Perpetually perplexing - the anti-deprivation rule in practice

If Lord Neuberger MR admits that his judgment does not leave the law in a clear state, how are the rest of us to deal with it?

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Introduction

1. Despite its rather older roots[1], the anti-deprivation rule first came to real prominence in the controversial decision[2] of the House of Lords in *British Eagle International Airlines Ltd v. Compagnie Nationale Air France* [1975] 1 WLR 758. Its ambit and scope has recently been limited by a Court of Appeal decision in two cases, heard together, namely *Perpetual Trustee Company Limited v. BNY Corporate Trustee Services Ltd*[3] ("*Perpetual*") and *Butters v. BBC Worldwide Ltd*[4] ("*Butters*"), together published at [2009] EWCA Civ 1160.

2. *Perpetual* concerned a structured finance transaction, which provided that the order of priority of distribution of the proceeds of realisation of collateral changes following an event of default under a swap agreement would flip if the defaulting party was the swap counterparty. Before default, the swap counterparty ranked first, but after default, it was the noteholders who had priority. In *Butters*, BBC granted Woolworths a licence to produce videos and DVDs of BBC television programmes. The joint venture agreement provided that upon the occurrence of a insolvency event, notice could be served requiring the other party to sell its shares at market value and also that such an event would cause the automatic termination of the licence.

3. In Each case the Court of Appeal was called upon to determine to what extent, if any, the anti-deprivation rule rendered the contractual provisions void.

The anti-deprivation rule: what is it?

4. Lord Neuberger MR summarised the "so-called anti-deprivation rule" in these terms[5]:-

> "There cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors."

Patten LJ[6] summarised the rule as follows[7]:-

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1 See *Borland's Trustee v. Steel Brothers & Co Limited* [1901] Ch 279, where at p.290 Farwell J stated the principle in accordance with the dicta of James LJ in *Ex p Jay; In re Harrison* (1880) 14 Ch D 19 at p.25: "The principle is 'that a simple stipulation that upon a man's becoming bankrupt that which was his property up to the date of bankruptcy should go over to some one else and be taken away from his creditors, is void as being a violation of the policy of the bankrupt law.'"

2 Controversial because by a majority of 3-2, the House of Lords overruled a unanimous Court of Appeal, which had affirmed the first instance decision of Templeman J. The House of Lords held that British Eagle's claim as a clearing house member in respect of the IATA clearing system set up so that sums due for member airlines to each other would be netted out each month, was a claim against the individual airline (in that case Air France) such that the netting system could not be operated post-liquidation so as to entitle British Eagle to the net sum in accordance with the scheme rules. Subjecting the claim to the netting arrangements was to divest the company of its assets, in breach of the *pari passu* principle and of the requirement of mutuality which precluded the set-off of claims of those third parties. As a consequence, the rules were redrafted so as to circumvent the decision. in *International Air Transport Association v. Ansett Australia Holdings Ltd* [2008] HCA 3, [2008] BPIR 57, the majority of the High Court of Australia concluded that the redrafting had achieved its aim.

3 On appeal from a decision of the Chancellor, [2009] EWHC 1912 (Ch); [2009] 2 BCLC 400, [2009] BPIR 1093.

4 On appeal from a decision of Peter Smith J, [2009] EWHC 1954 (Ch); [2009] BPIR 1315.

5 Quoting from Cotton LJ at p.26 of *Ex p Jay; In re Harrison*.

6 Agreeing with the Master of the Rolls, but adding some observations of his own because of the general interest of the appeals and the importance of the issues raised.

7 At para 113.

> "Expressed in its simplest and most general form, the anti-deprivation rule is said to be a common law rule of public policy that the property of an insolvent person must be administered for the benefit of his creditors in accordance with the provisions of what is now the Insolvency Act 1986. Consistently with and as part of this rule, the individual bankrupt or insolvent company may not contract at any time, either before or after the making of the bankruptcy or winding-up order, for its property subsisting at that date to be disposed of or dealt with otherwise than in accordance with the statute. Put another way, it is not possible to contract out of the Act."

They both[8] referred to the dicta of Peter Gibson J in *Carreras Rothmans Ltd v. Freeman Matthews Treasure Ltd* [1985] 1 Ch 207 at p. 226F, as regards what was decided in *British Eagle* in the following terms[9]:-

> "Thus the principle that I would extract from [*British Eagle*] is that where the effect of a contract is that an asset which is actually owned by a company at the commencement of its liquidation would be dealt with in a way other than in accordance with section 302 of the Companies Act 1948 [now s.107 of the Insolvency Act 1986], then to that extent the contract as a matter of public policy is avoided, whether or not the contract was entered into for consideration and for bona fide commercial reasons and whether or not the contractual provision affecting that asset is expressed to take effect only on insolvency."

