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The Nature and Scope of the Anti-Deprivation Rule in the English Law of Corporate Insolvency – Part One

James Davies, Barrister[1]

Introduction

The classic description of the so-called anti-deprivation rule was provided by Cotton LJ in the case of *Ex p Jay*, where the rule was expressed in terms 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 shall be taken away from his creditors'.[2] In spite of this seemingly straightforward formulation, the courts and commentators alike have struggled to elicit from the case law a coherent principle with well defined limits. Indeed the recent Court of Appeal case of *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* seems to have done more to highlight the uncertainties as to the nature and extent of the rule than it has to settle them.[3] Leave to appeal to the Supreme Court in England has been given in this case and it may be that the Justices of the Supreme Court will provide additional clarification of the law in this area in 2011.

In the first part of this paper, I will seek to distinguish the rule from other rules and principles which operate in the English law of insolvency and therefore attempt to stem some sources of confusion. In the second part, I will go on to consider the scope of the rule.

Facts of the case

Perpetual involved two combined appeals to the Court of Appeal. The first arose out of the collapse of the global financial services group, Lehman Brothers in 2008. It involved a complicated synthetic collateralised debt obligation, by which a Lehman Brothers company set up a Special Purpose Vehicle ('the Issuer') in a tax-friendly jurisdiction, which sold notes to investors, including Perpetual Trustee. The Issuer used the proceeds of sale to purchase government bonds as collateral, which were vested in a trust corporation called BNY Corporate Trustee Services Ltd ('the Trustee'). The Issuer also entered into a swap agreement with another Lehman Brothers company by the name of Lehman Brothers Special Financing Inc ('LBSF'). The substance of the swap agreement was that LBSF would pay the Issuer the sums due to the noteholders in return for an amount equal to the yield on the collateral. This arrangement gave rise to a sort of credit insurance. The collateral was charged in favour of both the Trustee to secure the Issuer's obligations to the noteholders and in favour of LBSF. The charge in favour of LBSF was to take priority over that in favour of the Trustee unless an event of default, as defined in the agreement, occurred and LBSF was the defaulting party. In this event, the priority would 'flip' and the charge in favour of noteholders would take priority. The events of default included the insolvency or default of LBSF and the insolvency of the ultimate parent company of LBSF, Lehman Brothers Holdings Inc ('LBHI'). The administrator of LBSF challenged the validity of the priority flip on the basis that it offended the anti-deprivation rule, by depriving LBSF's estate of the priority that it enjoyed. Both at first instance and in the Court of Appeal, it was held that the anti-deprivation rule did not apply.

The second appeal in the *Perpetual* case, the Butters appeal, arose out of the administration of the Woolworths group of companies.

The anti-deprivation rule and the pari passu principle

It has been argued by Look Chan Ho that the Court of Appeal in the *Perpetual* case wrongly conflated the anti-deprivation rule with the *pari passu* principle.[4] It is suggested that in this regard Look Chan Ho is absolutely correct and that distinguishing the *pari passu* principle

Notes

1 James Davies is currently a pupil at Enterprise Chambers.
2 *Ex p Jay* (1880) 14 Ch D 19, at 26.
3 [2009] EWCA Civ 1160 (CA) (on appeal from [2009] EWHC 1912 (Ch)).
4 Look Chan Ho, 'The Principle against divestiture and the *pari passu* fallacy' (2010) 1 JIBFL 3.

from the anti-deprivation rule is absolutely critical to an understanding of the latter.

It has been noted by a number of commentators that there are two versions of the *pari passu* principle.[5] The first is the 'orthodox *pari passu* principle' and is enshrined in s. 107 of the Insolvency Act 1986 ('IA 1986') and in rule 4.181(1) of the Insolvency Rules 1986 ('IR 1986'). This is the rule which requires insolvency law to take claimants 'exactly as it finds them',[6] and treat them on an equal footing, so that any distribution will be *pro rata*, based on the claimants' pre-insolvency entitlements. Therefore preferential claims and set-off will constitute exceptions to this principle. The second sense in which the term is used is to describe the *pro rata* distribution within the various classes established by insolvency law. Therefore paradoxically, s. 175(2)(a) IA 1986, which deals with preferential claims, can be seen both as an exception to the 'orthodox *pari passu* principle' and as an application of the *pari passu* principle, when that term is used in the second sense.

