International Corporate Rescue

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

Annual Subscriptions:
Subscription prices 2010 (6 issues)
Print or electronic access:
EUR 695.00 / USD 845.00 / GBP 495.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

© 2010 Chase Cambria Company (Publishing) Ltd

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, mechanical, photocopying, recording or otherwise, without prior permission of the publishers.

Permission to photocopy must be obtained from the copyright owner. Please apply to:
E-mail: permissions@chasecambria.com
Website: www.chasecambria.com

The information and opinions provided on the contents of the journal was prepared by the author/s and not necessarily represent those of the members of the Editorial Board or of Chase Cambria Company (Publishing) Ltd. Any error or omission is exclusively attributable to the author/s. The content provided is for general purposes only and should neither be considered legal, financial and/or economic advice or opinion nor an offer to sell, or a solicitation of an offer to buy the securities or instruments mentioned or described herein. Neither the Editorial Board nor Chase Cambria Company (Publishing) Ltd are responsible for investment decisions made on the basis of any such published information. The Editorial Board and Chase Cambria Company (Publishing) Ltd specifically disclaims any liability as to information contained in the journal.

ARTICLE

Insolvency Deprivation, Public Policy and Priority Flip Clauses

Sarah Worthington, Professor of Law, London School of Economics and Political Science, London, UK

Lawyers are used to preparing for the worst. Contract terms, security arrangements, insurance and guarantees are all designed to arm the well-prepared against disaster. It matters, then, that certain protective provisions may be void on public policy grounds. Perhaps predictably, the Lehman Brothers liquidation has provided a new test case.

In *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd*,[1] the Court of Appeal was asked to strike down a priority flip clause which switched the priority enjoyed over collateral away from a Lehman Brothers credit default swaps counterparty and in favour of third party noteholders (including Perpetual Trustee Co Ltd) in defined circumstances, to the potential detriment of the now insolvent Lehman Brothers counterparty.[2] The administrators argued that the priority flip clause breached the 'anti-deprivation rule' and was therefore void on the grounds of public policy. The anti-deprivation rule broadly asserts that 'there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors.'[3] The Court of Appeal found against the administrators and in favour of the third parties, affirming the judgment of Morritt J, the Chancellor, in the High Court. The case is now likely to go on appeal to the Supreme Court. The issue is important, given the potential application of the same rule to other structured finance and securitisation deals.

The facts and findings in the *Perpetual Trustee* case

The facts in the *Perpetual Trustee* case are complicated, but the key elements are as follows. All the transactions (except the purchase of the collateral) were governed by English law. Noteholders such as Perpetual Trustee Co Ltd purchased Notes through a special purpose vehicle ('the Issuer') formed by a Lehman company in a tax friendly jurisdiction. The Issuer used the subscription monies to purchase government bonds or other secure investments ('the collateral') vested in a trust corporation (BNY Corporate Trustee Services Ltd, 'the Trustee'). A credit default swap was entered into by the Issuer and a Lehman company, Lehman Brothers Special Financing Inc ('LBSF', the second defendant). Under the credit default swap LBSF paid to the Issuer the amounts due by the Issuer to the Noteholders in exchange for sums equal to the yield on the collateral. The net excess paid by LBSF under this swap was, effectively, the premium for the notional 'credit insurance' provided by the Noteholders.[4] The amount payable by LBSF to the Issuer on the maturity of the Notes (or on early redemption or termination) was the initial principal amount subscribed by the Noteholders less amounts calculated by reference to defined credit events during a specified period, thereby delivering the effective insurance aspect of the programme. The insurance may have been intended to enhance the credit rating accorded to the Notes; it presumably also generated additional fees for Lehman Brothers.

The focus of litigation was the clause which provided for security over the collateral. The collateral was charged by the Issuer in favour of the Trustee to secure the Issuer's obligations to the Noteholders and LBSF on terms which changed their respective priorities on the occurrence of certain specified events (including the insolvency or default of LBSF, or the insolvency of the ultimate parent of LBSF (i.e. Lehman Bros Holdings Inc ('LBHI')). The relevant clause was in the Supplemental Trust Deed, clause 5.5, in these terms:

> 'The Trustee shall apply all moneys received by it under this Deed in connection with the realisation or enforcement of the Mortgaged Property as follows:

Notes

1 [2009] EWCA Civ 1160 (CA) ('*Perpetual Trustee* (CA)'), on appeal from [2009] EWHC 1912 (Ch) ('*Perpetual Trustee* (HCt)').
2 The court also addressed the treatment of 'unwind costs' between these parties, and determined the outcome of a related appeal which raised the anti-deprivation rule (*Butters v BBC Worldwide Ltd*). This article focuses exclusively on the anti-deprivation rule as raised by the facts of the priority flip in the *Perpetual Trustee* appeal.
3 *Ex p Jay* (1880) 14 Ch D 19, 26 (Cotton LJ), cited by Lord Neuberger in *Perpetual Trustee* (CA), n. 1 above, para. 1.
4 The contract was worded so that the payments under the swap were independent, so not formally an insurance contract.

Swap Counterparty Priority unless ... an Event of Default ... occurs under the Swap Agreement and the Swap Counterparty is the Defaulting Party ... in which case Noteholder Priority shall apply.'

The administrator of LBSF contended that the Noteholders (including Perpetual Trustee) were not entitled to rely on this priority flip as it offended the anti-deprivation rule. Both the Court of Appeal and the Chancellor rejected this argument on two grounds: first, there was no relevant deprivation; and secondly, even if there was a relevant deprivation, it did not offend the rule unless it was triggered by the insolvency of LBSF, and here it had been triggered by the earlier insolvency of the parent company, LBIH. Both aspects merit comment.

The Master of the Rolls, Lord Neuberger, (with whom Longmore LJ agreed[5]) explained his conclusions as follows:[6]

'66 Patten LJ has reached the same conclusion on the simple basis that the "flip", that is, the reversal of the order of priority against a company as the holder of a charge, in favour of another chargee over the same assets, cannot be caught by the rule, even if it operates after the liquidation of the company, at least if such a reversal was an original feature of the company's charge when it was granted. I have considerable sympathy with that view, which has the merit of simplicity ... Further, it is fair to say that the principle of party autonomy[[7]] ... supports his view.

67 However, while that view may well indeed be right, I prefer to rest my conclusion in this case on the more limited ground that, in addition to the facts relied on by Patten LJ, the assets over which the charge exists were acquired with money provided by the chargee in whose favour the "flip" operates, and that the "flip" was included merely to ensure, as far as possible, that that chargee is repaid out of those assets all that he provided (together with interest), before the company receives any money from those assets pursuant to its charge. It seems to me that there may be room for argument that, in the absence of these additional facts, the arrangement in this case would have fallen foul of the [anti-deprivation rule] ... There is also a danger that the simple analysis adopted by Patten LJ could, in the light of the very limited circumstances in which the court will hold a transaction to be a sham, make it very easy to dress up sale transactions in such a way as to enable the rule to be circumvented.'

