

## International Corporate Rescue – Special Issue

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## Insolvency Deprivation, Public Policy and Priority Flip Clauses

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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*,<sup>1</sup> 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.<sup>2</sup> 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.’<sup>3</sup> 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.<sup>4</sup> 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

- [2009] EWCA Civ 1160 (CA) (‘*Perpetual Trustee* (CA)’), on appeal from [2009] EWHC 1912 (Ch) (‘*Perpetual Trustee* (HC)’).
- 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.
- Ex p Jay* (1880) 14 Ch D 19, 26 (Cotton LJ), cited by Lord Neuberger in *Perpetual Trustee* (CA), n. 1 above, para. 1.
- 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<sup>5</sup>) explained his conclusions as follows:<sup>6</sup>

'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:<sup>8</sup>

'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 re-vest 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.

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.<sup>9</sup> 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.<sup>10</sup>

The rule has been applied by courts since at least the 18th century,<sup>11</sup> 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*.<sup>12</sup> As Lord Neuberger put it in *Perpetual Trustee*:<sup>13</sup>

‘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.’<sup>14</sup> 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.’<sup>15</sup>

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;<sup>16</sup> 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.

## 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.<sup>17</sup> 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<sup>18</sup> or under specific statutory, common law or equitable rules<sup>19</sup> (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.<sup>20</sup> Equally, the presence or absence of a deliberate intention to contract around the insolvency legislation is irrelevant;<sup>21</sup> 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.

corporate collapses of *Goldcorp*<sup>22</sup> and *London Wine*.<sup>23</sup> 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'.<sup>24</sup> 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.<sup>25</sup> 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*,<sup>26</sup> and as the Court of Appeal thought in *Perpetual Trustee*<sup>27</sup>), 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?<sup>28</sup>

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.<sup>29</sup>

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.<sup>30</sup> 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*.<sup>31</sup>

## 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.

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.<sup>32</sup> 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.<sup>33</sup> 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.<sup>34</sup> 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.<sup>35</sup>

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.<sup>36</sup> 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.'<sup>37</sup>

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.<sup>38</sup> 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.<sup>39</sup> 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*,<sup>40</sup> with concern expressed not to extend the rule any further,<sup>41</sup> to protect party autonomy,<sup>42</sup> 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 Corp'n 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.



a permissible reduction in value rather than an impermissible deprivation of property.<sup>43</sup> 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.<sup>44</sup> 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.<sup>45</sup> 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.<sup>46</sup> 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.<sup>47</sup>

Thirdly, the party's insolvency *must* trigger the deprivation.<sup>48</sup> 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,<sup>49</sup> or purchase money security interests.<sup>50</sup> 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,<sup>51</sup> or by deprivation or forfeiture clauses that are not triggered by the party's own insolvency, are all untouched by the 'insolvency-deprivation' rule.<sup>52</sup> This is illustrated by the effective deprivations in cases such as *Newitt* (deprivation triggered by default)<sup>53</sup> and *Detmold* (deprivation triggered by alienation).<sup>54</sup>

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*<sup>55</sup> 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.<sup>56</sup> 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*,<sup>57</sup> 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)

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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.

contractual default forfeiture clause. Lord Neuberger and Patten LJ both suggest that *Newitt* cannot survive the decision in *British Eagle*.<sup>58</sup> That would not necessarily follow from the analysis proposed here.<sup>59</sup> 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,<sup>60</sup> 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.<sup>61</sup>

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<sup>62</sup>) 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.<sup>63</sup>

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.<sup>64</sup> 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:<sup>65</sup> see *Whitmore*<sup>66</sup> (partnership assets taken at market valuation), *Borland*<sup>67</sup> (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',<sup>68</sup> then that offends the insolvency-deprivation rule and the arrangement is void: see *Mackay* (royalties), *Jay* (builder's chattels), *Detmold* (marriage settlement), *Oystertec* (patents).<sup>69</sup> From this follows the well-recognised rule that parties cannot set up

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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.

protective trusts of their own property in favour of themselves.<sup>70</sup>

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.<sup>71</sup> 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.<sup>72</sup> 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 as 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.<sup>73</sup> 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.<sup>74</sup> 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.<sup>75</sup> 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.<sup>76</sup> 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<sup>77</sup>).

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'.<sup>78</sup> 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

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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.

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.<sup>79</sup> The statutory protective trust repeats this division, and protects only the income rights of beneficiaries.<sup>80</sup>

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.<sup>81</sup> *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.<sup>82</sup> 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,<sup>[83]</sup> and be taken away from his creditors.'<sup>84</sup> 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.<sup>85</sup>

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

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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 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').

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.<sup>86</sup> 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.<sup>87</sup>

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,<sup>88</sup> 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.<sup>89</sup> 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.<sup>90</sup> 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?<sup>91</sup> 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 there is a priority flip. The insolvency-deprivation rule looks to deprivations, not to how material they are.<sup>92</sup> 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.

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.

*In re Stanford International Bank Limited* [2009] EWHC 1441 (Ch)

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**Overview**

If a company used to perpetrate a fraud (Ponzi, Madoff, Stanford) should fail, how should its centre of main interests (COMI) be determined?

The question is without an easy answer because, on one view, COMI should only ever be a question of fact whereas, on another view, the meaning of COMI not settled and may require refinement in the context of Council Regulation 1346/2000 on insolvency proceedings (the 'Insolvency Regulation'), and in the different context of the Cross Border Insolvency Regulation 2006 (the 'Cross Border Regulation'), to accommodate cases of fraudulent failure.

COMI is a question of fact (or more accurately a question of application) if it is treated as having a tolerably clear legal meaning derived from the legislative text and relevant legislative background. The Court must identify a company's 'interests', identify from those 'interests' which are 'main' and which are not, and, in relation to the former, locate their 'centre'. In applying each component to the facts found, the Court is entitled to exercise discretion in reaching its conclusion. Such discretion is permissible because it is unavoidable in making a judgement as to the proper application of a legal concept. On this view, there is no need to sharpen the legal meaning of COMI to reach a right answer consistent with the legislative intent and, significantly, there is no basis on which to do so.

There is no practical obstacle on this view, the broad view, to accommodating cases of fraudulent failure within the same framework as cases of non-fraudulent failure. COMI is to be determined at the point proceedings are opened, or at which recognition is sought, and that enquiry may take into account facts revealed post failure which would not have been apparent to creditors and other third parties (including, for example, financial regulators) in dealing with the company prior to its failure and the revelation of the fraud.

COMI is, alternatively, a concept that has a much more precise legal meaning. It is to be determined by reference to objective factors ascertainable to third parties which either confirm or rebut the presumption that a company's COMI is at the place of its registered office. The components of COMI outlined above are on this

view, the narrow view, subject to a rule which regulates the factors which the Court can take into account in determining COMI.

The narrow view does create a practical obstacle to accommodating fraudulent and non-fraudulent failure within the same framework. The same test can, of course, be applied in *all* cases, but in cases of fraudulent failure it is deeply unattractive that the opening and recognition of main insolvency proceedings should turn on the façade apparent to third parties and not the facts. For example, the mastermind of a fraud might organise the head office functions of his front company in Jurisdiction A because of its lack of effective regulatory oversight in order to facilitate a fraud on investors in Jurisdiction B. The matter is complicated if the assets acquired are diverted to Jurisdiction C. In such cases, it is difficult to see the practical value of protecting creditors' and others' reliance on the façade created. What is important is the getting in and distribution of the assets (and their substitutes) that still exist. For the most part, this will turn on a thorough investigation of the fraud itself, but secondary considerations include the effectiveness of the claims handling and distribution process to be put in place.

*In re Stanford International Bank* [2009] EWHC 1441 (Ch), Mr Justice Lewison considered himself bound to adopt the narrow view in the context of the Cross Border Regulation, having regard to the recitals to and the case law in connection with the Insolvency Regulation.

This case note summarises the facts and reasoning underlying the decision in *Stanford* and asks whether the broad view might sensibly be adopted as the test for COMI under the Cross Border Regulation and the Insolvency Regulation.

**Facts**

A receiver appointed by the Securities and Exchange Commission in the United States ('SEC'), and a liquidator appointed by the Financial Services Regulatory Commission ('FSRC') in Antigua, in relation to Stanford International Bank ('SIB') applied for recognition in the United Kingdom under the Cross Border Regulation. The practical reason for recognition was to gain control of bank accounts in London.

SIB was a bank incorporated in Antigua where it had its registered office. In the course of its business, it issued certificates of deposit to customers resident in countries other than Antigua and to customers in the United States through financial advisers in that country, being the country in which the majority of its assets were managed under contract.

The receiver was appointed pursuant to an SEC complaint which did not allege that SIB was insolvent but which sought to prevent waste and dissipation of assets to the detriment of investors, although the receiver might have applied to the US Court at a later stage to sanction a distribution plan.

The liquidator was appointed pursuant to a petition which alleged actual or imminent balance sheet insolvency and which was verified by an affidavit confirming insolvency, although the winding up order was expressed in just and equitable terms and on the basis of a statute in which insolvency did not feature as a ground.

## Held

Against this background, Lewison J was required to decide –

- (1) whether the receiver, or the liquidator, was a foreign representative? And
- (2) whether the foreign proceedings were foreign main proceedings?

The judge's reasoning on the second issue can be summarised as follows:

- (1) COMI is a concept common to the Cross Border Regulation (derived from the UNCITRAL Model Law) and the Insolvency Regulation, and, having regard to the legislative history, it is reasonable to infer an intention that COMI in the Cross Border Regulation has the same meaning as in the Insolvency Regulation (paragraph 45).
- (2) Recital 13 to the Insolvency Regulation provides:
 

‘The centre of main interest should correspond to the place where the debtor conducts the administration of his interests on a regular basis and is *therefore* ascertainable by third parties’ (emphasis added).
- (3) On this interpretation, the recital ‘is really an assumption of fact’ (paragraph 55). It assumes that because a debtor administers his interest from a place on a regular basis that that place will be ascertainable by third parties (but that assumption may not be true on some facts).
- (4) The Court in determining a company's COMI is not, however, thereby justified in putting to one side how third parties perceive matters; on the

contrary, because insolvency is a foreseeable risk ‘transparency and objective ascertainability’ are important (paragraphs 55 and 61).

- (5) A two stage approach is required (paragraph 63):
  - (a) The Court must first identify a set of objective and ascertainable factors.
  - (b) The Court must then determine from that set of factors where a company's head office functions are carried out in order to confirm or to rebut the presumption that its COMI is at the place of its registered office.
- (6) In this context, ascertainable by a third party refers to ‘what was in the public domain and what a typical third party would learn as a result of dealing with the company’ (paragraph 62). It does not extend to facts which would have been revealed by an honest answer to a question had it been asked.

