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

James Davies, Barrister[1]

In the second part of this article, I will consider the scope of the anti-deprivation rule in the English law of corporate insolvency. Particular consideration will be given to the case of *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd*, the facts of which are stated in the first part of this article.[2]

When will a purported deprivation be caught by the rule?

If the distinction, which is made by Worthington between the contracting-out rule and the anti-deprivation rule, is to be drawn, it must be considered at what stage a purported contracting-out or deprivation will be invalid. Given that, as discussed in the first part of this article, the contracting-out rule is no more than a reflection of the primacy of the insolvency legislation, that rule cannot have a wider reach than the provisions of the insolvency legislation itself. However, given that the anti-deprivation rule is a common law rule of public policy, would the rule invalidate a deprivation which was triggered by the mere insolvency of a company as opposed to the commencement of formal insolvency proceedings?

Part of the confusion has been formed by the conflation of the rule with the *pari passu* principle. It is evident that if the *pari passu* principle is seen as the basis for the anti-deprivation rule, the rule, like the *pari passu* principle will only operate in the context of formal insolvency proceedings. However, given that, the anti-deprivation rule is concerned with the conservation of the insolvent estate, it might at first glance seem sensible that the rule would apply to deprivations which occur prior to formal insolvency proceedings in order to protect the creditors of the insolvent company. Indeed a good example of this reasoning can be seen in the case of *Fraser v Oystertec.*[3] In this case, Peter Prescott Q.C., sitting as a Deputy High Court Judge, held that an agreement which provided that a patent owned by a company would be assigned to a third party upon the company becoming unable to pay its debts was void. In support of his finding, the judge cited the nineteenth century case of *Whitmore v Mason*,[4] in which Page Wood V-C held that the rule applied to deprivations triggered by mere insolvency and was not dependent on bankruptcy proceedings having been commenced. Page Wood V-C considered that if this was not the case, it would mean that 'the bankrupt laws might, in all cases, be defeated'.[5] Apart from this case, there seems to be no authority in the case law to support the contention that the rule operates to invalidate deprivation provisions triggered by mere insolvency as opposed to the commencement of formal insolvency proceedings. It may be helpful however, to examine, as a matter of policy, whether it would be sensible and logical for the rule to apply to deprivations which occur upon mere insolvency.

If the rule were only to apply to deprivations triggered by the commencement of insolvency proceedings, it may lawfully be agreed that the insolvent company may be deprived of assets upon its insolvency. If the company was later subject to formal insolvency proceedings, provisions of the IA 1986 may invalidate such deprivations. In particular, the provisions relating to transactions at an undervalue contained in s. 238 and those relating to preferences in s. 239 are likely to be particularly relevant. However, if the rule does not apply to deprivations effected upon mere insolvency, in those cases where the company does not latterly become subject to formal insolvency proceedings, as happened in the *Oystertec* case, the insolvent company may be lawfully stripped of its assets. It is suggested that this is correct since as Patten LJ noted in

Notes

1 James Davies is currently a pupil at Enterprise Chambers.
2 [2009] EWCA Civ 1160 (CA) (on appeal from [2009] EWHC 1912 (Ch)).
3 [2004] B.C.C. 233.
4 (1861) 2 J & H 204.
5 *Ibid.*, at 215.

Perpetual, it would seem to be wrong in principle if 'the anti-deprivation rule can apply to invalidate contracts even where no bankruptcy or winding-up order is ever made'. This would place an unnecessary restriction upon a company, which may be in no danger of becoming subject to formal insolvency proceedings, yet may be momentarily insolvent, whether on the cash-flow test or the balance-sheet test.