5. Thus the rule is essentially based on the proposition that one cannot contract out of the provisions of the insolvency legislation[10] which govern the way in which assets are dealt with in a liquidation.

6. In the events that had happened, the Court of Appeal in *Perpetual* and *Butters* was unanimous in holding that the anti-deprivation rule was infringed in neither case, concluding:-

   6.1. The clauses did not offend the anti-deprivation rule because they did not divest the insolvent entity of its property; rather, it simply altered a right granted to that entity without conferring an unfair advantage on some of its creditors over others.

   6.2. The rule did not apply to deprivations of property that occurred before a winding up order has been made in respect of the entity that owned the property. Further, it did not apply where the deprivation was triggered by the winding up of a different entity.

   6.3. Generally, a provision that terminated a licence upon the insolvency of the licensee did not offend the principle.

   6.4. In general, it was for Parliament to legislate against anti-avoidance devices and the courts should be wary of creating their own anti-avoidance policies, particularly where doing so may have the effect of frustrating the terms of commercial contracts entered into by sophisticated parties.

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8 The third judge, Longmore LJ, agreed with the Master of the Rolls, and dealt with one factual point arising on the *Butters* appeal.

9 At para. 48 per the Master of the Rolls and para. 121 per Patten LJ.

10 In particular, s.107 of the Insolvency Act 1986 ("the Act") and r.4.181 of the Insolvency Rules 1986 providing that the company's property in a winding up should be applied in satisfaction of the company's liabilities *pari passu*, and ss. 143(1) and 144(1) of the Act stating 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, subject to that, he must "take into his custody or under his control all the property and things in action to which the company is . . . entitled". In addition, s.127 of the Act providing that "any disposition of the company's property . . . made after the commencement of the winding up is, unless the court otherwise orders, void" and ss.238 and 239 enabling a liquidator to apply to the court for an order "restoring the position", where the company has "at a relevant time" "entered into a transaction with any person at an undervalue", or has done anything which, in the event of the company's insolvent liquidation, would put a creditor (or guarantor) of the company in a better position than he would otherwise be in. Finally, certain floating charges are avoided under s 245 if created in favour of a person "connected with the company" within two years, and otherwise within one year, of "the onset of insolvency".

The decisions of the Master of the Rolls and Patten LJ are not exactly the same, it appearing that Patten LJ was prepared to limit the interpretation of the rule even more narrowly than the Master of the Rolls[11]. However, what is clear is that in so doing *British Eagle* "has [had] its wings clipped by the Court of Appeal."[12]

When does it apply?

7. Recently, there has been much debate as to precisely the type of insolvency event that was relevant. Historically, the rule applied in bankruptcy, and was applied in liquidation in *British Eagle* and *Carreras Rothmans*. But, is administration a relevant insolvency event for the purposes of the rule coming into play? In *Perpetual* and *Butters*, it was made clear that the Court thought that it was. The Master of the Rolls stated:-

> "43. All these decisions (save, it would seem, *Williams* 7 Ch D 138, which may have applied on a liquidation) related to bankruptcy. It is common ground, at least at this level, that the rule exists and applies equally to liquidations, not least in the light of the decision of the House of Lords in *British Eagle International Air Lines Ltd v. Compagnie Nationale Air France* [1975] 1 WLR 758. It is also common ground that the rule also applies where the company concerned goes into administration (at least where, as in the *Butters* case, the administration is effectively for the purpose of maximising the return on the insolvency and will lead to a winding up order) or where the company concerned files for Chapter 11 protection in the United States (as in the *Perpetual* case) at least where the filing is for the purpose of maximising the return on the insolvency and cessation of business."

8. Accordingly, the Court of Appeal was prepared to accept the common ground that the anti-deprivation principle should apply on administration, as well as liquidation or bankruptcy.

What is the relevant insolvency event?

9. This was one of the key elements of the decision of the Court of Appeal in each of *Perpetual* and *Butters*.

10. In *Perpetual*, the relevant event that have rise to Noteholder Priority rather than Swap Counterparty Priority was the filing for Chapter 11 protection of Lehman Brothers Holdings Inc (LBHI) on 15 September 2008. Thus it was not the subsequent filing under Chapter 11 of the company holding the asset, namely Lehman Brothers Special Financing Inc (LBSF), which took place on 3 October 2008. So, the relevant event of default was not the insolvency of LBSF, but the insolvency some 18 days earlier of LBHI.

11. Similarly, in *Butters*, the termination of the licence grated to Media was brought about by the insolvency of Group (which went into administration on 27 January 2009) and not Media (which went into administration on 11 February 2009).