## Comment

In so holding, Lewison J considered that he was required to depart from the reasoning (but not the result) in his own recent decision *In re Lennox Holdings Ltd* [2009] BCC 155. This twist is surprising because Lewison J referred to same passages of the Court of Justice decision in *Eurofood* in *Lennox* as he did in *Stanford*, but a close comparison of *Stanford* and *Lennox* does reveal an appreciable difference in approach.

*Lennox* concerned a company that supplied UK food products to UK expatriates and holidaymakers in Spain and which had a number of major UK suppliers. In holding that the company had its COMI in the UK, Lewison J had regard to the following facts summarised in the evidence:

- (1) The directors lived and worked in England.
- (2) The board of directors and management conducted meetings from offices in London.
- (3) The company's accounts were prepared by accounts in England.
- (4) A substantial number of the company's creditors were located in England and a number had contacted the board of directors and management in response to the deterioration in its finances apparent from a fall in its share price listed on AIM.

By contrast, in *Stanford* Lewison J discarded factors that were not objective and ascertainable and only analysed those that were in terms of their relevance and as pointing to or away from Antigua, for example (paragraph 98):

- (1) The location of the directors (the principal movers of the fraud) was irrelevant as it was not ascertainable by third parties.



- (2) The marketing of certificates of deposit through financial advisers in the United States was irrelevant because, on the facts, an investor would not have considered a financial adviser as acting for SIB.
- (3) The fact that the purchasers of certificates of deposit were located outside Antigua was irrelevant as it pointed to no state other than Antigua.
- (4) The locations of assets outside Antigua, mostly in the United States, may have been ascertainable but, on analysis, was irrelevant because those assets were managed by other entities under contractual arrangements with SIB.

The approach in *Stanford* is, therefore, narrower than that applied in *Lennox*, but no practical difference is immediately obvious in the ordinary run of cases. There is no example of a case which would have been decided differently had the approach in *Stanford* been applied. The factors which carried the most weight in *Lennox* were funding and day-to-day management in connection with creditors, which would have been accounted for on the *Stanford* approach as objective and ascertainable factors.

The key question is whether the approach in *Stanford* is likely to make a practical difference outside the ordinary run of cases. In cases of fraudulent failure, there is likely to be a significant practical difference because the requirement that factors be ascertainable excludes matters which, by definition, are concealed prior to the revelation of the fraud following failure. Lewison J's understanding of what makes a factor ascertainable – that it is in the public domain – must be correct. To say that something is ascertainable because it would have been revealed by an honest answer to a question had it been asked deprives the requirement that factors be ascertainable of all content. The rigour with which this requirement might be applied however begs the question whether the legislature intended the determination of COMI to be regulated by a rule which excludes otherwise relevant factors.

In this respect, Lewison J is right to identify the factual assumption which underpins recital 13 to the Insolvency Regulation as key. If a debtor company regularly administers its affairs from a given place, it is reasonable to assume that that place will be ascertainable by third parties. It is also reasonable to infer from that assumption that the legislature intended creditors' perceptions to play a prominent role in weighting each relevant factor; however, it is leap of logic to move from recognising the importance to be given to creditors' perceptions (as a matter of weight) to the exclusion of matters which creditors cannot have perceived, especially in circumstances in which they, along with others, were deceived.

COMI, as first conceived, is a conceptual tool intended to give practical effect to the aims underlying the Insolvency Regulation. The primary aim of that

regulation is to regulate the opening and recognition of insolvency proceedings in the Member States against the background of a single market. In that market, insolvency is a foreseeable risk and so the Court must give prominence to creditors' perceptions if the opening and recognition of insolvency proceedings is to align usefully with the perceptions of market actors. That primary aim cannot however sensibly be relied on as a justification for excluding factors not apparent to market actors in their dealings with the company. As victims, their reliance is not worth protecting. The legal certainty important to the market only has value if reliance is grounded in fact and not façade. To exclude as irrelevant factors which might enable a more effective insolvency proceeding is to compound victims' detrimental reliance.

Looked at in this way, the case of fraudulent failure is a reason for adopting the broad view in determining COMI under the Insolvency Regulation and the Cross Border Regulation. Cases in that run are likely to occur in the context of either regulation, and only in relation to the Insolvency Regulation is there a single market context which appears to pull towards the narrow approach. To give weight to that market context is however inappropriate in the case of fraudulent failure because (just as reliance is not worth protecting) there are no underlying market expectations to protect.

A more difficult case is one in which a fraud is untraced but the company carried on a substantial and genuine business as well. There is no obvious basis for giving the perceptions of one group priority. From their own point of view, the victims of the fraud relied in the same way as the creditors for whom the company intended to and did perform, and vice versa. The broad view is that the Court must engage in a balancing exercise, taking into account all factors, and make an assessment of their relative importance in determining the company's COMI. By contrast, the narrow view would seemingly require the Court to ignore the fraud just as it does in the case of a fraudulent failure.

COMI analysis in the US-based SEC proceeding appears headed toward the broad view. Though, as of this writing, the parties have yet to complete their presentations before the US District Court in Texas, the specific questions on which Judge Godbey has requested briefing suggest a focus on the similarity of COMI to a debtor's 'principal place of business' as that concept is recognised under US law. Though not inconsistent with what creditors would have perceived about the debtor (i.e., the narrow view discussed above), the 'principal place of business' focuses more broadly on factors which, though objective, are not tied as closely to what the debtor held out to (or concealed from) specific parties. Instead, the debtor's 'principal place of business' views the totality of the debtor's operations (fraudulent or not) and, on the basis of these facts, determines the debtor's 'principal place of business.'

*Stanford* is subject to appeal and judgment is awaited. If the Court of Appeal is troubled by the case of fraudulent failure, it likely that the Judge's reasoning (but perhaps not his conclusion) will be modified to some extent to accommodate cases outside the ordinary run of things.

## *In re Sigma Finance Corporation* [2009] UKSC 2

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### 1. Introduction

How is the Court to make sense of a document which has no obviously correct construction?

In *Glynn v Margetson & Co* [1893] AC 351, in relation to a dispute about a deviation clause in a bill of lading, Lord Halsbury observed, at 359, that ‘both carrier and customer differ very widely sometimes as regards what is reasonable and what is not, and for that reason they call upon Courts of Law to construe sometimes somewhat loose and irregular instruments’. The Court assumes that ‘mercantile men when they do business ... recollect that a business sense will be given to business documents’.

In *re Sigma Finance Corporation* [2009] UKSC 2, in construing the terms of a security trust deed, Lord Collins similarly observed, at [35] and [37], that ‘[i]n complex documents of the kind in issue there are bound to be ambiguities, infelicities and inconsistencies’ and that ‘[d]etailed semantic analysis must give way to business common sense’.

Lord Mance agreed with these observations at [10], describing ‘the reasonable man’s task’ at [32] as being ‘greatly facilitated by the existence of a clear basic form from which it is improbable that the parties would have wished to depart.’

On one view, it is very difficult to disagree with this approach. Words are different from their meaning. If this were not true, translation would be impossible. The task of any interpreter is, therefore, to give sense to the words used. In the contractual context, that sense must derive from the parties’ intention because that is the source of their rights. The extreme example of this logic is the so-called ‘private dictionary case’, in which the Court has regard to particular pre-contractual negotiations to identify a specific, idiosyncratic meaning common to the parties: *Chartbrook Ltd v Persimmon Homes Ltd* [2009] UKHL 38 at [44]-[45]. In ordinary cases, the Court is, as noted above, content to assume a conventional meaning of language and, crucially, as used by reasonable commercial parties in the position of the actual parties.

On another view, it is in fact very hard to agree with this approach because of the discretion inherent in supposing what reasonable commercial parties would have intended. In *Sigma*, there is no sharp distinction between the principles of interpretation explained in the Supreme Court and those explained in the Court of Appeal or by the judge at first instance; but, counting the votes of all the judges involved, four favoured the so-called ‘pay-as-you-go’ construction, four favoured the effective ‘pari passu’ construction, and one favoured an entirely different approach.

This case note summarises the facts and decision of the Supreme Court in *Sigma* and asks whether anything is usefully added to the ‘iterative process’ of construction (described by Lord Neuberger at [98] of his judgment in the Court of Appeal) by a general assumption about what reasonable parties would have intended. The cost of making such an assumption too readily is commercial certainty.

### 2. Issue and decision

The case turned on the correct construction of the Security Trust Deed pursuant to which the assets of Sigma Finance Corporation were secured for the benefit of the holders of loan notes issued by Sigma and held by the Security Trustee.

The issue focused on clause 7.6 of the Security Trust Deed and, very broadly, was whether Sigma’s secured liabilities were to be discharged as they fell due or on some other basis in the Realisation Period (x) following enforcement by the Security Trustee but (y) prior to distribution of the assets from the various asset pools to be formed in accordance with the Security Trust Deed.

The Court of Appeal (Lloyd and Rimer LLJ) had affirmed the decision of Sales J in holding that Sigma’s secured liabilities were to be discharged as they fell due in the Realisation Period.

The Supreme Court reversed the Court of Appeal and held that Sigma’s secured liabilities falling due in the Realisation Period were instead to be regarded as

#### Notes

<sup>1</sup> Simon Mortimore QC, Richard Sheldon QC, Felicity Toubé and Daniel Bayfield were counsel for the representative creditors. Gabriel Moss QC and Barry Isaacs were counsel for the receivers.

liabilities to be paid from a particular asset pool and so, in effect, paid on a *pari passu* basis.

### 3. Background

Sigma had carried on business as a structured investment vehicle. It had used short to medium term funding to acquire longer term asset-backed (and other financial) securities. Its principal source of funding was intermediated securities in the form of loan notes secured against assets acquired. The loan notes issued were held by the Security Trustee in accordance with the Security Trust Deed.

This structure relied on Sigma's continuing ability to roll over its short to medium term funding. It failed when the market in asset-backed securities collapsed.

The notice issued to the Security Trustee by a facility provider therefore constituted an Enforcement Event with an Enforcement Date effective from 2 October 2008.

An immediate effect of Enforcement was to trigger an Asset Realisation Process which was to be completed within the prescribed 60-day realisation period ending on 29 November 2008, the Realisation Period referred to above.

Clause 7.6 of the Security Trust Deed provided:

'[1] The Security Trustee shall use its reasonable endeavours ... to establish by the end of the Realisation Period a Short Term Pool, a number of Long Term Pools ... and a Residual Equity Pool.

[2] In order to establish such Pools, the Security Trustee shall during the Realisation Period (but not thereafter) realise, dispose of or otherwise deal with the Assets in such manner as, in its absolute discretion, it deems appropriate.

[3] During the Realisation Period the Security Trustee shall so far as possible discharge on the due dates therefore any Short Term Liabilities falling due for payment during such period, using cash or other realisable or maturing Assets of the Issuer.'

