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ARTICLE

Making Sense of Arguments about the Anti-Deprivation Rule

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The anti-deprivation rule

Liquidators and administrators are skilled in increasing the payouts to creditors. To that end, practitioners faced with the fallout from the GFC have become increasingly interested in an old common law rule, now dusted down and re-branded as 'the anti-deprivation rule'. Its 19th-century formulation remains apt: '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.'[1] That is the UK version. The US version, the *ipso facto* rule, is enshrined in statute.[2]

A contractual arrangement which infringes the rule is void. Avoidance increases the asset pool available for distribution to the insolvent's general creditors.[3] Conversely, if the rule is not infringed, the agreement will operate according to its terms and deliver the intended insolvency advantage to the nominated party.[4]

The rule[5] has been applied by courts since at least the 18th century.[6] On its face it looks simple, yet the line between what is permitted and what is not remains surprisingly unclear. Lord Neuberger made this plain in both *Perpetual Trustee* and *Money Markets*.[7] The only House of Lords authority is *British Eagle*.[8] Earlier this year, the *ICR* published my analysis of the Court of Appeal decision in *Perpetual Trustee*,[9] but the issues clearly merit wider discussion.

What follows is an analysis of the arguments commonly advanced against application of the anti-deprivation rule, either generally or in specific circumstances.

Preliminary issue: is the anti-deprivation rule one rule or two?

In my earlier ICR article,[10] I suggested that the anti-deprivation rule comprised two sub-rules, a 'contracting out' rule and an 'insolvency-[triggered] deprivation' rule. That remains my position. But since the terms 'contracting out' and 'deprivation' are also frequently used in the cases, my labels may need further explanation.

The common law anti-deprivation rule is routinely justified on the basis of a public policy that empowers the courts to prevent parties from contracting out of,[11]

Notes

1 *Ex p Jay* (1880) 14 Ch D 19, 26 (Cotton LJ), cited by Lord Neuberger in *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160, [2010] Ch 347 (CA) ('*Perpetual Trustee* (CA)'), para. 1. This is subject to the statutory rules on protective trusts: Trustee Act 1925 s 33. 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*'); *International Air Transport Association v Ansett Australia Holdings Ltd* [2008] HCA 3 (Aust HCt) ('*Ansett*'); and *Peregrine Investment Holdings Ltd v Asian Infrastructure Fund Management Co Ltd* [2004] 1 HKLRD 598 (Hong Kong CA) ('*Peregrine*'). Now also see *Mayhew v King* [2010] EWHC 1121 (Ch) ('*Mayhew*').

2 See the analysis of the statutory rule in *Lehman Brothers Special Financing Inc v BNY Corporate Trustee Services Ltd* Case no. 09-01242 (Bankr. SDNY), 25 January 2010.

3 E.g. *Mackay* and *British Eagle*, n. 1.

4 E.g. *Perpetual Trustee* (CA) and *Ansett*, n. 1.

5 It is sometimes described as a rule, and sometimes as a principle – nothing seems to hang on the difference, and no distinction is intended here.

6 See the cases cited in n. 1.

7 See *Perpetual Trustee* (CA), n. 1, paras [32], [57], [93] (Lord Neuberger); and *Money Markets*, n. 1, paras [87] and [117] (Neuberger J). Also see *Oystertec*, n. 1, paras [46]-[47].

8 N. 1.

9 S Worthington, 'Insolvency Deprivation, Public Policy and Priority Flip Clauses' (2010) *International Corporate Rescue* 28-39.

10 N. 9.

11 *Perpetual Trustee* (CA), n. 1, paras [50], [54], [73] (Lord Neuberger) citing *British Eagle* (both Lords Cross and Morris), *Carreras* and *Ansett*; also see paras [113], [118], [123] (Patten LJ).

or evading,[12] or defeating,[13] or working a fraud on,[14] the insolvency legislation. The modern (and perhaps also the historical) view is that this rule goes no further than preventing parties from contracting out of the insolvency legislation.[15] It targets arrangements which effect a different distribution of the insolvent's assets from that which would obtain under the legislative rules. As Patten LJ put it, the insolvent 'may not contract ... for its property ... to be disposed of or dealt with otherwise than in accordance with the statute.'[16]

Patten LJ distinguishes between 'disposed of' and 'dealt with'. So do I. The 'insolvency-triggered deprivation' rule looks to disposals; the 'contracting out' rule to dealings. Disposals and dealings both deliver 'deprivations': both describe arrangements which ensure that the insolvent's creditors – or some of them – are deprived of assets that would otherwise be theirs under the insolvency legislation.

Differentiation is essential because different conditions for invalidity apply. The two sub-rules target the two distinct strategies a debtor might pursue. In particular, a debtor who wished to favour a nominated third party on insolvency could either provide for a specific insolvency-triggered deprivation of its assets in favour of that party (being assets that would otherwise be available for distribution on the debtor's insolvency),[17] or it could agree to more attractive contractual set offs or netting arrangements, thus avoiding the distribution rules that would otherwise apply to the debtor's property.[18] To the extent that either type of arrangement effects a contracting out of the insolvency legislation, and thereby deprives some of the insolvent's creditors of what would otherwise be due to them, the arrangement will be void.[19]

The different conditions which call into play these two sub-rules bear repeating.[20] The first sub-rule – the insolvency-triggered deprivation rule – is only breached if the agreement is triggered by the insolvency of the debtor *and* it provides for a deprivation of property that would otherwise be available to the debtor's creditors. In particular, this sub-rule does not touch deprivations pre-dating insolvency, or deprivations triggered by events other than the debtor's insolvency,[21] or deprivations which simply pursue permitted legislative allocations (as with valid security agreements), or deprivations in name only (where what is deemed to be fair value is given in exchange for the deprivation).[22]

The second sub-rule – the contracting out rule (which might have been better, although less comprehensively, labelled the set off and netting rule) – does not require any trigger, insolvency or otherwise. This sub-rule is breached by any agreement for set off or netting or for any other contractual distribution scheme which goes beyond what is permitted by the mandatory insolvency set off rules, or by other permissive legislative provisions.[23] The sub-rule only catches arrangements applying on insolvency; those completed prior to insolvency do not offend the anti-deprivation rule.[24] The common bilateral arrangements which infringe this sub-rule are routinely avoided with barely a pause for thought, never mind express mention of any anti-deprivation rule; multilateral arrangements, by contrast, attract more discussion.[25]

Unless the two sub-rules are distinguished, the significance of the insolvency-trigger does not emerge. Other than this, however, there is little separating the two sub-rules, and certainly nothing dividing their motivation or policy ambitions. This is despite the inherently different forms that these two types of arrangement inevitably take.

With that ground cleared, it is now possible to turn to the arguments that are often advanced to cut down the potential application of the anti-deprivation rule.