12. On this point, the Court of Appeal could not have been clearer: a deprivation that took effect before the insolvency of the party said to be deprived of the asset is not caught by the anti-deprivation rule[13]. The court would not look behind a group structure and effectively treat the insolvency of a different party as being the insolvency of the relevant party, no matter how closely connected they were. Such transactions, if they were not shams, came within the scope of the statutory regimes (such as ss.238 and 239 of the Act) and it was not possible to impose the anti-deprivation rule on top of those statutory provisions.

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11 In particular by agreeing with a very narrow interpretation of the rule as propounded in the minority decision of Cheung JA in *Peregrine Investments Holdings Ltd v. Asia Infrastructure Fund Management Co Ltd* [2004] 1 HKLRD 598, a decision of the Hong Kong Court of Appeal.

12 ILA Technical Bulletin #233, 8 Dec 2009

13 Comments to the contrary in *Fraser v. Oystertec plc* [2004] BPIR were overruled.

What is the nature of the right lost?

13. Again, these were key parts of the decision of the Court of Appeal, although the reasons for the decisions on this point in each of *Perpetual* and *Butters* were different.

14. In *Perpetual*, it was held by Patten LJ that the change in priority consequent upon the insolvency of a company was not prohibited by the Act and that the change in priority did not actually deprive that company (LBSF) of an asset that would otherwise have been available in the insolvency. The Master of the Rolls, whilst recognising that this straightforward and simplistic approach may well be right, based his decision on more limited grounds, based upon the terms of the document itself. His Lordship noted that the charged asset had actually been purchased with the money of the party in whose favour the "flip" provisions operated; accordingly the purpose of the provisions was not to deprive LBSF of a asset but simply to ensure that the charge was repaid before the company benefitted from any of the asserts subject to the charge.

15. In *Butters*, the position was starker. The effect of the insolvency of Group was to determine a licence granted to Media. On that basis, the Curt stated that there absolutely nothing objectionable in the licence being terminated upon the insolvency of a member of the group (or even the company itself). The effect of the termination was simply to cut down the terms upon which the right was grated to Media in the first place: it was a limited right, or flawed asset.

On what ground is the relevant clause being relied upon?

16. Whilst this was not a matter that was relevant for the purposes of the decisions in *Perpetual* and *Butters*, it is a matter that is particularly relevant in construction contracts involving direct payment clauses. Various direct payment clauses were included in JCT contracts[14] up until the 2005 revision, when direct payment clauses were removed from the standard model. Nonetheless, many construction contracts have them amended back in. Commonly, such clauses are not expressly drafted so as to be relied upon only in the event of insolvency.

17. The purpose of the clauses is clear: in circumstances where the Contractor has been paid by the Employer but has not paid a Sub-Contractor in respect of works that were the subject of the payment to the Contract, the Employer can:-

    17.1. by-pass the Contractor and make direct payment of future sums to the Sub-Contractor; and

    17.2. set-off the sums paid to the Sub-Contractor against future sums due to the Contractor.

    But, what if the reason that the Contractor has been unable to pay the Sub-Contractor is because the Contractor has gone into administration?

18. Historically, there was little doubt that direct payment clauses in construction contracts were valid[15]. However, these cases were decided well before the decision in *British Eagle*, and it does not appear that there was any consideration of insolvency legislation and principles in those earlier cases.

19. Since *British Eagle*, there does not appear to have been a decision in this jurisdiction as to the effect of the rule on direct payment clauses[16]. Such a clause has been permitted to

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[14] Subject to an express provision that they would not operate in the event of the winding up of the Company.

[15] See *Re Wilkinson; ex p Fowler* [1905] 2 KB 713 and *Re Tout & Finch Ltd* [1954] 1 WLR 178.

[16] In *Sydenhams (Timber Engineering) Limited v. CHG Holdings Limited* [2007] EWHC 1129 (TCC) the issue arose tangentially. HHJ Coulson QC (sitting as a High Court Judge) had to consider whether there was a direct contract between a developer and a timber firm supplying windows to a project where the main contractor had gone into

stand in Australia[17]. The High Court of Ireland has reached a similar conclusion[18]. However, the Court of Appeal in Northern Ireland has held that *Re Wilkinson* and *Re Tout & Finch Ltd* were inconsistent with *British Eagle*[19]. This has been followed in Hong Kong[20]. Additionally, in South Africa, a direct payment clause was held to be invalid against the main contractor's liquidator[21], and a similar result has been reached in Canada[22]. This was followed in Singapore[23]. A direct payment clause foundered in the New Zealand case of *Attorney-General v. McMillan & Lockwood Ltd* [1991] 1 NZLR 53[24].