The assets allocated to the various Short and Long Term Pools were to correspond to the various secured liabilities in terms of maturity, payment dates and currency of payment. The Long Term Pools were, moreover, to comprise a pool in relation to each series of loan notes.

### 4. Reasoning

Lord Mance's reasoning can be summarised as follows:

- (1) An Enforcement Event was not necessarily to be equated with insolvency, still less an insufficiency of assets to meet all secured liabilities. The underlying assumption was that all secured liabilities can

be covered and so no issue of priority should arise. The clause 7.6 obligation to discharge secured liabilities as they fall due for payment was to be construed in this context (paragraphs 13 and 14).

- (2) The Short and Long Term Pools were to be established to meet Sigma's total indebtedness. Any suggestion that clause 7.6 was intended to carve out secured liabilities falling due in the Realisation Period was accordingly to be questioned because, for example, such a carve-out might entirely exhaust Sigma's assets before formation of the Pools and would skew the relationship between the Pools (paragraphs 15, 16 and 17).
- (3) The conferral of priority by such a carve-out would be wholly fortuitous and it was improbable that the parties intended such (paragraph 21).
- (4) If a pay-as-you-go construction were correct on a literal reading of clause 7.6, there is no provision for secured liabilities falling due *before* the realisation period. The fact that the Court of Appeal had to imply a term to deal with this anomaly indicates that its premise was not correct (paragraph 23).
- (5) There is no provision for payment of the Security Trustee or Receiver by reservation. It is absurd that the assets might be exhausted in the Realisation Period without payment of their fees (paragraph 25).

To these reasons, Lord Mance added a cross check at paragraph 32 by reference to the 'basic scheme' which involved the creation of Short and Long Terms pools:

'[A pay-as-you-go construction] elevates Realisation Period creditors to a special status, extracts them from the Pool to which the Deed assigns them, and distorts the apparent aim to achieve equity between all creditors by the creation of Short and Long Term Pools.'

### 5. Analysis

The difficulty with Lord Mance's cross check is his assumption that the method of ultimate distribution – a distribution from the Short and Long Term Pools – should dictate what is to take place before that method is set up.

There is no logical connection between Sigma's payment obligations in the Realisation Period and the distribution obligations following the establishment of the Short and Long Term Pools. What's more, in the abstract there is nothing obviously unreasonable in a construction under which payment obligations were to continue unaffected until such time as the relevant pools were established. Commercial parties might well have reasoned that it is better that payment obligations continue as normal in the immediate/short term

to protect existing arrangements and to subsequently make a transition to a second stage to distribute whatever is then at hand. It is only on the assumption that equality was intended post-Enforcement that Lord Mance's cross check adds anything to his five primary reasons.

The basis for such an assumption has been set out by Arden LJ at paragraphs 3-5 of her judgment in *In re Golden Key Ltd (in receivership)* [2009] EWCA Civ 636, but may reasonably be doubted because, although the pari passu rule of distribution is well established, it does not obviously have a role to play in construing

a contractual document because it yields to contrary intention and, deriving from the maxim that equality is equity, is only applied by the Court when it can apply no other rule.

In other words, in a case in which the construction of the document is not obvious without close examination of its terms, to make an assumption about what the answer should be is, pretty much, to end up there.

For this reason, it is very difficult to see what is added to the 'iterative process' of construction described by Lord Neuberger (with which Lord Mance agreed) by an over-general cross check.

## A First Step in Shaping Rules for Cooperation in International Insolvency Cases

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### Introduction

In April 2010 the authors published a set of Global Principles for Cooperation in International Insolvency Cases. These Principles reflect a non-binding statement, drafted in a manner to be used both in civil-law as well as common-law jurisdictions, and aim to cover all jurisdictions in the world. To a large extent these Global Principles for Cooperation in International Insolvency Cases ('Global Principles') build further on the American Law Institute's Principles of Cooperation among the member-states of the North American Free Trade Association (the 'ALI NAFTA Principles').<sup>1</sup> These Principles have evolved from the American Law Institute's Transnational Insolvency Project, conducted between 1995 and 2000, for which the Reporter was Professor Jay L. Westbrook. The objective of that Project was to provide a non-statutory basis for cooperation in international insolvency cases involving two or more of the NAFTA states of the United States, Canada and Mexico. The ALI NAFTA Principles were published as a separate volume in the four volume text of the Transnational Insolvency Project (2003).<sup>2</sup> In their work for the Global Principles project the authors are co-reporters, having been appointed by the American Law Institute and the International Insolvency Institute.<sup>3</sup>

### Global Principles: structure and contents

The Global Principles for Cooperation in International Insolvency Cases cover mainly four areas. After an introduction, Section II provides a list of terms and definitions. As is explained in the Report, in recent times

many states, regional public institutions, international non-governmental organisations, and practitioners' associations have produced many laws, regulations, principles, guidelines and statements of best practices, all aiming for the better coordination of insolvency measures or proceedings concerning economic enterprises which have operations, assets, activities, debtors or creditors in more than one state. The resulting complexity is compounded by a bewildering variety of technical terms and expressions used in the various texts. Section II aims to promote the development of a uniform global legal terminology in matters relating to insolvency and therefore to assist insolvency practitioners, courts and legislators in their efforts of improving the components to smoothen cross-border communication and coordination.

Section III constitutes the heart of the statement, the Global Principles for Coordination of International Insolvency Cases. These Global Principles are the result of a global research survey that established the extent to which it is feasible to achieve a worldwide acceptance of the ALI NAFTA Principles, either in their existing form or, if necessary, with modifications or variations. This section includes a review of the appreciation of the Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases ('Court-to-Court Guidelines'). These Guidelines in their original form were included in Appendix B of the ALI NAFTA Principles and represent procedural suggestions for increasing communications between courts and between insolvency administrators in cross-border insolvency cases. They have been revised in the light of subsequent developments in relation to this important form of cross-border cooperation which have been strongly

### Notes

- 1 For its website, see: <[www.ali.org](http://www.ali.org)>.
- 2 See American Law Institute, *Transnational Insolvency: Cooperation Among the NAFTA Countries: Principles of Cooperation Among the NAFTA Countries*, 2003, hereinafter 'ALI NAFTA Principles'. As in the NAFTA Principles, the terms 'bankruptcy' or 'insolvency' are herein used as synonyms, although in worldwide English-language usage 'insolvency' is the more common term for such proceedings where a business debtor is involved, whilst in the North American region 'bankruptcy' is at least as often used for business proceedings as well as those involving consumers. See NAFTA Principles Report (2003), at 1.
- 3 For its website, see: <[www.iiiglobal.org](http://www.iiiglobal.org)>.

influenced by the original Guidelines themselves. The text of the result of this review is recorded in a separate Appendix I, with the heading Global Guidelines for Court-to-Court Communication in International Insolvency Cases.

Also in a separate Appendix (Appendix II) the Reporters' proposals for Global Rules on Conflict of Laws Matters in International Insolvency Cases are set out. The Global Rules serve as legislative recommendations in general and sometimes in more detailed terms. They may also serve too as a guide for courts, insolvency practitioners and creditors in those circumstances where applicable law with regard to international insolvency cases fails to deal with a certain point in issue or is vague. They do not purport to employ specific statutory language however, as expressing conflict of laws rules in an appropriate way is a challenge for national or regional legislators. The main goal is to demonstrate that globally there is a wide measure of support for the enactments of rules of this nature, based on the given principle to avoid miscommunication, to prevent uncertainty, to provide accurate translation and to ensure smooth cross-border cooperation. A primary benefit brought about by achieving uniformity in the area of conflict of laws is that parties' legitimate expectations can be more consistently fulfilled, thereby reducing the levels of uncertainty and instability that have a key influence on the assessment of risk by those engaging in international transactions.

## Background of the project

Having laid the groundwork for a wider dissemination of the ALI NAFTA Principles and their accompanying Guidelines, the American Law Institute and the International Insolvency Institute considered that it would be timely and appropriate to undertake a systematic evaluation of the possibility of adapting them so as to provide a standard statement of principles suitable for application on a global basis in international insolvency cases. The ALI NAFTA Principles, though written with the specific needs of the three NAFTA states primarily in mind, are necessarily of an international nature and the Reporters for that project had expressed the hope that the Principles 'may be helpful to our colleagues in other countries as well'.<sup>4</sup> The Global Principles Project was conceived and approved as a joint venture between ALI and IIL. In February 2006 ALI appointed the Reporters for the project, initially titled 'Transnational Insolvency: Principles of Cooperation', which during

the course of research and discussions was changed to: 'Global Principles for Cooperation in International Insolvency Cases'. The most important objective within the remit of the project was to establish the extent to which it is feasible to achieve a worldwide acceptance of the ALI NAFTA Principles together with the Guidelines.<sup>5</sup> The Reporters therefore developed a systematic consultation exercise, conducted with the help of experts drawn from a wide range of jurisdictions and legal traditions around the world and able to pronounce authoritatively on the feasibility of applying the Principles (or conversely, any obstacles to doing so) from the perspective of each state and legal system with which they have direct personal experience. In addition, the Reporters considered it to be both appropriate and necessary to take account of the considerable volume of work that has already been carried out in this field in recent years.

## Fitting the project in the current developments in soft law and legislation

A number of projects and studies which either directly or indirectly relate to insolvency matters have been conducted by such organisations as the Asian Development Bank, the World Bank, the IMF, the European Bank for Reconstruction and Development, UNCITRAL, UNIDROIT, the ALI and IIL, and by other bodies of experts (for example, the Principles of European Insolvency Law 2003, and the European Communication and Cooperation Guidelines for Cross-border Insolvency 2007). As a result of the work of these organisations and bodies, there have emerged a number of texts, variously called 'principles', 'guidelines', 'good practice standards' or 'recommendations'. These texts include the following:

- UNCITRAL: Model Law on Cross-border Insolvency 1997;
- American Law Institute: Principles of Cooperation among the NAFTA Countries 2000;
- American Law Institute: Guidelines Applicable to Court-to-Court Communications in Cross-Border Cases 2000;
- Asian Development Bank: Good Practice Standards for Insolvency Law 2000;
- World Bank: Principles and Guidelines for Effective Insolvency and Creditor Rights Systems 2001 (revised Draft December 2005);

## Notes

- 4 See American Law Institute, *Transnational Insolvency: Cooperation Among the NAFTA Countries: Principles of Cooperation Among the NAFTA Countries, 2003* ('ALI NAFTA Principles'), Reporter's Preface, at xxi. See Jay Lawrence Westbrook, 'Chapter 15 and Discharge', (2005) 13 *American Bankruptcy Institute Law Review* 515. As a reminder, contrary to USA and Canada, Mexico belongs to the family of civil code countries.
- 5 The method of our research is explained in the report.

