

Case

Perpetual Trustee Co. Ltd vs BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc and Butters vs BBC Worldwide Limited [2009] EWCA Civ 1160

Synopsis

The Court of Appeal gave detailed consideration to the scope of the English anti-deprivation principle as it affects a pari passu distribution of assets.

Topics covered: Anti-deprivation Principle, SPVs, Financial Institutions, Distributions

Background

As a matter of English law, an agreement that provides that assets are to belong to a company until its insolvency, but are then to be taken away from the insolvent estate, is invalid as a matter of public policy. This is known as the "anti-deprivation principle" although it is sometimes referred to as the rule in *British Eagle*. The scope of the anti-deprivation principle is important as it can result in contractual arrangements which are found to offend the principle being ineffective, thus cutting across the parties' intentions.

However, where the debtor only has a limited interest in the asset in question and that interest comes to an end on insolvency, this is unlikely to infringe the anti-deprivation principle. In such circumstances the asset is considered to be subject to an inherent limitation which has always existed, accordingly, the party is not deprived of anything when the interest comes to an end. This is sometimes referred to as the "flawed asset" principle. Examples include a lease or licence which is terminable on the tenant's or licensee's insolvency or a bank deposit which is only repayable if certain conditions are met. These types of scenario can be distinguished because such a provision merely qualifies the insolvent company's interest in the property.

The CA had to consider the effect of the anti-deprivation principle in relation to two different contractual arrangements, the first resulting from the collapse of the Lehman Brothers group and the second from the collapse of Woolworths Group plc.

The Facts

Perpetual Trustee Co. Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc

In *Perpetual Trustee* the court had to consider whether a clause in a security trust deed which provided that a swap counterparty (Lehman Brothers Special Financing Inc (LBSF)) was to be paid in priority to noteholders, unless an event of default occurred under the swap agreement, in which case the priority "flipped" so that noteholders would be paid in priority to LBSF (the so-called "flip clause"), infringed the anti-deprivation principle. Events of default included the bankruptcy of LBSF or its parent Lehman Brothers Holdings Inc (LBHI) and failure to pay. All documents were governed by English law and subject to the non-exclusive jurisdiction of the English courts.

The first event of default was not the filing for Chapter 11 by LBSF but the earlier filing for Chapter 11 by LBHI. Therefore questions arose whether the anti-deprivation principle could apply where the alleged deprivation occurred prior to the insolvency of the party who was allegedly deprived of the asset or as a result of the insolvency of a company in the same group.

It should be noted that the structure of the overall financing arrangements meant that it was the monies provided by noteholders which were used to purchase the collateral to which the security trust deed related. This was found to be an important factor by two of the three judges.

At first instance the English court held that the flip clause did not infringe the anti-deprivation principle; primarily on the basis that LBSF's interest had always been subject to the inherent limitation imposed by the flip clause.

The Facts

Butters v BBC Worldwide Limited

In Butters the court had to consider clauses in a licence of intellectual property rights which operated to terminate the licence on the insolvency of a member of the licensee's group and were linked to a joint venture agreement. In the event of the insolvency of a joint venture partner (or the parent company of a joint venture partner) the joint venture agreement and the termination clauses in the licence had the effect of allowing the solvent joint venture partner to force the other partner to transfer its shares in the joint venture vehicle for "fair value" (the Right of Pre-emption). Broadly, "fair value" was market value with no discount to be applied for the fact that the shares represented a minority holding. However, in taking account of "fair value" the price was to be discounted to reflect the simultaneous loss of the licence. The parent of the joint venture partner was placed into administration.

At first instance the court held that the clauses, in particular the way they were linked, did infringe the anti-deprivation principle. The effect, upon the insolvency of any of the companies in the group, was that the shares could be acquired at less than the fair value price that would have been established but for the insolvency event.

Issues for determination

The key issues for the CA to determine were:

- the scope and meaning of the anti-deprivation principle;
 - whether the contractual provisions in question constituted an invalid deprivation under that principle; and
 - whether the anti-deprivation principle could apply where the deprivation occurs prior to the insolvency of the party who was deprived of the asset or as a result of insolvency proceedings being commenced in respect of a company in the same group.
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Scope of the anti-deprivation

It was common ground that the anti-deprivation principle applied not only in relation to bankruptcy and liquidation but also where the company concerned goes into administration (at least where the administration was effectively for the purpose of maximising the return on insolvency and will lead to a winding up order). It was also common ground that the principle applied where the company files for an equivalent proceeding in a foreign jurisdiction (i.e. in Perpetual Trustee Chapter 11 under the US Bankruptcy Code).

The CA held that the anti-deprivation principle should be given a narrow interpretation. In this respect, Patten LJ appeared to wish to restrict its application to a greater degree than that advocated by the Master of the Rolls. What follows is a broad overview and necessarily is not an analysis of the differences between the two judgments.