20. The issue has been the subject of consideration in a number of textbooks as follows (in no particular order):-

20.1. *Halsbury's Laws* Vol. 4(3) Building Contracts etc, on the limitations on the employer's right to pay contractor expresses the view at para. 49 (limitations on the employer's right to pay contractor) and para. 124 (insolvency) that *Re McLouglin & Harvey plc* would be likely to be followed in England and Wales.

20.2. *McPherson's Law of Company Liquidations* (2nd ed, Sweet & Maxwell, 2009) expresses the view at para. 13.06 that *Re Gericevich Contracting Pty Ltd* is wrong.

20.3. *Emden's Construction Law* (Butterworths, loose-leaf) Vol. 1, III, para. 3167 to 3206 considers the general principles, the authorities from around the globe and concludes[25] that:-

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administration and whether the developer was liable for outstanding payments to the timber firm. It was held that the anti-deprivation principle did not arise, as there was an express agreement between the employer, CHG, and the subcontractor, Sydenhams, pursuant to which the employer would pay the subcontractor direct. The administration of the man contractor had no effect on that direct contractual agreement. *Re McLouglin & Harvey plc,* mentioned below, was therefore distinguished.

17 See *Re Gericevich Contracting Pty Ltd (in liq)* (1985) 3 ACLC 33. In that case Pidgeon J of the Western Australian Supreme Court held that head contractors were entitled to act upon express clauses in sub-contracts empowering them to pay the employees of their sub-contractors wages or allowances for which judgments or orders had been awarded against the sub-contractors, even though the sub-contractors were in liquidation. The appointment of a liquidator did not annul this clause of the sub-contract. Moreover, according to Pidgeon J, the public policy that an employee should as a matter of high priority receive wages in full prevailed over the public policy inherent in the *pari passu* principle. See also *Re CG Monkhouse Properties* [1968] SR (NSW) 429 where it was held that the operation of the direct payment clause meant that the contractor, and its liquidator, were not entitled to receive the money due anyway.

18 See *Glow Heating Ltd v. Eastern Health Board* [1988] IR 110. In that case a direct payment clause provided that, before issuing a certificate of payment to the head contractor, the owner's architect was to require the head contractor to give him proof that sub-contractors had been paid and in default that the owner would pay such amounts and deduct the amount paid from what was owing to the head contractor. The head contractor became insolvent and went into liquidation and one of the sub-contractors sought a declaration that it was entitled to direct payment by the owner out of funds that had been retained by the owner. The Court distinguished *British Eagle,* giving the declaration sought. It held that the liquidator of the head contractor took a right to payment subject to a clause in the contract under which the head contractor would see a reduction if it defaulted in a specified way, in effect that the head contractor's right to payment was a flawed asset.

19 See *Re McLouglin & Harvey plc (in liquidation); B Mullan & Sons (Contractors) Ltd v. Ross* (1996) 86 BLR 1. Kerr J. said that the *pari passu* principle was the fundamental principle of insolvency law and this was recognised by the decision in *British Eagle* with the result being that the direct payment clause, in that case, could not have effect. The learned judge said that the payments owed to the sub-contractors by the head contractor that had entered administrative receivership, represented property belonging to the head contractor. Hence, the payments were subject to the *pari passu* principle.

20 See *Golden Sand v. East Success Enterprises* [1999] 2 HKC 356.

21 See *Natal Administrator v. Magill Grant & Nell (Pty) Ltd (in liquidation)* (1969) (1) SA 660.

22 See *AN Bail v. Gingras* [1982] 2 SCR 475, although *British Eagle* was not cited.

23 See *Joo Yee Construction Proprietary Ltd v. Diethelm Industries Proprietary Ltd* (1991) 7 Constr LJ 53. The Court declined to follow *Re Tout & Finch Ltd* because in that case the principle of *pari passu* distribution of the insolvent's property under the relevant insolvency legislation was not considered.

24 But this was as much to do with the specific nature of the clause being considered, rather than the nature of the anti-deprivation rule as a whole.

25 At para. 3194.

> "It would be interesting however to hear the views of an English court on the post-liquidation effectiveness of direct payment clauses in the aftermath of *British Eagle*. The issue has provoked great controversy in different common law jurisdictions and there is a need for judicial statement or principle made after full consideration of all the competing authorities and arguments."

However, it does note earlier that the JCT contract was specifically redrafted in the 1980 version to provide for the direct payment provision to cease upon the contractor's insolvency, and that if *Re Tout & Finch Ltd* survived *British Eagle* then such redrafting was unnecessary[26].

20.4. *Totty & Moss on Insolvency* (Sweet & Maxwell, loose-leaf) recognises the distinction between *Re Tout & Finch Ltd* and *British Eagle* at para. H6-03 but expresses no concluded view.