Notes

12 *Mackay*, n. 1, p 647; *British Eagle*, n. 1, p 770 (Lord Morris, dissenting on the outcome, but not on the principle)
13 *Whitmore*, n. 1, p 215; *British Eagle*, n. 1, p 770 (Lord Morris).
14 *Perpetual Trustee* (CA), n. 1, para. [152] (Patten LJ).
15 *Perpetual Trustee* (CA), n. 1, para. [54] (Lord Neuberger), citing *Mackay*, *Newitt*, *British Eagle*, *Carreras* and *Ansett*.
16 *Perpetual Trustee* (CA), n. 1, para. [113].
17 Most cases fall into this category: see all the successful anti-deprivation cases in n. 1 other than *British Eagle*.
18 E.g. *British Eagle*, n. 1.
19 See the cases cited at n. 1.
20 More detail is given in my earlier ICR article, n. 9.
21 E.g. see *Perpetual Trustee* (CA), overruling *Oystertec* in this regard (para. [74]), and criticising *Peregrine* (paras [165]-[170]), all cases cited at n. 1.
22 *Borland* and *Perpetual Trustee* (CA) (the Media share deprivation in the *Butters* appeal), both cases cited at n.1.
23 Such as the exemptions specifically provided for recognised investment exchanges or clearing houses: Financial Markets and Insolvency (Settlement Finality) Regulations 1999, SI 1999/2979, reg 14 (iro payment and settlement systems) and Financial Collateral Arrangements (No 2) Regulations 2003, SI 2003/2336, reg 12(1), which applies to financial collateral arrangements.
24 All this is plain from *British Eagle*, n. 1. Also see *Carreras*, n. 1.
25 See, e.g., *Bank of Credit and Commerce International SA (in liq)(No 8)* [1998] AC 214 (HL); and *British Eagle* and *Ansett*, both at n. 1. Note that the *British Eagle* arrangement did not *divest* assets from British Eagle's estate (in particular, it was not an arrangement effecting an insolvency-triggered deprivation of the sort embraced by the first sub-rule); it merely provided for a different asset distribution (i.e. it offended the second sub-rule). Indeed, if the arrangement *had* divested assets from British Eagle's estate, then that would have been achieved prior to insolvency and the arrangement would have been effective on British Eagle's insolvency – this is precisely the point that divided the majority of the HL from the minority and from all the other judges in the lower courts, and the point which ensured a different conclusion in the *Ansett* litigation.

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1. The Insolvency Act 1986 is a comprehensive code, and should not be supplemented by the common law or by public policy interventions from judges. [False]

A significant number of authorities explicitly or implicitly reject this proposition, including *British Eagle* in the House of Lords. No anti-deprivation case has suggested that the rule itself no longer exists. The debate is only ever as to whether the rule applies on the facts.

That is not to deny the noticeable judicial hesitation in *Perpetual Trustee*,[26] with concern expressed not to extend the rule any further;[27] and the majority's clear reluctance in *Ansett* to reach a conclusion that might upset the commercially successful and internationally beneficial IATA clearing house scheme.[28] Other modern cases are similarly cautious.

Leaning the other way, the anti-deprivation rule has a long history which must have been familiar to the framers of the IA 1986 and its predecessors. The statutory provisions for protective trusts implicitly assume the existence of a common law anti-deprivation rule.[29] And judicial intervention which simply outlaws contractual evasion of the statutory insolvency distribution regime (and in particular contractual evasion that purports to prefer the contracting parties and effect a deprivation on the non-contracting parties) is surely not especially controversial. *Perpetual Trustee* recognised this.[30]

The more aggressive argument, and one that could only be delivered by the Supreme Court or by legislation, is that the IA 1986 has comprehensively defined what is outlawed, and all other arrangements should now be regarded as legitimate notwithstanding earlier precedents.[31] This would take us a good distance from where we now are. The IA 1986 preference and undervalue provisions (ss 239 and 238 respectively) have time limits which would not bite in a good number of the earlier successful anti-deprivation cases. In addition, the necessary intention to prefer is easily countered.[32] And the test of undervalue would rarely be met (see the next illustration below). The fraud provision (s 423) has no time limit, but requires proof of both an intention to defraud and a transaction at an undervalue. Fraud is notoriously difficult to prove; in *British Eagle*, such a claim could certainly not have been made out. In *Mackay*, even assuming fraud could be proved (not inevitable, unless every insolvency-triggered provision raises a strong presumption of fraud), the transaction would have failed the undervalue requirement: the offending flaw was not undervalue, but the granting of additional (contractual) security to support a transaction for value.[33] Given all this, the advantages of confining the anti-deprivation rule to contraventions of the IA 1986 – at least without focused amendment of that Act – are not obvious.

This is not to say the IA 1986 is completely without teeth in this area. Sometimes the Act is up to the task of overturning contractual deprivation provisions, but only rarely and rather randomly. In *British Eagle*, for example, the netting provisions might now be outlawed simply because they conflict with the mandatory insolvency set off rules.[34] Indeed, this might be true of the entire sub-class of 'contracting out' cases. And in *Mackay*, the arrangement to hold back the second half of the royalties income stream could now be seen as an agreement for a floating charge, void for want of registration. But most of the insolvency-triggered contractual deprivations illustrated by the existing authorities are not by way of security; they are absolute. It could prove hard to shoehorn these cases into an analysis that finds invalidity based on failure to register a registrable security interest.[35] This is despite the strong intuitive attraction of the floating charge analogy.

That analogy is worth brief pause for thought. It says something about the work being done by the common law anti-deprivation rule, and in particular the insolvency-triggered anti-deprivation limb. With a good number of insolvency-triggered deprivation clauses, the arrangement allows the debtor the benefit of its property until insolvency intervenes, and only then will the contracting counterparty obtain the agreed rights to the property. This has palpable parallels with a floating charge. If the arrangement is not designed to provide security, however, then the floating charge

Notes

26 *Perpetual Trustee* (CA), n. 1, paras [54], [113], [123] and especially [171-2], all seemingly confining intervention to 'contracting out' provisions, although contrast paras [32] et seq and [152] et seq; also see para. [91].

27 *Perpetual Trustee* (CA), n. 1, para. [57].

28 *Ansett*, n. 1, e.g. paras [76]-[79]. In this respect, the hesitancy also related to the notion that carefully negotiated contractual arrangements between sophisticated parties should be given their full effect (see below).

29 Trustee Act 1925 s 33.

30 N. 1, paras [32] et seq. and [152] et seq.

31 Except perhaps sham arrangements, which would still be avoided – although what might be covered here is not clear.

32 *Re MC Bacon (No 1)* [1990] BCC 78.

33 *Ibid.*

34 That would be true on the majority's view of the contractual arrangements; the opposite would be true, of course, if the minority was correct (and then the outcome would be as in *Ansett*).

35 E.g., their facts do not fit the analysis of products and proceeds clauses in retention of title cases, where express agreements for ownership were construed as agreements for security, which were therefore void for want of registration. See, e.g., *Re Bond Worth* [1980] Ch 288; *Borden (UK) v Scottish Timber Products* [1981] Ch 25.

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analysis falls away. For the debtor's general creditors, this simply makes the deal even worse: the favoured counterparty's interest is absolute, not simply by way of security (and of course is not subject to all the IA 1986 impositions on floating charges). When insolvency-triggered deprivation arrangements follow this model, where the floating charge parallels are clear, it is difficult to see why an unregistered floating charge should be void if these arrangements are allowed to stand. Yet that seems to be the outcome under arguments that the IA 1986 is a complete code; indeed, it is also the outcome if certain other arguments discussed below were accepted.