The facts and legal principles which persuaded him to reach these conclusions were summarised earlier and bear repeating here if the various inter-related issues are to be clarified for the future:[8]

'61 ... The essence of the arrangements embodied in the extensive documentation appears to me to be as follows: (i) The collateral, over which the rights in question were created, was acquired mainly with money derived from the Noteholders, through their subscription monies. (ii) LBSF provided little by way of subscription monies: it simply agreed to pay the interest and capital due to the Noteholders through the SPV [the Issuer] in exchange for the interest and collateral, albeit that it was able to reduce the payments to the Noteholders by reference to failings in the credit standing of the "reference entities". (iii) So long as there was no risk of default, the Noteholders were prepared for the scheme to provide that LBSF would have priority when it came to "unwinding" the transaction. (iv) However, the scheme provided, and was sold on the basis that, if LBSF or LBHI defaulted so that they could not, or did not, pay the interest and the capital on the Notes, then it would be the Noteholders who would have priority both in relation to repayment and in relation to the Unwind Costs. (v) The effect of the "flips" would not be to entitle the Noteholders to more than they had subscribed (with interest), and, if there was no shortfall, LBSF would not have been out of pocket as a result of the "flips".

62 The effect of the "flip" provisions was thus not to divest LBSF of monies, property, or debts, currently vested in it, and to revest them in the Noteholders, nor even to divest LBSF of the benefit of the security rights granted to it. It was merely to change the order of priorities in which the rights were to be exercised in relation to the proceeds of sale of the collateral in the event of a default. Further ... the right granted to LBSF was a security right over assets purchased with the Noteholders' money, and, from the very inception, the priority, and the extent of the benefits, enjoyed by LBSF in respect of the security were contingent upon there being no Event of Default. Thus, the security rights, as granted to LBSF, included the "flip" provisions, and even at the date the "flips" operated, the priority enjoyed by LBSF was no more than a contingent right. As Patten LJ points out in his judgment, the effect of the "flip" provisions ... is merely to ensure that, as far as possible, the proceeds of sale of the collateral

Notes

5 *Perpetual Trustee* (CA), n. 1 above, para. 99.
6 *Perpetual Trustee* (CA), n. 1 above, paras 66 and 67.
7 Which Lord Neuberger also favoured as a reason for upholding the contractual provision: see *Perpetual Trustee* (CA), n. 1 above, para. 58.
8 *Perpetual Trustee* (CA), n. 1 above, paras 62-64.

© 2010 Chase Cambria Publishing

are used to repay the Noteholders their subscription monies in full, before LBSF recovers any sums from those proceeds. There is no question of the "flip" provisions giving the Noteholders more than they subscribed, at least before LBSF is paid the sums which are secured in its favour on the collateral.

63 In other words, the position, when the transaction came to be redeemed early, and "unwound", following an Event of Default, was not that LBSF had agreed, subsequent to the grant of the right, that it would lose the right it had been granted in relation to the proceeds of sale of the collateral as a result of the Default. Notwithstanding the Default, it retained its right, but, as had always been an agreed feature of that right, as a result of the Default, LBSF had to rank behind, rather than ahead of, the Noteholders, no doubt because it was those Noteholders whose money had been used to purchase the collateral.

64 Three principles which can be derived from the cases come into play. The first is that the rule has been held to apply to assets which were vested in the person on whose bankruptcy the deprivation is to occur. By contrast, this is a case where all that is changing is the priorities relating to the right, pursuant to a provision in the very document creating the right. Secondly, there is authority for the principle that the rule may have no application to the extent that the person in whose favour the deprivation of the asset takes effect can show that the asset, or the insolvent person's interest in the asset, was acquired with his money ... In this case, the collateral was effectively purchased exclusively with the Noteholders' money. The third principle is that the rule cannot apply to invalidate a provision which enables a person to determine a limited interest, such as a lease or a licence, which he has granted over or in respect of his own property, in the event of the lessee's or licensee's bankruptcy ... While not identical to a lease or licence, a charge, or provision for priorities for repayment, has features of similarity to a lease or licence, and differs from ownership.

Current understandings of 'the anti-deprivation rule'

The anti-deprivation rule is stated in various ways. Put at its strongest, A cannot agree that property will be A's until A is insolvent and then will revert to B.[9] This clarity and certainty is then immediately undercut by the common consensus that it is perfectly proper, and common, to provide that a lease or licence in favour of A will determine on A's insolvency.[10]

The rule has been applied by courts since at least the 18th century,[11] yet the line between what is permitted and what is not remains troublingly unclear. The only House of Lords authority is *British Eagle International Airlines Ltd v Compagnie Nationale Air France*.[12] As Lord Neuberger put it in *Perpetual Trustee*:[13]

> 'It is not entirely easy to identify the rule's precise limits, or even its precise nature ... as the reasoning in the various judgments in which the rule has been considered is often a little opaque, and some of the judgments are a little hard to reconcile.'

He expressed similar difficulties in the *Money Markets* case: 'I do not find it easy to discern any consistent approach in the authorities as to the application of the principle.'[14] And '... it is not possible to discern a coherent rule, or even an entirely coherent set of rules, to enable one to assess in any particular case whether [a deprivation provision] falls foul of the principle.'[15]

And matters do not seem to be improving. After three days of argument before the Court of Appeal in the *Perpetual Trustee* case, it is still not clear what counts as a deprivation; what public policy is being advanced;[16] whether the rule can only be triggered by insolvency proceedings; whether it matters that the parties' arrangement 'was always subject to the deprivation provision'; whether intention to avoid the insolvency legislation is relevant; whether regard should be paid to party autonomy; and whether it matters that the 'preferred' party effectively paid for the disputed benefit. The issues are clearly difficult; indeed, the deeper one digs into the area, the greater are the difficulties which emerge.

Notes

9 Subject to the rules on protective trusts: Trustee Act 1925 s. 33.

10 *Perpetual Trustee* (CA), n. 1 above, para. 64 (extracted above). Also see paras 81, 143-6.

11 The cases primarily relied on in *Perpetual Trustee* (CA) were *Whitmore v Mason* (1861) 2 J&H 204 ('*Whitmore*'); *Ex parte Mackay, re Jeavons* (1873) LR 8 Ch App 643 ('*Mackay*'); *Ex parte Jay, re Harrison* (1879) 14 Ch D 19 ('*Jay*'); *Ex parte Newitt, re Garrud* (1880) 16 Ch D 522 ('*Newitt*'); *In re Detmold* (1889) 40 Ch D 585 ('*Detmold*'); *Borland's Trustee v Steel Bros & Co Ltd* [1901] 1 Ch 279 ('*Borland*'); *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758 (HL) ('*British Eagle*'); *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd* [1985] Ch 207 (ChD) ('*Carreras*'); *Money Markets International Stockbrokers Ltd (in liq) v London Sock Exchange* [2002] 1 WLR 1150 (Neuberger J) ('*Money Markets*'); *Fraser v Oystertec plc* [2003] EWHC 2787 (Ch) ('*Oystertec*'); and *International Air Transport Association v Ansett Australia Holdings Ltd* [2008] HCA 3 (Aust HCt) ('*Ansett*').

12 N. 11 above.

13 *Perpetual Trustee* (CA), n. 1 above, para. 32; also see para. 93.

14 *Money Markets*, n. 11 above, para. 87.

15 *Money Markets*, n. 11 above, para. 117. Also see *Oystertec*, n. 11 above, paras 46-7.

16 *Perpetual Trustee* (CA), n. 1 above, para. 57.