In the House of Lords case of *British Eagle International Airlines Ltd v Compagnie Nationale Air France*,[7] the court clearly viewed the rationale of the anti-deprivation rule as based upon the orthodox *pari passu* principle. In this case, the liquidator of British Eagle International Air Lines ('British Eagle'), the Claimant airline, claimed against Air France for sums allegedly owed by Air France in the liquidation of British Eagle. Both companies, were members of the International Air Transport Association ('IATA'), which established a clearing house so that all claims arising between the airlines, for the performance of services for each other, could be netted out on a monthly basis. Each month, each airline would thus either receive a payment from the clearing house, or would pay a sum to the clearing house, depending on the sum total of services which it had provided for other airlines and the services it had received. The question for the House of Lords was whether this netting house system could validly continue to operate regarding debts owing and owed to British Eagle once British Eagle had gone into liquidation, or whether that amounted to an impermissible contracting out of the insolvency legislation. Giving the leading speech in the House of Lords, Lord Cross analyses the IATA arrangements as contracting out of the *pari passu* principle.[8] This analysis of the rationale of the anti-deprivation rule as being based on the orthodox *pari passu* principle is fundamentally flawed. If the anti-deprivation rule did have such a rationale, in a liquidation where not even the preferential creditors are paid in full, the orthodox *pari passu* would play absolutely no role at all and therefore presumably the anti-deprivation rule would not apply. This cannot be true. For the application of the anti-deprivation rule to depend on how much the insolvent estate is worth would be entirely arbitrary and is clearly not an outcome which their Lordships intended.

Look Chan Ho has thus suggested a distinction between the *pari passu* principle, which is a means of distribution and the 'principle of collectivity'. The latter is about the conservation of the estate once the collective insolvency regime has kicked in and it is this principle which was infringed in cases such as *British Eagle*, where there was effectively a contracting out of the insolvency regime. This argument seems logical, as the principle is exemplified by provisions in the IA 1986 such as s. 130(2), which provides for a stay on claims following the appointment of a winding up order or the appointment of a provisional liquidator, and s. 127, which provides for the avoidance of property dispositions made after the commencement of winding up.

This distinction certainly seems to have a great deal of force. The principle of collectivity does not depend in any way upon the *pari passu* principle, indeed it is compatible with any form of distribution. Given that the anti-deprivation rule would seem to ensure the conservation of the insolvent estate for the benefit of the creditors and the *pari passu* principle simply ordains the way in which the insolvent estate will subsequently be distributed, what does the principle of *pari passu* have to do with the anti-deprivation rule? It seems the confusion may have begun in *British Eagle*. Indeed, Mokal has described the failure of the House of Lords in *British Eagle* to consider the principle of *pari passu* clearly as 'deeply unsatisfactory'.[9] In that case it seems that the House of Lords focussed on the distribution of the insolvent estate due to the fact that the multi-party netting arrangement which was put in place through the IATA, effected what was described in argument as a 'mini-liquidation'. The House of Lords concentrated on the difference between the distribution effected under the IATA regulations and that under the *pari passu* regime enshrined in the insolvency legislation. In doing so, the House of Lords glossed over the fact that if the IATA arrangements were allowed to stand, the insolvent estate would effectively have been deprived of the sums owed to it by those airlines who owed debts to British Eagle. In effect, the House of Lords missed a step in the insolvency process. Before the insolvent estate can be distributed, on the basis of the orthodox *pari*

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5 Among them Look Chan Ho, *ibid* and R. Mokal, 'Priority as Pathology: the *Pari Passu* Myth' (2001) 60 CLJ 581.
6 *Re Smith, Knight & Co., ex p. Ashbury* (1868) L.R. 5 Eq. 223, at 226 per Romilly M.R.
7 [1975] 1 W.L.R. 758.
8 *Ibid.*, at 780.
9 R. Mokal, 'Priority as Pathology: the *Pari Passu* Myth', (2001) 60 CLJ 581, at 597.