If the rule only applies to deprivations which occur upon the commencement of formal insolvency proceedings, certain deprivations may escape the scope of ss. 238 and 239 even if the company is unable to pay its debts at the time the deprivations occur. The deprivations will be incapable of avoidance by ss. 238 and 239 if they occurred outside of the time limits set by s. 240. Consequently, certain deprivations will be lawful even if they occur after the company becomes insolvent. At first glance, this may seem to run counter to the rationale of the anti-deprivation rule as conserving the insolvent estate and preventing the insolvency regime being circumvented. However,if the rule was to apply to deprivations triggered by mere insolvency as opposed to formal insolvency proceedings, this would allow the application of ss. 238 and 239 to be subverted. Parliament placed time limits on the application of ss. 238 and 239 in s. 240 and consequently transferees of property from the company and those who receive payments from the company know that under the statutory regime, those transactions cannot be challenged after six months has passed or after two years if the party is a connected person as defined by ss. 249 and 435 IA 1986. There is a clear conflict here between protecting the interests of the general creditors of a company and giving legal certainty to the transferees of property from the company. Parliament has sought to regulate this conflict through the time limits imposed in s. 240. To allow the anti-deprivation rule to apply outside of the time limits would be to subvert the will of Parliament and it is suggested that if there is a lacuna to be filled, it is up to Parliament to legislate and not up to the courts to seek to fill it. While the anti-deprivation rule itself is not based upon the insolvency legislation, the courts should be extremely careful not to impinge upon areas which are comprehensively covered by the statutory scheme.

The Master of the Rolls in *Perpetual* criticised the application of the rule to deprivations triggered by mere insolvency and wondered what would happen if the company was insolvent at the time of the deprivation, but subsequently recovered.[6] In response to this criticism, Look Chan Ho has stated that the principle of collectivity would not therefore have been transgressed and no creditors would suffer any loss.[7] The difficulty with this reasoning is that if the rule applies to deprivations which are triggered by mere insolvency, any provision which purports to provide for such a deprivation will be void from the outset. The subsequent recovery of the company can have no effect on this state of affairs. Henderson took the reasoning of the Master of the Rolls in the *Perpetual* case a step further and wondered what the situation would be if the company, which had recovered, after five years fell back into insolvency.[8] If the company entered into formal insolvency proceedings at that point, would the liquidator or administrator be able to look back to the first period of insolvency and seize the assets of the company which had been transferred? At that point, the transferee may have felt that any question as to the validity of his title to the assets would have been definitively resolved by the effluxion of time given the time limits set out in s. 240 IA 1986. These difficulties can clearly be avoided if the rule only operates upon the commencement of formal insolvency proceedings.

The judge in *Fraser* was of the opinion that if the law was such that the rule applied only to deprivations, which occur on the commencement of formal insolvency proceedings, 'it would be mere pointless form and the mischief would not be addressed fully'.[9] However this doesn't seem to take into account the provisions of the insolvency legislation which may apply to avoid such mischief transactions. It has been argued that it would seem arbitrary if a deprivation were to be lawful a minute before the presentation of a winding up petition or the appointment of an administrator and be unlawful following such a presentation or appointment. Look Chan Ho has argued that this means that Claimants such as those in *Fraser* must race to put the company into formal insolvency proceedings before the deprivation occurs, and this may not necessarily be the most efficient or optimal outcome. As the judge pointed out, '[a] better remedy may be for the directors to try to save it – perhaps by offering one of its principal assets for sale at full value, or by further support from its investors'.[10]

This serves to highlight another problem with the application of the rule to deprivations effected upon mere insolvency. It has the consequence that the rule may be used by the shareholders of the insolvent company, the insolvent company itself or the transferee of the asset to have the deprivation declared as void. It is

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6 *Perpetual*, n. 2 above, at [72].
7 Look Chan Ho, 'The Principle against divestiture and the *pari passu* fallacy' (2010) 1 JIBFL 3, at 6.
8 A. Henderson, 'Perpetual and the principle against divestiture outside insolvency proceedings: a response' (2010) 4 JIBFL 224, at 226.
9 *Fraser v Oystertec*, n. 3 above, at [119].
10 *Ibid.*, at [116].

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suggested that the rule will therefore be stretched beyond its intended limits and its rationale of protecting the collective basis of the insolvency regime may be of only historical relevance. This is exemplified by the case of *Fraser*, where the Claimants were creditors of the company but claimed in their capacity as minority shareholders by way of derivative action. It is suggested that shareholders have adequate protection under company law legislation without the need to extend the anti-deprivation rule for their benefit.

To the extent that *Whitmore* and *Fraser* accepted that the rule should apply to deprivations which occur upon mere insolvency, it is suggested that they were wrongly decided.

What about deprivations which occur upon some other event?