- Principles of European Insolvency Law 2003;
- European Bank of Reconstruction and Development: Core Principles for an Insolvency Law Regime 2004;
- American Law Institute / UNIDROIT: Principles of Transnational Civil Procedure 2004;
- UNCITRAL: Legislative Guide on Insolvency Law 2004;<sup>6</sup>
- European Bank of Reconstruction and Development: Office Holders Principles 2007;
- European Communication & Cooperation Guidelines for Cross-border Insolvency 2007;
- Principles for Rescue of Multi-National Enterprise Groups (International Insolvency Institute, Draft June 2009);
- Prospective Model International Cross-border Insolvency Protocol (Draft-Annotated, June 2009);
- UNICITRAL: Practice Guide on Cross-Border Insolvency Cooperation of July 2009 (the ‘Practice Guide’).<sup>7</sup>

Collectively these documents amount to a striking demonstration of the globalisation of commercial activity in the present era, and the raised awareness

internationally of the need to address the issues associated with insolvency in a cross-border context.<sup>8</sup> A number of the international organisations mentioned work in the insolvency law field, including the World Bank, although their work is not principally concerned with the harmonisation or renovation of legal systems. These organisations work mainly within the international financial system and deal with insolvency matters only insofar as they recognise that effective insolvency regimes play a major role in strengthening economic and financial systems in any jurisdiction, particularly those in course of transition or in emerging economies. In this context, work by regional entities such as the Asian Development Bank and the European Bank for Reconstruction and Development assist the particular needs of their constituency, especially by enhancing domestic legal systems as a means of preventing the onset of financial crises or, where financial crises do occur, as a means of restoring or rehabilitating entities affected by the crisis. The value of strong domestic insolvency laws is a feature of the reports and enquiries of these organisations in the field. In 1999 the IMF published a survey of the most important policies for designing a system of insolvency law. These include the goal and function of insolvency proceedings, the task of a ‘liquidator’ or an ‘administrator’, and the function of the court system.<sup>9</sup>

## Notes

- 6 See the report ‘Orderly & Effective Insolvency Procedures. Key Issues, composed by the Legal Department, International Monetary Fund’ of 1999, which builds on a 1998 report submitted by the G-22 Working Group on International Financial Crisis, entitled ‘Key Principles and Features of Effective Insolvency Regimes’. These are not included in the list, mentioned in the text, as most of its topics are covered in the more recent sources.
- 7 See Libby Elliott and Neil Griffiths, ‘UNCITRAL Practice Guide on Cross-border Insolvency Co-operation’, *Corporate Rescue and Insolvency*, February 2010, pp. 12-14. For an overview of a comprehensive collection of essential texts, see Bob Wessels (ed.), *Cross-Border Insolvency Law: International Instruments and Commentary* (Kluwer Law International, Alphen aan den Rijn, 2007). For a more systematic overview of these sources, see Bob Wessels, Bruce A. Markell and Jason J. Kilborn, *International Cooperation in Bankruptcy and Insolvency Matters* (New York, Oxford University Press, 2009) (passim); Terence C. Halliday and Bruce G. Carruthers, *Bankrupt: Global Lawmaking and Systemic Financial Crisis* (Stanford, Stanford University Press, 2009), pp. 70ff.
- 8 In the same way Roman Tomasic, ‘Insolvency Law Reform in Asia and Emerging Insolvency Norms’, (2007) 15 *Insolvency Law Journal* 229-242.
- 9 The Reporters appreciate that the growing volume of these documents are the result of the search for compatibility of the effects of globalisation for national legal systems. One of these effects is the decreasing autonomy of national legal systems. The problems confronting countries increasingly transcend national boundaries, either because the problems do not lend themselves to solely national regulation or because they involve the interests of the international community as a whole. In this new environment the traditional areas of national law (such as private law, criminal law or administrative law) acquire an increasingly internationalised character. Principles and Guidelines, in the nature of the ones which are subject of this project, may have several disadvantages: (i) they have an uncertain legal status, (ii) it may be problematic to ascertain these texts, (iii) they may lack quality and clarity, (iv) their legitimacy may be questioned, (v) their application or enforcement seldom is reported, and (vi) their effectiveness seldom is tested. It is beyond the boundaries of the project to further access certain concerns of a regulatory nature of measures of soft law. See Kenneth W. Abbott and Duncan Snidal, ‘Hard and Soft Law in International Governance’, in John J. Kirton, with Jelena Madunic (eds), *Global Law* (Ashgate, 2009), pp. 257-292; Bob Wessels, ‘Complementing the European Insolvency Regulation With Soft Law’, in Ulrich Ehricke et al. (eds), *Yearbook* (Institut für Internationales und Europäisches Insolvenzrecht der Universität zu Köln, forthcoming) (Institute for International and European Insolvency Law, University of Cologne, Germany); and Bob Wessels, ‘ALI – III Global Principles – New Strategies for Cross-Border Cooperation?’, in Janis Sarra (ed.), *Annual Review of Insolvency Law* (2009), pp. 587-611. For scholarly work on the general theme of the sources and development of international law, see John J. Kirton and Jelena Madunic (eds), *Global Law* (Ashgate, 2009). In the context of the European Community attention should be paid to Article 288 TEU (Article 249 EC Treaty), which allows for the introduction measures of ‘soft law’, as its last paragraph states: ‘Recommendations and opinions shall have no binding force’. See L.A.J., Senden, *Soft Law in European Community Law* (Oxford, Hart Publishing 2004); D.M. Curtin, *Europese Juridische Integratie: ‘Paradise Lost?’* (Preadvies Nederlandse Juristen Vereniging, 2006); Dagmar Schiek, ‘Private Rule-making and European Governance – Issues of Legitimacy’, (2007) 32 *European Law Review* 443ff; L.A.J. Senden and A. Tahtah, ‘Reguleringsintensiteit en regelgevingsinstrumentarium in het Europese Gemeenschapsrecht. Over de relatie tussen wetgeving, soft law en de open methode van coördinatie’, (February 2008) SEW 43ff; Filippo Fontanelli et al. (eds), *Shaping Rule of Law Through Dialogue* (Europe Law Publishing, 2009).



Furthermore, account has been taken of the fact that some of the central issues addressed in the original ALI NAFTA Principles (including recognition, relief, and cooperation) have since ALI's adoption in 2000 found their way into national or federal legislation. In the USA, since 17 October 2005, Chapter 15 US Bankruptcy Code is in place. It enacts virtually all of the provisions of the UNCITRAL Model Law on Cross-Border Insolvency of 1997 and thereby encapsulates several of the ALI's Principles. In Great Britain an amended version of the Model Law became effective as of 4 April 2006. Other states have also enacted legislation within which the Model Law, and hence some aspects of the ALI Principles, are reflected. These states include Australia, British Virgin Islands, Canada, Cayman Islands, Japan, Ireland, Mauritius, Mexico, Montenegro, New Zealand, Poland, Romania, Serbia, Slovenia, South-Africa and South Korea.<sup>10</sup>

Since 2002 a significant contribution to the process of international insolvency has been made by the entry into force of the EU Insolvency Regulation. Several topics dealt with in ALI's Principles now are applicable on a compulsory basis in 26 of the 27 EU Member States. These topics include e.g. cooperation (between 'liquidators') in parallel proceedings, recognition, access to court, information and communication, claims filing and avoidance actions, as well as rules governing – for intra-Community cases – jurisdiction to open insolvency proceedings and jurisdiction in respect of insolvency-related matters, the recognition of foreign proceedings, and uniform rules of conflict of laws. In 2004 the United Nations Committee on International Trade Law (UNCITRAL) published its Legislative Guide on Insolvency Law, which forms a comprehensive statement of key objectives and core features for a strong insolvency, debtor-creditor regime, including out-of-court restructuring, and a legislative guide containing flexible approaches to the implementation of such objectives and features. As a novelty, the Guide contains certain recommendations regarding applicable law in international insolvency cases. Like the ALI NAFTA Principles, the Legislative Guide contains considerations and suggestions with regard to group consolidation. In July 2009 UNCITRAL adopted the Practice Guide on Cross-Border Insolvency Cooperation ('UNCITRAL Practice Guide') containing information for insolvency office holders and judges on practical aspects of

cooperation and communication in cross-border insolvency cases. The Guide's recommendations regarding applicable law in international insolvency cases sparked our intention to make provision for such matters in our work, laid down in a separate Appendix to the Report, which sets out Global Rules on Conflict of Laws Matters in International Insolvency Cases. Here, another source should be mentioned which has facilitated the Reporters' work, namely the steadily growing body of in-depth studies devoted to many varied topics of international and comparative insolvency law in this decade.<sup>11</sup>

Hence, as an integral part of the Global Principles Project, we believe it would be a challenging but valuable task – indeed a necessary one – to identify such core values and principles as can be discovered from a comparative analysis of the available texts, evaluated in the context of the consultative debate among the participating experts. The Global Principles for Cooperation in International Insolvency Cases are therefore in line with other international developments and other attempts of developing modes of international cooperation in the area of international insolvency.

The Reporters are conscious of the fact that their research, from which the Global Principles were produced, could have included other matters which it would have been appropriate to explore with a view to ascertaining the prospects for acceptance of global standards to be applied in the transnational insolvency process. A number of issues which have an important bearing upon the overall quality and efficiency of the international insolvency 'process' were either not directly addressed in the context of the earlier project which yielded the ALI NAFTA Principles, or were dealt with on a somewhat tentative basis. These include the principles and procedures to be applied where insolvency occurs within multinational corporate groups (the subject of Procedural Principles 23 and 24 of the ALI NAFTA Principles). Further issues which we believe to be in need of study and development are the elaboration of internationally tenable standardised principles of professional behaviour of insolvency office holders. Although of direct relevance to the goal of promoting effective co-operation in international insolvency cases, it was decided that these and other issues should be studied and dealt with by other international institutions or associations, which have taken these topics on their respective agendas.<sup>12</sup>

## Notes

- 10 These countries are listed by UNCITRAL as having enacted legislation based on the Model Law, see <[www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model\\_status.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.html)>. It should be noted however that also the Ley Concursal of Spain (2003), and draft legislation in the Netherlands (2007) have been inspired by the Model Law, see Bob Wessels, *Judicial Cooperation in Cross-border Cases, Inaugural Lecture University of Leiden* (Deventer, Kluwer, 2008), at 19.
- 11 However, based on the languages at the Reporters' command, only a selection written in German, French or Dutch could be analysed, along with those published in an English version.
- 12 An overall view, also describing UNCITRAL's present work regarding enterprise groups, is provided by: Janis Sarra, 'Maidum's Challenge, Legal and Governance Issues in Dealing with Cross-Border Business Enterprise Group Insolvencies', (2008) 17 *Int'l Insolvency Rev.* 73. The European

## Aims and purposes of the Global Principles

The main goal of the American Law Institute and the International Insolvency Institute is for the Global Principles to provide a standard statement of principles suitable for application on a global basis in international insolvency cases. As in the ALI NAFTA Principles, a 'principle' is a statement of value serving as a guidance for behaviour in cross-border insolvency cases. While the Global Principles are linked to the ALI NAFTA Principles, the present Report is to be regarded as an independent text.