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passu principle or otherwise, the assets of the insolvent estate must be collected in. In the case of *British Eagle*, the IATA arrangements purported to effect a multi-party set-off, which was inconsistent with the insolvency regime and if it were allowed to stand, would have had the effect that insolvent estate was deprived of funds which should have been available under the insolvency rules. Although the distribution which was effected by the IATA arrangement was different to that provided by the insolvency regime, it was the collective element of the regime which was infringed by the arrangement and not the distributive element.

Moreover, if it is accepted that the anti-deprivation rule may apply equally upon the commencement of an administration as upon the commencement of a liquidation, which it was by the Court of Appeal in the *Butters* case, then the rule may apply in the absence of any distribution at all. If the aim of the administration is to rescue the business as a going concern, then the rule will still apply but there may be no distribution. Surely this suggests that the rule has nothing whatsoever to do with the distributive aspect of the insolvency regime. By contrast, both an administrator and a liquidator are concerned with the conservation of the insolvent estate.

The case of *British Eagle* is often held up to be the 'leading modern authority on the pre-eminence of the *pari passu* principle',[10] however, as Mokal has pointed out, this is not without its irony.[11] As described above, the orthodox *pari passu* principle is concerned with treating claimants on an equal footing according to their pre-insolvency entitlements. However, in *British Eagle*, the airline, while solvent was not able to claim directly against the airlines that were members of the IATA, nor were they able to claim against British Eagle. Pre-insolvency therefore, the members of the IATA were in a quite different position to the other creditors of British Eagle who were able to claim directly against British Eagle. However, according to the majority of the House of Lords, post-insolvency the liquidator was able to claim directly against the individual airlines and therefore the pre-insolvency entitlements were not respected. For this reason, it has been suggested that a better way to understand the case is to look at the netting arrangements as an 'attempt on the part of IATA to prevent its members from having to submit to the collective liquidation regime'.[12]

On this basis therefore, it is suggested that the case is better understood against the backdrop of the so-called 'principle of collectivity' rather than that of the *pari passu* principle. However, cases following *British Eagle* repeated the mistake in that case and continued to analyse the anti-deprivation rule in terms of the *pari passu* principle. In *Perpetual*, the members of the Court of Appeal seem to accept that the anti-deprivation rule is, at least in part, based on the fact that it is impossible to contract out of the *pari passu* rule. Although at no point do any of the members of the Court of Appeal predicate their analysis upon the anti-deprivation rule being wholly based on the *pari passu* principle, the Master of the Rolls lists s. 107 IA 1986 as one of the provisions which underpins the rule and Patten LJ seems to accept the premise that the common law rule of public policy applied in *British Eagle* was no more than the application of the *pari passu* principle.[13] This betrays a misunderstanding of the distinction between the collective aspect of the insolvency regime and the distributive aspect exemplified by the principle of *pari passu*.

The 'contracting-out rule' and the 'insolvency-deprivation rule'

Another distinction which has been suggested by Worthington is between the anti-deprivation rule (which Worthington terms the 'insolvency-deprivation rule') and what she has termed the 'contracting-out rule'.[14] Worthington states that 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' and the insolvency-deprivation rule 'concerns arrangements triggered by insolvency that purport to deprive the insolvent of assets on which the insolvency distribution can bite'.[15] Further, Worthington states that while the basis of the contracting-out rule is simply the application of the insolvency legislation, the basis of the insolvency-deprivation rule is public policy.

The difficulty with this distinction is that both versions can be said to operate to prevent the insolvent estate being deprived of assets on which the distribution can bite. This is more obvious in the case of the insolvency-deprivation version, where the arrangement may purport to deprive the estate of one asset which is thereby not available for distribution. However, in the case of a clearing house, such as that involved in *British Eagle*, if the scheme was allowed to

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10 F. Oditah, 'Assets and the treatment of claims in insolvency' (1992) 108 LQR 459, at 465.
11 R. Mokal, n. 9 above, at 598.
12 *Ibid.*, p. 599.
13 *British Eagle*, n. 7 above, at [50] and [118] respectively.
14 S. Worthington, 'Insolvency deprivation, public policy and priority flip clauses' (2010) 7 *Int. C.R.* 28, at 31.
15 *Ibid.*

