

The priority rule (proposed amendment to Rule 2.67 on the priority of expenses in administration)

9 There is no logical need for a separate Rule 2.67A in order to deal with the recovery of pre-appointment costs and expenses our recommendation is that a new paragraph be inserted in the existing Rule 2.67 saying what is recoverable by way of pre-appointment expenses and avoiding cross-referencing to other paragraphs. The proviso contained in the proposed Rule 2.67A(2) can be included as part of the new paragraph.

10 The rest of our comments relate to the way the new provision is currently drafted.

11 The first point is that to say that certain categories of expense will include "sums falling within those categories which relate to actions taken prior to the appointment of the administrator" does not distinguish between expenses of the administration and expenses of the administrator. Given that the specified categories of expense refer in each case to "the administrator", it seems to us that the amendment would be interpreted as referring to the actions of the person who was subsequently appointed as administrator. That is straightforward as far as categories (a) and (h) are concerned but not so far as "necessary disbursements" under category (f) (which might, for example, be tax or rate liabilities of the company) are concerned. It is not clear what is being brought into the net by expanding pre-appointment expenses to cover category (f). Either that means that there is going to be some new class of pre-administration company liability which can be paid as an expense and which thereby gains a priority which it does not currently enjoy, or else category (f) will operate differently before and after the administrator is appointed even though the ostensible effect is to remove the significance of the moment of appointment.

12 The second point arises out of our interpretation of the proposed amendments as referring to the actions of the person who is subsequently appointed as administrator. This raises a point of principle so far as pre-packs are concerned. If the present amendment is carried through, an advising IP will have a strong disincentive to recognise that he has any conflict of interest precluding him from proceeding to accept appointment and execute a pre-pack because (a) his pre-appointment remuneration will not qualify as an expense unless he himself is appointed and, even if that were not so, (b) he would be in the hands of the administrator to propose that he be paid.

13 Our recommendation is that the rule should not be framed in such a way as to deter IPs from recognising conflicts of interest in pre-pack cases. One way to do it might be to amend Rule 2.67(1)(c) to make express provision for an advising IP's costs and expenses. We think it regrettable that the interpretation difficulties with that provision should be acknowledged but not directly addressed and recommend that amendment be considered in any event.

The approval mechanism (proposed draft Rule 14 on the approval of pre-appointment expenses and remuneration in administration and proposed draft Rule 15 on the ability for creditors to challenge approved pre-appointment remuneration and expenses as excessive)

14 To the extent that the proposed Rule 14 resembles Rule 2.106 it is an acceptable mechanism for the fixing and approval of remuneration. However, the proposed paragraph does not include an equivalent of the existing Rule 2.108(1) which gives the administrator recourse to the court if he considers that his remuneration, fixed by the creditors' committee or creditors' resolution, is "insufficient". The provision of such recourse is imperative.

15 A further point to flag in relation to proposed Rule 14 is that, unlike Rule 2.108(4), there is no provision in place to cover the costs of an application to court even though proposed Rule 15(6) applies the existing provision within Rule 2.108(4) to a creditor's application. It is not clear why proposed Rule 15 is not modelled on existing Rule 2.109(5). Our recommendation is that, as regards the costs of court applications, the new rules on pre-appointment remuneration should follow the existing rules.

Yours sincerely

Hamish Anderson
Partner