© 2010 Chase Cambria Publishing

A new approach

This article proposes a route through the difficulties. It suggests there are two quite different rules in play. These need to be isolated and analysed separately. First, a party cannot contract out of the insolvency legislation. This is hardly a 'rule of public policy' demanding controversial judicial intervention; it merely reiterates that legislation trumps party autonomy, and the insolvency legislation does that.[17] Secondly, a party cannot arrange its affairs in order to deprive itself of property on its insolvency, so that it has fewer assets to distribute to its unsecured creditors. This *is* a public policy argument, and laying bare the extent of the prohibition is important. Put this way, it is clear that both rules are only material 'on insolvency', although only the second demands a provision triggered by the insolvency of the party to be deprived of the disputed asset. The first rule (*the 'contracting out' rule*) concerns arrangements that purport to provide for a different distribution of the insolvent's assets than would be provided by the insolvency legislation; the second (*the 'insolvency-deprivation' rule*) concerns arrangements triggered by insolvency that purport to deprive the insolvent of assets on which the insolvency distribution can bite.

Falling outside both these categories are transactions and arrangements that are fully executed prior to insolvency. These transactions do not raise the 'contracting out' rule, nor the 'insolvency-deprivation' rule, although they may sometimes be unwound under claw-back provisions in the insolvency legislation itself[18] or under specific statutory, common law or equitable rules[19] (often unrelated to insolvency) that might enable the liquidator to enhance the size of the insolvent estate.

Before looking at the reach of these two distinctive rules, the ground can be further cleared by eliminating a number of distractions that are completely irrelevant to the operation of either rule.

First, party autonomy is immaterial, even the autonomy of sophisticated and well advised parties. Autonomy is, of course, relevant when construing rights and obligations arising solely between contracting parties. But here, on insolvency, the real issue is the rights of creditors, and no amount of self-interested desire or careful drafting will allow contracting parties to expropriate statutory insolvency rights from third parties if, at law, the mechanism offends either the rule against contracting out of the insolvency legislation or the insolvency-deprivation rule. This autonomy argument (reinforced by claims of decades of custom and practice) similarly failed to win the day in the *Spectrum* litigation when the courts had to decide whether an arrangement described by the parties as a fixed charge was, at law, a floating charge.[20] Equally, the presence or absence of a deliberate intention to contract around the insolvency legislation is irrelevant;[21] it is the effect of the contractual arrangement that matters, not the aspirations supporting it.

On the other hand, both rules only attack agreements entered into by the insolvent. It is the *insolvent* who is not allowed to contract out of the insolvency legislation as it would otherwise apply on its insolvency; it is the *insolvent* who is not allowed to organise its affairs so as to deprive itself of property on its insolvency, so that it has fewer assets to distribute to its unsecured creditors. There is nothing to stop the secured or the unsecured creditors agreeing *with each other* that the assets to which some or all of them are entitled, as a group, will be redistributed amongst themselves in some different fashion. This is the essence of subordination agreements.

In addition, both rules only attack agreements that effect a 'contracting out' or a 'deprivation triggered by insolvency'; they do not touch agreements that simply squander the insolvent's assets in ill-advised commercial deals. These latter types of transactions can be unwound, if at all, only under the Insolvency Act 1986 ('IA 1986') or some relevant general law principle, or remedied for the benefit of the disappointed creditors by suing the irresponsible directors for damages for breach of duty.

Secondly, it is irrelevant that the 'preferred' (non-insolvent) party effectively paid for the disputed benefit. On insolvency, disappointed creditors are perhaps doubly disappointed when they can readily identify 'their' assets in the pool of assets to be distributed on insolvency, but, notwithstanding this, they can have priority of access only if their agreement includes effective security over the assets in question. This can be provided relatively easily – e.g. retention of title, mortgages, charges, *Quistclose* trusts – but, unless it is done, the benefits cannot be claimed. This was precisely the predicament of the disappointed creditors in the

Notes

17 And if it is a 'rule of public policy', its application is hardly controversial. In *British Eagle*, n. 11 above, Lord Cross at p. 780 describes contracting out as contrary to public policy, and other cases adopt the same line. See, e.g., *Ansett*, n. 11 above, paras 163 and 171 (Kirby J, dissenting).

18 Insolvency Act 1986 ('IA 1986') ss 238 (transactions at an undervalue), 239 (preferences), and 245 (avoidance of certain floating charges).

19 E.g. the equitable rule providing relief against forfeiture. See S Worthington, 'What is Left of Equity's Relief Against Forfeiture?' in Elise Bant and Matthew Harding (eds), *Exploring Private Law* (2010, CUP) (forthcoming), where it is suggested that equitable relief is far more limited than traditionally conceived.

20 *National Westminster Bank plc v Spectrum Plus Ltd* [2005] UKHL 41.

21 *British Eagle*, n. 11 above, Lord Cross at p. 780. Although it may be relevant in determining whether arrangements are fraudulent or undue preferences under the IA 1986.

© 2010 Chase Cambria Publishing

corporate collapses of *Goldcorp*[22] and *London Wine*.[23] Noteholders are in no better position unless their security arrangements are effective. Importantly, their arrangements are only effective if they comply with all the usual rules relating to effective security *and* do not offend either of the rules noted earlier. In *Perpetual Trustee*, any assertion of a proprietary interest in favour of the Noteholders over either their purchase monies or the purchased collateral is likely to be overridden by contractual provisions which allowed the Issuer to use the monies and collateral as its own, including assigning the disputed property and issuing security over it to others.

Thirdly, it is irrelevant that the parties' arrangement 'was always subject to the deprivation provision'.[24] This focus on timing misses the core issue. A party cannot initiate or participate in an arrangement which has the effect that assets it already owns, *or assets it is about to acquire*, will be dealt with on its insolvency in a way that is contrary to the insolvency legislation or offends the insolvency-deprivation rule. The cases make this very clear.[25] The real issue is not the timing of the disputed agreement, but its function: does the agreement define the insolvent's property itself in an acceptably limited way (as the majority of the House of Lords thought in *British Eagle*,[26] and as the Court of Appeal thought in *Perpetual Trustee*[27]), *or* does it identify an existing asset and provide different rules for its distribution on insolvency (i.e. offend the 'contracting out' rule), or provide that on insolvency the identified asset will no longer be part of the insolvent's estate (i.e. offend the 'insolvency-deprivation' rule).

The 'contracting out' rule

This is the *British Eagle* issue. It arises only very infrequently. Taking the assets of the company at the time of its insolvency, are there contractual arrangements that effect a distribution of the insolvent's estate that is different from that provided under the insolvency legislation?[28]

In this class of case, it is irrelevant that the parties did not intend to achieve an insolvency advantage, or that the arrangement is long-standing, or has always represented the relationship between the parties, or is a static arrangement involving no insolvency trigger which changes the arrangement between the parties. All this is plain from the *British Eagle* case itself.[29]

On the other hand, it is crucial that the company is in insolvency proceedings, and that it has assets that need to be dealt with under those proceedings. What is then important is the *effect* of the impugned arrangement on the treatment of the insolvent's assets *on* its insolvency. If the assets have already been dealt with prior to insolvency, then the only recourse for the liquidator is the claw-back provisions under the IA 1986. This was crucial to the finding in the *British Eagle* case that transactions that had already been netted out through the IATA clearing house the previous month were safe. These were treated as discharged debts of British Eagle, and the only remedy available to the liquidator would be to complain that the discharge was on terms that breached the IA 1986 – and of course this was not the case. Similarly, this idea of proper discharge was crucial to the finding in *Carreras* that the debt owed by Carreras to Freeman Mathews (which was the property of Freeman Mathews) was properly discharged on the payment by Carreras into the trust account.[30] As the insolvency legislation then stood, this discharge, it seems, was not able to be impugned. On the other hand, any debts due to Freeman Mathews that remained outstanding at the date of liquidation could not be dealt with under the special account arrangements; this would effect a contracting out of the IA 1986 since the arrangement would effectively prefer one creditor (the one doing Carreras' work) over all the other creditors of Freeman Mathews.[31]

Notes

22 *Re Goldcorp Exchange Ltd (in rec)* [1995] 1 AC 74 (PC).