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continue post-insolvency, the estate would similarly have been deprived of assets from Air France among others, which would therefore not be available for distribution to the non-IATA creditors. It can be said that such a contract purports to define what forms part of the insolvent estate, and more importantly, what does not form part of the insolvent estate. Similarly, both versions can be said to effect a different distribution of assets than that provided by the insolvency legislation. Worthington seems to focus on the distributive aspect in the contracting out version and on the collective aspect in the insolvency-deprivation version. So what then is the difference between these two versions? It is true to say that while provisions to which the insolvency-deprivation rule apply will simply remove an asset from the scope of the insolvency regime, those provisions to which the contracting-out rule applies will effectively seek to displace the insolvency regime from the inside, by providing for a scheme of distribution which is different to that contained in the insolvency legislation. Broadly speaking, both the insolvency-deprivation rule and the contracting-out rule are underpinned by a similar rationale. Both versions can be analysed in terms of the counter-parties to the arrangement attempting to bargain for immunity from the collective insolvency regime.[16] The rationale for both versions can therefore be seen as preventing parties to an agreement from gaining immunity from the collective insolvency regime. As Mokal has argued, it is the '*whole collective system* (emphasis added) for the winding up of insolvent estates' which cannot be contracted out of.[17] If a distinction is to be drawn between these two rules, a distinction other than the one suggested above must be found.

One of the major distinctions which can be drawn between these two rules is that the insolvency-deprivation rule applies to those provisions which purport to effect a change upon either insolvency or the commencement of formal insolvency proceedings. Whether the rule applies to deprivation provisions which purport to operate on mere insolvency or formal insolvency proceedings will be discussed in part two of this article. For the moment it may be useful to use the term 'insolvency event' to mean either one. Typically a provision which is subject to the insolvency-deprivation rule will purport to transfer ownership of an asset from the insolvent company to a third party on the happening of an insolvency event. In contrast, the contracting-out rule will involve a situation where a contract applies equally before and after the happening of an insolvency event. There is no change effected on the happening of the insolvency event and no reference is made to such an event in the provision. The case of *British Eagle* provides a prime example of the contracting out rule. As noted by the members of the House of Lords, 'there was no change whatever on the winding-up; the same "clearing house" provisions applied both before and after...'.[18] The provision operates entirely validly prior to the insolvency event and it is clear from *British Eagle* itself that it makes no difference that the parties did not intend to bargain for an insolvency advantage. Does this, however, amount to a normative distinction?

One consequence of this difference is that the legal effects of the two rules are likely to be different. Provisions to which the contracting-out rule applies are entirely valid before the insolvency event. Before this, they are entirely unobjectionable and certainly, as was argued in *British Eagle*, such arrangements may make a great deal of commercial sense for all parties involved. The provision will only become void upon the happening of the insolvency event, when the contractual regime will be displaced by the statutory regime. Provisions to which the insolvency-deprivation rule applies however, given that they effect the deprivation upon the happening of the insolvency event, are always objectionable and therefore are void *ab initio*. In the case of an agreement which contains such a clause, the court may therefore be able to apply the 'blue pencil rule' and delete the offending provision, without affecting the meaning of the part remaining. In the case of *Fraser v Oystertec*,[19] it was argued that the deprivation agreement remained valid between the parties but void as between the insolvent company and its creditors. The judge rejected this argument, holding that the provision was void from the outset, and it is suggested that this is correct. The argument was based upon a passage in the judgment of Cotton LJ in *Ex p Jay*, where his Lordship stated that '...though the contract is good between the parties to it, it is on principle void in the event of the builder's bankruptcy'.[20] Yet as the Judge in *Fraser* points out, a transaction is either a nullity or it is not.

So can these two rules be separated by identifying that each has a different genesis? As stated above, Worthington has argued that the basis of the contracting-out rule is simply that one cannot contract out of the insolvency legislation. She argues that this is simply a matter of legislation trumping party autonomy and therefore there is no need to revert to public policy arguments to justify the rule. However, giving the leading

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16 R. Mokal, n. 9 above, at 597.
17 *Ibid.*
18 *British Eagle*, n. 7 above, per Lord Cross at p. 780.
19 [2004] B.C.C. 233.
20 *Ex p Jay*, n. 2 above, at 26.