2. Contracts should be enforced according to their terms, especially contracts agreed by sophisticated parties with the benefit of legal advice. [False]

This argument pitches the principle of freedom of contract (and party autonomy) against the principle of collective insolvency management, and asserts that the former should win. It does not explain why.

The argument can be seen in *Perpetual Trustee* (CA):[36] '… if possible, the courts [should] give effect to contractual terms which parties have agreed. Indeed, there is a particularly strong case for party autonomy in cases of complex financial instruments [since] the parties are likely to have been commercially sophisticated and expertly advised.'

By contrast, in *Mayhew*,[37] where a promised indemnity would terminate if the indemnified party became insolvent, Sir Edward Evans-Lombe refused to accept the supremacy of contract argument, replying that, as a matter of policy, such an approach would enable routine avoidance of the anti-deprivation rule in almost every imaginable case; and, further, as a matter of precedent, the proposition ran contrary to both modern and older authorities.

But even this does not put the case strongly enough. The argument for freedom of contract advocated here goes much further than favouring a pro-party interpretation of bilateral arrangements. It suggests this same pro-party approach is appropriate even when the arrangement affects the rights of non-contracting third parties. This cannot be right. However much the contracting parties wish it, a bilateral arrangement cannot deprive third parties of their legitimate statutory rights.[38] When these two important principles collide, the arguments from precedent, principle and public policy all suggest that freedom of contract cannot trump the collective management rules enshrined in the insolvency legislation. There is only freedom of contract within the law.

3. There is no point having an anti-deprivation rule that can be readily avoided by careful drafting. [False]

A few commentators suggest that because it is easy to draft around the anti-deprivation rule,[39] the rule itself is pointless. This comes close to saying that if an objective could be achieved legitimately, then it should be regarded as achieved no matter what delivery mechanism is selected. If this were even remotely true, a good deal of law would simply disappear. Consider the law on penalties, charges, hire-purchase, trusts; the list is endless.

If the anti-deprivation rule *is* legitimately avoided by careful drafting, then the insolvent's creditors have no complaint. Their entitlements simply follow the statute. But the authorities make it clear that devising effective protection for the favoured party is not necessarily straightforward; simple drafting is often not up to the task. And in any event, the drafting alternatives generally come with costs to the winners and protections for the losers. The anti-deprivation rule works to ensure that these costs and benefits are a necessary part of any 'insolvency-favoured counterparty' package.

4. In deciding whether an arrangement offends the anti-deprivation rule, complicated arrangements can be analysed by considering their economic effect or functional equivalents. [False]

It should go without saying that if the parties choose to use intermediaries, or a group corporate structure, then it is not for the courts to pretend they have done otherwise.[40] That is the complaint with *Peregrine*.[41] Equally, and hypothetically, in *Perpetual Trustee* it would not be right to assume that the contracts between LBSF and the Issuer, and between the Issuer and Perpetual Trustee, could be treated as the economic or functional

Notes

36 At n. 1, para. [58]. Also see paras [91] and [99].
37 [2010] EWHC 1121.
38 Also see Argument 17, below. A similar argument emerged in the *Spectrum* litigation ([2005] UKHL 41), but there too the HL refused to favour the clear intention of the contracting parties in the face of the disadvantage that would thereby be wreaked on non-contracting creditors seeking their due protection under the IA 1986.
39 In *Perpetual Trustee* (CA), n. 1, para [92] (Lord Neuberger) notes the ease of avoidance. This view seems widely held, but such confidence in drafting alternative structures is perhaps misplaced.
40 *Perpetual Trustee* (CA), n. 1, paras [165], [170], [172] (Patten LJ).
41 N. 1, considered in *Perpetual Trustee* (CA), n. 1, paras [165]-[170] (Patten LJ).

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equivalent of a contract between LBSF and Perpetual Trustee, ignoring the nominated intermediary. Indeed, *had* that been the simplified arrangement from the start, then the parties' stated commercial objectives could have been met by LBSF granting to Perpetual Trustee a floating charge over the collateral which, absent the intermediary structure, LBSF or its trustee would have held. If properly registered, that charge would have provided effective protection to Perpetual Trustee on LBSF's insolvency. But that was not the arrangement, and no arguments from economic or functional equivalence can make it so at law. Rigorous legal analysis must be of real facts, not their financial equivalents.

5. *A contractual deprivation does not offend either limb of the anti-deprivation rule if it takes place before the onset of the debtor's insolvency.* [True]

With this timing, an agreed deprivation cannot constitute either a contracting out of the insolvency regime by improper set off or netting or other distribution rules, nor (by definition, given the timing) an improper insolvency-triggered deprivation. This conclusion is illustrated by all the cases. In *British Eagle*, for example, the netting out arrangements which had been completed before British Eagle went into liquidation were valid; in *Carreras*, the assets already received on trust were held that way through to liquidation, even though post-insolvency receipts could not be.[42]

Equally, any agreed deprivations triggered by events other than the debtor's insolvency are prima facie valid, although they can sometimes be unwound under claw-back provisions in the insolvency legislation itself[43] or under specific statutory, common law or equitable rules (often unrelated to insolvency).[44] These claw backs enable the liquidator to enhance the size of the insolvent's estate.

6. *A deprivation is valid if the parties had no intention of avoiding the insolvency laws.* [False]

This suggestion can be given short shrift.[45] As far as the 'contracting out' sub-rule is concerned, and perhaps more generally, *British Eagle* makes it abundantly clear that what matters is the effect of the relevant contractual provisions, not their purpose.[46] And as far as the 'insolvency-triggered deprivation' sub-rule is concerned, none of the leading authorities rely on – or pay much attention to – the intention of the parties.[47]

In passing, it is sometimes said that the opposite rule may be true: that devices calculated to defeat the operation of the insolvency laws will not be enforced.[48] But this seems doubtful unless the device also contravenes the more demanding requirements of the statutory prohibition against defrauding creditors (s. 423), or the common law anti-deprivation rule, or is a sham.

7. *A deprivation is valid if not effected by means of an insolvency trigger.* [Partly true]

British Eagle makes it clear that an insolvency trigger is not essential where the contracting out rule is in play. By contrast, this trigger is crucial where the insolvency-triggered deprivation rule is relied upon (and indeed a deprivation *not* triggered by insolvency will not be caught by this sub-rule). This is addressed in more detail in my earlier ICR article.[49]

8. *An arrangement which appears to be an improper 'contracting out'[50] can be characterised as a valid agreement defining the debtor's assets themselves.* [Sometimes true]

Proper characterisation of arrangements is precisely what divided the majority in the House of Lords in *British Eagle* from the minority, and from all the judges in the lower courts. The majority held that British Eagle had a subsisting claim against Air France, and that the IATA netting arrangements therefore delivered an illegitimate contracting out of the insolvency regime for dealing with this debt. By contrast, all the other

Notes

42 Both cases cited at n. 1.

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

44 But these rules are often of limited help. E.g., in 'What is Left of Equity's Relief Against Forfeiture?' in E Bant and M Harding (eds), *Exploring Private Law* (2010, CUP), I argue that this form of equitable relief is far more limited than traditionally conceived.

