

Lehman Brothers Administration Update

In this briefing we consider the key issues relating to the UK administration process in the context of the recent appointment of administrators to four UK incorporated Lehman entities.

What is Administration?

Administration is a procedure designed primarily to rehabilitate financially distressed companies which are or are likely to become unable to pay their debts. Where this is not practicable, administration may be a means of achieving a better result for creditors than in a liquidation (see paragraph 3 below).

A company can be placed into administration by way of an application to the Court for an administration order. Administration may also be achieved by way of notice, in an out of Court procedure.

Who Are The Administrators?

An administrator is a licensed insolvency practitioner, usually from a firm of accountants. In the case of Lehman Brothers International (Europe) ("LBIE"), Lehman Brothers Ltd, LB Holdings PLC and LB UK RE Holdings Ltd (the "Relevant UK Lehman Entities"), Tony Lomas, Steven Pearson, Dan Schwarzmann and Mike Jervis, partners at PricewaterhouseCoopers LLP, were appointed as joint administrators on 15 September at 07.56 hrs. Each of the Relevant UK Lehman Entities were placed into administration by way of an application to Court by the relevant directors of such entities.

The administrators act as agents for the company, without personal liability. They effectively replace the management of the company.

Purpose of Administration

The administrator of a company must perform his functions with the objective of:

- (i) rescuing the company as a going concern; or
- (ii) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration); or
- (iii) realising property in order to make a distribution to one or more secured or preferential creditors.

In the initial press statement released by the administrators, they indicated that they had been appointed to "wind down the business in as orderly manner as possible". This would suggest that objectives (ii) or (iii) at paragraph 3.1 above are most likely for the Relevant UK Lehman Entities.

The administrator of a company must perform his functions as quickly and efficiently as is reasonably practicable.

Key Issues

What is administration

Effects of the moratorium

Termination rights

Set off

Powers of administrator

Information to creditors

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Moratorium

While a company is in administration and between the making of an application or the filing of a notice of intention to appoint and the appointment of an administrator:

- (i) no resolution may be passed for the winding up of the company;
- (ii) no order may be made for the winding up of the company;¹
- (iii) no step may be taken to enforce security over the company's property except with the consent of the administrator or the permission of the Court;²
- (iv) no step may be taken to repossess goods in the company's possession under a hire-purchase agreement (this includes retention of title agreements) except with the consent of the administrator or permission of the Court;
- (v) a landlord may not exercise a right of forfeiture by peaceable re-entry in relation to premises let to the company except with the consent of the administrator or permission of the Court; and
- (vi) no legal process (including legal proceedings, execution, distress and diligence) may be instituted or continued against the company or property of the company except with the consent of the administrator or permission of the Court.

Where the Court gives permission for a transaction prohibited by the moratorium, it may impose a condition or requirement in connection with that transaction.

We consider that, as a matter of English law, the powers of an administrator are of universal and, therefore, extra-territorial application. This principle is given statutory recognition in European jurisdictions (other than Denmark), in which the administration of a debtor (other than an insurance undertaking, credit institution, investment undertaking holding funds or securities for third parties and collective investment undertakings) with a centre of main interests in a member state of the European Union would be automatically recognised by virtue of the provisions of the European Regulation 1346/2000 on Insolvency Proceedings (the "Regulation"). The administration orders made in respect of the Relevant UK Lehman Entities, other than LBIE, explicitly state that the Regulation applies and that each of these proceedings are main proceedings as defined in Article 3 of the Regulation. The Regulation was stated not to apply in the court order made in respect of LBIE. We understand that LBIE, which is stated as "able to hold and control client money" on the register of the Financial Services Authority, qualifies as an investment undertaking holding funds for third parties and is, therefore, excluded from the Regulation. We further understand that LBIE does not qualify as a credit institution for the purpose of the Directive 2001/24/EC on the reorganisation and winding up of credit institutions (the "Credit Institutions Directive"). As a result of the non-application of the Regulation and the Credit Institutions Directive, LBIE falls outside European wide regimes which provide for recognition of collective insolvency proceedings including administration.

In respect of the Relevant UK Lehman Entities excluding LBIE the moratorium imposed by an administration would not extend (amongst other things) to interfere with a creditor or third party enforcing their rights against those assets where to do so would affect the rights in rem, set off rights, and rights and obligations of the parties to a payment or settlement system or to a financial market which are specifically provided for in the Regulation. Whether the moratorium would be recognised in a foreign jurisdiction outside of Europe would depend upon the jurisdiction in question. Some assistance may be derived from the UNCITRAL Model Law on Cross-Border Insolvency (the "Model Law") which has been adopted in various modified forms in several jurisdictions.³ The aim of the Model Law is to facilitate the recognition of foreign insolvency proceedings by standardising the process by which recognition is obtained and the effect in law once recognition is granted. In some, but not all, of these jurisdictions there is an automatic moratorium. Generally speaking, however the moratorium should not affect the enforcement of security or assertion of rights of set off, but local law advice should be sought. For assets that fall outside of Europe and jurisdictions where the Model Law has been adopted, recognition of the administration and moratorium would be a matter of local law and jurisdiction.