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speech for the majority of the House of Lords in *British Eagle*, Lord Cross of Chelsea stated that '[s]uch a "contracting out" must, to my mind, be contrary to public policy'.[21] There seems consequently to be some dispute as to whether public policy needs to be invoked in order to justify the rule. When the High Court of Australia examined the basis of the rule in the case of *International Air Transport Association v Ansett Australia Holdings Ltd*,[22] the majority rejected the invocation of public policy and viewed the basis of the rule simply as an application of the insolvency legislation. This view seems persuasive. There seems to be little merit in invoking public policy, when the rule simply reflects the primacy of the legislation. In *Perpetual*, the Master of the Rolls seeks to identify the provisions of the IA 1986 which govern the way in which assets are dealt with in a liquidation and therefore cannot be contracted out of. He identifies s. 107 IA 1986 and r. 4.181 IR 1986, which deal with *pari passu* distribution. As discussed above, this is unsurprising given the courts' long-held misconception of the *British Eagle* principle being based upon the *pari passu* principle. More interesting however, are the remainder of the provisions which Lord Neuberger identifies as being incapable of being contracted out of. All of these sections involve provisions which constitute part of the collective element of the insolvency regime. Lord Neuberger refers in particular to ss. 143(1) and 144(1), which state that where a company is subject to a winding-up order, the liquidator must 'secure that the assets of the company are got in, realised and distributed to the company's creditors…', and that he must 'take into his custody or control all the property and things in action to which the company is…entitled'. It seems that taken together, these two sections represent exactly the collective regime which cannot be contracted out of. Although not mentioned by Lord Neuberger in the *Perpetual* case, a provision which encapsulates the same principle but for administration as opposed to liquidation can be identified in Paragraph 67 of Schedule B1 IA 1986, by which '[t]he administrator of a company shall on his appointment take custody or control of all the property to which he thinks the company is entitled'.

It is interesting to compare the contracting-out rule to the case of *Halesowen Press and Assemblies Ltd v National Westminster Bank Ltd*,[23] where the House of Lords pronounced that the set-off regime provided for in the insolvency legislation is mandatory and consequently cannot be contracted out of. In that case, no reference was made to public policy. It was simply accepted that the primacy of the legislation trumped any agreement which purported to contract out of it. A party could not agree to forgo their right of contractual set-off, even though the disclaimer of that right was obviously to their detriment. It is suggested that there is no reason why public policy needs to be invoked in order to justify the inability to contract out of the collective aspect of the legislation when it is not required to justify the inability to contract out of the set-off regime contained in the insolvency legislation. The insolvency legislation is thus, both the basis and rationale for the contracting-out rule. As such, the contracting-out rule is devoid of any normative content.

With regard to the insolvency-deprivation rule, Worthington argues that this is rooted entirely in public policy. This seems to be confirmed by the long line of case law that has involved the insolvency-deprivation rule type provisions as opposed to those seen in *British Eagle* or *Ansett*. There is no provision in the insolvency legislation which embodies the insolvency-deprivation rule and prohibits the insolvent depriving itself of property on its insolvency. The provisions in ss. 238 and 239 of the IA 1986, which allow the court to avoid antecedent transactions where the company has given a preference, or entered into a transaction at an undervalue may overlap with the insolvency-deprivation rule, but their function is not the same. Unlike the contracting-out rule therefore, the insolvency-deprivation rule cannot be said to be a direct application of the insolvency legislation. The rule has emerged from the common law in order to ensure that the insolvency regime is not subverted. Its rationale is to prevent the value of the estate being diminished by transfers to third parties at the expense of the creditors. It prevents the parties to a contract agreeing to effectively avoid the scope of the collective system of insolvency. While the contracting-out rule attempts to prevent parties agreeing to manipulate the collective statutory regime, the insolvency-deprivation rule prevents parties agreeing that certain assets should never become subject to the regime. The courts have applied this rule in cases which date back at least to the 19th century. In the case of *Money Markets International Stockbrokers Ltd v London Stock Exchange,* Neuberger J as he then was, stated that the rule 'is essentially based on a common law rule of public policy, which is itself based on the long-established approach of English Law to the treatment of assets and creditors on insolvency'.[24] This description would seem to be a fair assessment of the genesis of the insolvency-deprivation rule.