45 Noted in H Beale et al, *The Law of Personal Property Security* (2007, OUP), p 285, para [6.85] citing *Money Markets* [2001] 4 All ER 223, 255 and also the direct payment cases in building contracts. But concluding that the proposition is of doubtful authority because its effect is to disadvantage third party creditors and advantage the party exercising the forfeiture right (*ibid*).

46 *British Eagle*, n. 1, p 780.

47 This is true of all the relevant cases cited in n. 1.

48 *Re Johns, Worrell v Johns* [1928] Ch 737.

49 N. 9.

50 Being an arrangement which does not also include an insolvency-triggered deprivation clause.

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judges held that the arrangement between the various airlines and IATA was such that no claim by British Eagle against Air France survived, and the only asset that British Eagle had was a net claim through IATA, which claim would then be dealt with precisely as required by the statutory insolvency rules.

This same characterisation question was again in issue in the *Ansett* litigation, where the validity of the revised IATA contracts was called into question on the insolvency of Ansett. The Australian High Court held that the revised IATA terms were effective to define the assets held by Ansett, ensuring that its only claim was a net claim through IATA.

Proper characterisation seems simple, but note the powerful dissent in *Ansett* by Kirby J,[51] and also note how many commercial parties now prefer to rely on express statutory exemptions[52] or formal novation rather than simple but potentially risky multilateral netting agreements which might be disadvantageously characterised by the courts (as in *British Eagle*).

9. An arrangement which appears to be an improper 'contracting out' can be characterised as a valid contractual subordination agreement. [True if it is the debtor's creditors who are prioritised/subordinated; false if it is the debtor who is contractually subordinated and the parties seek to have the agreement operate when the debtor is insolvent]

This argument looks complicated, but it is not. It is widely agreed that effective subordination agreements fall outside the anti-deprivation rule.[53] But note the types of arrangements that are being described. It is the debtor's *creditors* – whether secured or unsecured – who are free to agree as between themselves that their combined statutory insolvency entitlements (whether as secured or unsecured creditors) will be distributed *as between themselves* in any fashion they choose.[54] This does not deprive the debtor's non-consenting creditors of anything they might otherwise be entitled to. This route to achieving a different insolvency distribution of the debtor's assets is often used, with courts upholding arrangements that work by turnover subordination,[55] or by the junior creditor agreeing to hold any dividends or distributions for the senior creditor (either expressly on trust, or via a contractual agreement which likely gives rise to a constructive trust), or by expressing the subordinated debt as a contingent obligation, or even by a subordination agreement that prohibits the junior unsecured creditor from proving in the liquidation until the senior creditor has received 100 pence in the pound;[56] indeed, sometimes such agreements are *implied* in order to ensure fair distribution of pooled assets.[57]

What creditors *cannot* agree, however, is that non-consenting parties will be affected by the agreement between the consenting parties. The only exception to this (and even this was controversial for a time) is where the agreed arrangement is to the *advantage* of the non-consenting parties. This is the case, for example, with a subordination agreement where the junior creditor does not just agree to turnover provisions (which leave the other unsecured creditors unaffected), but agrees instead not to prove in the liquidation until the senior creditor has been paid in full. A creditor is not obliged to prove in the debtor's insolvency, of course, and this agreed denial/waiver/deferral of the junior creditor's legal rights to prove means that the insolvent debtor's liabilities are temporarily reduced, to the advantage of *all* the unsecured creditors proving in the liquidation.

This qualification concerning non-contracting parties can complicate matters. If the junior creditor is itself insolvent, the subordination agreement cannot operate in breach the *British Eagle* principle; it cannot advantage the senior creditor and disadvantage the junior creditor's other unsecured creditors by providing for a different insolvency distribution of the asset, being the debt due to the junior creditor from the third party debtor. A conclusion that the contractual subordination agreement offends the contracting out rule, and is therefore invalid on the junior creditor's insolvency, can only be avoided on the facts if (i) the junior creditor is paid in full in any event (i.e. possible, if the subordination agreement is not called upon because the third

Notes

51 N. 1, para. [145].

52 See n. 23.

53 *Re Maxwell Communications Corp plc (No 2)* [1994] 1 BCLC 1; *Horne v Chester & Fein* (1986) 11 ACLR 485.

54 And this is explicitly the limited point made by F Oditah, *Legal Aspects of Receivables Financing* (1991, Sweet & Maxwell), p 174-5, asserting that a priority agreement is not contrary to the *British Eagle* principle *unless* it purports to prefer the senior creditor in a way that infringes the rights of the junior creditor's creditors via some mechanism which is personal rather than giving the senior creditor effective proprietary rights against assets in the junior creditor's hands: citing *National Provincial Bank v Ainsworth* [1965] AC 1175 at 1225, 1252-1254; *Prichard v Briggs* [1980] Ch 338.

55 Indirectly confirmed in *Re British and Commonwealth Holdings plc (No 3)* [1992] 1 WLR 672; *Re SSSL Realisations (2002) Ltd, Manning v AIG Europe (UK) Ltd* [2004] EWHC 1760 (Ch), [25] (Lloyd J).

56 *Home v Chester & Fein Property Developments Pty Ltd* (1987) 11 ACLR 485 (Southwell J); *Re Maxwell Communications Corp plc (No 2)* [1994] 1 BCLC 1 (Vinelott J); *Re SSSL Realisations (2002) Ltd, Manning v AIG Europe (UK) Ltd* [2004] EWHC 1760 (Ch), confirmed on appeal sub nom *Squires v AIG Europe (UK) Ltd* [2006] EWCA Civ 7, [2006] 2 WLR 1369.

57 This is one possible interpretation of *Barlow Clowes v Vaughan* [1992] 4 All ER 22 (CA).

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party debtor is solvent and pays the senior and junior creditors in full);[58] (ii) the subordination agreement is not simply contractual, but gives the senior creditor a proprietary interest (by way of formal security) in the junior creditor's claim against the original third party debtor (i.e. possible); or (iii) the junior creditor's right to be paid was, from the outset, always subject to the senior creditor being paid ahead of it, but note that the *only* way to achieve this is for the claims of the senior and junior creditors to have been granted secured by first and second ranking charges against the assets of the third party debtor; attempts to achieve this end by contract alone will themselves fall foul of the rule in *British Eagle*) (i.e. possible, but note the constraints).

Consider the application of these conclusions to a variation of the facts in *Perpetual Trustee* (CA). The Issuer owed obligations to LBSF and to Perpetual Trustee. As the Issuer's creditors, LBSF and Perpetual Trustee could agree to subordinate their respective claims against the Issuer as they wished (whether those claims were secured or unsecured); this would be of no concern to the *Issuer's* general creditors should the Issuer fall insolvent. If *LBSF* fell insolvent, however, then a post-LBSF-insolvency application of any subordination arrangement which purported to make LBSF the junior creditor would be subject to the analysis in the preceding paragraph. This analysis indicates the subordination agreement would be invalid (because of *British Eagle*) unless LBSF was paid in full by the Issuer (not the case); *or* Perpetual Trustee had security over *LBSF's* property to secure the subordination obligation in favour of Perpetual Trustee (not done; Perpetual Trustee's only security was against the collateral, not against any assets held by LBSF); *or* Perpetual Trustee's claim against the Issuer was always to rank ahead of LBSF's claim, with appropriately ranking security against the Issuer's assets to ensure that (not done; in fact *LBSF*, not Perpetual Trustee, was the first ranking secured creditor, with that priority designed to flip in favour of Perpetual Trustee only if certain conditions were met, one being LBSF's insolvency). This insolvency-triggered flip complicates matters. Its proper analysis needs to wait until some further ground has been cleared.