20.5. *Keating on Construction Contracts* (8th ed, Sweet & Maxwell, 2006)[27] concludes at para. 15-038 that the traditional view of *Re Tout & Finch Ltd* would have to be reviewed following the decision in *Re McLouglin & Harvey plc (in liquidation)*, which it is asserted is of persuasive authority. It concludes by suggesting that the present JCT Standard Form, which does not permit direct payment of sub-contractors following a determination due to bankruptcy or liquidation correctly represents the law.

20.6. *Chitty on Contracts* (30th ed, Sweet & Maxwell, 2008) specifically refers to the fact that the insolvency legislation and principles were not referred to in *Re Wilkinson* and *Re Tout & Finch Ltd*, and suggests that such clauses needed to be operated with care by an employer, which should establish some means of securing return of payment from the sub-contractor if required to account to the liquidator of the contractor.

20.7. *Goode: Principles of Corporate Insolvency Law* (3rd ed, Sweet & Maxwell, 2005) comments at para. 6-11 that, but for *Glow Heating*, all the cases since *British Eagle* have distinguished the earlier cases, and have held that a direct payment clause was ineffective in the main contractor's insolvency as being contrary to the *pari passu* rule.

20.8. *Lightman & Moss: The Law of Administrators and Receivers of Companies* (4th ed, Sweet & Maxwell, 2007) submits that *Re Wilkinson* and *Re Tout & Finch Ltd* should no longer be followed, because of the effect of the decision in *British Eagle*.

20.9. *Armour & Bennett: Vulnerable Transactions in Corporate Insolvency* (2003, Hart Publishing) appears to be the only textbook that might be regarded as supportive of the more traditional, pre-*British Eagle* approach. At paras 1.49 to 1.57, its analysis supports the idea that the contractor's right to receive payment is a flawed asset, in accordance with the decision in *Glow Heating*.

21. Finally, *Davis: Construction Insolvency* (3rd ed, Sweet & Maxwell, 2008) contains a detailed analysis of the arguments for and against the validity of discretionary direct payment clauses paras. 17-009 to 17-019 and summarises the position as follows:-

> "There are therefore two lines of authority: England, Australia and the Irish Republic, on the one hand, and South Africa, Canada, New Zealand, Singapore, Northern Ireland and Hong Kong on the other. The English cases were both decisions at first instance and in neither case was the possible conflict with the *pari passu* rule argued. Re *Wilkinson* rests on a concession that the authority given to the employer to pay direct was irrevocable even on the contractor's bankruptcy. The decisions are unsatisfactory and should not be followed.

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[26] The fact that the JCT contract was first redrafted in an attempt to avoid the impact of *British Eagle*, and then re-amended to avoid the issue by excluding such a direct payment clause completely is a potential indicator of the views of the JCT draftsmen that such a clause was not longer operable.

[27] The first supplement, up to date to 31 July 2008, adds nothing to para. 15-038 of the main work.

Only the Australian decisions (and the dissenting judgment of Wessels J.A. in the *Magill* case) grapple with the real issue: is the contractor's property a debt subject to reduction by set-off following direct payment or only such amount as is left after the direct payment and set-off have been made? It seems immaterial whether the direct payment is made out of the debt owed to the contractor (as in *McMillan & Lockwood)* or made out of the employer's own funds and then set off against a debt due to the contractor. In other words, the issue is whether the debt owed by the employer is absolute subject only to contractual set-off or conditional so that it cannot arise if the contract conditions governing its accrual are never fulfilled."

Then, after having dealt with the arguments arising from *British Eagle*, it concludes:-

"Most contracts have discretionary clauses permitting a direct payment both during and on termination of the contract. The question arises whether the former could be operated where the latter is invalidated. There could be difficulties because first, it is not necessary for a clause or contractual arrangement to be operative only on insolvency to infringe the *pari passu* rule; and secondly, as the contract has provided what is to happen in the event of termination it is thought that the employer's direct payment rights may be restricted to those contained in the termination clause in that event.
In view of the absence of modern English case law, and the conflict between the two lines of authority, the position could be summarised thus:

1. A direct payment clause, whether operated during the contract or after termination, which has the effect of paying one particular group of creditors from the property of the contractor, will, if operated after bankruptcy or liquidation, offend against the *pari passu* rule because the money ought to be distributed rateably among all the contractor's creditors. This is the case whether the clauses provide for payment by the employer from its own resources and subsequent set-off against money due to the contractor or payment from money due to the contractor.

2. Whatever the merits of the public policy considerations in Re *Wilkinson,* they must yield to the *pari passu* rule. For considerations of public policy to prevail over the rule, they would have to be enshrined in statute: *Farrier-Waimak v. Bank of New Zealand* [1965] NZLR 426; *Panorama Development v. Fitzroya Investments* [2003] 1 SLR 93 (discussed in Ch. 18).