23 *Re London Wine Company (Shippers) Ltd* [1986] PCC 121. Also see *Re Wait* [1927] 1 Ch 606.

24 In *British Eagle*, n. 11 above, an argument to same effect was held not sustainable (see Lord Cross, p. 780F-H). Also see *Mackay*, n. 11 above. Contrast *Perpetual Trustee* (CA), n. 1 above, Patten LJ at para. 135, and perhaps Lord Neuberger at para. 62.

25 This is addressed in detail below, but see *British Eagle*, n. 11 above, Lord Cross at p. 780.

26 N. 11 above, and see the detailed discussion below.

27 N. 1 above.

28 The impugned arrangements may be one effecting a contractual set-off a mini-liquidation to the advantage of some creditors when compared with the outcome that would have pertained given set-offs permitted under the insolvency legislation; or it may be an arrangement which defeats the general insolvency rules that prioritise secured creditors, prefer certain defined categories of unsecured creditors, and then generally rank remaining unsecured creditors pari passu. See *Carreras*, n. 11 above, at p. 226: 'Thus the principle that I would extract from [*British Eagle*] is that where the effect of a contract is that an asset which is actually owned by a company *at the commencement of its liquidation* would be dealt with in a way other than in accordance with [the relevant insolvency legislation], then to that extent the contract as a matter of public policy is avoided, whether or not the contract was entered into for consideration and for bona fide commercial reasons and whether or not the contractual provision affecting that asset is expressed to take effect only on insolvency.' (emphasis added)

29 N. 11 above.

30 *Carreras*, n. 11 above, p. 226G.

31 *Ibid.* pp. 228G-229B.

© 2010 Chase Cambria Publishing

Equally, if the impugned arrangement does not determine the distribution of the insolvent's assets, but defines the very asset which is the subject of the insolvency proceedings, then the transaction is safe (subject to the operation of IA 1986 claw-back provisions, of course). This was the issue in *British Eagle* itself. There the majority of the House of Lords thought that the IATA arrangement determined the distribution of British Eagle's primary assets, being the airline debts owed to British Eagle by Air France and others.[32] The minority in the House of Lords, however, and all the judges in all the courts below, thought that the IATA arrangement eliminated the underlying debts between individual airlines and replaced them with the net claims against IATA.[33] Accordingly, they all concluded that there was no illegitimate arrangement that effected a contracting out of the insolvency legislation; British Eagle's assets was simply its claim against IATA, and those would be dealt with precisely as the insolvency legislation provided. Similarly, this issue was key in the *Ansett* litigation before the High Court of Australia.[34] There, by contrast, the majority of the High Court held that the amended IATA contract effectively defined the insolvency property of Ansett as the net claims against IATA. *If* this construction of the IATA contract is correct, then the conclusion that the arrangement did not effect an illegitimate contracting out of the insolvency regime clearly follows. However, the 'if' is important, and – with respect – Justice Kirby's rigorous dissenting analysis of the IATA contract is persuasive.[35]

On its face, this 'contracting out' rule has no application to the *Perpetual Trustee* case. The priority flip clause defines the property of LBSF on insolvency as a debt from the Issuer secured over certain collateral held by the Trustee. The 'flip' element, however controversial, is not an arrangement that determines the distribution of LBSF's assets on its insolvency.[36] Instead, it defines the assets available for distribution on insolvency, and so could potentially offend the second rule, the insolvency-deprivation rule.

The 'insolvency-deprivation' rule

This second rule is a true anti-deprivation rule: a party cannot arrange its affairs so as to deprive itself of property on its insolvency, so that it has fewer assets to distribute to its unsecured creditors. Adopting Lord Neuberger's description from *ex parte Jay*, 'there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors.'[37]

This *is* a rule rooted in public policy. It is the courts that prohibit such arrangements, not the IA 1986. Public policy is not engaged simply because parties conduct their businesses in a manner that leaves too few assets to be distributed to disappointed creditors; that is a natural risk of commercial activity.[38] It is engaged only when parties agree that insolvency will trigger a deprivation of property so that the insolvent has fewer assets to distribute to its creditors. The crucial, and difficult, issue is what constitutes such an impermissible deprivation of property, and how this is distinguished from legitimate arrangements, albeit ones that leave insolvents with a shortfall for distribution.

Once again, certain issues are clear (even if they have generated some confusion in recent cases).

First, it *is* legitimate for courts to intervene on the grounds of public policy, even in areas primarily governed by statute. Such interventions are likely to be rare, but nevertheless important. Every equity student is familiar with cases where conditions imposed on property rights have been held void on the grounds of immorality, illegality or matters otherwise contrary to public policy.[39] Arrangements designed to defeat the interests of creditors are not unique in attracting the concern of public policy. Despite this, there was noticeable judicial hesitation in intervening in *Perpetual Trustee*,[40] with concern expressed not to extend the rule any further,[41] to protect party autonomy,[42] and to prefer a conclusion that the flip clause effected

Notes

32 *British Eagle*, n. 11 above, Lord Cross at pp. 778-9. Also see *Carreras*, n. 11 above, pp. 224-226.

33 *British Eagle*, n. 11 above, Lord Morris of Borth-y-Gest (dissenting) at pp. 760 *et seq.*, especially p. 769, with Lord Simon agreeing with him. And in the lower courts, [1974] 1 Lloyd's Rep 429 (CA), Russell LJ for the court, at p. 433; [1973] 1 Lloyd's Rep 414 (HCt), Templeman J, especially pp. 434-435.

34 *Ansett*, n. 11 above.

35 *Ibid.* para 145. Kirby J does not suggest that the parties could not have set up an insolvency-proof clearing house system, merely that their contract by its terms had not succeeded in that aim. He recognised the enormous international commercial benefits of such a scheme, but held that market arguments could not override legal arguments when third party insolvency rights were at stake.

36 This conclusion might be different if the flip clause effected a *contractual* set off or limitation, rather than defining a security. See *Swiss Bank Corpn v Lloyds Bank Ltd* [1982] AC 584 (HL) on the relevance of the parties' intention in determining whether a charge is created.

37 *Jay*, n. 11 above, p. 26, cited in *Perpetual Trustee* (CA), n. 1 above, para. 1.

38 And there is often nothing that creditors can complain about, but when complaints can be made, they are not rooted in this rule—they are, instead, rooted in the various claw-back and breach of duty provisions in the IA 1986.

39 G Moffatt, *Trusts Law: Text and Materials* (4th edn, CUP, Cambridge, 2005), pp. 291-306.

40 *Perpetual Trustee* (CA), n. 1 above, paras 54, 113, 123 and especially 171-172, all seemingly confining intervention to 'contracting out' provisions, although contrast paras 32 *et seq.* and 152 *et seq*; also see para. 91.