10. An arrangement which appears to be an improper 'insolvency-triggered deprivation' can be characterised as a valid agreement defining the debtor's assets themselves. [Sometimes true – the dividing line is controversial and the relevant issues need to be clearly separated]

This argument parallels the previous one, but is inherently more complicated in the context of insolvency-triggered deprivation clauses. It is clear that determinable interests, such as leases and licences, are valid even if the determining event is the insolvency of the grantee.[59] But beyond this, matters are less clear. Various strands in the arguments can be separated, as described in the next four sections.

11. An arrangement which appears to be an improper 'insolvency-triggered deprivation' can be characterised as a valid security agreement. [Sometimes true]

All the debtor's formal security arrangements fall outside the insolvency-triggered anti-deprivation rule. Indeed, the anti-deprivation rule is never brought into play because the debtor's 'deprivation'[60] occurs when it *grants* the security, not when it becomes insolvent (even if that is the occasion for the grantee or security-holder to exercise its proprietary rights).[61] In any event, such arrangements generally have statutory backing, typically subject to defined registration or formalities requirements, so their use is hardly a form of contracting out of the insolvency regime. This security 'exception' is uncontroversial, although the drafting requirements to deliver effective security agreements are not necessarily straightforward (recall the difficulties with retention of title products and proceeds clauses which are often construed as unregistered and therefore void floating charges, or with purported fixed charges construed as floating charges).

Precisely the insolvency protection desired in *Mackay* could now be delivered by a registered floating charge.[62] But *Mackay* reinforces the point that arrangements which fail to meet the statutory requirements will not deliver effective proprietary security, and any purported contractual operation of the agreement is likely to

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58 See Argument 15 below (on receiving full value).

59 *Perpetual Trustee* (CA), n. 1 (the *Butters* appeal): see especially paras [64], [81], [143-6].

60 The anti-deprivation rule looks to 'deprivation' solely in the sense of assessing the assets available for distribution to the debtor's general creditors according to the rules in IA 1986. If the question were different – i.e. does the *debtor* who grants security have fewer assets? – then of course *MC Bacon*, n. 32, suggests not.

61 And informal (or quasi-) security arrangements, by contrast, work precisely because title to the relevant 'secured' asset never passes to the debtor.

62 The functional similarity between formal (and valid) registered floating charges and certain informal (and void) insolvency-triggered deprivations arrangements has already been noted: see Argument 1 above, and recall that US common law courts denied traders the right to create a floating charge precisely because they regarded it as a fraud on the creditors (although the UCC now provides for its equivalent by way of a floating lien).

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breach the insolvency-triggered anti-deprivation rule. As Patten LJ said, explaining *Mackay*:[63]

> '[the contractual arrangement] for additional security is void because it removes property from the estate over which the creditor had no prior entitlement or interest and which, but for the provision [and it was crucial that the provision was insolvency-triggered], would fall to be administered as part of the bankrupt's estate. The only purpose and effect of the further charge was therefore to encumber the remaining half of the royalties on bankruptcy in favour of the assignee in priority to the rights of the general creditors.'

12. An arrangement which appears to be an improper 'insolvency-triggered deprivation' can be characterised as a valid subordination or priority agreement. [False if the debtor's priority loss is triggered by the debtor's insolvency]

The previous section considered security interests *granted* by the debtor. Here the concern is with security interests *held* by the debtor, and in particular with insolvency-triggered subordination or priority changes in relation to those security interests. The priority flip in *Perpetual Trustee* illustrates the problem. All the judges in that case agreed that the clause was effective,[64] and expressed their reasoning in broadly similar ways: a change in priority 'does not amount to the disposition of any property of the company';[65] the flip clause effects a permissible reduction in value rather than an impermissible deprivation of property;[66] it effects a mere change in priorities relating to the (otherwise unchanged) right.[67]

Is it true that a priority flip involves a change in value but no deprivation of LBSF's property? That seems doubtful. The flip clause does not simply change the value; it changes the entitlement to value. Nevertheless, Lord Justice Patten analysed it this way:[68] the flip condition, being part of the charging agreement, 'does not therefore remove an asset from LBSF. Nor does it give to [Perpetual Trustee] security over an asset in which they previously had no interest. It merely regulates the order in which [LBSF and Perpetual Trustee] are entitled to be recouped out of the security' which they hold over the collateral.

First, even if this analysis *is* accurate (and that is doubted), it may not ultimately help the argument. *If* there is no change in LBSF's property rights, but there is a contractual arrangement which 'regulates the order of [recoupment]' under those rights, then – as in the *British Eagle* case – that contractual arrangement breaches the contracting out rule if it ensures that the asset pool is distributed differently on LBSF's insolvency than it would have been in the absence of the clause. Here, it would. That is plain on the facts; it is why the parties litigated. If that is right, then the clause effects an impermissible contracting out of the insolvency regime, disturbing the distribution that would otherwise apply, and so will be void.

This conclusion cannot be ousted by an argument that Perpetual Trustee has effective security which it can enforce on LBSF's insolvency. Perpetual Trustee has no security against any of LBSF's assets; its only security is against the collateral, and that is an asset held by the Trustee through the Issuer. The conclusion might, however, be ousted if the appropriate analogy is with *Ansett* rather than *British Eagle*. The argument must then be that LBSF's only asset is one which is simply less valuable in the circumstances, and it is for *this* reason, *not* for reasons of any insolvency-triggered deprivation or contracting out, that the LBSF creditors get less than they had hoped for. This is the 'flawed asset' argument, considered below at Argument 14. Its effectiveness is doubted, but the reasons can wait.

For completeness, note that any flips taking place prior to LBSF's insolvency will not offend the contracting out anti-deprivation rule.[69] That might save Perpetual Trustee, if it can successfully argue that the facts were in its favour.[70]

The better analysis, however, is surely that a priority flip *does* deprive LBSF of property, and *if* the deprivation is triggered by LBSF's insolvency, the clause is void. This means, again, that Perpetual Trustee may be saved by the facts, provided it can show that some event other than LBSF's insolvency triggered the flip.

Why does the flip deprive LBSF of property? The agreed arrangement is trilateral. The job cannot be done by a bilateral agreement, whether by contract between LBSF and the Issuer, or between LBSF and Perpetual Trustee. Consider briefly what the position might have been if the transaction had been undertaken in steps, rather than secured in one document (or its equivalent).

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63 *Perpetual Trustee* (CA), n. 1, para. [156], also noting at para. [157] that the deliberateness in nominating the debtor's bankruptcy as the occasion for the creation of the charge confirms the attempt to contract outside the insolvency legislation.
64 Although also noting the alternative ground for validity, i.e. that the flip trigger appeared not to have been LBSF's insolvency.
65 *Perpetual Trustee* (CA), n. 1, para. [137] (Patten LJ).
66 *Ibid.* para. [152] (Patten LJ).
67 *Ibid.* para. [64] (Lord Neuberger) and para. [99] (Longmore LJ).
68 *Ibid.* para. [136] (Patten LJ).
69 See Argument 5 above.
70 But see n. 9, footnote 86.

