

Restructuring and special situations briefing

# Lehmans files for administration; what happens now?

## Summary

Early on 15 September 2008, four UK Lehman companies were placed into administration; Lehman Brothers International (Europe) (an unlimited private company), Lehman Brothers Ltd, LB Holdings PLC and LB UK RE Holdings Ltd. Four partners from PWC in London have been appointed as administrators (Tony Lomas, Steven Pearson, Dan Schwarzmann and Mike Jervis).

It appears that the UK filings were made because the UK group was unable to meet their funding obligations over the weekend of 13-14 September.

It is not yet clear what strategy the administrators will adopt, but in a statement issued on the morning of 15 September, it was confirmed that they "have been appointed to wind down the business in as orderly a manner as possible". They have further stated that their "priority now is to work with management and trading counterparties to agree the manner in which the assets and liabilities will be handled".

The administrators have also stated that " a number of group companies remain solvent and will continue to trade. These companies include LBAM (Europe) and a series of special purpose vehicles designed to manage portfolios of residential and commercial real estate assets and non-performing loans". It is not yet clear whether any other Lehman group companies will file for administration.

This briefing covers some of the key legal issues that arise when a company enters administration.

## What is administration?

Unlike many other countries, the UK has no special regime for dealing with failing banks and the powers of the authorities (the Treasury, the FSA and the Bank of England) are limited.

Reliance is placed on the application of general corporate insolvency laws. Administration is a procedure governed by the Insolvency Act 1986 (IA 86) whereby a company may be rescued or reorganised or its assets realised under the protection of a statutory moratorium.

Under IA 86 as originally enacted, banking companies and other authorised institutions under banking legislation were excluded from the administration procedure. However, the IA 86 was extended to apply (with modifications) to banks by orders made in 1989 and 2006.

Administration has the unique effect of imposing a total freeze on the enforcement of security rights and rights of repossession, levying distress, the institution or continuance of legal proceedings and the winding up of the company during the administration period except with the leave of the court or the consent of the administrator. This moratorium is intended to give the company breathing space to try to achieve the purpose or purposes of the administration.

The procedure shares some features with Chapter 11 of the US Bankruptcy Code, such as the moratorium and the power on the part of the administrator to overreach a secured creditor's position on payment of the value of the security. However, there are significant differences in the two procedures, in particular, there is no requirement that a company filing for relief under Chapter 11 must be insolvent and the management of the company in Chapter 11 proceedings remains in place with most of its management powers intact.

The administrator, once appointed, replaces the management in running the business of the company. The appointment of an administrator ceases to have effect one year after the date on which it takes effect (unless extended by the court).

Although limited, by virtue of the Financial Services and Markets Act 2000 (FSMA), the FSA does have

certain powers to participate or initiate insolvency proceedings in relation to authorised persons (or previously authorised persons). The Lehman's entities that are regulated by the FSA would have had to obtain the FSA's consent to the administration by virtue of section 362A of FSMA.

### **Effects of administration?**

Commercial contracts are unaffected by entry into administration, (unless they contain automatic termination provisions which would be enforceable pursuant to English law). Administrators often do not wish to continue existing contracts but, unlike liquidators, they have no power to disclaim an onerous contract.

As stated, the effect of administration is to place a moratorium on the enforcement of creditors' rights. Other than in respect of financial collateral arrangements which remain enforceable (see below), this prevents legal proceedings being brought against the company in administration, but does not prevent the exercise of any contractual rights as the purpose of the administration is to allow the entity to continue to trade. A counterparty would, therefore, have the choice to either:

- exercise its contractual rights to close-out a transaction; or
- allow the transaction to continue,

neither of which would prevent the counterparty from exercising an equitable or express contractual right of set-off.

If a counterparty chooses to close-out a transaction, it is possible to calculate the credit exposure and the counterparty will be entitled to vote at the creditors' meeting on any proposals put forward by the administrator to effect the administration. However, in choosing to close-out, the counterparty will lose the potential benefit of a third party taking over the positions of the company in administration. Further, if the transaction that is closed-out has been put in place to hedge another transaction, the counterparty will risk market exposure on the hedged transaction.

### **Set-off**

Under UK law, mandatory set-off rules apply under the IA 86 where a party to a transaction enters administration or liquidation. It is not possible to contract out of these rules and they will displace all rights of set-off not already exercised before entering administration. However, it should be noted that the mandatory set-off rules will not apply to close-out netting provisions in respect of financial collateral

arrangements within the Financial Collateral Arrangements (No 2) Regulations. These are considered further below.

The mandatory set-off rules apply where, before the company goes into liquidation or administration, there have been "mutual credits, mutual debts or other mutual dealings" between the company and a creditor. In these circumstances an account must be taken of what is due from each party to the other in respect of the mutual dealings and the sums due from one party shall be set-off against the sums due from the other. So, only the balance may be claimed by a liquidator/administrator or proved for by the creditor.

The requirement for mutuality means that parties must be acting in the same capacity in respect of the relevant obligations for set-off to apply, although the claims need not arise from the same transaction.

### **Financial collateral arrangements**

The Financial Collateral Arrangements (No 2) Regulations 2003 (Regulations) (implementing the EC Directive on Financial Collateral Arrangements (2002/47/EC) provide certain exceptions to the general rules which apply on insolvency in respect of financial collateral arrangements.

The Regulations apply to financial collateral arrangements which are basically collateral arrangements (whether entered into by way of title transfer or security) involving cash or financial instruments – the latter meaning shares and tradeable debt and equity securities.

There are two types of financial arrangements:

- Title transfer arrangements – where full ownership of the collateral is transferred to the lender who then transfers equivalent collateral back when the borrower has satisfied its obligations. These would include repurchase agreements (REPO agreements); and
- Security arrangements – where the lender obtains possession of, or can exercise some degree of control over the collateral, but does not become "owner" of the collateral.

The Regulations apply to security taken over cash, shares, bonds or gilts (or any combination of these). Pledges, mortgages, liens, fixed charges or charges created as floating charges may fall within the ambit of the Regulations provided that the collateral is delivered, transferred, held or otherwise designated to be in the control of the charge holder.

More particularly they provide that:

- financial collateral arrangements remain enforceable even where a party to the transaction is in administration proceedings. This means that security held over a company's property under a financial collateral arrangement will still be capable of enforcement in the event of a company being put into administration and the moratorium which
- would normally prevent the creditor taking enforcement action does not apply; and
- the mandatory set-off rules which would normally apply on an insolvency are disapplied in respect of a close-out netting provision in a financial collateral arrangement. Close-out netting provisions are quite widely defined and would include set-off rights triggered on an event of default.

## Contacts

We hope you find this briefing useful. For more information or if you have any queries on these issues, please speak to your usual Ashurst contact or one of the people listed below.



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