We think that the Global Principles may serve several purposes. They are worded in language which permits courts to apply them in a flexible way and tailored to the specific circumstances of each individual case. They may serve as an indication for insolvency office holders of the best approach in cross-border cases. Both for judges as well as for practitioners the Global Principles may apply in cases where (international) insolvency legislation has been formulated in general, open terms or provisions or in cases where the existing body of binding legislation does not cover a specific matter. Furthermore, the Global Principles may serve as non-binding codified customs and norms which may assist in matters of interpretation. They therefore may indicate an alternative or a solution in cases where it proves to be impossible to determine a specific rule of the law applicable. In this way too the Global Principles may stimulate convergence and coherence between several regional or national legal systems. The Global Principles could assist as a model or a guide for national or regional legislators. Finally, it is suggested that the Global Principles could form a part of courses and classes in academia all over the world, so students could be taught some of the principles that guide or steer international approaches. The true aspiration for cooperation in international insolvency cases will be stimulated by educating younger generations within the spirit which the Global Principles aim to reflect: the embodiment of what is globally perceived as the best solution in certain matters of cross-border insolvency cases. In these ways it is hoped that, as embodied in the final text, the Global Principles possess persuasiveness, as they are supported by a large global consensus, and will obtain the approbation of governmental authorities, domestic and international organisations, practitioners, and (most importantly) courts in their search for suitable solutions and their approach to the conduct of international insolvency matters in the future.

## Your participation

During our work we have had the privilege of collaborating with a wide circle of international advisers who volunteered to participate, notably by supplying expert advice about the suitability (or otherwise) of the Principles for application in systems of which they have first-hand knowledge, and also by commenting on the evolving drafts of our report at various stages of its gestation. We are immensely grateful for the assistance thus provided by our collaborators, being practitioners, scholars and judges, which have enabled us to base our report on surveys of more than 30 separate jurisdictions representing a variety of different legal traditions. Furthermore, throughout the process of gestation of the Report we have had the opportunity of discussing various aspects and sections of the project at conferences and seminars in over ten jurisdictions all over the globe. The feedback from these sessions has been particularly instructive. As mentioned earlier, in April 2010 the Preliminary Draft of the Report of the Global Principles Project was circulated on a restricted basis among the panels of international advisors. At the present time the text is provisional and is subject to further revision, although it is intended that it should become generally available in due course. It is here where readers of *International Corporate Rescue* come in. The texts of, respectively, 41 *Global Principles* for Cooperation in Global Insolvency Cases, 18 *Global Guidelines* for Court-to-Court Communication in International Insolvency Cases, and 23 *Global Rules* on Conflict of Laws Matters in International Insolvency Cases (in each case accompanied by commentary)<sup>13</sup> are at this stage provisional, pending approval and formal adoption by the ALI and IBCA respectively. There will undoubtedly be numerous revisions in the light of the feedback gained from the consultative process which is at present in progress. Accordingly, we request that the texts which are provided for perusal should not be publicly cited or quoted in print at this stage. However, during the present, consultative stage of the project we would welcome comments and criticism from readers of *International Corporate Rescue*, and we thank the Editor-in-Chief, Mark Fennessy, for his invitation to bring this project to the attention of the readers of this journal. We are looking forward to your comments.<sup>14</sup>

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### Notes

Bank for Reconstruction and Development (EBRD) has released the EBRD Insolvency Office Holder Principles (June 2007), intended to assure that member-countries employ qualified, regulated and impartial persons for positions which are key in insolvency proceedings, see <[www.ebrd.com/country/sector/law/insolve/princip/principals.pdf](http://www.ebrd.com/country/sector/law/insolve/princip/principals.pdf)>. See Adrian Walters, 'Regulating the Insolvency Office-Holder Profession across Borders', in Bob Wessels and Paul Omar (eds), *Crossing (Dutch) Borders in Insolvency* (Nottingham, Paris, INSOL Europe, 2009), pp. 49-56.

13 In all, including commentaries and Reporters' Notes, over 260 pages. Available via <[bobwessels.nl/wordpress/?p=996](http://bobwessels.nl/wordpress/?p=996)>.

14 Either to Ian F. Fletcher (i.f.fletcher@ucl.ac.uk) or Bob Wessels ([bwessels@bobwessels.nl](mailto:bwessels@bobwessels.nl)), preferably before mid-September 2010.

***(1) Harms Offshore AHT 'Taurus' GmbH & Co KG (2) Harms Offshore AHT 'Magnus' GmbH & Co KG v (1) Alan Bloom (2) Colin Dempster (3) Thomas Burton (4) Roy Bailey (as Joint Administrators of Oilexco North Sea Limited) (5) Oilexco North Sea Limited (in Administration) [2009] EWCA Civ 632***

William Willson, Barrister, 3–4 South Square, Gray's Inn, London, UK

### Introduction

In what circumstances does the English court have jurisdiction to protect the assets of a company in administration in England from foreign process where those assets are outside the United Kingdom?

The Court of Appeal considered this question on appeal from a judgment of Robert Englehart QC, sitting as a deputy judge of the Chancery Division, Companies Court ([2009] EWHC 1620 (Ch)).

### Background

The Company was incorporated in England, and carried on the business of offshore oil and gas exploration. On 7 January 2009 the Companies Court made an administration order as well as ordering, on the application of the Joint Administrators, that they be authorised to enter into a loan agreement with specific lenders and to draw down funds under that agreement to make such payments of post-administration liabilities as they considered would achieve the purpose of the administration. The Appellants were companies incorporated in Germany, and pre-administration creditors under time charterparties governed by English law and subject to arbitration in London.

On the date of their appointment the Joint Administrators informed the Appellants in writing that the Company had entered administration, that they had been appointed and that it would continue its business under their supervision whilst they attempted to realise a sale of the Company or its business or assets.

On 16 January 2009 the Appellants, without notice to the Joint Administrators, commenced proceedings in the United States District Court for the Southern District of New York (the 'District Court') under its admiralty and maritime jurisdiction seeking judgment for sums due from the Company under the charterparties and an attachment and garnishment of the Company's

property in New York sufficient to satisfy those claims. The Appellants' complaint to the District Court did not mention the fact (which the Appellants knew) that the Company was in administration, and that the charterparties contained London arbitration clauses. On 21 and 26 January 2009 the District Court made ex parte orders attaching the property of the Company within the Southern District of New York, and shortly thereafter writs of attachment and garnishment were issued against Company property, including property held for its benefit or moving through or within the possession of 19 banks. The Appellants did not inform the Joint Administrators of these proceedings or the attachments they had obtained until 24 March 2009.

On 15 May 2009, on the application of the Joint Administrators, Robert Englehart QC granted a mandatory injunction requiring the Appellants to use their best endeavours to procure the release of the two ex parte orders made by the District Court. The order also restrained the Appellants from taking any steps in the substantive proceedings they had commenced in the District Court. On 20 May 2009 the Court of Appeal heard the Appellants' urgent application for a stay of the order, and their appeal against it. The Appellants submitted that the hearing was urgent because the United States Bankruptcy Court in the Southern District of New York (the 'Bankruptcy Court') was due to hear an application by the Joint Administrators for the release of the attachments later that day.

### The submissions

Counsel for the Appellants argued that the moratorium against legal process provided by paragraph 43 (6) of Schedule B1, Insolvency Act 1986 (the 'Insolvency Act') does not have extra-territorial effect. The assets of a company in administration, unlike those of a company in liquidation, are not subject to the trust that justified anti-suit injunctions against creditors of companies in

liquidation. The District Court was properly seized of an attachment against property within its jurisdiction, and comity required the English court to abstain from interfering with proceedings before that Court.

The Joint Administrators submitted that the actions taken by the Appellants had interfered with the Joint Administrators' exercise of their functions and that the subject matter of the foreign proceedings had no connection with the foreign jurisdiction.

## The judgment

Giving the leading judgment Stanley Burnton LJ referred to the long-established principle that the statutory prohibition against creditors bringing proceedings against a company being wound up by the Court is not extra-territorial (see *Re Oriental Inland Steam Company ex parte Schinde Railway Company* (1874) LR 9 Ch 557). He found it difficult to interpret paragraph 43 (6) of Schedule B1 as applying to proceedings brought by a creditor who is not subject to the jurisdiction in a court outside the jurisdiction.

However, where a company is in liquidation, the property of that company is subject to a trust such that the property may be protected from legal process in any jurisdiction. His Lordship did not accept that the protection of the assets of a company in administration is to be regarded by the Court as differing in substance from the protection of the assets of a company in compulsory liquidation. One of the statutory duties of the Joint Administrators was to take custody or control of all the company's property both within and outside of the jurisdiction. As in a winding up, the creditors of a company in administration were entitled to have the company and its assets dealt with in accordance with the statutory scheme. The Court had a jurisdiction to protect the assets of a company that was being wound up by the court from foreign attachments and executions, and had a similar jurisdiction where a company was in administration (*Re Buckingham International plc (in administration) No. 1* (1997) BCC 907, CA; *Re Polly Peck International plc (in administration) No. 5* [1998] 3 All ER 812, CA).

His Lordship continued that the exercise of the jurisdiction to prevent a creditor from taking advantage of a foreign attachment will depend on the facts of the case,

and must be tempered by considerations of comity. The comity owed by the courts of different jurisdictions to each other would normally make it inappropriate for the court to grant injunctive relief affecting proceedings in a foreign court. Nonetheless, the conduct of the creditor against whom the injunction is sought, and the circumstances of the attachment of the property of the company may justify the injunction despite the strong presumption that the court will not interfere with the proceedings of a foreign court, in particular if the conduct can be classified as oppressive or vexatious (see *Barclays Bank v Homan* [1993] BCLC 680).

On the facts, Stanley Burnton LJ found that the Appellants' conduct had been unconscionable: they had not informed the Joint Administrators of the attachment orders until after they had succeeded in attaching funds sufficient to secure their claims, and had effectively set a 'trap' for them. The circumstances were exceptional, and they justified the grant of injunctive relief, limited to the release from attachment of the monies paid by the Joint Administrators in respect of post-administration liabilities before they were given notice of the orders made by the District Court. The appeal would therefore be dismissed.

## Comments

What distinguishes this case is the conduct of the Appellants and, more particularly, the way in which that obstructed the Joint Administrators' discharge of their duties. The presumption against interference with foreign proceedings is a strong one, tempered by considerations of comity, and it requires unconscionable conduct (in this case, a 'trap') to rebut such a presumption. An administrator is appointed to carry out certain statutory functions, and the Court will take a dim view of any interference with its officers' discharge of those functions.