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Some of the issues might then emerge more clearly. The first step is for LBSF to take a charge over the collateral. This gives LBSF a property right which secures the obligations owed by the Issuer to LBSF. Perpetual Trustee might then take a second charge over the same assets. This second charge gives Perpetual Trustee a property right to secure the obligations owed by the Issuer to Perpetual Trustee. This second security is less valuable than the first, especially given the non-recourse nature of the obligations secured, but that is not to the point at this stage.

Now suppose the parties wished to reverse the positions as between LBSF and Perpetual Trustee. What would they do? They *could* enter into a purely contractual subordination or postponement agreement, whereby LBSF agreed to become the junior creditor in the relationship with the Issuer. That would, however, potentially run foul of the 'contracting out' rule, as described earlier. More to the point, none of the judges in *Perpetual Trustee* suggested the flip operated by contract alone. They all regarded Perpetual Trustee as *having* a first charge if and when the flip took effect. How could that be achieved? The most straightforward route is a contract between LBSF and Perpetual Trustee to do what might rather casually be described as 'swap' their proprietary interests at a defined time in the future. This most certainly effects a deprivation of the property of each, and, if triggered by the insolvency of one, would potentially run foul of the insolvency-triggered anti-deprivation rule unless fair value was given.[71] Looked at from LBSF's side, this safe harbour of fair value is not reached. The swap promise of each is the only consideration for the agreement of the other; they owe no other obligations to each other. On these facts, therefore, LBSF does not receive fair value. This means that if the arrangement proceeds by a series of steps, this step will cause it to fail. Alternatives might be sought to avoid this, but each looks equally tainted by the ultimate need to provide for each party to give up its equitable security interest in exchange for a different security interest. The alternatives would therefore also potentially fall foul of the insolvency-triggered anti-deprivation rule.

Will the result be any different if the entire arrangement is delivered by a single document? In *Mackay*, the use of several documents was seemingly immaterial in reading their combined effect; in *Whitmore*, by contrast, the use of one partnership document did not save the multilateral arrangement.[72] The only argument left, it seems, is one which asserts that it *is* crucial that the arrangement is achieved in one document, and that the flip was therefore 'always a term of the contract', so that the asset held by LBSF is a 'flawed asset', not caught by the contracting out rule (because the *Ansett* approach applies), and not caught by the insolvency-triggered deprivation rule for the same reason. This 'flawed asset' argument is addressed in Argument 14 below.

13. An arrangement which appears to be an improper 'insolvency-triggered deprivation' can instead be characterised as one which effects a legitimate determination of the debtor's interest on its insolvency. [Sometimes true, but the dividing line is controversial]

This argument goes back to the common consensus that it is perfectly proper to provide that a lease or licence in favour of A will determine on A's insolvency.[73] By contrast, other similarly worded deprivation arrangements relating to assets such as partnership property, shares or patents, are void.[74] The difficulty is deciding where the line is drawn.

Note that the argument can only be advanced if the debtor *received* the asset subject to the insolvency-triggered limitation. If, by contrast, the debtor initially acquired the asset without limitation, then any subsequent agreement to subject it to such an insolvency-triggered limitation will be void; it will inevitably offend the insolvency-triggered deprivation rule. This is so even if the underlying asset is a lease or a licence;[75] these assets are not automatically immune from all claims under the anti-deprivation rule. For example, a debtor who *has* a 999 year lease, cannot agree with anyone that on his insolvency his interest will be diverted to X. By contrast, a debtor who is granted a lease 'for 999 years *or* until he is bankrupt' *never has* a 999 year lease (indeed, it is only his heirs, on his death, who will know for certain that they have whatever then remains of the 999 year lease, for only then is there no further possibility that the lease will terminate earlier on the debtor's bankruptcy).

It is not to the point to ask whether the consideration for the lease was vastly different in the two cases. The anti-deprivation rule attacks gifts with as much vigour as fairly remunerated contracts. The value of the

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71 Note that it is the insolvency trigger that creates the problem; if the flip were triggered by any other event it would not attract the anti-deprivation rule (although it might on certain facts raise IA 1986 claw back possibilities).

72 Both cases cited in n. 1.

73 *Perpetual Trustee* (CA), n. 1, paras [64], [81], [143-6].

74 E.g., *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: see n. 1.

75 *Jay*, n. 1, p. 26. For further detail, see my earlier ICR article, n. 9, at pp 35-6.

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original consideration is immaterial. The issue is deprivation of the debtor's property *on his insolvency*, not whether he originally over- or under-paid for the asset now being lost.[76] The 'fair value' exception to the anti-deprivation rule applies where the insolvency-triggered deprivation is, at *that* stage, compensated fairly by a corresponding injection of assets into the insolvency pool.[77]

On the other hand, if the debtor only ever held the asset subject to an insolvency-triggered deprivation clause, then it is commonly suggested that the divide between invalidity and validity tracks the distinction between impermissible conditional interests ('but if' the person becomes insolvent – i.e. a condition subsequent[78]), and permissible determinable interests ('until' the person becomes insolvent, as with leases and licences). In my earlier ICR paper,[79] I describe the problems with this approach and suggest, instead, that the real 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, even if the limitation was imposed from the outset.

As I said in that earlier ICR piece, leases, licences, rights to interest payments and dividend payments, rights to income and annuities all fall into the former category. Within this category only, the debtor 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 debtor's insolvency.[80] *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, by 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 or deprivation; 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. 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, and be taken away from his creditors.'[81]

Note one interesting difference between insolvency-triggered deprivations or forfeitures and insolvency-triggered determinations. Where the asset is *not* necessarily and inherently time limited, any insolvency-triggered deprivation will need to specify, even if only implicitly, in whose favour the debtor's interest is forfeited. By contrast, where the asset *is* inherently time-limited, specification is unnecessary; the debtor's interest simply ends; there is no need – and indeed no possibility – for the grantor of the lease or licence or other time-limited interest *to get its own* (or any other) *property back*.[82]

How do the courts decide which interests fall on which side of the line? In *Perpetual Trustee* (CA), Lord Neuberger tentatively opted for a charge being more like a lease or licence, and thus legitimately able to be determined by a provision which took effect on insolvency.[83] He gave no explanation for this categorisation, and its justifications are not obvious.

In *Mayhew*,[84] this same 'deprivation or determination' distinction lay behind the (unsuccessful) argument that '[i]n substance the case is concerned with the duration of a negotiated contractual promise [i.e. the provision of an indemnity], not the relinquishment of an asset.' This approach was held by the court to be contrary to *ex parte Mackay*, and to be an argument which would allow avoidance of the anti-deprivation rule in almost every imaginable case. The analysis could have been put more starkly. Parties can of course agreed that one will indemnify the other for liabilities arising during a defined term, and the duration of the term may legitimately be limited by express reference to the indemnified's insolvency. But what the parties cannot agree is that indemnity payments for liabilities which arise during the defined term will be forfeited if the indemnified party becomes insolvent before the

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76 It is material, of course, if the deprivation is on the condition that fair value is *then* paid to the debtor for the insolvency-triggered loss: see Section 16 below.