41 *Perpetual Trustee* (CA), n. 1 above, para. 57.

42 *Perpetual Trustee* (CA), n. 1 above, paras 58, 91.

© 2010 Chase Cambria Publishing

a permissible reduction in value rather than an impermissible deprivation of property.[43] Similarly in the Australian *Ansett* case, there was judicial reluctance on the part of the majority to reach a conclusion that would upset the commercially successful and internationally beneficial IATA clearing house scheme.[44] But deliberate insolvency-triggered deprivations that were the concern in *Perpetual Trustee*, and all the earlier cases, are not prohibited by any express provision in the IA 1986. If these arrangements are to be outlawed, it is the courts that must act. *Perpetual Trustee* recognised this.[45] As noted earlier, it also recognised that it and earlier cases have not yet successfully articulated a clear set of principles which justify intervention.

Secondly, *if* the arrangement breaches the insolvency-deprivation rule, then it is void. The courts can put a blue pencil through the provision. Although the offending clause would only take effect when triggered by insolvency, it is not necessary to wait until that point to decide that the clause is contrary to public policy. On the other hand, it will be necessary to wait until insolvency to determine what assets are available for distribution. This is especially so if the agreement contains other deprivation triggers (e.g. forfeitures triggered by non-performance or other events), since these triggers are likely to be effective.[46] It follows that it is meaningless to say that the deprivation clause is effective as between the parties but void as between the insolvent and its creditors. The clause is only designed to take effect on insolvency, and so is never effective between the parties. This assertion confuses the two rules—contracting out and insolvency-deprivation. It *is* true that contracting out arrangements, by contrast, are effective between the parties prior to insolvency, but ineffective on insolvency.[47]

Thirdly, the party's insolvency *must* trigger the deprivation.[48] The rule does not catch arrangements which prevent property ever reaching the insolvent's hands, as happens with effective retention of title agreements, *Quistclose* trusts,[49] or purchase money security interests.[50] Equally, deprivations caused by some other event – any other event – are not touched by this rule. In particular, deprivations caused by pre-insolvency disposal of assets,[51] or by deprivation or forfeiture clauses that are not triggered by the party's own insolvency, are all untouched by the 'insolvency-deprivation' rule.[52] This is illustrated by the effective deprivations in cases such as *Newitt* (deprivation triggered by default)[53] and *Detmold* (deprivation triggered by alienation).[54]

If the parties have provided for a number of deprivation triggers, then the outcome can be fortuitous. The first deprivation to be activated in *Detmold*[55] was effective (triggered by alienation, not insolvency), and so on insolvency the husband's creditors did not gain access to the assets, and the wife took them instead. The result would have been quite the opposite if the first triggering event had been the husband's insolvency. That deprivation provision would have been void, so the assets would have remained with the insolvent and been available for the insolvent's creditors. Any later trigger might have nothing to bite on, and then the preferred parties under subsequent triggering clauses might receive nothing.[56] But the 'might' here is important. The court in *Perpetual Trustee* recognised the potential difficulty in cases where the parties purport to activate a non-insolvency deprivation trigger, but to do so after insolvency. This was the position in *Newitt*,[57] where the insolvent builder's chattels were held to be legitimately forfeited to the landowner notwithstanding a post-insolvency activated triggering of a (non-insolvency)

Notes

43 *Perpetual Trustee* (CA), n. 1 above, para. 152.
44 *Ansett*, n. 11 above, e.g. paras 76-79.
45 N. 1 above, paras 32 *et seq*. and 152 *et seq*.
46 Subject to IA 1986 claw backs, etc.
47 *British Eagle*, *Carreras* and *Ansett*, n. 11 above, all illustrate this. Contrast *Perpetual Trustee* (CA), n. 1 above, para. 56.
48 It does not matter whether the trigger is practical insolvency or later formal proceedings: *Whitmore*, n. 11 above, p. 215 (Page Wood V-C). The public policy argument is equally strong in either case, and a rule confined to formal insolvency would enable insolvent parties to evade the rule with impunity.
49 *Barclays Bank Ltd v Quistclose Investments Ltd* [1970] AC 567 (HL).
50 This must be the explanation of the dicta in *Whitmore*, n. 11 above, pp. 212, 214-5 (Page Wood V-C).
51 Including encumbering assets by granting effective security over them.
52 This does not mean that the deprivation cannot be overturned, just that the means of overturning it is not this public policy insolvency-deprivation rule. Instead, the arrangement can be overturned – and the assets available to the unsecured creditors enhanced – using all the IA 1986 claw back provisions or other common law, equitable or statutory remedies.
53 N. 11 above. Now, however, such a clause needs to be construed a little more carefully. Forfeiture enabling the landowner to use the chattels to complete the work may be acceptable, but a forfeiture that entitles the landowner to keep the chattels as liquidated damages may be held to be a penalty (see Worthington, n. 19 above), and one that entitles the landowner to sell the chattels and retain an appropriate sum as damages may be held to be a floating charge (likely to be invalid as unregistered): see *Re Cosslett (Contractors) Ltd* [1998] Ch 459 (CA).
54 N. 11 above.
55 N. 11 above.
56 *Jay*, n. 11 above; *Re Burroughs-Fowler* [1916] 2 Ch 251.
57 N. 11 above.

© 2010 Chase Cambria Publishing

contractual default forfeiture clause. Lord Neuberger and Patten LJ both suggest that *Newitt* cannot survive the decision in *British Eagle*.[58] That would not necessarily follow from the analysis proposed here.[59] Both pre- *and* post- bankruptcy enforcement of any *non-insolvency* deprivation triggers would be effective to the extent permitted by the relevant insolvency legislation and other common law and equitable rules. In other words, *non-insolvency* deprivation triggers would not, on insolvency, suddenly morph into automatically void insolvency-deprivation provisions. Under insolvency rules, the appropriate analysis is that post-insolvency dispositions are prohibited,[60] but that liquidators take the insolvent's assets as they find them; which limb is applicable depends on the particular arrangements in issue, but often it will be the latter limb that should be applied.[61]

Fourthly, the rule only concerns arrangements entered into *by* the insolvent. Arrangements between the insolvent's creditors, which do not include the insolvent, such as debt subordination agreements, can quite properly effect a different allocation of assets than that prescribed by the IA 1986. Such arrangements in themselves have no impact at all on the total estate available for distribution, only on the outcome of that distribution – and such arrangements between creditors alone are not impugned as an illegitimate 'contracting out'.

Fifthly, it is irrelevant that the asset being 'deprived' was acquired by way of gift rather than for valuable consideration. It is still an asset of the insolvent on the insolvent's winding up, and the fact that it was obtained by valid (this is important[62]) gift does not mean it is then subject to different rules in determining its distribution on insolvency. For the same reason, the insolvent's bona fides in agreeing to the deprivation arrangement are irrelevant.[63]

Sixthly, as in the 'contracting out' cases, it is irrelevant that the provision was 'always a term of the contract', rather than a post-acquisition initiative that effected a deprivation triggered by insolvency. *If* the arrangement effects an impermissible deprivation (and one that is triggered by insolvency), then the arrangement is void, and it is immaterial that it was always a term of the contract. The 'if' is, admittedly, more difficult to assess – see below. But the precedents are plain: *Whitmore* (deed dealing with partnership property), *Borland* (shares), *Money Markets* (shares) are all cases indicating that a provision which was 'always a term of the contract' might be held void as offending the insolvency-deprivation rule. It misses the point to argue that the party's asset cannot pass to the liquidator *except* subject to the deprivation condition.[64] The function of the insolvency-deprivation rule is precisely to determine whether the condition is void or effective.