In view of the urgency of the application, the appeal was dismissed at the end of oral argument. Sir John Chadwick gave a brief summary of the reasons for dismissal on the basis that it would be of assistance to the Bankruptcy Court to know why the English Court had maintained the injunction (and on the basis that the English Court would give its reasons more fully in writing subsequently).

## *SRM Global Master Fund LP & Ors v Treasury Commissioners* [2009] EWCA Civ 788

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The statutory scheme established to compensate shareholders subsequent to the nationalisation of Northern Rock plc, on the basis of the assessment of the valuation of the shares by means of the statutory assumptions provided for in sections 5(4) of the Banking (Special Provisions) Act 2008 ('the 2008 Act') did not violate the shareholders' right to the protection of their property guaranteed under Article 1 of the First Protocol to the Convention for the Protection of Human Rights and Fundamental Freedoms (set out in Part II of Schedule 1 to the Human Rights Act 1998). Those statutory assumptions struck the balance, required by the Convention, between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights.

The Court of Appeal (Sir Anthony Clarke MR, Waller LJ, Laws LJ) so held dismissing the appeals of the claimants, SRM Global Master Fund LP, a hedge fund holding 11.5% of Northern Rock's issued ordinary share capital on the date of nationalisation; RAB Special Situations (Master) Fund Ltd, an investment company, having an 8.18% holding; and Dennis Grainger and others, representatives of some 150,000 small shareholders, against the decision of the Divisional Court (Stanley Burnton LJ and Silber J) on 13 February 2009 [2009] EWHC 227 (Admin) which dismissed their claims for judicial review challenging the compatibility of the legislation relating to the assessment of compensation payable to them as former shareholders of Northern Rock following its nationalisation.

### The background

As many readers will be familiar, Northern Rock used to be a building society, mainly based in the north east of England. At the time of its nationalisation it was the fifth largest UK mortgage lender. The bank financed a large part of its loan book by borrowing money on the wholesale money market. While this initially allowed it to achieve high growth, it was particularly affected by the severe disruption in the global financial markets that began in or around July 2007. By August 2007, its liquidity problems had become critical. On 3 September 2007, the Tripartite Authorities (the Treasury, the

Bank of England and the Financial Services Authority ('the FSA') agreed in principle that the Bank of England (in its capacity as the lender of last resort) would provide financial support so that Northern Rock could maintain its liquidity. On 13 September 2007 the fact that the company had sought and was to be provided with support was leaked to the press. There followed a run on the bank.

By 31 December 2007, the Bank of England had lent almost GBP 27bn to Northern Rock, and the Treasury had assumed contingent liabilities under certain guarantees it had provided to the tune of about GBP 29bn. Attempts to find a purchaser for the bank were unsuccessful and in February 2008 the decision was taken to nationalise it. The 2008 Act was passed into law on 21 February 2008. On the same day the Northern Rock plc Compensation Order 2008 (SI 2008/718) ('the Transfer Order'), was made pursuant to section 3 of the 2008 Act. It came into force on 22 February and by paragraph 2 effected the transfer of Northern Rock's share capital to the Treasury Solicitor as at the beginning of that day.

Section 5(1) of the 2008 Act provided that the Treasury must by order make a scheme for determining the amount of any compensation payable by the Treasury to persons who held shares in Northern Rock immediately before they were transferred. Section 5(4) of the 2008 Act provided that in determining the amount of any compensation payable by the Treasury it must be assumed: (a) that all financial assistance provided by the Bank of England or the Treasury to the deposit-taker in question has been withdrawn (whether by the making of a demand for repayment or otherwise); and (b) that no financial assistance would in future be provided by the Bank of England or the Treasury to the deposit-taker in question (apart from ordinary market assistance offered by the Bank of England subject to its usual terms).

The Transfer Order made provision for the payment of compensation to shareholders of Northern Rock in accordance with the 2008 Act. Article 3(2) of the Transfer Order provided that the amount of compensation payable to a person shall be an amount equal to the value immediately before the transfer time of all shares in Northern Rock held immediately before the

transfer time by that person. Article 9(6) provided that in determining the amount of any compensation payable by the Treasury it must be assumed (in addition to the assumptions required to be made by section 5(4) of the 2008 Act) that Northern Rock (a) is unable to continue as a going concern; and (b) is in administration. Article 7 of the 2008 Order made provision for the appointment by the Treasury of an independent valuer.

## Basis of the challenge

It was accepted that the nationalisation was itself lawful. Instead, the principal challenge was only to the effect of the statutory assumptions in section 5(4) of the 2008 Act. It was argued that the assumptions which the valuer of the Northern Rock shares was required to make pursuant to section 5(4) of the 2008 Act meant that the appellants would be deprived of their shares for nothing (or a derisory amount), and that in those circumstances their rights under Article 1 of the First Protocol were violated. In particular, it was argued that it was ‘manifestly disproportionate’ for the State, upon the company’s nationalisation, to take the whole benefit of its value, and potentially to collect a handsome profit on re-sale, leaving the shareholders effectively with nothing.

The appellants also raised two secondary arguments namely that: (1) the regulatory authorities were guilty of a series of culpable errors in their regulation of Northern Rock and that wrongful conduct by the expropriating state should be taken into account in setting the terms of the nationalisation (‘the regulatory issue’); and (2) an interference with rights protected by Article 1 of Protocol 1 would not be lawful unless there were in place procedures by which the merits of the expropriation in issue could be tested (‘the procedural issue’).

## The decision

Laws LJ (with whom the other members of the Court of Appeal agreed) held that the jurisprudence of the European Court of Human Rights had established three governing principles all of which were engaged in the present case:

- the need for a fair balance to be struck between public interest and private right;
- the requirement of proportionality (therefore the nationalisation had to be proportionate to the aim); and
- the doctrine of the margin of appreciation (namely that national authorities are in principle better placed to evaluate local needs and conditions than an international court).

The overarching principle was the first; the other two provided the means by which the balance was struck. The application of proportionality to a confiscation ordinarily meant payment of an amount reasonably related to the value of the property taken, so as not to impose a disproportionate burden on the person deprived. However the relation between proportionality and the first principle is qualified by the third, the margin of appreciation. Its effect is that that relation is not rigid or constant. It must acknowledge the claims of government policy on democratic grounds, albeit within the framework of the Convention rights.

The government support accorded to Northern Rock from September 2007 onwards amounted to a lender of last resort operation which entirely fulfilled the conditions for such an exercise. Furthermore, the decision to take the bank into public ownership was a strategic exercise of government policy, intended to preserve for the sake of the national economy the benefits won by the lender of last resort operation at the least possible cost to the taxpayer. Its purpose was not to confer a benefit on the shareholders but to prevent damage or further damage to the banking system as a whole.

The statutory assumptions set out in section 5(4) of the 2008 Act were in line with the conditions on which support by the Bank of England as the lender of last resort was provided. They were an application of the policy considerations which underpinned the Bank of England’s function as lender of last resort. In the circumstances, the margin of appreciation had to be a wide one. The court would only interfere if it were to conclude that the state’s judgment as to what was in the public interest was manifestly without reasonable foundation. The purpose of the legislative assumptions was to put the shareholders in the position they would have occupied had no lender of last resort support been provided. Accordingly, in context the state’s objective could not be characterised as manifestly without reasonable foundation.

The Court of Appeal also rejected, on the evidence, an argument that the Government was motivated by profit in seeking the terms on which the compensation was calculated. The Court of Appeal therefore concluded that there was no breach of Article 1 of Protocol 1.

As to the regulatory issue, the Court of Appeal agreed with the Divisional Court’s reasons for the rejection of this argument. First, the primary responsibility for the insolvency of Northern Rock lay with its management. Secondly, if there was any failure on the part of the regulatory authorities, it was not in any duty owed to the shareholders of Northern Rock. Neither the Bank of England nor the FSA owed any duty to the shareholders. Thirdly, the allegations of regulatory failure could not assist those shareholders (including the First or the Second Appellants) who acquired their shares after 13 September 2007 (if not an earlier date). This is because any loss of value of the shares caused by any regulatory failure had already occurred. Finally, it was

by no means demonstrated that any regulatory failings were an effective cause of Northern Rock's difficulties.

As to the procedural issue raised by the appellants, the Court of Appeal held that the statutory assumptions were not assumptions of facts which might or might not be true, and whose truth or otherwise ought to be examined. They constituted the policy according to which the valuation would proceed. The requirement of procedural fairness inherent in Article 1 of Protocol 1 was met by the availability of judicial review.

## Comment

The most interesting feature of this judgment is perhaps the careful analysis of how the Northern Rock crisis unfolded, and of the principles upon which the Tripartite Authorities operated, in particular the basis on which the Bank of England acted as lender of last resort. The majority of the Appellants arguments failed

because the assumptions imposed by the 2008 Act merely reflected the reality that the Bank of England was entitled to withdraw its lender of last resort support at any time. The judgment is also of note for the wide margin of appreciation given to the state in this context.

The case is likely to continue to attract attention. On 8 December 2009, the independent valuer published his consultation document, which sets out his provisional views on the valuation and on the amount of any compensation payable by the Treasury to parties affected by the transfer of Northern Rock into public ownership. His view was that on the terms of reference the shares had no value and no compensation would therefore be payable. Shortly afterwards the Supreme Court announced it would not be accepting the application for permission to appeal made by the Appellants. It has been reported that the shareholders intend to continue to pursue their case to the European Court of Human Rights. The saga therefore looks set to continue.

***Byers v Yacht Bull Corporation Ltd & Ors* [2010] EWHC 133 (Ch)**Adam Al-Attar, Barrister, 3-4 South Square, Gray's Inn, UK<sup>1</sup>**Overview**

If property falling within an English company's liquidation estate is seized in breach of the statutory stay applicable under English law and its right to that property disputed by the seizing party, is that breach of the statutory stay (and any matter incidental to that) to be determined in England and Wales or another Member State?

In part the answer turns on the interplay of Council Regulation 1346/2000 on insolvency proceedings (the 'Insolvency Regulation') and Council Regulation 44/2001 on the recognition and enforcement of judgment in civil and commercial matters (the 'Judgments Regulation') but, significantly, the answer turns on how the issue is characterised.

The question set out above is how the issue in *Byers v Yacht Bull Corporation Ltd & Ors* [2010] EWHC 133 (Ch) was characterised by the Joint Liquidators ('JLs') appointed to Madoff Securities and International Limited ('MSIL'). By contrast *Financiere Meeschaert* ('FM') had asked whether a proprietary claim against an asset situated and seized in France by a French company and asserted by the JLs on the basis of a purchase money resulting trust was to be determined in France or in England and Wales. On this characterisation the interference with the English liquidation estate and the breach of the English law statutory stay were incidental issues to the logically prior issue of equitable ownership.