¹ The prohibition does not apply to an order made on a petition under section 124A (public interest) or section 367 of the Financial Services and Markets Act 2000 (petition by the FSA).

² It should be noted that for arrangements that fall within the definition of the Financial Collateral Regulations, the moratorium under paragraph 43 of Schedule B1 of the Act is disapplied. For further information on the Financial Collateral Regulations see our client briefing "Secured Lending and the Financial Collateral Arrangements Regulations (January 2004).

³ Legislation based on the UNCITRAL Model Law on Cross-Border Insolvency has been adopted in: Australia (2008); British Virgin Islands, an overseas territory of the United Kingdom of Great Britain and Northern Ireland (2005); Colombia (2006); Eritrea (1998); Great Britain (2006); Japan (2000); Mexico (2000); Montenegro (2002); New Zealand (2006); Poland (2003); Republic of Korea (2006); Romania (2003); Serbia (2004); South Africa (2000); and United States of America (2005).

Contractual Rights to Terminate

The ability of a counterparty to terminate a contract with a company in administration is determined by the terms of the contract in question. The LSTA, LMA and ISDA have provided useful information on particular issues that are arising in relation to Lehman Brothers and contracts based on their standard documentation. We do not seek to deal with these specific issues in this note.

If there is a contractual ability to terminate an agreement, or the agreement specifies that termination may occur automatically upon a formal insolvency event as defined by the contract which includes administration, the contract as a matter of English law may be terminated. However, advice should be taken on a case by case basis on whether termination of a particular contract will be applicable or effective. The ability to serve contractual notices to terminate are not affected by the administration moratorium, subject to any restrictions imposed in relation to forfeiture by a landlord, security enforcement and rights to repossess under hire purchase agreement (see above).

Set-Off

Generally speaking, the exercise of a right of set-off (including a banker's right to combine accounts) ought not to be within the scope of the moratorium. A right of set-off is not a security right.

In the event that the administrator is authorised to make a distribution, once he has given notice of that distribution, a statutory insolvency set-off rule (Rule 2.85, Insolvency Rules 1986) comes into play. Generally this means that where the administrator is to make a distribution, a mandatory regime will apply where all the mutual dealings and sums due from one party shall be set off against the sums due from the other. The mandatory set off regime that applies in the event of the administrator giving notice of a distribution are complicated. It should be noted that claims acquired after the commencement of administration may not be taken into account. Specific advice should be sought on the detailed provisions contained in Rule 2.85.

Rights of set-off may be affected by any subsequent scheme of arrangement or company voluntary arrangement implemented by the administrators.

Powers of Administrator

The powers vested in the administrator are extensive. He is authorised to do all such things as may be necessary for the management of the affairs, business and property of a company. Detailed powers for administrators are set out in Schedule B1 and Schedule 1 of the Act. They include (amongst other things) the power to sell the property of the company, the power to bring, proceed or defend legal proceedings, the power to carry on a business and power to make any payment which is necessary or incidental to the performance of his functions - including making any arrangements or compromises on behalf of the company. In addition, an administrator can challenge antecedent transactions such as preferences and transactions at an undervalue.

An administrator has a general power to make a distribution to secured and preferential creditors. He also has the ability to make distributions to the unsecured creditors, but only with the permission of the Court. In order to make distributions to creditors an administrator must give twenty-eight days' notice to creditors which includes details of the intended dividend, the deadline for submission of claims and a distribution date at least two months from that date, together with a notice inviting creditors to prove their claims.

Charged Property

An administrator may apply to the Court for an order allowing him to dispose of property which is subject to security. However, an administrator can realise floating charge assets in any event, but the floating chargeholder (i.e. a secured creditor who has taken security over the whole or substantially the whole of the company's property) retains the same priority in respect of acquired property (i.e. the proceeds of sale) as he had in respect of the property disposed of.

The Court will only make an order for the disposal of property subject to security where it considers that the disposal of the property would be likely to promote the purpose of administration in respect of the company. Any such order is subject to the condition that there be applied towards discharging the sums secured by the security:

- (i) the net proceeds of disposal of the property, and
- (ii) any additional money required to be added to the net proceeds so as to produce the amount determined by the Court as the net amount which would be realised on the sale of the property at market value.

Information To Creditors: Administrator's Proposals And Reports

In the discussions which we have had with the administrators of the Relevant UK Lehman Entities to date, they have indicated that for present purposes they are dealing with creditors on a case by case basis. Their present focus is on establishing policies for dealing with the different stakeholders.