Finally, what counts as a deprivation? What arrangements, if insolvency-triggered, will offend the insolvency-deprivation rule? This is undoubtedly *the* difficult issue, although even here there are a number of situations that are easy to classify. First, it is clear that deprivations are assessed pragmatically. If the deprivation is on terms that assets being withdrawn from the insolvent's estate are replaced by funds (or, presumably, other assets) of equivalent or appropriate monetary value, then the provision does not offend the insolvency-deprivation rule:[65] see *Whitmore*[66] (partnership assets taken at market valuation), *Borland*[67] (shares taken at what the court deemed to be a 'fair' value).

Secondly, if the insolvent *has* an asset, and arranges that it – or any part of it – will 'remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors',[68] then that offends the insolvency-deprivation rule and the arrangement is void: see *Mackay* (royalties), *Jay* (builder's chattels), *Detmold* (marriage settlement), *Oystertec* (patents).[69] From this follows the well-recognised rule that parties cannot set up

Notes

58 N. 1 above, Lord Neuberger at paras 92-93 and Patten LJ at paras 162-163.

59 Unless the provision is construed as providing contractually for a different distribution of the insolvent's assets on insolvency (thus breaching the 'contracting out' rule), rather than effecting a deprivation of the insolvent's property.

60 IA 1986 s. 127.

61 *Newitt*, n. 11 above, p. 531 (James LJ), cited by Patten LJ in *Perpetual Trustee*, n.1, para. 160. Also see *George Barker (Transport) Ltd v Eynon* [1974] 1 WLR 462.

62 Invalid gifts can be subject to resulting trusts claims from the purported donor.

63 Fraud may also be caught by the IA 1986 s. 207.

64 *Perpetual Trustee* (HCt), n. 1 above, para. 45.

65 Although even this concession was not initially made: see *Wilson v Greenwood* (1818) 1 Sw 471, 482 (Lord Eldon LC), cited in *Perpetual Trustee* (CA), n. 1 above, at para. 32. The partnership deed provided that, on bankruptcy or insolvency, the interest of the insolvent partner should be taken by the solvent partners at valuation, and Lord Eldon thought this was nevertheless void.

66 N. 11 above, cited in *Perpetual Trustee* (CA), n. 1 above, by Lord Neuberger at para 34.

67 N. 11 above, pp. 291-293, including an extensive discussion of whether the measure of compensation met the requirements to avoid the insolvency-deprivation rule.

68 *Jay*, n. 11 above, p. 26.

69 All cases cited at n. 11 above. This conclusion on patents is not, it seems, touched by Lord Neuberger's suggestion in *Perpetual Trustee* that parts of the *Oystertec* decision must be deemed overruled: n. 1 above, para. 74.

© 2010 Chase Cambria Publishing

protective trusts of their own property in favour of themselves.[70]

On the other hand, and thirdly, if the arrangement is such that the insolvent receives and only ever holds the asset subject to a deprivation limitation, then the deprivation question is considerably more difficult. For example, leases or licences determinable on the lessee's or licensee's insolvency are exceedingly common and undoubtedly valid.[71] By contrast, other similarly worded deprivation arrangements are void: *Whitmore* (partnership property), *Borland* (shares), *Money Markets* (shares), and *Oystertec* (patents) all illustrate potentially void insolvency-triggered deprivation provisions that had always been part of the parties' agreement.[72] What divides these two types of cases? And does the *Perpetual Trustee* priority flip clause (if insolvency-triggered) fall on the same side of the divide as partnership interests, shares and patents (all unacceptable insolvency-deprivations), or on the same side a leases and licences (all either not deprivations at all, or legitimate deprivations)?

Cases and commentary often suggest that the divide tracks the distinction between impermissible conditional interests ('but if' the person becomes insolvent), and permissible determinable interests ('until' the person becomes insolvent). Moreover, the line between these two categories is said to turn primarily on the language used, or on the form rather than the substance of the arrangement.[73] If breach of the insolvency-deprivation rule hangs on the form of words used, so that 'but if' offends public policy whilst 'until' does not, even though both might relate to the same underlying asset and impose the same insolvency limitation, then there is certainly something seriously wrong with the law.[74] But the crucial distinction, it seems, is not rooted simply in language. For instance, it has never been suggested that the validity of insolvency-triggered limitations in leases and licences turns on such niceties of language.

Once again, different objectives in judicial intervention seem to have been run together to create a degree of confusion that now needs some unravelling.[75] Recall some of the learning common to most law undergraduates. Conditional interests can be interests subject to conditions precedent (interest to vest 'if and when X happens') or conditions subsequent (interest to divest 'if/but if' X happens). These conditions may sometimes be held invalid, and important practical consequences then follow. For example, conditions may be invalid if they are too uncertain. Complications arise because the test of certainty and the impact of a decision that the condition is too uncertain differ depending upon whether the interest is subject to a condition precedent or a condition subsequent. Such conditions might also be void on other grounds, including public policy grounds. In addition, conditions subsequent (but not conditions precedent) were deemed void if they purported to take away freedom of alienation. The reason for this was that such a condition was held 'repugnant' to the legal nature of a fee simple or right of ownership; the condition was not void because it was contrary to public policy, but because as a matter of legal logic the interest in question could not have the right of alienation severed.[76] This meant that an interest subject to a condition subsequent that '*if/but if* A shall seek to charge or otherwise dispose of the interest or shall become bankrupt then A's interest will cease' was deemed void. On the other hand, determinable interests were held not to fall foul of the rule against 'repugnancy', and accordingly a disposition to A for a limited term '*until* A shall seek to charge or otherwise dispose of the interest or shall become bankrupt then A's interest will cease' was deemed valid. This distinction between interests subject to a condition subsequent (often simply termed conditional interests, but without intending to include interests subject to a condition precedent) and determinable interests – or between 'but if' and 'until' limitations – became well-established and eventually provided the basis for protective trusts (as accepted by the courts and later enshrined in statute[77]).

Perhaps predictably, this understanding led to savage criticism that dramatically different outcomes might hang on wafer-thin differences in language – '*but if*' rather than '*until*'.[78] But this conclusion ignores the underlying 'repugnancy' rationale for finding invalidity in conditions subsequent, and then compounds the error by eliding the repugnancy ground of invalidity with a potentially broader ground of invalidity based

Notes

70 *Re Brewer's Settlement* [1896] 2 Ch 503. This is so even though protective trusts (of income) are allowed under the Trustee Act 1925 s. 33, and that provision does not explicitly deny a settlor the ability to do this with his own property; s. 33(3) merely preserves the general law rules in respect of invalidity. On the other hand, an insolvent can of course be the beneficiary of a protective trust (of income) which has been set up by others over property that they then owned.

71 See n. 10 above.

72 All at n. 11 above.

73 G Moffatt, *Trusts Law: Text and Materials* (4th edn, CUP, Cambridge, 2005), pp. 257-258.

74 See the comments below at n. 78.

75 One of the better analyses is in G Moffatt, *Trusts Law: Text and Materials* (4th edn, CUP, Cambridge, 2005), ch 6, p 254 *et seq*.