The CA accepted that the principle was based on the fact that, as a matter of public policy, it is not possible to contract out of the insolvency legislation. It was therefore based on statute and was a direct application of the provisions of the IA86 to the transaction under consideration. As such, while the common law has shaped the principle it should not be seen as operating outside the relevant statutory provisions. Accordingly, in order for a contract to offend against the anti-deprivation principle there must be both property of the company in liquidation (or equivalent proceeding) to which the contract relates and the contract's treatment of that property must produce a result which is inconsistent with the provisions of the IA86. The anti-deprivation principle was therefore restricted to protecting the creditors of the company in liquidation (or equivalent proceeding) by, in effect, enforcing the provisions of the IA86 in respect of their property. This meant that there was no general rule of public policy which invalidates contractual provisions merely because they have the economic effect of reducing the value of the insolvent estate.

The Master of the Rolls set out guidelines which could impact on whether the anti-deprivation principle applies. First, for the principle to apply it must be shown that the assets are vested in the company on whose insolvency the deprivation is to occur. Secondly, the principle 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 party's interest in the asset, was acquired with his money. Thirdly, the principle cannot apply to invalidate a provision which enables a party to determine a limited interest, such as a lease or licence, which he has granted over or in respect of his own property in the event of the lessee's or licensee's insolvency (i.e. support for the flawed asset principle). Fourthly, when applying the anti-deprivation principle to a particular provision, in principle, there was no difference between cases where the contractual provision is expressed to apply on insolvency or liquidation (or equivalent proceeding) and those where it is not so expressed (i.e. it was the effect of the clause in question in the event of insolvency that was crucial, not whether the clause was linked specifically to insolvency).

Despite this guidance, the CA recognised that it was difficult to define precisely what sort of deprivation provisions will be caught by the rule and that it was inevitable that the courts develop the law in this area, at least at the moment, on a relatively cautious case by case basis. However, as a general principle, the Master of the Rolls stated that there should be an overriding theme of freedom of contract in that, if possible (and in particular in cases of complex financial instruments), the courts should give effect to the contractual terms which the parties have agreed.

Finally, the CA noted that it was not possible for the court to grant itself the right to widen the sanction of invalidity under the anti-deprivation principle so as to encompass transactions which the application of the IA86 would leave untouched. This was something for the legislature to decide.

Application of the anti-deprivation principle to the contractual provisions

The CA held that neither the flip clause in Perpetual Trustee nor the licence termination provision connected with the Right of Pre-emption in Butters gave rise to a deprivation under the principle.

The Decision

Perpetual Trustee Co. Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc

While the CA concluded unanimously that the flip clause did not infringe the anti-deprivation principle, there were differences in two of the judges' reasoning.

Patten LJ based his conclusion simply on the fact that a change in priority consequent upon the insolvency or liquidation of a company is not prohibited by any express term of the IA86 and did not amount to the disposition of any property of LBSF. Patten LJ noted that the consequence of the operation of relevant provisions was not to deprive LBSF or its creditors of any property or assets which they would have been entitled to but for its bankruptcy. In his judgment Patten LJ stated: "The only interest or property which the company ever enjoyed in the collateral was a charge granted by the issuers of the Notes on the terms of the Supplemental Trust Deed. That security interest remains part of the property of the company unchanged by the event of its bankruptcy. The reversal of the order of priority under Clause 5.5 was always a facet of the security designed to regulate the competing interests over the collateral of LBSF and the Noteholders. To say that its operation in the event of the company's bankruptcy constitutes the 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". In other words the flip clause did not divest LBSF of any property and re-vest it in the noteholders nor even divest LBSF of the benefit of the security granted to it. LBSF's interest in the security was always contingent on there being no event of default.

The Master of the Rolls based his conclusion on more limited grounds. In addition to the reasons relied on by Patten LJ, the Master of the Rolls specifically relied on the fact that "assets over which the charge exists were acquired with money provided by the chargee in whose favour the "flip" operates and that the "flip" was included merely to ensure, as far as possible, that the chargee is repaid out of those assets all that he provided (together with interest), before the company receives any money from the assets pursuant to its charge". Without this additional factor the Master of the Rolls felt there may have been room for argument

that the flip clause would have fallen within the anti-deprivation principle. The third judge, Longmore LJ, agreed with the Master of the Rolls' reasoning. The reliance on this additional factor by the Master of the Rolls (and the support for it by Longmore LJ) unfortunately means that slightly less certainty can be taken away from the decision than would otherwise be the case. However, in this regard it should be noted that the Master of the Rolls stated that Patten LJ may well have been right in his more straightforward and simplistic approach to the matter.

The Decision

Butters v BBC Worldwide Limited

It was held that there was nothing in the clauses whether taken separately or together which could infringe the anti-deprivation principle. There was nothing objectionable in a clause which provided for a licence to terminate in the event of the insolvency of a member of a licensee's group. This simply involved a limited interest being brought to an end in accordance with its terms. Furthermore, in exercising the Right of Pre-emption a "fair value" (in effect market value) was to be paid for the shares. If the termination of the licence did not infringe the principle then the fact that the method for arriving at a "fair value" for the shares reflected that loss also could not infringe the anti-deprivation principle.