So how should provisions which allow a company to be deprived of an asset upon the happening of an event other than mere insolvency or the commencement of formal insolvency proceedings be treated? There is no doubt that deprivations which occur before insolvency should be valid. Indeed, the Court of Appeal concluded in *Perpetual* that even if the priority flip clause may have amounted to an unlawful deprivation if it had occurred on the insolvency of LBSF, the trigger was LBHI filing for Chapter 11 Bankruptcy and therefore was lawful. The Court of Appeal rejected submissions that given the ubiquitous nature of group company cross-guarantees, it was unrealistic to treat members of the same group as separate entities and therefore LBHI's insolvency should be treated as having engaged the rule. In light of the judgment in *Re Polly Peck International plc*,[11] in which the 'single economic unit' argument was emphatically rejected, it is hardly surprising that this submission failed to impress the members of the Court of Appeal. Clearly therefore, deprivations which occur upon the insolvency of a company other than that which is being deprived of the asset, will be valid.

In the preceding section, it was suggested that the anti-deprivation rule should only apply to those provisions which occasion a deprivation following the commencement of formal insolvency proceedings. On this basis, provisions which purport to deprive the company of an asset while it is insolvent but before it becomes subject to formal insolvency proceedings, whether due to its insolvency or on the happening of some other event, will be valid subject to the provisions of the insolvency legislation.

So what is the position when the deprivation trigger occurs after the company enters formal insolvency proceedings? If the courts hold that the rule does not apply to such deprivations, the rule will be easily circumvented by parties providing for deprivations to occur on a whole host of other events. In *Ex p Newitt*,[12] a landowner who had granted a builder possession of his land had agreed with the builder that the landowner had the right to re-take possession and to forfeit any of the builder's chattels which were on the land 'as and for liquidated damages' in the event that the agreement was breached. Subsequent to the agreement being made, the builder had been declared bankrupt. In that case, James LJ in holding the forfeiture valid, declared that the court has 'no power to add to the Act for the purposes of making this security for the performance of the contract, which was *bona fide* taken by the landlord, bad by reason of the bankruptcy of the builder'.[13] This can be contrasted with the case of *Ex p Jay*, which involved almost identical factual matrix except for the fact that the forfeiture of the chattels was expressed to be conditional on the bankruptcy of the builder, the builder was not in breach of contract and the right to forfeit was not expressed to be in respect of any money claim. In that case, the court held that the deprivation had infringed the rule and was therefore invalid.

The determination of this point was not necessary in the *Perpetual* appeal, however, the Court of Appeal were of the opinion that such a purported deprivation after the commencement of insolvency proceedings operating on grounds other than insolvency, would be caught by the rule. In particular, Patten LJ expressed the view that '[o]nce the Insolvency Act regime has come into effect a contractual provision which seeks to remove property out of the estate and to vest it in a third party cannot override the provisions of the Act'.[14] In support of this position, Patten LJ cites the example of *British Eagle*, where in spite of the fact that the airlines had made no specific provision for the liquidation of one of the member airlines, the arrangement was still held to contravene the anti-deprivation rule because it had the effect of excluding the property of British Eagle from the operation of the insolvency regime. It is suggested that the reasoning of Patten LJ would have benefited from distinguishing the contracting-out rule from the insolvency-deprivation rule. Indeed, it is true to say that the House of Lords in *British Eagle* were concerned with the effect of the IATA regime and not with the fact that the provision was not expressed to take effect upon British Eagle becoming insolvent, however, this is the distinction that can be drawn between the

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11 [1996] BCC 486.
12 *Ex parte Newitt, re Garrud* (1880) 16 Ch D 522.
13 *Ibid.*, at page 530.
14 *Perpetual*, n. 2 above, at [163].

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anti-deprivation and the contracting-out rule. It is a feature of the latter that the provision purports to apply equally both pre and post-liquidation and therefore, the court will always be concerned with whether the effect of the provision post-liquidation amounts to a contracting out of the insolvency legislation. However, for the purposes of the insolvency-deprivation rule, the event upon which the deprivation takes effect is vital. *Newitt* would support the view that a deprivation which operates upon the happening of an event other than the insolvency of the transferee may be valid, even if this event occurs post-insolvency.