However, the insolvency legislation provides that the administrator must make a statement setting out his proposals for achieving the purpose of the administration and send it to, *inter alia*, the creditors of the company as soon as reasonably practicable after the company enters into administration and in any event before the end of the period of eight weeks beginning on the date the company entered administration. This statement will include:

- (i) details of the financial position of the company;
- (ii) how it is envisaged the purpose of administration will be achieved and how it is proposed that the administration will end;⁴
- (iii) where the administrator has decided not to call a creditors' meeting, his reasons; and
- (iv) the manner in which the affairs and business of the company have, since the date of the administrator's appointment, been managed and financed, and will, if the administrator's proposals are approved, continue to be managed and financed.

The administrator must send "progress reports" in respect of the administration at prescribed intervals⁵ to, *inter alia*, creditors of the company and a "final progress report" on the conclusion of the administration.

Creditors' Meetings

The administrator must present a copy of his statement of proposals to an initial creditors' meeting, which must be held as soon as reasonably practicable, and in any event within ten weeks of the date the company entered into administration. The meeting must be held on fourteen days' notice. However, the administrator need not summon a creditors' meeting if his statement of proposals states that he thinks:

- (i) that the company has sufficient property to pay all its creditors in full;
- (ii) that the company has sufficient property to enable a distribution to be made to unsecured creditors other than by virtue of the unsecured fund⁶; or
- (iii) that neither of the purposes referred to in paragraphs 3.1(i) or (ii) above can be achieved.

The administrator must, in any event, summon an initial meeting if requested by creditors whose debts amount to at least 10% of the total debts of the company.

The initial meeting may approve the proposals without modification, or with modification to which the administrator consents. A majority in value of creditors present and voting or by proxy must approve the proposals. Generally speaking, creditors are only entitled to vote if they have provided details in writing of their claims before the creditor's meeting. (Secured creditors are only entitled to vote in respect of the balance of their debt after deducting the value of security.)

The administrator must report the result of the initial meeting to, *inter alia*, every creditor of whom he is aware and any other person who received a copy of the original proposal.

The administrator must call further creditors' meetings if he proposes to make substantial revisions to the proposals which have already been approved for consideration and voting upon by the creditors.

The administrator must also summon further creditors' meetings if requested by creditors whose debts amount to at least 10% of the total debts of the company or if directed by the Court.

Creditors' Committee

At the creditors' meeting it may be resolved that a creditors' committee be elected. Any creditor is eligible so long as its claims have not been rejected by the administrators. The Committee will comprise of three to five members and its function is to assist the administrator and act in such a manner as may be agreed from time to time.

⁴ This might be by way of a company voluntary arrangement under Part I of the Act ("CVA") or a scheme of arrangement under Part 26 of the Companies Act 2006 ("Scheme"), by which creditor claims are compromised. Secured creditors' rights would only be compromised in a CVA with their agreement and so, in effect, gives them the right to veto a CVA. In the case of a Scheme, the Scheme would be unlikely to be given effect by the Court where it expropriated secured creditors' rights.

⁵ Broadly, every six months.

⁶ The unsecured fund is derived from a proportion of floating charge realisations.

Ending Administration

The appointment of an administrator will cease one year after it takes effect. However, the term of office may be extended:

- (i) by order of the Court, for a specified period; or
- (ii) with the consent of the creditors, for a specified period not exceeding six months.

Administration may also be brought to an end by an application to the Court where the administrator believes:

- (i) the purpose of administration cannot be achieved;
- (ii) that the company should not have entered into administration;
- (iii) a creditors' meeting requires him to do so; or
- (iv) (in the case of an administrator being appointed by the Court) that the purpose of administration has been sufficiently achieved.

The Court may also provide for the appointment of an administrator to cease to have effect on an application by a creditor alleging an improper motive on the part of the applicant for the administration order or the person who appointed the administrator.

Administration Converted Directly into a Creditors' Voluntary Liquidation

In instances where the secured and preferential creditors have been paid or reserved for and there remains sufficient assets within the company to make a distribution to unsecured creditors, the administrator may place the company directly into creditors' voluntary liquidation by filing a notice with the registrar of companies, together with a final report. When the registrar of companies receives the notice, the company goes into liquidation.

Administration Followed By Dissolution

If the administrator is of the view that there is no property for distribution to creditors (after any distribution which might have been made to secured and preferential creditors) he may take steps to dissolve the company. This is achieved by the administrator sending a notice to the registrar of companies, together with a final progress report. The company will be dissolved three months after registration of the notice sent to the registrar.

Administration Telephone Hotline

The administrator have provided the following telephone hotline numbers:

+44 (0)20 7102 0372

+44 (0)20 7102 6759

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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