The decision in Butters will be welcomed by those practitioners involved in the drafting of IP licences. The decision makes it clear that clauses in IP licences providing for termination on the licensee's insolvency are not (in the absence of special circumstances) affected by the anti-deprivation principle.

Should the anti-deprivation principle apply where the deprivation occurs prior to the insolvency of the party who was deprived of the asset or as a result of insolvency proceedings being commenced in respect of a company in the same group?

The CA was unanimous in the conclusion that a deprivation that takes effect before the winding up (or equivalent) is not caught by the anti-deprivation principle unless the deprivation is effected pursuant to a sham transaction. Furthermore, the anti-deprivation principle could not apply to invalidate contracts where no bankruptcy or winding up order is ever made – to the extent that Fraser v Oystertec [2004] BPIR 486 was contrary to this principle it should not be followed. The CA held that the IA86 contained specific provisions to deal with deprivations which occur prior to the opening of formal insolvency proceedings (sections 238 and 239 IA86 in relation to transactions at an undervalue and preferences) and that the anti-deprivation principle should not be super-imposed over these statutory provisions.

Further, the CA rejected the notion that the anti-deprivation principle could be triggered by the insolvency of a party other than the company which would suffer the deprivation (even a closely connected party). It was not open to the court to treat a closely-integrated group of companies as a single economic unit. These conclusions are to be welcomed in providing greater certainty as to the types of clause which the anti-deprivation principle may affect. It is now clear that any clause which has the effect of depriving a company of an asset before formal insolvency proceedings are commenced cannot be affected by the anti-deprivation principle. However, this will not necessarily mean that the operation of the clause will not fall foul of sections 238 or 239 IA86.

Comment

The anti-deprivation principle as it affects the perceived statutory imperative to achieve *pari passu* distribution has long been controversial. Moreover, *British Eagle* is one of those cases which conspicuously needs to be re-visited at the highest level – now the Supreme Court. In his judgment at first instance in *Money Markets*, Neuberger J explained his concerns with the anti-deprivation rule:

"87. MMI relies on the principle that "there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that eventual go over to someone else, and be taken away from his creditors", which as already mentioned I call "the principle". As a number of the cases to which I have referred show, there is no doubt that the principle exists, and has been applied to defeat provisions which have that purported effect. However, it is equally clear from the authorities that there are occasions where a provision which, at least on its face, appears to offend the principle has been upheld. I do not find it easy to discern any consistent approach in the authorities as to the application of the principle. In this, I do

not appear to be alone. The difference of outcome in *ex p Jay* 14 Ch. D. 19 and *ex p Newitt* 16 Ch. D. 522 has been described as "rather surprising..." by Dr Fidelis Oditah in an article entitled "Assets and the Treatment of Claims in Insolvency" (1992) 108 LQR 459 at 476. "The result in *British Eagle* has not been the subject of universal approbation" according to Gerard McCormack in "Proprietary Claims and Insolvency" (1997) at 18. The "distinction between a determinable interest and an interest forfeitable on a condition subsequent has rightly been characterised... as "little short of disgraceful to our jurisprudence " when applied to "a rule professedly founded on considerations of public policy" a view endorsed in *re Sharp's Settlement Trusts* 1 Ch. 331 at 340D" - per Professor Roy Goode *op.cit.* at 148."

It is understood that there is presently no permission to appeal to the Supreme Court in relation to either case. However, the chance for the Supreme Court to consider the anti-deprivation principle some 25 years on from *British Eagle* would be welcomed by practitioners and academics alike.

Although the CA did not specifically refer to a "flawed asset" the judgments can be seen to support the argument that a "flawed asset" arrangement will not infringe the English anti-deprivation principle. This modern day support for this argument is also to be welcomed, although, in practice, the distinction between the grant of an interest in property which is determinable on insolvency (which is valid) and the transfer of property on terms that it shall be forfeited on insolvency (which is not valid) can be a fine one. However, the Master of the Rolls' more limited conclusions (which Longmore LJ agreed with) and the strength he placed on the fact that the noteholders paid for the collateral should be borne in mind when considering the anti-deprivation principle in the future. How much reliance is placed on the Master of the Rolls' additional factor in future cases will be an important consideration in the further development of the anti-deprivation principle.

It should be noted that, in relation to the *Perpetual Trustee* case, there are concurrent proceedings in the US concerning the validity of the flip clause as a matter of US bankruptcy law. It may be that, notwithstanding the English judgment upholding the flip clause, if the US court decides that the flip clause is invalid as a matter of US bankruptcy law, a formal request may be made to the English courts to recognise and give effect to the US decision. Should such an application be made this is likely to raise important principles in relation to global cross-border insolvency cases and is very much a space to watch. This issue of the validity of the flip clause as a matter of US bankruptcy law was considered at a hearing on 19 November (judgment was reserved).

In anticipation of the US bankruptcy court hearing on 17 November the English court, at the request of noteholders, sent a letter of request to the US bankruptcy court. The letter invited the US judge, in the event that he found the flip clause to be void or otherwise unenforceable as a matter of US law, to limit his decision to granting declaratory relief only. A separate bulletin is being produced on the judgment regarding the letter of request.