Although the reasoning of Patten LJ may have been flawed due to his misunderstanding of the distinction between the insolvency-deprivation rule and the contracting-out rule, it is suggested that his conclusion that a purported deprivation after the commencement of insolvency proceedings operating on grounds other than insolvency, would be caught by the rule, was fundamentally correct. Given that the rationale of the insolvency-deprivation rule is based upon the principle of collectivity, from a policy point of view, to allow post-insolvency deprivations upon the happening of an event other than insolvency, would undermine the rule. It is suggested that the only authority for the validity of post-insolvency deprivations, *Newitt*, was wrongly decided. To allow a deprivation of property in which the landowner previously had no interest due to default on the part of the builder, which coincided with the builder's bankruptcy means that the rule can easily be subverted. Default will always be a likely consequence of a company becoming insolvent and entering into formal insolvency proceedings and allowing deprivations to occur as and for liquidated damages would provide an easy way to circumvent the rule. In a case such a *Newitt*, the landowner should have to prove in the liquidation in the normal manner.

What constitutes a deprivation?

This was the major issue in the *Perpetual* appeal and the issue seems no clearer for the court's judgment in that case. So how can a deprivation be defined? Peter Smith J, the judge in the *Butters* case at first instance, believed that the scope of rule could be defined by assessing the economic impact of the transaction upon the estate. Potentially this could mean that any contractual provision which takes effect upon insolvency and leads to a diminution in value of the estate, however small, could be caught by the rule and would therefore be invalid. Indeed, as is discussed below, where the asset of which the insolvent is deprived has no value, or where the insolvent estate is adequately compensated for the removal of the asset from the estate, there will be a deprivation, but that deprivation will be valid. It is clear therefore that in some circumstances, the economic impact of the provision can be conclusive as to the validity of the deprivation, but not as to whether a deprivation has occured. As Patten LJ pointed out in *Perpetual*, it is well established in the case law that the forfeiture of a lease or licence upon insolvency is valid, and this could clearly involve a diminution in the value of the estate. On this basis, it is suggested that the Court of Appeal were correct to reject the application of a purely economic test to define a deprivation.

Some arrangements are not problematic and clearly constitute invalid deprivations. Examples of these can be seen in cases such as *Ex parte Mackay, re Jeavons*,[15] where the arrangement purports to deprive the insolvent of an asset which he already owns upon the happening of an insolvency event.

Similarly, there are arrangements which do effect a deprivation of the insolvent's property, however this deprivation will be valid. In *Money Markets*, Neuberger J, as he then was, noted that cases where the right or property that is subject to the deprivation provision, has no value, is incapable of assignment, or depends on the character or status of the owner, all constitute examples of where public policy considerations may mean that deprivation provisions would be upheld.[16] In these situations, it is clear that there is no rationale for the application of the rule. Another scenario in which it seems clear that the rule has no application is where fair value is given for the asset of which the insolvent is deprived.[17]

In *Perpetual*, the Master of the Rolls partly based his reasoning as to why the priority flip provision did not engage the rule, on the fact that the third party who stood to benefit from the flip in priority, that is the noteholders, had themselves provided the money for the collateral, over which the security was taken. Authority for the proposition that 'the rule may have no application to the extent that the person in whose favour the deprivation of the assets takes effect can show that the asset, or the insolvent person's interest in the asset, was acquired with his money'[18] was said by the Master of the Rolls to be the case of *Whitmore*. This did not form the *ratio* of this case and was therefore *obiter.* The fact that a third party has provided the purchase money for the asset does not in itself prevent ownership in the newly acquired asset becoming vested in the company which

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15 (1873) LR 9 Ch App 643.
16 *Money Markets International Stockbrokers Ltd v London Stock Exchange*, [2002] 1 WLR 1150, at [110] –[111].
17 [1901] 1 Ch 279.
18 *Perpetual*, n. 2 above, at [64].

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later descends into insolvency. The third party could easily protect itself by taking security over the asset, or by other means and therefore there seems no reason to extend the rule in this way. Allowing a deprivation in favour of a third party who has provided the purchase money for an asset, would effectively elevate the third party to the status of a secured creditor. Interestingly, Patten LJ who gave the other full judgment in the Court of Appeal, did not base his reasoning on this argument, but based it on the narrower ground that the reversal of priority could not be caught by the rule because it was an original feature of the charge and did not amount to a disposition of any property of the company.