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21 *British Eagle*, n. 7 above, at 780.
22 [2008] BPIR 57.
23 [1972] A.C. 785.
24 [2002] 1 WLR 1150, at 1173.

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Applicability of the rule solely to agreements entered into by the insolvent

Another clarification which can be made regarding the nature of the rule is that it now seems fairly clear that both the contracting-out rule and the insolvency-deprivation rule only apply to agreements entered into by the insolvent. It is the insolvent itself who is not allowed to contract out of the insolvency legislation or agree to deprive itself of assets upon its insolvency. The creditors of the insolvent may enter into whatever agreement they wish with regard to the distribution of their share of the estate. Thus, in this context it is entirely legitimate to agree to a different distribution of assets than that provided by the IA 1986. This seems entirely correct. There is no rationale for preventing creditors from contracting to define their entitlements as between each other, upon the company's insolvency. Obviously, such an agreement would not be valid in so far as it purports to redistribute assets to which creditors who are not a party to the agreement would be entitled.

The inapplicability of the rules to such agreements underlines the fact that both the contracting-out rule and the insolvency-deprivation rule are concerned with the conservation of the insolvent estate and not with the *pari passu* principle or any other mode of distribution. An agreement between two or more creditors to split their share of the insolvent estate in a way which is at variance to the distribution which would be effected under the insolvency legislation does not in any way undermine the principle of collectivity.

A common example of an agreement whereby creditors agree that the assets to which they are entitled should be redistributed in a fashion other than that provided in the insolvency legislation is a subordination agreement. This is an agreement whereby one creditor agrees that debts owed to him shall rank below other debts owed by the debtor. Following the House of Lords decision in *British Eagle*, some doubt was cast on the validity of such agreements due to the fact that they seemed to involve a contracting out of the legislation by providing for a distribution which was different to that under the statutory scheme. This concern was heightened given the misunderstanding of the contracting-out rule as being an application of the *pari passu* principle. The validity or not of subordination clauses was a matter of substantial importance, given the commercial value of being able to enter into such agreements.

Even after the case of *Re Maxwell Communications Corporation plc*,[25] where Vinelott J expressly considered the implications of *British Eagle* upon the validity of subordination clauses and considered that in spite of that case, such an agreement could be valid, doubt remained. Following the case of *Re SSSL Realisations*[26], the question seems to have been put beyond doubt. This case involved Save Group plc ('Save'), which was the parent of a number of subsidiaries, of which one was SSSL Realisations ('SSSL'). SSSL owed substantial inter-company debts to Save. The group of companies owed substantial amounts to HM Customs and Excise. A third-party company AIG Europe (UK) Ltd ('AIG') agreed to provide a bond to HM Customs and Excise on behalf of the group. AIG entered into an indemnity agreement with Save and SSSL, among other members of the group, whereby the companies agreed to indemnify AIG against all claims incurred under the bond. The agreement contained subordination provisions to the effect that until all sums payable by the group companies to AIG had been paid in full, no group company should be able to prove as a creditor of another group company in competition with AIG. Both SSSL and Save went into liquidation and AIG argued that by virtue of the agreement SSSL's debt to Save was subordinated to that of AIG. In effect, nothing could be paid to Save until the amount due to SSSL had been discharged in full. In the Chancery division of the High Court, Lloyd J held that 'the situation is...quite different from that in *British Eagle*, or in *Ex parte Mackay* and other cases of that kind'[27] and therefore the subordination agreement was valid. Indeed, the IR 1986 expressly recognise the right of a creditor to assign his right of dividend to another creditor, which is effectively exactly what occurs when one creditor agrees to be subordinated to another.

This case was of particular importance because it upheld the validity of an agreement, in spite of the fact that the subordinated creditor was also in insolvent liquidation. In this case, although the debtor company, SSSL was a party to the contract, it was Save who has agreed to be subordinated to AIG. In that regard, it can be distinguished from the situation whereby the insolvent has purported to agree with a creditor to contract out of the insolvency legislation, or to deprive itself of an asset upon its insolvency, which would be invalid.

Notes

25 [1993] 1 WLR 1402.
26 [2005] 1 BCLC 1.
27 *Ibid*, at [45] .

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International Corporate Rescue

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