76 *Ibid.*, p. 257, noting that the circularity of this approach is comprehensively attacked by Glanville Williams ((1943) 59 LQR 343).

77 Trustee Act 1925 s. 33.

78 E.g. *Re Kings' Trusts* (1892) 29 LR Ir 401, 410 *per* Porter MR ('little short of disgraceful to our jurisprudence'); *Re Sharp's ST* [1973] Ch 331, 340; *Re Trusts of the Scientific Pension Plan* [1999] Ch 53, 59 (Rattee J); *Money Markets*, n.11 above, para. 87.

© 2010 Chase Cambria Publishing

on the public policy interest in overriding attempts to defeat the interests of creditors.

Indeed, it is notable that the cases themselves do not mechanically classify interests as either conditional or determinable, and then simply hold the former void on the grounds of public policy and the latter valid as legitimate arrangements. Instead, they hold a line between capital and income interests (roughly speaking), with the former not able to be limited or made subject to insolvency-deprivation provisions, and the latter able to be made subject to them.[79] The statutory protective trust repeats this division, and protects only the income rights of beneficiaries.[80]

This clearly acknowledged capital/income distinction is instructive, and intuitively attractive, yet it too provides a dividing line that is hardly robust enough to carry the burden of a rigorous application of the insolvency-deprivation rule. Too many cases would remain debatable. A clearer and more certain rule is needed when the conflicting rights of innocent creditors hang in the balance.

One workable option is suggested here. It is supported by all the cases, even if not expressly articulated by them. It is this. *If* the proprietary interest in question can *only* and must *necessarily* be defined in a time-limited way, then it is legitimate to define the time limitation in any way the parties choose, including by reference to the insolvency of the interest-holder. Leases, licences, rights to interest payments and dividend payments, rights to income and annuities all fall into this category. Within this category, a party can agree to receive (by gift or by contract) such assets in a way that is time limited from the outset, including a time limitation that determines on the party's insolvency.[81] *Only* in these cases is it true to say that the limitation marks the bounds of the right, so the right *terminates*, or is determined, on the insolvency trigger, and the insolvent's estate is not illegitimately deprived of an asset it would otherwise have for distribution.

By contrast, with *all* other proprietary rights, the insertion of a time limitation effects a forfeiture; it does not simply define the term of the interest. In this category are houses, shares, patents, debts, royalties, and so on. In this category, *if* a time limitation is inserted, and *if* it is triggered by the right-holder's insolvency, then the limitation is void.[82] It will be regarded as designed to ensure that the asset – or some part of it – will 'remain [the insolvent's] until his bankruptcy, and on the happening of that event shall go over to someone else,[[83]] and be taken away from his creditors.'[84] This offends the insolvency-deprivation rule, and the arrangement is void. The courts can run a blue pencil though the provision.

The intuition behind this proposed distinction between interests that are *necessarily* and *inherently* time-limited and those that are not is one that all the recent cases have implicitly pursued, although in the end the analysis has invariably been deflected and become entangled in the technical distinctions between conditional and determinable interests.[85]

Applying this analysis to the facts in *Perpetual Trustee*, the insolvency-deprivation rule would render the

Notes

79 Starting from *Brandon v Robinson* (1811) 18 Ves 429. See, e.g., *Re Smith* [1916] 1 Ch 369, especially p. 374 (Sargant J), where a clause worded as a forfeiture clause and using 'if ... then ...' language was held to be void for repugnancy, but essentially on the ground that the capital aspects could not be severed from the income aspects, with the implication that the outcome might have been different, despite being worded as a condition subsequent, if the assets had been exclusively income assets. Similarly, in *Re Trusts of the Scientific Pension Plan* [1999] Ch 53, at pp. 59-63 (Rattee J), where a clause which provided that all rights to an annuity would be 'forfeited' on bankruptcy was held effective, but it was seen as significant that the annuity was an income right, not a right to a capital sum or to an absolute or life interest in capital, and so *Smith* (above) and the Australian case of *Caboche v Ramsay* (1993) 119 ALR 215 were both distinguished. *Re Leach* [1912] 2 Ch 422 (income limited 'until ...' held valid). *Re Forder* [1927] 2 Ch 291 (CA), especially p. 311 (Sargant LJ), where a forfeiture clause was held not void for repugnancy because it was limited to income interests arising before the beneficiary was entitled to an absolute interest in the capital (so, again, enabling the case to be distinguished from *Smith*, above).

80 See Trustee Act 1925 s. 33. More generally in this area, the focus on public policy / repugnancy rationales, not on form over substance, is reinforced by the treatment of interests arising under trusts. The famous flexibility of trusts is ignored, and indeed the courts simply 'look through' the trust structure, and reach the same conclusions as would have been reached if the underlying asset had been held directly at law: see Lord Eldon in *Brandon v Robinson* (1811) 18 Ves 429, 434. Some commentators suggest this was part of Lord Eldon's objective to assimilate equity and law (e.g. Alexander, (1985) 37 Stanford LR 1189, 1199, cited in Moffatt, n. 75 above, p. 258). This may have been a motivation, but neither public policy nor repugnancy concerns could have been addressed if trust devices were allowed to operate as shrouds over the underlying dispositions or deprivations.

81 Recall, however, that the insolvent cannot set up such an arrangement over assets that are already his – see above, n. 69 and related text.

82 E.g., many assets can be made subject to contractual forfeiture provisions, or can be held under trusts in ways that define different parties' interests along a time line. These arrangements can sometimes be overturned outside insolvency (see, e.g., the rules on forfeiture, n. 19 above), but will invariably be held void if the forfeiture or deprivation trigger is the right-holder's insolvency. These arrangements breach the insolvency-deprivation rule.

83 Notably with this category of assets, the deprivation provision will need to specify, even if only implicitly, in whose favour the interest is forfeited.

84 *Jay*, n.11 above, at p. 26 (Cotton LJ).

85 E.g., see Neuberger J in *Money Markets*, n.11 above, para. 37 (interests that are 'inherently determinable or where there is some sort of superior reversionary interest'), and para. 118 (also cited in *Perpetual Trustee* (HCt), n. 1 above, para. 38, distinguishing between an interest 'coming to an end' and an interest 'revesting').

© 2010 Chase Cambria Publishing

priority flip clause void *if*, and only if, the clause is triggered by LBSF's insolvency *and* the flip constitutes a deprivation. Here it seems the flip was triggered earlier, and not by LBSF's insolvency.[86] If LBSF's insolvency did not trigger the flip, then the insolvency-deprivation rule has no application, and there is no need to consider the further issue of whether the arrangement effects a deprivation – it is in any event outside the insolvency-deprivation rule. Of course, even if the insolvency-deprivation rule is dismissed, there is still a practical need to assess the impact of the non-insolvency triggered deprivation provision, but that is not of primary concern here.[87]

If the flip *had been* triggered by LBSF's insolvency, then the second issue becomes material. Is a priority flip a deprivation? The issue at stake must not be confused because of the number of parties. The question is not whether the *Issuer* can offer security over its assets in a way that prioritises one secured creditor (LBSF, the first chargee) in some circumstances and a second chargee (Perpetual Trustee) in other circumstances. If all three parties agree, this can certainly be done and the Issuer's unsecured creditors have nothing to complain about, assuming all the securities are valid and enforceable. Indeed, further encumbering its assets by advancing additional securities, even to existing creditors, is not a 'disposition' of the Issuer's assets,[88] and may not be a fraudulent preference or an undue preference unless the relevant statutory conditions are met. In *this* context it is true that a change in priority is not a disposition of assets that would offend the insolvency-deprivation rule: if the *Issuer* were insolvent, and LBSF and the Noteholders changed their secured priority triggered by the Issuer's insolvency, this would not be an illegitimate disposition of the *Issuer's* assets. But this is not the question. The question is, does the priority flip effect a deprivation of *LBSF's* assets?