A major difficulty arises where the insolvent receives and only ever holds the asset subject to the deprivation provision. It seems absolutely beyond doubt that a forfeiture provision in a lease or licence, which takes effect upon the insolvency of the lessee or tenant, is valid. Authority for the validity of a provision for determination of a lease in the event of the tenant's bankruptcy can be traced back as far as 1787.[19] Indeed, s. 145 of the Law of Property Act 1925 recognises the validity of such a provision.

Other arrangements however, have been held to be void. There are plenty of examples in the case law where the insolvent receives and only ever holds assets subject to the deprivation provision, and that provision has been held to be void. In *Whitmore*, for example, it was clear that the partnership deed had always contained the provision which excluded the mining lease from the market valuation and therefore the bankrupt's interest in the partnership had always been subject to this exclusion. Page Wood V-C held that insofar as it related to the mining lease, the provision was void as it infringed the rule.

In *Perpetual*, the Master of the Rolls explained that

> 'the fundamental reason why the clause does not infringe the rule is that its invocation does not involve what has been the property of the insolvent party becoming vested in a third party. It merely involves a limited interest being brought to an end, in accordance with its terms, by the third party who had granted it to the party who has become insolvent'.[20]

In the former case, there is a transfer of an absolute interest subject to a condition subsequent, that the asset will revest upon the company's insolvency. Indeed this type of provision will be void not only because it offends against the anti-deprivation rule, but will be rejected for repugnancy, due to the severance of the right of alienation being inconsistent with the outright transfer of ownership. In the case of a provision which merely brings to an end a limited interest in an asset however, the asset is at no point the outright property of the company and the interest is merely determinable upon the company's insolvency. This distinction is a very fine one. It has been suggested that the difference may be as slight as the use of the word 'until' to create a determinable interest, as opposed to 'but if' which may create a conditional interest. If this is so, the insolvency-deprivation rule can easily be avoided where an asset is transferred to the company on terms which use the 'until' formulation. If this distinction is based on form rather than substance, more sophisticated parties would be able to validly circumvent the rule, whereas the less sophisticated or well advised parties may still be caught by the rule if they use the wrong form of words. It is a distinction which has been applied in other areas of the law but seems particularly arbitrary in the current context. Rightly so, it has been described as 'nothing short of disgraceful to our jurisprudence' considering that it is applied to 'a rule professedly founded on considerations of public policy'.[21]

In *Money Markets*, Neuberger J discusses an exception to the rule that a deprivation effected upon insolvency is invalid, which suggests a different distinction. He states that a deprivation may be valid

> 'where the asset is inherently determinable or where there is some sort of superior reversionary interest and the terms under which the asset was created or granted include a provision for its determination in the event of insolvency, or indeed, on the happening of any other event'.[22]

This suggests that the nature of the asset itself is important as well as the form of the words used in the deprivation provision. Perhaps the most obvious assets which are capable of falling into this category of assets which are inherently determinable, or subject to some sort of superior reversionary interest, are leases and licences. Other assets such as shares or patents for example are clearly not either inherently determinable or subject to a superior reversionary interest. This perhaps goes some way to explaining the seemingly special treatment which has historically been accorded to leases and licences. It also seems less arbitrary than a distinction solely based upon the form of words used, given that it seems to restrict the type of assets which can be subject to a deprivation provision to those that are by necessity 'determinable' or capable of reversion. Still, the wording of Neuberger's formulation is vague and in that respect it is unsatisfactory.

Notes

19 *Roe. d. Hunter v Galliers* (1787) 2 TR 133.
20 *Perpetual*, n. 2 above, at [83].
21 *Re King's Trust* (1892) 29 L.R. Ir 401, per Porter M.R. at 410.
22 *Money Markets*, n. 16 above, at [37].

