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Anti-deprivation: a question of substance not form

In the much anticipated decision of *Belmont Park Investments PTY Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc* [2011] UKSC 38 the Supreme Court has unanimously dismissed the appeal of Lehman Brothers Special Financing Inc (**"LBSF"**) and in so doing provided clarification as to the scope and application of the anti-deprivation rule (the **"Rule"**).

Significantly, the majority of the Court held that the Rule applies to invalidate arrangements which deliberately and intentionally seek to remove assets from an insolvent's estate to the detriment of its creditors. Accordingly the Court stated that where sophisticated commercial parties had entered into an arrangement in good faith, the courts should be slow to invalidate the bargain which had been struck and should consider the application of the Rule on a case by case basis.

Having concluded that the Rule was not breached by the contractual clauses under consideration, it was not necessary for the Court to determine whether the Rule operates where the alleged deprivation is triggered by the insolvency of a third party, as opposed to the party who is deprived. However, Lord Collins expressed the view that the Rule would have no application in such circumstances, as had been decided at both first instance and in the Court of Appeal.

The Facts

In October 2002 the Dante programme (the **"Programme"**) was established through a special purpose vehicle formed by Lehman Brothers International (Europe) (the **"Issuer"**). The Programme raised capital for investment by issuing credit-linked notes to investors (the **"Noteholders"**). The subscription monies received from the Noteholders were used to purchase securities as collateral, which were charged and then vested in a trust corporation (the **"Trustee"**). The various contracts comprising the Programme, with the exception of that for the purchase of collateral, were governed by English law.

In order to meet the interest payments due to Noteholders, the Issuer entered into an ISDA swap agreement with LBSF on terms that LBSF would receive the income received on the collateral, and in return would pay to the Issuer an amount equal to the interest due to Noteholders.

The swap provided that the proceeds from the collateral were to be applied first to satisfying the Issuer's obligations to LBSF and only then to satisfying the Issuer's obligations to the Noteholders. However, the swap agreement provided that if LBSF was in default under the swap it would rank after the Noteholders in respect of the collateral proceeds (the **"Flip"**). This contractual arrangement was also set out in the terms and conditions attached to the prospectus sent to the Noteholders.

On 15 September 2008 Lehman Brothers Holdings Inc (LBSF's parent) entered Chapter 11 bankruptcy in the US, which triggered an event of default under the swap. The Trustee, pursuant to the direction of the Noteholders, caused the Issuer to terminate the swap with LBSF. Significantly, this event of default prompted the operation of the Flip within the swap agreement, such that the priority of claims to the collateral held by the Trustee was altered. LBSF challenged the validity of the Flip on the basis that it contravened the Rule and claimed that the Trustee should first apply the collateral proceeds for the benefit of LBSF.

The High Court, and latterly the Court of Appeal, upheld the terms of the swap agreement and found that the Flip provision did not breach the Rule, although for different reasons. LBSF appealed to the Supreme Court.

Decision of the Supreme Court

Lord Collins (with whom Lord Phillips, Lord Hope, Lord Walker, Lady Hale and Lord Clarke agreed) gave the leading judgment and dismissed the appeal of LBSF. Lord Mance also dismissed the appeal, but for different reasons.

(1) A breach of the anti-deprivation rule?

Lord Collins sought to ascertain the limits of the anti-deprivation rule using the existing body of relevant case law and, in so doing, strike a balance between the need to prevent assets being withdrawn from an estate on insolvency to the detriment of creditors, as against the important principle of party autonomy on entering into agreements which *"is at the heart of English commercial law"*. Lord Collins upheld the anti-deprivation principle, but framed its application as a matter to be ascertained on a case by case basis, depending on the *"commercial reality"* of the transaction.

The Court considered four main arguments in reaching its decision:

- First, that commercial sense and an absence of intention to intentionally evade insolvency laws were found to be significant factors in previous decisions where the court has declined to find a breach of the Rule, and instead upheld the autonomy of the contracting parties. Lord Collins did not stipulate that a subjective intention to evade mandatory insolvency laws was necessary, but that the intention was to be inferred from the circumstances of each case. Lord Collins went on to say that *"there is a particularly strong case for autonomy in cases of complex financial instruments"*. Accordingly, His Lordship applied the Rule in a commercially sensitive manner, taking into account the policy of contractual autonomy and upholding proper bargains. In so doing, it was held that the Flip did not breach the anti-deprivation principle and that the swap formed part of *"... a complex commercial transaction entered into in good faith"*; it is this reasoning which underpinned the majority decision of the Court.
- Secondly, Lord Collins clarified that the Rule does not apply where the deprivation in question takes place for reasons other than insolvency. This is consistent with the purpose of the Rule being to safeguard the estate of an insolvent for the benefit of its creditors, such that there is no call for its application in circumstances outside insolvency.
- Thirdly, an issue which emerged from the body of case law was the question as to whether there is a difference between (i) a flawed asset (one in which the interest was always subject to the condition of the counterparty not going into insolvency) and (ii) an interest which is granted outright and then forfeited due to the onset of insolvency. It was on this aspect that Lord Mance split from the majority of the Court. For the majority of the Court, the fact that the Flip was provided for in the Programme documentation at the outset was not determinative of the question whether the Flip provision contravened the Rule. While Lord Collins recognised that it remains unclear where the line between a flawed asset and an interest forfeited on insolvency is or ought to be drawn, his Lordship found that the concept of the flawed asset is too well established to be destabilised otherwise than by legislative intervention. Lord Mance took a different approach and found that prior to an event of default under the swap, neither the Noteholders nor LBSF had priority over the collateral proceeds. His Lordship found that it was only once there had been an event of default that the priority to the collateral proceeds would be determined pursuant to the terms of the swap, and that the Flip did not contravene the Rule. Given the differences in the Court's reasoning in this respect, the scope of the flawed asset theory remains uncertain.
- Fourthly, under the Programme it was the Noteholders who had provided the funding for the collateral to be acquired and it was the Noteholders who were to have priority over the proceeds of that collateral pursuant to the Flip. Accordingly this raised the question as to whether the Rule applies if the assets being taken from an insolvent estate (the apparent deprivation) had come from the party who would receive the benefit of the deprivation. Lord Collins did not consider that it would be right for there to be a general exception to the Rule based on the source of the assets. However, his Lordship went on to say that it may well be *"an important, and sometimes decisive, factor in a conclusion that a transaction was a commercial one entered into in good faith"*.

(2) Timing of the deprivation

As the Court concluded that the Rule had not been contravened by the Flip, it was not necessary for the Court to resolve the question as to whether there could be a deprivation within the meaning of the Rule where the insolvency triggering the deprivation is of a third party, rather than the party deprived. Both the High Court and Court of Appeal accepted that in such circumstances the Rule would not be engaged. While Lord Mance preferred not to provide an opinion on the issue, Lord Collins expressed the view that both the judge at first instance and the Court of Appeal were correct in this regard.

Comments

The approach of the Supreme Court in this appeal reflects the desire of the courts, as far as possible, to give effect to contractual terms agreed between parties. In particular, the terms of Lord Collins' judgment rests heavily on the commercial context and sophistication of the parties to the Programme. In this regard, there remains scope for argument that the application of the Rule may have a different outcome where the parties in question are not sophisticated financial investors or institutions. However, the will of the Court to give effect, where possible, to the terms of a commercial bargain is consistent with the purposive approach taken by the Court in connection with questions of contractual interpretation and construction, and one which promotes certainty of contract.

The approach taken by the Court means that it is a question of the substance of the transaction rather than its form which determines its susceptibility to the anti-deprivation principle. While breaches of the Rule will continue to develop on a case by case basis, the factors identified by Lord Collins as being relevant in determining a breach of the Rule provide long-awaited guidance on this topic.

In light of the views expressed by Lord Collins and the reasoning of Lord Mance, the continued uncertainty surrounding the validity of a flawed asset arrangement remains an important area for future legislative development and clarification.

From the perspective of corporate trustees operating in complex financial transactions, the decision provides more certainty for those entities administering trust assets in an enforcement or wind down scenario in accordance with the terms of transaction documents.

Disappointingly, the decision of the Supreme Court does not expressly address the question of the extent to which the Rule is applicable in circumstances where the insolvent company in question (LBSF) is not an English company or subject to English insolvency law. Accordingly, a significant element of uncertainty remains, both as to the practical effect of the decision in this particular matter (in light of a potentially contrary conclusion reached by the US Bankruptcy Court on the application of the equivalent of the Rule in the US Bankruptcy Code) and as to how similar situations will be dealt with by the courts in future. It seems probable that further litigation will ensue, and developments on this aspect of the case will continue to be monitored closely on both sides of the Atlantic.

If you would like more information relating to this decision or the insolvency principles discussed above, please do not hesitate to contact:

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