77 See Argument 15 below.

78 It is difficult to see how many anti-deprivation cases could involve an insolvency-triggered condition precedent: it would strain interpretation of the condition itself, test the notion of proper contractual consideration, and raise problems with potential restitutionary recoveries on the debtor's insolvency.

79 N. 9, at pp 36-7.

80 Recall, however, that the debtor cannot set up such an arrangement over assets that are already his – see above.

81 *Jay*, n.1, at p. 26 (Cotton LJ).

82 When the term of a lease ends, the landowner does not get his lease back – he simply owns the land; similarly, when an agreement to pay over dividends for a term ends, the shareholder does not get her dividends back; she simply owns the shares.

83 *Perpetual Trustee* (CA), n. 1, para. [64].

84 N. 1.

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payout date. The former arrangement is determinative; the latter effects a forfeiture or deprivation. In *Mayhew*, the settlement agreement was clearly of the latter type.

Still more difficult cases are emerging. The 1992 and 2002 versions of the ISDA Master Agreement contain conditional payment provisions in section 2(a)(iii)(1). These were considered in *Marine Trade SA v Pioneer Futures Co Ltd BVI*.[85] The High Court held, obiter, that the clause effected an extinguishment of the obligation, not a suspension of it. It did not consider whether the clause effected an improper deprivation, presumably because neither party was in insolvency proceedings. This broader issue is now before the courts.[86] Put generally, the issue is whether a promise to pay the debtor £X on Y date unless the debtor is insolvent (or some similar form of words) is valid, or whether it offends the insolvency-triggered deprivation rule. If the payment is merely suspended, it may be hard to argue there is a deprivation.[87] But if the obligation to pay is extinguished on the debtor's insolvency, then the arrangement effectively provides that a creditor is obliged to provide consideration for its side of the bargain if the debtor is solvent, but not if the debtor is insolvent.[88] This is on all fours with *Mackay* and *Mayhew*. The contrary argument, that such an arrangement describes a flawed asset, is considered next.

Finally, it is not to the point that careful drafting might have delivered the same ends legitimately: the contract might have provided that the sum was not due unless the debtor had fully performed its side of the bargain; or that the creditor could terminate the contract if the debtor did not perform, time being of the essence.[89]

14. The agreement does not effect an illegitimate insolvency-triggered deprivation, but simply defines the debtor's asset as a limited or flawed asset, being one which has a value which is rather less when the debtor is insolvent than when the debtor is solvent. [False if the debtor's insolvency triggers the deprivation]

This flawed asset argument is seductively simple, and therefore inherently attractive, but on examination seems to carry no weight at all in the context of the anti-deprivation rule.

Put at its best, the argument explains the outcome in *Perpetual Trustee* (CA) as follows: 'the interests conferred on LBSF in the collateral were from the outset limited in extent in such a way that they would terminate on the happening of an event of default. LBSF never had any larger interest which was purportedly cut down on its insolvency.'[90]

The flawed asset argument can only be advanced if the debtor acquired the asset subject to the flaw (and in these anti-deprivation cases the flaw is an insolvency-triggered limitation[91]). By contrast, any attempt to subject the debtor's existing assets, by subsequent agreement, to an insolvency-triggered limitation will automatically offend the insolvency-triggered deprivation sub-rule.

When might this flawed asset characterisation accurately describe the agreement between the parties? Rather sweepingly, but attractively simply, Richard Calnan suggests what the law ought to be (while conceding that it is not yet this on current authorities):[92]

> '... but insolvency law does not generally interfere with the contractual and proprietary arrangements made by the debtor before his insolvency. It takes the debtor as it finds him. It should follow, therefore, that the principle being discussed [the anti-deprivation principle] does not apply where the debtor's

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85 [2009] EWHC 2656.

86 *Re Lehman Brothers International (Europe); Lomas & ors v JFB Firth Rixson Inc & ors*, hearing date 6/12/10.

87 Although see the discussion of delayed payment in the partnership case of *Whitmore*, n. 1.

88 The contrary argument, that these arrangements are more akin to indemnity agreements for a term (see the discussion of *Mayhew* above), is perhaps possible with 'if..' contracts, but most of the commercial contracts before the courts are contracts for a defined term with periodic payment provisions and express early termination clauses.

89 See Argument 3 above.

90 *Perpetual Trustee* [2009] EWHC 2953 (Ch), para [7] (Henderson J) [This is the judgment concerning the sending of a letter to the US Bankruptcy Court Judge, Peck J.] Also see how the point was put by Gabriel Moss QC in *Perpetual Trustee* (CA) [2010] Ch 347, 356-7: 'To constitute a fraud on the bankruptcy laws there must be property of the bankrupt which the contract purports to take away: ... It is therefore critical to identify the property: the second defendant has a beneficial interest under an English law-governed trust deed in the proceeds of the enforcement of the security over the collateral which has higher priority than another secured creditor in some events and lower priority in others. The contractual provisions do not remove any asset which the second defendant had at the start of the insolvency proceedings. There is no sum unconditionally due to the second defendant, and no removal of an unconditional asset vested in the company at the commencement of the winding up ...'.

91 Hypothetically, it may also be possible to construct 'contracting out' flaws, but *British Eagle* and *Ansett*, n. 1, demonstrate that the appropriate analysis is to define the debtor's chose in action very rigorously, not simply accept that a multilateral netting agreement imposes a 'flaw' on the debtor's multiple claims. In any event, the argument presented here is general, and to that extent will apply equally to 'contracting out' flaws.

92 R Calnan, *Proprietary Rights and Insolvency* (2010, OUP), p 8; also see p 9, and generally pp 6-13.

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> proprietary interest is itself limited in scope. *If the debtor has been granted a proprietary interest in an asset which is limited in such a way that it falls away on his insolvency, the arrangement should be entirely effective.* This is not a case of a contract purporting to remove a proprietary interest from the debtor on his insolvency, but, rather, a contract defining the scope of the debtor's proprietary interest in the asset. It is, in the vernacular, a "flawed asset".' (emphasis added)

This was also the approach favoured by Patten LJ in *Perpetual Trustee*. It was conceded to have the merits of simplicity, but was nevertheless explicitly rejected by Lord Neuberger,[93] and no majority has ever adopted it as the rationale for its decision.

If this were adopted as the modern approach to flawed assets, then the insolvency-triggered anti-deprivation rule would never bite on any form of arrangement where the deprivation or limitation was 'always a term of the contract'. These agreements could invariably be interpreted as straightforward grants of a proprietary interest 'limited in such a way that it falls away on ... insolvency'. This contradicts existing authority, where such arrangements can fall foul of the anti-deprivation rule.

But this barely touches the edges of the real argument here. The 'flawed asset' analysis suffers from a fatal impediment in the context of the anti-deprivation rule, and that is the inherent and inevitable failure of its own underlying premise. The flawed asset analysis depends entirely on the logic that the debtor has been granted nothing more than a limited interest in an asset, and the debtor's assets cannot pass to a liquidator or administrator without being subject to that limitation.[94] But this ignores the whole point of the anti-deprivation rule. The *function* of the insolvency-triggered anti-deprivation rule is precisely to determine whether an agreed condition or limitation is void or effective. *If* the condition is effective, *then* – but only then – is it true that the debtor's asset can only pass to the liquidator or administrator subject to that condition. So the flawed asset analysis simply cannot work without first answering the question about the validity of the purported condition. To do otherwise either ignores the very question which has to be answered, or simply assumes that the answer supports validity. This is not defensible. The real question remains: does the agreed condition effect an unacceptable insolvency-triggered deprivation, or, on the other side of the line, does it define the asset itself or provide for an acceptable limitation to its term? In short, is the 'flaw' legal?