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Worthington has suggested a different distinction, which she argues avoids the arbitrariness of that between determinable and conditional interests. Although her suggested distinction has not been expressly mentioned in any of the case law, she argues that the outcomes of those cases support her suggestion. Worthington's suggestion is that

> '*if* the proprietary interest in question can *only* and must *necessarily* be defined in a time-limited way, then it is legitimate to define the time limitation in any way the parties choose, including by reference to the insolvency of the interest-holder'.[23]

According to this distinction, because leases and licences are necessarily time-limited, it would be legitimate to allow them to determine upon the insolvency of the tenant or licensee. Other property such as rights over shares, patents, debts or royalties are not necessarily time limited. Ultimately, this may amount to exactly the same distinction as that suggested by Neuberger J in *Money Markets*, with Worthington perhaps putting a little more flesh on the bones of the formulation in that case. In any event, this suggestion seems eminently sensible and it is one which the Supreme Court should consider at length if they are faced with elements of the appeal in *Perpetual*. It would preserve the validity of the forfeiture of leases and licences, while giving the anti-deprivation rule the widest possible application.

In light of this discussion on what constitutes a deprivation, it is interesting to examine briefly whether the *Perpetual* appeal involved a deprivation and if it did, whether that deprivation was caught by the rule or whether it constituted one of the valid exceptions. Although the members of the Court of Appeal expressed their opinions on both of these questions, they were of secondary importance given the fact that the court held that the rule would not apply in any event because the trigger was LBHI filing for Chapter 11, and not LBSF's own insolvency.

Interestingly, Patten LJ placed considerable emphasis on the fact that the provision which purported to effect the flip in priority, was an original feature of the contract and the security was always subject to it. He reasoned that the asset in question was the security interest and the priority was merely a 'facet' of that security. Patten LJ thus reasoned that

> 'to say that its operation in the event of the company's bankruptcy constitutes removal of an asset from the liquidation is to confuse the security itself with the operation of its terms in the events prescribed by the charge. LBSF retains the same asset as it had before its bankruptcy…'[24]

However, it seems that Patten LJ rather missed the point in that surely the priority itself was an asset within the meaning of s. 436 IA 1986. There is no doubt that the priority has commercial value and at the very least, it was 'incidental to…property' and therefore came within the definition in that section. Indeed, the Master of the Rolls in that case seems to have recognised this point, stating that 'the right to recoup money under a change in priority is every bit as much of an asset as the right to monies (in the form of royalties) arising in the future',[25] as was the case in *Ex p Mackay*. Looked at this way, it seems a deprivation did occur.

The question can be put as to whether the priority enjoyed by LBSF in the *Perpetual* appeal, which was clearly always subject to the flip provision, was more akin to a conditional or a determinable interest. The Master of the Rolls in that case was of the opinion that '[w]hile not identical to a lease or licence, a charge, or provision for priorities for repayment, has features of similarity to a lease or licence, and differs from ownership'.[26] The question in effect is whether the priority which was enjoyed by LBSF was an interest which determined upon the happening of the relevant event of default, or whether it was retransferred to the Trustee in favour of the noteholders. Conceptually, it is possible to argue that either was the case. Perhaps this case clearly illustrates that the distinction between conditional and determinable interests is not only arbitrary, but difficult to apply to more complicated commercial transactions.

If one then turns to the formulation of Neuberger J in *Money Markets* and the suggestion of Worthington and applies them to the facts of *Perpetual*, it seems that had the deprivation occurred upon LBSF entering formal insolvency proceedings, the deprivation would have been caught by the rule and consequently would have been invalid. This is so because neither the charge, nor the priority (if that is taken to be the relevant asset), is either 'inherently determinable' or subject to a superior reversionary interest, nor are they necessarily defined in a time limited way.

Ultimately, it will be for the Supreme Court to determine the nature and scope of the anti-deprivation rule in the law of English insolvency if elements of the *Perpetual* appeal come before it in the early part of 2011. At the moment, the law in this area is in confusion with much of the case law being seemingly contradictory. If the Supreme Court is unable to clarify the rule, it may be that Parliament will have to step in and legislate in order to provide certainty.

Notes

23 S. Worthington, 'Insolvency deprivation, public policy and priority flip clauses' (2010) 7 *Int. C.R.* 28, at 37.
24 *Perpetual*, n. 2 above, at [135].
25 *Ibid.*, at [67].
26 *Ibid.*, at [64].

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International Corporate Rescue

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