The Chancellor accepted that FM's characterisation was correct notwithstanding that a party interfering with assets within an English liquidation estate now only has to dispute the title of the English company to require all issues to be determined in another Member State.

The purpose of this article is to explore some of the implications of the Chancellor's decision.

**Background**

MSIL was the English company within Bernard Madoff's web. Bernard Madoff Investment Securities LLC ('BMIS') was the New York company. BMIS was the principal engine of the fraud perpetrated by Bernard Madoff and which received funds from investors. MSIL by contrast was a proprietary trading company active in the London and pan European market.

Following the revelation of the fraud in relation to BMIS, MSIL's board of directors applied for the appointment of joint provisional liquidators on 19 December 2008. The making of a temporary restraining order in relation to Bernard Madoff and BMIS by the United States District Court for the Southern District of New York on 12 December 2008 and its notification to MSIL's banks, in particular, to Barclays Capital, who acted as MSIL's prime broker, had rendered MSIL cashflow insolvent. MSIL was subsequently held to be balance sheet insolvent upon the admission of a claim by BMIS under US law.

The joint provisional liquidators took steps to secure the physical assets and other assets of MSIL in particular to secure a Leopard 27m Sport Yacht known as 'the Yacht Bull' registered in the Cayman Islands in the name of the Yacht Bull Corporation ('YBC') and purchased with monies provided by MSIL.

The joint provisional liquidators' arrest of the Yacht Bull in Antibes was pre-empted by a matter of hours by the arrest of the same by FM at 10.25 am on 3 April 2009. FM had arrested the Yacht Bull in support of its alleged tort claim under French law against BMIS.

FM's claim against BMIS arose out of its indirect investment in that company. On 31 October 2008, FM had subscribed for shares in a vehicle referred to as SICAV Luxalpha ('Luxalpha'), a Luxembourg mutual trust managed by UBS, with an estimated value of EUR 10,045,565 for and on behalf its clients. Luxalpha had invested all of its assets with BMIS. Following the revelation of the fraud, and the loss of value of the Luxalpha shares, FM indemnified its clients for a total amount of EUR 10,145,452 and sought to recover the

**Notes**

<sup>1</sup> The author was junior counsel for the JLs with Felicity Toube. Gabriel Moss QC was senior counsel for the JLs instructed by Dundas & Wilson LLP. Vasanti Selvaratnam QC and Catherine Newman QC were counsel for FM instructed by Gide Loyrette Nouel LLP.



same from BMIS. In order to protect its position (and not to participate in the US bankruptcy proceedings) FM arrested the Yacht Bull in order that it might execute against it.

In these circumstances the joint provisional liquidators applied for a declaration that MSIL was the sole beneficial owner of the Yacht Bull and an order that FM, was, and had been since 19 December 2008, stayed from commencing or continuing proceedings against the Yacht Bull by virtue of section 130 of the Insolvency Act 1986 (the '1986 Act'). The application was continued by the joint provisional liquidators as JJs (the 'JJs' Application').

The JJs' Application was countered by an application by FM for a declaration that the Court had no jurisdiction over FM and for an order setting aside service of the JJs' Application ('FM's Application').

FM's Application for an order setting aside service was not determined by the Court. It was premised on a failure to serve on FM in accordance with the letter of French law and hence in breach of Council Regulation 1393/2007 on the service in the Member States of judicial and extrajudicial documents in civil or commercial matters (the 'Service Regulation'). The case did not therefore resolve the issue as to how the Service Regulation and the Insolvency Rules relating to service out interact.

FM's Application for a declaration that the Court had no jurisdiction was premised on no less than six grounds, including that the issue was within the mandatory scope of the Judgments Regulation which require FM to be sued in France, being its domiciliary jurisdiction; that the French Court was first seized and the matter was *lis alibi pendens*; that the JJs' Application was an abuse of process; that comity required the Court to decline jurisdiction; and that the JJs' Application was incompatible with *Allianz SpA v West Tankers* [2009] 1 AC 1138, which held that the Court could not issue an anti-suit injunction which would interfere with the jurisdiction of another Member State Court.

The Court did not determine each ground as logically each collapsed into one, namely whether the Judgments Regulation or the Insolvency Regulation applied.

### Interference with the estate

The JJs' submissions were put on the basis that the dispute as to the beneficial ownership of the Yacht Bull was incidental to the issue of whether FM had breached the statutory stay under English law.

The basis for the JJs' submissions was Article 3(1) of the Insolvency Regulation which the Court of Justice had interpreted in *C 339/07 Seagon (as liquidator of Frick Teppichboden Supermärkte GmbH) v Deko Marty Belgium NV* [2009] BCC 347 as conferring jurisdiction both in relation to the opening of main insolvency proceedings and the determination of matters 'derived

directly' from the insolvency proceedings and 'closely linked' to them. The JJs argued that that ancillary jurisdiction included the question of whether FM had breached a stay on proceedings against MSIL's property effective throughout the Member States, being a provision intended to prevent (and on application to the Court to set aside) 'legal acts' detrimental to creditors.

The JJs' submissions were bolstered by an analysis of section 130 of the 1986 Act. From the date that the joint provisional liquidators were appointed, no action or proceeding could be commenced or continued against MSIL or its property, except by leave of the Companies Court and subject to such terms as that Court might impose. Any proceedings commenced or continued without leave were liable to be avoided at the discretion of the Companies Court, or were void under English law. (See *Saunders, Re* [1997] Ch 60 and cf *Taylor, Re* [2007] BPIR 175.) Only the Companies Court was therefore able to grant effective relief under English law.

### Right to be sued in domiciliary jurisdiction

FM countered by characterising the JJs' submissions as putting the cart before the horse. The authorities established that:

- (1) Whether an issue is 'derived directly' from insolvency proceedings and is 'closely linked' with them is an autonomous concept: *C-133/78 Gourdain v Nadler* [1979] ECR 733, 743.
- (2) A claim based on insolvency law which would not exist but for the opening of insolvency proceedings (such as a claim to set aside a voidable preference) is within that autonomous concept.
- (3) An independent claim to the return of goods from a company in liquidation where title is retained by a seller, or a contractual claim turning on the parties' pre-liquidation relationship and capable of arising quite apart from the insolvency proceeding, is not within that autonomous concept: *C-292/08 German Graphics Graphische Maschinen GmbH v Alice van der Schee*, Court of Justice, First Chamber, 10 September 2009 at [29]-[31]; *UBS AG v Omni Holding AG* [2000] 1 WLR 916, 923d-g.

The JJs sought to distinguish these authorities on the basis that the ostensibly independent claims in those cases were undisputed claims and in which no breach of any statutory stay was alleged. The intended point of distinction was not *ad hoc* but to reflect the capability for forum shopping in the event of the seizure of an asset. The respondent to the officeholders' application would only have to put in issue the matter of title or, where the common law is applicable, equitable ownership to divest the Companies Court of jurisdiction.

## Resolution

The Chancellor rejected the JJs' submissions on the basis that the mandatory provisions of the Judgments Regulation were clear and that the JJs' objections were in fact only consequence of that mandatory regime. If MSIL had an interest in the Yacht Bull under a resulting trust, that interest arose as a result of the payment of purchase monies in circumstances in which no gift was intended and therefore arose at the time of payment and prior to the winding up of MSIL. It was therefore an independent claim. (See [2010] EWHC 133 (Ch) at [26] and [27].)

## Analysis

In one sense it is difficult to disagree with the Chancellor's conclusion. A resulting trust interest must have arisen prior to the opening of insolvency proceedings.

The alternative view is whether by reason of acts done in or in relation to the insolvency proceedings an otherwise independent claim might have become enmeshed with the insolvency proceedings such that a sensible interpretation of the jurisdictional rules would require the matter to fall within the Insolvency Regulation and not the Judgments Regulation.

The matter can be tested by asking what would have happened had FM not seized the Yacht Bull. The Court

of Justice recognised in *C-294/92 Webb v Webb* [1994] QB 696 that an interest under a trust of land was not an interest in land for the purpose of the Judgments Regulation and might therefore be determined other than exclusively by the Court in whose jurisdiction the land was situated. In that case the father was therefore free to sue his son in England and Wales to establish his beneficial entitlement to the property in France. If FM had not seized the Yacht Bull, and given YBC had consent to abide by whatever determination the Court made, the JJs could have had the matter determined by the Companies Court. The only reason for triggering the domiciliary rule and therefore requiring a determination in France was FM's seizure of the Yacht Bull in circumstances which, if the JJs were right, amounted to a breach of the statutory stay imposed by English law.

From the point of view of an insolvency lawyer, the decision in *Byers v Yacht Bull Corporation* is unattractive because it fragments the insolvency proceedings rather than collating aspects of those proceedings within the jurisdiction best able to accommodate them. The criticism is not then of the Chancellor's decision but of the rigid system of rules put in place by the Judgments Regulation and the Insolvency Regulation. A different outcome would however require abrogation of a defendant's right to be sued in his home Member State, and this is a keystone of the Judgments Regulation.

## *Re Kaupthing Singer and Friedlander Ltd* [2010] EWCA Civ 518: Set-off and Future Debts

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If at least one good thing has come out of the credit crunch, it is that the English Courts have been given the opportunity to consider some of the ambiguities in the drafting of the Insolvency Rules 1986.

The decision in *Re KSF* provides timely clarification on the proper application of Rule 2.85 (dealing with set-off in an administration) and Rule 2.105 (debts payable at a future time). This is a technical area, but the practical consequences of the decision are important and will have a significant impact in bank insolvencies.

The problem which the case deals with is best illustrated by an example. Assume that a creditor of an insolvent company is owed GBP 100, repayable immediately. Assume also that the creditor owes the company GBP 1000, but that the debt does not become payable for 10 years and carries simple interest at 4%. The company and creditor have had mutual dealings which should be susceptible to insolvency set-off. But set-off must operate between like and like, and it would be unfair to set GBP 100 (currently due) against GBP 1000 (not due for 10 years). Some form of discounting must be applied to the GBP 1000 (as envisaged by Rule 2.105) in order to give its current value. The decision of the Court of Appeal (and that at first instance) consider how the discounting formula works and how the balance, if any, is quantified and recoverable by the company from the creditor.

This problem is relatively new as a matter of English law. Historically, contingent or future claims against the creditor by the company were not available for set-off purposes because it was considered unfair for a creditor to have his liability (or potential liability) to pay accelerated merely because the company had become insolvent (see *Stein v Blake* [1996] AC 243 at 253). Amendments to both Rule 4.90 and Rule 2.85 in 2005 reversed this position but, in order to address the unfairness identified in *Stein v Blake*, both rules provided that any balance remaining due after set-off in favour of the insolvent company would only be paid as and when it fell due and payable: Rules 2.85(8) and 4.90(8).