More specifically, is it a deprivation to shift from a non-recourse debt secured by a first charge to a non-recourse debt secured only by a second charge? Put another way, is a charge (or a secured debt) *only and necessarily time-limited* (i.e., in the same category as leases, licences and the like), or not (i.e., in the same category as shares, patents and the like)? Lord Neuberger tentatively opted for the former.[89] If the preceding analysis is accurate, this might not be right.

A charge is clearly a proprietary interest, but *not* one that is only and necessarily limited by time; it is limited by performance of the underlying obligation. It follows from what has been said earlier that the addition of an insolvency-triggered limitation will offend the insolvency-deprivation rule.[90] This result might be further tested by changing the facts to make them more extreme: could LBSF agree that the debt owed to it by the Issuer is secured until LBSF is insolvent, and is then completely unsecured?[91] This too, it is suggested, clearly offends the insolvency-deprivation rule. It is not to the point that the value difference delivered by the insolvency-triggered deprivation will only be apparent if the Issuer is also insolvent, or (as here) if the debt is non-recourse and the there is a priority flip. The insolvency-deprivation rule looks to deprivations, not to how material they are.[92] On the analysis proposed here, a priority flip triggered by insolvency offends the insolvency-deprivation rule and is void.

Conclusion

This article suggests that the conclusions reached in *Perpetual Trustee* are correct, although the reasoning is far from being sufficiently clear to enable delivery of robustly predictable outcomes in other circumstances. Any future analysis might be assisted if the relevant principles and policies in play could be articulated more rigorously.

To that end, it is argued here that there are two distinct and distinctive rules in play, not one. There is a *'contracting out' rule*. This prohibits arrangements which provide for a distribution of the insolvent's assets that differs from the distribution that would be delivered by the IA 1986. There is also an *'insolvency-deprivation' rule*. This is a public policy rule which prohibits insolvency-triggered arrangements that deprive the insolvent of assets available for distribution on insolvency.

Notes

86 This is not absolutely clear from the judgment, and may merit further investigation given its potential significance to the outcome – see *Perpetual Trustee* (HCt), n. 1 above, paras 52-55, especially para. 52.

87 As noted earlier, such deprivations or forfeitures are subject to all the rules in the IA 1986, and to the general law. Timing may be crucial – see n. 55 above, and the related text.

88 *Re MC Bacon Ltd* [1990] BCLC 607.

89 *Perpetual Trustee* (CA), n. 1 above, para. 64. Also see para. 62: a charge given up or flipped is not a divestiture. Similarly, Patten LJ at para. 137: a priority flip is not a disposition of the company's property. These latter comments seem to misplace their focus, and relate to the chargor (the Issuer), not the chargee (LBSF). See the text immediately below.

90 By contrast, additional limitations defined by other events, including non-performance or third party insolvency, will not offend the insolvency-deprivation rule, although they may offend provisions in the IA 1986 or the general law.

91 This is the extreme of the 'flip' provision, and makes the point that the creditors of LBSF are not interested in *who* is advantaged by the potential deprivation effected by their insolvent debtor. *LBSF's* assets are not going to the Noteholders; rather, the *Issuer's* assets are going to the Noteholders rather than to LBSF, *because* of a clause that gives those assets to the Issuer when they might otherwise have belonged to LBSF.

92 Confirmed in *Perpetual Trustee* (CA), n. 1 above, para. 174.

© 2010 Chase Cambria Publishing

In assessing whether particular arrangements offend either of these rules, it is completely irrelevant that party autonomy may be overridden, that there was no intention to offend insolvency rules, that the arrangements between the parties were always subject to the provisions in question, or that the preferred parties effectively paid for the preferential benefits delivered by the provisions. In addition, in relation to the 'contracting out' rule, it is also irrelevant that there is no insolvency trigger (and maybe no trigger at all).

Finally, in relation to the 'insolvency-deprivation' rule, the commonly cited distinction between conditional and determinable interests is not the underlying discriminator in deciding whether an arrangement delivers an unacceptable deprivation. Rather, the distinction is between proprietary interests which can *only and necessarily* be defined in a time-limited way, and all other cases where interests need not be so defined. In the former category, the time limitation can be defined in any way the parties choose, including by reference to the insolvency of the interest-holder; in the latter category, any insolvency-triggered time-limitation will offend the insolvency-deprivation rule and the arrangement will be void.

© 2010 Chase Cambria Publishing

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists' Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

Editor-in-Chief: Mark Fennessy, Orrick, Herrington & Sutcliffe (Europe) LLP, London

John Armour, Oxford University, Oxford; Stephen Ball, Bryan Cove, London; Samantha Bewick, KPMG, London; Geoff Carton-Kelly, Baker Tilly, London; Sandie Corbett, Walkers, British Virgin Islands; Stephen Cork, Smith & Williamson, London; Ronald DeKoven, 3-4 South Square, London; Simon Davies, The Blackstone Group, London; David Dhanoo, Qatar Financial Centre Regulatory Authority, Qatar; Hon. Robert D. Drain, United States Bankruptcy Court, Southern District of New York; Nigel Feetham, Hassans, Gibraltar; Stephen Harris, Ernst & Young, London; Christopher Jarvinen, Hahn & Hessen LLP, New York; Matthew Kersey, Henry Davis York, Sydney; Joachim Koolmann, J.P. Morgan, London; Ben Larkin, Berwin Leighton Paisner, London; Alain Le Berre, Huron Consulting Group, London; Guy Locke, Walkers, Cayman Islands; Professor John Lowry, UCL, London; Lee Manning, Deloitte, London; David Marks Q.C., 3-4 South Square, London; Ian McDonald, Mayer Brown International LLP, London; Riz Mokal, 3-4 South Square, London; Lyndon Norley, Greenberg Traurig Maher LLP, London; Rodrigo Olivares-Caminal, United Nations Conference for Trade and Development, Geneva; Susan Prevezer Q.C., Quinn Emanuel Urquhart Oliver & Hedges LLP, London; Sandy Purcell, Houlihan Lokey Howard & Zukin, London; Dr. Arad Reisberg, UCL, London; Peter Saville, Zolfo Cooper, London; Daniel Schwarzmann, PricewaterhouseCoopers, London; Sandy Shandro, 3-4 South Square, London; Richard Snowden Q.C., Erskine Chambers, London; Dr. Shinjiro Takagi, Nomura, Japan; Lloyd Tamlyn, 3-4 South Square, London; Stephen Taylor, Alix Partners, London; William Trower Q.C., 3-4 South Square, London; Mahesh Uttamchandani, The World Bank, Washington, DC; Robert van Galen, NautaDutilh, Amsterdam; Miguel Virgós, Uría & Menéndez, Madrid.

For more information about *International Corporate Rescue*, please visit www.chasecambria.com