3. Even if expressed to be irrevocable, an authority given by a contractor to an employer to pay direct and set off will be defeated by the *pari passu* rule. In *British Eagle,* notice to the clearing house of any credit or debit for clearance was said to "constitute an irrevocable authority to Clearing House to clear the same and for that purpose to collect or pay (as the case may be) the amount thereof in accordance with the Regulations and current clearing procedure and to make all necessary sets off in that behalf and to pay any ultimate balance due as a result of the clearance effected." Despite this irrevocable authority, the House of Lords on a majority of three to two, decided that the clause was not binding on the liquidator (see Prentice 1983, Oditah 1992).

4. To regard the contractor's right to payment as conditional or contingent on the operation of the direct payment clause as was held in *Monkhouse* would be wrong as that would be applying the very term in the contract which offended the *pari passu* rule.

In view of current uncertainty, the prudent draftsman would still include the right to pay direct in the event of liquidation or bankruptcy but before exercising such right an employer should seek an indemnity from the subcontractor, secured if necessary, for the return of the payment if the employer is forced to pay the same amount to the liquidator. If the contractor's obligations had been guaranteed, it is advisable either to obtain the guarantor's approval beforehand or legal advice that the direct payment will not affect the guarantor's liability. In *Doe v. Canadian Surety* (1937) 1 S.C.R. 1 a guarantor was discharged from liability partly because the employer had made direct payments to subcontractors with the contractor's consent. To avoid any problems over ownership of materials or equipment whose value is included in the direct payment, a form of agreement should also be prepared in which the subcontractor gives a warranty as to title and agrees that title will pass to the employer on payment unless the goods have already been incorporated."

22. The considered view appears to be that the English cases are not reliable, and that therefore direct payment clauses do not survive the House of Lords' decision in *British Eagle*. Whilst the context and application of the anti-deprivation principle has to be seen in the context of the more recent Court of Appeal decision in *Perpetual* and *Butters*, nothing has changed.

23. It may be different if, as a matter of construction, it is clear that the Contractor's rights as against the Employer can be categorised as amounting to a flawed asset: the Contractor's right to collect the book debt due from the Employer could be construed as being conditional, or otherwise flawed, such that upon the (usually) certificate of non-payment some other provisions should come into effect in the same way that an intellectual property licence may be terminated upon an insolvency event. But, more unusually, such direct payment clauses seek to take away an asset of the Contractor, in favour of an identified class of its unsecured creditors, which does not bear the hallmark of a flawed asset.

24. The other point is that the Employer is not relying upon an insolvency event in respect of the Contractor, but is relying upon the fact of non-payment. Does that change things? Does the anti-deprivation rule still apply to it, even though the Employer is not relying upon the fact of insolvency?

25. The effect of both the decisions in *Perpetual* and *Butters* was that the anti-deprivation principle did not apply to deprivations of property that occurred before a winding up order has been made in respect of the entity that owns the property, nor did it where the deprivation was triggered by the winding up of a different entity. So, if the Employer seeks to rely upon the provision pre-administration, because it is clear at that stage that the Contractor had not paid the identified sub-contractors, then it would appear that the Clause was validly operational at that stage: in the absence of an insolvency, the Employer was entitled to rely upon it. But, in so far as the Employer has sought to rely upon the Clause post-administration, the Contractor not paying identified sub-contractors because of the administration, then it would seem that it cannot do so.

26. In relation to this issue, Patten LJ stated as follows:-

> "162. … Therefore the only real area of dispute is in relation to the enforceability of provisions which might infringe the anti-deprivation rule when operated post-bankruptcy on grounds of insolvency but which are in fact operated at that time on some alternative grounds.
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> 163. The determination of this issue is not necessary for the resolution of these appeals and does not arise on the facts. But, in the light of the decision of the House of Lords in *British Eagle*, I have some difficulty in accepting the correctness of the proposition that, following the making of a bankruptcy or winding-up order, provisions of the kind described in *Ex p. Jay* and *Ex p. Newitt* could remain exercisable on grounds other than insolvency. As mentioned earlier, the IATA clearing house rules made no specific provision for the bankruptcy of one of the airline members but were still held to contravene the anti-deprivation rule because they had the effect of excluding the property of *British Eagle* from the operation of s.302 of the Companies Act. The forfeiture of the building materials would obviously constitute a disposition of the bankrupt's property vested in his trustee otherwise than in accordance with the *pari passu* rule. On that basis, it seems to me that a provision in an agreement which removes an asset of the kind under consideration in cases like *Ex p. Mackay* and *Ex p. Jay* out of the bankrupt's estate following his bankruptcy is also caught by the rule. Once the bankruptcy or winding-up order is made the priorities between creditors is to be determined by the provisions of the Insolvency Act. The validity of the operation of a forfeiture provision of the kind considered in these cases cannot depend on whether the event relied on to trigger the provision was insolvency or a breach of the building agreement. Once 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. The creditor must prove for his loss in the bankruptcy or liquidation. I would therefore decline to follow *Ex p. Newitt* on this point. …
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> 170. … In appropriate cases the court has always reserved to itself the power to look through a transaction and to pierce the corporate veil when the property in question is in substance that of the company in liquidation. But when that cannot be done the anti-