Although the explanatory note to the new versions of both Rule 2.85 and 4.90 emphasised that they had been designed to 'provide greater detail and clarify of meaning for the user', the KSF administration identified

a number of areas of potential confusion. The nature of KSF's banking business was such that there were a considerable number of future debts due to the company. At first instance, Norris J [2010] 1 BCLC 222 held *inter alia* that:

1. a debt was a future debt for the purpose of Rule 2.85 if it was not due for payment at the date of the notice of intention to make a distribution;
2. future debts were, by reason of Rule 2.85(7), subject to the discounting formula in Rule 2.105 in order to ascertain their current value for set-off purposes;
3. post-administration interest payable on debts due to or from the company was not to be taken into account for the purpose of set-off;
4. Rule 2.105 (and the discounting formula) applied to the entirety of a future debt. As a consequence, the balance (if in favour of the company) was the remainder of the debt discounted to its present value. Interest would be payable to the company on that balance in accordance with the contractual provisions of the agreement between the parties. The judge rejected the suggestion that the company could add back in the interest which would have been payable in the period between the administration and the final maturity date of the debt.

The appeal concerned only point 4. In practical terms, the effect of the decision greatly benefited a creditor who could take advantage of insolvency set-off as compared to one who could not. That was because the balance payable would reflect the discounted current value of the debt. It would exclude the value of any interest which would otherwise have been payable on the debt in the period between the administration and maturity date. Etherton LJ described it at paragraph 24 as producing a result which was extraordinarily beneficial to the creditor in question, and highly detrimental to the body of creditors.

That result can be illustrated by the same example referred to above i.e. a creditor to whom GBP 100 is currently due, but who also owes the Company GBP 1000 (due in 2020, with interest payable in the intervening period on the full GBP 1000 at 4%).

The comparative recoveries against that debtor and one who does not have the benefit of set-off are significant. The debtor who does not benefit from set-off will, by 2020 (and assuming simple interest with no intervening payment of the balance) pay GBP 1400.<sup>1</sup> Even if the debt is paid off immediately (and early), the debtor will pay GBP 1000. By contrast, the debtor who could take advantage of a GBP 100 set-off would pay only GBP 718<sup>2</sup> by virtue of the discounting mechanism in Rule 2.105.

That this result was correct was reluctantly accepted by Norris J, who concluded that he was compelled to reach that decision in light of the wording of the relevant rules. In particular, all sums due in respect of mutual dealings are to be taken into account for the purpose of effecting the set-off: Rule 2.85(3) and 2.85(4). There is no provision which permits the exclusion of any part of the sums due from the taking of the account. Rule 2.85(7) states that Rule 2.105 is to be applied to 'any sum' due from the company, and not merely that part necessary to satisfy any cross-claim. Rule 2.85(8) provides for a balance to be claimed, which balance is the product of the taking of the statutory account and extinguishes the original causes of action (see *Stein v Blake* at 255B). If the balance is in favour of the company, there is no provision enabling the reduction brought about by Rule 2.105 to be undone or reversed.

As such, it was suggested that, even if the result was surprising, the wording of the relevant rules was clear and unambiguous and an amendment would be required to reverse the result.

The Court of Appeal was unwilling to accept that this conclusion could be correct, which Etherton LJ described as having 'no sensible policy rationale' and as being 'inconsistent with the basic principles and objectives of insolvency administration' (paragraph 32).

The Court emphasised that the aim of insolvency set-off was to promote speedy and efficient administration of the assets of a company in a manner which achieves substantial justice between the parties to the set-off and, so far as practicable, equality in the treatment of creditors.

Although not accepting the construction submissions originally made by the Administrators, the Court of Appeal concluded that it was possible to interpret Rules 2.85(7) and 2.85(8) in a manner which avoided the surprising inequality of treatment identified above. Etherton LJ held that the language of Rule 2.85(8), and the use of the phrase 'for the purposes of this Rule', was sufficiently wide to be read as confining the incorporation of Rule 2.105 to such part of the debt due to the company as is necessary to calculate what should be paid to the creditor by way of set-off in satisfaction of its claim. Rule 2.105 would not, however, have any effect at all on the remainder of the debt due to the company after insolvency set-off had taken place (paragraph 34).

The effect of this decision is undoubtedly sensible, even if the interpretation might be said to strain the language and structure of the rules at least a little bit. The only alternative way of equalising the position of the creditors benefiting from set-off and those without would have been to include the future interest payable on the future debt so as to increase the face value of the debt which is subject to the discounting formula in Rule 2.105. That argument was, however, rejected by Norris J at first instance in light of the express application of Rule 2.88 to debts due to the company which included interest (see Rule 2.85(6)), which Rule makes it plain that post administration interest should not be taken into account. It would also be somewhat artificial because the calculation would give a present value of a debt which included interest that would never be paid.

## Notes

- 1 GBP 1000 plus interest of GBP 40 for 10 years.
- 2 GBP 1000, subject to discounting in accordance with Rule 2.105, is GBP 613 (i.e.  $(X / 1.05^n)$  where X is the face value of the debt and n is the time period before the debt becomes due). Deduct GBP 100, plus interest of GBP 20.50 for 10 years = GBP 718.

### Look Chan Ho (ed.), *Cross-Border Insolvency: A Commentary on the UNCITRAL Model Law*

Reviewed by: David Marks QC, Barrister, 3–4 South Square, Gray's Inn, London, UK

This is the only specialist work entirely devoted to the United Nations Commission on International Trade (UNCITRAL) Model Law on Cross Border Insolvency. The Model Law is an entirely new concept now enacted directly into English law by its inclusion in almost all material respects in the Cross-Border Insolvency Regulations 2006. The Regulations came into force on 4 April 2006.

There has since that time been only a handful of English decisions on various aspects of the Regulation, in particular the consideration of the types of proceedings, essentially main proceedings which justify recognition in this country. The same is hardly unusual with an enactment of this sort. The same slow but steady growth occurred with the EC Insolvency Regulation introduced into English law in 2000. Even now the English jurisprudence on the EC Regulation is not immense. It does, however, benefit from the substantial growth in reported case law and commentary on mainland Europe although the failure properly to record such decisions in a formal, systematic and easily accessible form is not helpful. It is to be hoped that the same problems do not apply over time with regard to the Model Law.

This is the 2nd edition of this work and is very welcome. The main editor remains the same individual who is increasingly familiar as a respected commentator on insolvency and banking subjects particularly in periodical literature. He is well known for causing there to be the occasional reassessment of well known themes such as the *pari passu* rule and subordination principles. He is a solicitor at one of the best practices dealing with insolvency and restructuring. This may well explain the presence of such an excellent group of contributors who comment on other jurisdictions in which the Model Law has been enacted. The work is the latest in a small but developing collection of specialist imprints by the same publisher each related to various forms of restructuring and financing.

The editor sensibly begins with an overview. It is often forgotten and overlooked that no reciprocity lies at the heart of the Model Law although a few jurisdictions have imposed that requirement in a *de facto* manner. Many concepts are, of course, familiar as they reflect similar concepts in the EC Insolvency Regulation. One

issue, however, yet to be explored, certainly in the English jurisprudence, is the balance to be struck between competing claims, eg between a secured claimant in the recognising State and the effect of the home State insolvency process. This and similar problems remain great challenges ahead. In addition the vast and equally unexplored range of cross-border communication and co-operation mechanisms and concepts need to be worked out. As an overall principle, cross-border communication between judges at least, has not been embraced with total fervour by United Kingdom courts and much will have to be addressed on this score in the years to come.

As this review is being written, the Insolvency Service in the United Kingdom has launched an initial inquiry amongst practitioners as to the way in which the Model Law has been received, implemented and considered. This is no doubt because it presents so many features which are still relatively new and novel in the eyes of UK practitioners and lawyers.

Matters may not be vastly helped by the relatively small number of jurisdictions which have adopted the Model Law but there are some very important members in that club. They include particularly Australia, New Zealand, Canada, South Africa and most importantly the United States. The fact that these jurisdictions have adopted the Model Law reflects itself in the degree of detail which each contribution relating to those countries enjoys in this work.

The real value of the book is in its cross-references. Many of the contributors provide copious footnotes, not simply as to the origin and genesis of the way in which the Model Law has been enacted and adopted in particular jurisdictions but also with regard to domestic law and jurisprudence. There is no doubt that there will have to be much comparative analysis by each new jurisdiction as and when it joins the club. In October 2008, for example, the New South Wales Supreme Court issued a practice note to the effect that parties should consider guide lines applicable to court to court communication in cross-border cases. The format of those guidelines was drawn from the American Law Institute more or less designed in conjunction with the International Insolvency Institute. The same phenomenon has occurred in Canada.

The editor himself deals with the English Regulations. Given his American qualifications it is not surprising that he resorts to much United States citation both as to case law and as to periodical literature. He uses such citations as a justification to criticise a recent US bankruptcy court decision of *In Re Betcorp Limited* 400 BR266 in support of his argument that a 'foreign proceeding' under the British Model Law should not be interpreted to include a foreign members' voluntary liquidation. His discussion is to be compared with the discussion found in the United States section and readers of this review should buy the book, if nothing else, to compare and contrast the approach of both contributors. For what it is worth, this reviewer feels that there are certainly strong grounds for assuming that an English court would not follow the United States bankruptcy court's approach in affording recognition in all such cases.

In particular the editor in this section cites US authorities as part of the general debate to the effect that there could be said to be even in the United States a residual common law type discretion to recognise properly constituted foreign insolvency proceedings provided fairness and due process have been respected. Such an approach is entirely right and consistent with the United Kingdom approach. There seems no reason in principle why the Model Law, the EC Insolvency Regulation, section 426 of the Insolvency Act 1986 as well as the common law right to recognise foreign

insolvency proceedings should not all co-exist and operate in parallel as and when appropriate. On the other hand it should be remembered, perhaps self evidently, that the aims of the EC Regulation and the Model Law at least remain entirely distinct. As the editor points out on more than one occasion, the former deals with the opening of initial proceedings while the latter addresses recognition alone having nothing to do with the former. This section not surprisingly contains a rich vein of information on all aspects of the subject.

Some countries yield of necessity shorter contributions in this work and that is only to be expected. But the book remains faithful to its evident and entirely laudable aim, namely to ensure that all the main jurisdictions which have signed up to the Model Law are properly represented and commented upon.

As the extremely eminent contributor of the United States' chapter points out, the Model Law reflects a 'significant expansion' in pre-existing law and practise. The writer in question, namely Selina Melnik adds that it 'incorporates precepts and underpinnings not readily apparent on its surface and thus presents numerous challenges – as well as opportunities – to the uninitiated'.

The book is a very handsome contribution to the study of the subject both to the uninitiated and to others, all of whom can profit from it and enjoy it immensely.

Globe Law and Business, 2nd edn, 2009

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