None of this denies the existence of flawed assets – there are numerous examples of them; but the flaw cannot be an insolvency-triggered deprivation; it must be some limitation to the grantee's rights which the law allows.

15. The arrangement does not effect an improper insolvency-triggered deprivation because the deprivation is matched by a repayment to the debtor of fair value for the asset subtracted from the insolvency pool. [True]

This idea that deprivations are assessed pragmatically is supported by both *Borland*[95] and *Butters* (CA),[96] where the price payable for shares on their insolvency-triggered deprivation was deemed, respectively, 'fair' or 'market' value.

16. The anti-deprivation rule may not apply if it would prevent parties who have paid for assets from recovering those assets from the debtor in priority to the other unsecured creditors on the debtor's insolvency. [False]

In *Perpetual Trustee* (CA), Lord Neuberger, (with whom Longmore LJ agreed[97]) explained this as follows:[98]

> '... 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 [Perpetual Trustee's] money.

As explained in detail in my earlier ICR paper,[99] 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. In *Perpetual Trustee*, any

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93 *Perpetual Trustee*, n. 1, paras [66]-[68].
94 *Perpetual Trustee* (HCt), n. 1, para. [45]. This is the 'benefits and burden' argument, but as argued here, the 'burden' must be a legally permitted one.
95 See n. 1.
96 See *Perpetual Trustee* (CA), which involved a determination of this case too.
97 *Perpetual Trustee* (CA), n. 1, para. [99].
98 *Perpetual Trustee* (CA), n. 1, para. [64]
99 N. 9.

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assertion of a proprietary interest in favour of Perpetual Trustee over either its purchase monies or the purchased collateral will, it seems, inevitably 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.

17. The policy behind the anti-deprivation rule is unclear, the rule itself is difficult to define, and its application leads to outcomes which are unpredictable and fortuitous, so the rule should be dropped. [False]

The preceding paragraphs have already addressed a good number of the particular concerns (and misconceptions) that lie behind this final argument – or assertion – against the anti-deprivation rule.

The policy behind the anti-deprivation rule is straightforward: parties cannot arrange their affairs so as to defeat the collective rules enshrined in the insolvency regime. That is it. This does not touch their freedom to behave wisely or foolishly in their business and domestic affairs (subject of course to compliance with whole raft of other laws). But parties cannot arrange their affairs in a way that deliberately defeats the legislative ambitions of collectivity for creditors should insolvency ensue. Any other rule would give legal support to the debtor's moral hazard: the debtor has no personal incentive to ensure his insolvency pool is preserved; his counterparty, by contrast, has every incentive to bargain for personal benefits that protect her, and indeed may even advantage her, in circumstances where the debtor has no personal stake in that bargain.[100] An arrangement whereby the counterparty's contractual obligations must be satisfied unless the debtor is insolvent is a pointed illustration.[101] The debtor's other creditors stand outside this bargain; their only protection is what is delivered by the law.

The anti-deprivation rule itself is simple. That should be clear from what has gone before. That is not gainsaid by complicated and sometimes contradictory authorities. Every area of the law is littered with those.[102] The anti-deprivation rule avoids agreements which contract out of the insolvency regime by providing for either a different distribution of the debtor's assets or a reduced pool of assets which can be distributed. I have called these sub-rules 'the contracting out rule' and 'the insolvency-triggered deprivation rule'. There may be better labels, but the substance behind those labels is clear.

Finally, application of these two sub-rules is not difficult, and the outcomes are not unpredictable or fortuitous. If the anti-deprivation rule is breached, the arrangement which breaches it is void. The debtor's creditors are thereby advantaged, and the debtor's counterparty is disadvantaged. Perhaps neither side predicted this, but that does not make the rule unpredictable. Equally, the sequence of events in the debtor's business or domestic life may be such that the rule is never called into play. Assets may be transferred, obligations settled and contracts determined before the onset of insolvency. That makes life fortuitous, not the anti-deprivation rule. When insolvency occurs, it must take events as it finds them. The legislative rules must do that. So too with the anti-deprivation rule.

Conclusion

Together, these seventeen arguments address different policy and doctrinal reasons for not applying the anti-deprivation rule. My conclusions, at the end of this analysis, are these.

We have, and should continue to have, a common law anti-deprivation rule. It supports the statutory regime by ensuring that parties cannot arrange their affairs to defeat the collective rules enshrined in that legislation. This is not subverting freedom of contract. There is only freedom to contract within the law, and the law protects non-contracting parties against loss of their statutory entitlements. The parties must – and often can – organise their affairs to deliver their objectives within the law.

The anti-deprivation rule avoids agreements which contract out of the insolvency regime by providing for either a different distribution of the debtor's assets or a reduced pool of assets which can be distributed. These two elements are of a piece, motivated by the same policy objectives. It seems impossible to justify having one without having the other. Here I have called these sub-rules 'the contracting out rule' and 'the insolvency-triggered deprivation rule'.

In assessing whether particular arrangements offend either of these sub-rules, it is irrelevant that there was no intention to defeat the insolvency rules, that the arrangements between the parties were always subject to the provisions in question, or that at the outset the

Notes

100 The counterparty might argue that a finding which renders the deprivation void (because it offends the anti-deprivation rule) will completely change its commercial deal. But a private deal to advantage the counterparty to the detriment of the statutory entitlements of the general creditors cannot be allowed to stand. If the counterparty has bet on the debtor's insolvency, then it has mispriced the risk.

101 E.g. *Mayhew*, n. 1.

102 Pick almost any area: assignment, charges, contract interpretation or termination, forfeiture, constructive and resulting trusts, dishonest assistance and knowing receipt, tracing, directors' duties – and on and on.

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preferred parties effectively paid for the property or preferential benefit delivered by the provisions.[103] In relation to the contracting out rule only, it is also irrelevant that there is no insolvency trigger (and maybe no trigger at all).

In relation to the insolvency-triggered deprivation rule only (and repeating what I said in my earlier ICR piece), the underlying discriminator between acceptable and unacceptable insolvency-triggered deprivations is not the commonly cited distinction between conditional and determinable interests. 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 limitation will offend the insolvency-deprivation rule and the arrangement will be void. In this latter category, an arrangement is not saved simply because the limitation was always a term of the contract: flawed assets do exist, but the 'flaw' must be a legally valid one. In short, and put broadly so perhaps not catching every nuance addressed in the analysis above, parties cannot agree that one will grant rights to the other only if the other is not insolvent (whatever form of words are used), *unless* the right so granted is necessarily and inherently a time limited one in any event.

This approach seems simple and straightforward, and may contribute to current endeavours to make sense of the anti-deprivation rule.

Notes

103 By contrast, payment of fair value by the preferred party *on the debtor's insolvency*, in exchange for the benefit, excludes operation of the rule: see Argument 15 above.

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International Corporate Rescue

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

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