deprivation rule has, in my judgment, to be confined to cases where property of the insolvent company or bankrupt within the meaning of the Insolvency Act is removed from the insolvent estate either for less than its market value or for no value at all.

171. There is, I think, a basic point of principle which needs to be addressed. Some of the arguments advanced on behalf of LBSF have treated the anti-deprivation rule as if it had or should have an existence and operation of its own entirely divorced from the terms of the provisions of the Insolvency Act which it is supposed to protect. Many of the contracts which feature in such cases as *Ex p. Mackay* are nowadays likely to fall foul of the express provisions of the Insolvency Act. As mentioned earlier, dispositions of the property of a company are invalidated when they occur at any time following the presentation of the petition unless validated by the court. That power will, in practice, never be exercised unless the terms of the disposition offer full value to the creditors of the company. If the dispositions are made prior to the commencement of the winding-up but at a time when the company is insolvent then the court has power to set them aside if they constitute transactions at an undervalue or a preference. Similar provisions apply in bankruptcy.

172. Although not essential for the determination of these appeals, it seems to me to be extremely questionable whether what is said to be a common law rule of public policy can have any existence or purpose at all as a legal rule separate from the Insolvency Act. Whatever may have been the position in the nineteenth century, the Insolvency Act now contains a detailed code for determining and regulating the property of a bankrupt or insolvent company for the benefit of its general creditors. The Act itself really says and does all that is necessary. By the same token, if the rule continues to exist it can have no wider scope than the statutory provisions it is designed to enforce. When Parliament has expressly considered the categories of transaction which should not be allowed to survive bankruptcy or liquidation I can see no proper basis on which the court can arrogate to itself the right to widen the sanction of invalidity so as to encompass transactions which the application of the Insolvency Act would leave untouched. That should be something for the legislature alone to decide. This has, I think, the consequence of placing the anti-deprivation principle within relatively narrow bounds the key to which, as I have explained, is the ability to identify in the transaction under consideration a disposition of property on insolvency otherwise than in accordance with the Act. But, as explained at the outset of this judgment, that is all that the authority of *British Eagle* permits. The rule is therefore restricted to protecting the creditors of the bankrupt or company in liquidation by, in effect, enforcing the provisions of the Insolvency Act in respect of their property. It does not entitle the court to set aside contracts between subsidiaries not in liquidation or administration and third parties merely because they may have some economic effect on the value of the holding company."

27. This suggests that if the deprivation is completed prior to the insolvency event in relation to the party whose right is lost as a consequence of the operation of the provision, then it does not fall foul of the anti-deprivation rule. But, if is after the insolvency event, then it does. And, if exercised after the insolvency event, it remains foul of the rule even if the right could have remained exercisable on grounds other than insolvency.

Conclusion

28. The Master of the Rolls concluded his judgment with some rather opaque comments:-

"90. In this judgment, I have tried to adhere to the logic of [the reasoning in *British Eagle*], while also bearing in mind the need for clarity and consistency in this area of the law, the undesirability of interfering with party autonomy in business transactions, the inappropriateness of the courts extending the law in areas where Parliament has enacted an extensive code, and the assistance which can be gleaned from a significant body of jurisprudence.

91. It is true that the conclusion on the second issue in each appeal, namely that a deprivation will not (at least normally) be caught by the rule if it is completed before liquidation or bankruptcy (or its equivalent), means that it may be reasonably easy in many cases to devise schemes to avoid the rule. However … the decision in *Ansett Australia* [2008] BPIR 57 shows that the effect of the rule can often be avoided by careful drafting. It is ultimately up to Parliament to legislate against anti-avoidance devices in the insolvency field, as it has done in sections 238 and 239 of the 1986 Act. Especially in an area where Parliament has intervened so substantially and so significantly, it can only be very rarely, if

ever, that it would be right for the court to invent its own anti-avoidance policies and frustrate the terms of commercial contracts freely entered into by sophisticated parties.

92. It can also be said that it is difficult to define precisely what sort of deprivation provisions are caught by the rule. That point is particularly acutely raised by the question whether there is a deprivation capable of falling within the rule in the "flip" provisions in the documentation in the *Perpetual* appeal. The difficulty is reinforced by the view expressed by Patten LJ (which I share) that the decision in *Newitt* 16 Ch D 522 cannot survive the analysis and reasoning in the speech of Lord Cross in *British Eagle* [1975] 1 WLR 758. The effect of my reasoning on the first point in the *Butters* appeal leaves, I hope, the law in a relatively clear state, but, as indicated, I am not sure that that is so true of my reasoning on the first point in the *Perpetual* appeal. However, because of the multifarious, sophisticated and increasingly complex arrangements contained in modern financial instruments, such as the synthetic collateralised debt obligations in these proceedings, it is probably inevitable that the courts must develop the law in this area, at least for the moment, on a relatively cautious, case-by-case basis."

29. The comments as regards the nature of the drafting are important. It has often been said that the distinction between the grant of a proprietary interest in property which is determinable on insolvency (a valid provision) is very difficult to distinguish from a provision for the transfer of property on terms that it shall be forfeited on insolvency (which is not valid)[28]. The judgment provides little guidance on that issue.

30. Against that background, it is difficult to know to what extent *Perpetual* and *Butters* is the final word on the matter. A rule highlighted by the House of Lords has been severely curtailed by a decision of the Court of Appeal. The Court of Appeal recognises itself that the judgment in one respect does not leave the law in a clear state, and acknowledges that against the background of modern sophisticated transactions and documentation, the further scope of the rule will have to be developed on a case-by-case basis. Indeed, the Master of the Rolls seeks to distance himself from one of his own first instance judgments, *Money Markets International Stockbrokers Ltd (in liquidation) v. London Stock Exchange Ltd* [2002] 1 WLR 1150, acknowledging that the analysis in *Perpetual* was not quite the same as, and was, he hoped, rather more focussed than, the analysis which he had earlier proffered.

31. If the first attempt of the Master of the Rolls to deal with the issue is unfocussed, and the second attempt unclear, it is difficult to see how mere mortal practitioners can deal with the rule in practice[29].

32. Perhaps such clarity as there is can be derived from the summary provided by Patten LJ at para. 172:-

"Although not essential for the determination of these appeals, it seems to me to be extremely questionable whether what is said to be a common law rule of public policy can have any existence or purpose at all as a legal rule separate from the Insolvency Act. Whatever may have been the position in the nineteenth century, the Insolvency Act now contains a detailed code for determining and regulating the property of a bankrupt or insolvent company for the benefit of its general creditors. The Act itself really says and does all that is necessary. By the same token, if the rule continues to exist it can have no wider scope than the statutory provisions it is designed to enforce. When Parliament has expressly considered the categories of transaction which should not be allowed to survive bankruptcy or liquidation I can see no proper basis on which the court can arrogate to itself

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[28] See, for example, the decision of Rattee J in *In Re Scientific Investment Pension Plan Trust* [1999] Ch 53. The Court of Appeal decision in *Fisher v. Harrison* [2003] EWCA Civ 1047; [2003] BPIR 1322 is also equally difficult to follow as regards how to distinguish between the two. It should be noted that the basis upon which it is said that a forfeiture clause purports to operate on the bankruptcy of the individual in a personal pension scheme has all the hallmarks of being the operation of the anti-deprivation rule, possibly the better ground for such clauses being void is the rule in *Re Burroughs-Fowler* [1916] 2 Ch 251 which provides that a man cannot create a protective trust of his own asset.

[29] Indeed *Look Chan Ho: The Principle Against Divestiture and the Pari Passu Fallacy* (2010) 1 JIBFL 3 considers that the Court of Appeal failed to understand the rule at all. The article considers the outcome of *Perpetual* and *Butters* and says that the conflation of the rule with the *pari passu* principle is woven with the same fibres used to form the fabric in The Emperor's New Clothes - an illusion. It reviews the decision and seeks to show that, while the actual outcome in *Perpetual* is correct, the court's understanding of the rule is breathtaking and indefensible and that the actual outcome in *Butters* is also hard to follow.

the right to widen the sanction of invalidity so as to encompass transactions which the application of the Insolvency Act would leave untouched. That should be something for the legislature alone to decide. This has, I think, the consequence of placing the anti-deprivation principle within relatively narrow bounds the key to which, as I have explained, is the ability to identify in the transaction under consideration a disposition of property on insolvency otherwise than in accordance with the Act. But, as explained at the outset of this judgment, that is all that the authority of *British Eagle* permits. The rule is therefore restricted to protecting the creditors of the bankrupt or company in liquidation by, in effect, enforcing the provisions of the Insolvency Act in respect of their property. It does not entitle the court to set aside contracts between subsidiaries not in liquidation or administration and third parties merely because they may have some economic effect on the value of the holding company."

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