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Court of Appeal upholds enforceability of priority 'flip clause'

10 November 2009

(1) Perpetual Trustee & (2) Belmont Park Investments v (1) BNY Corporate Trustee Services & (2) Lehman Brothers Special Financing Inc [2009] EWCA Civ 1160[1]

The Court of Appeal has dismissed the appeal brought by Lehman Brothers Special Financing against the decision of the High Court upholding the enforceability of a priority 'flip clause' contained in several series of credit-linked notes. Lehman Brothers Special Financing had appealed the finding of the High Court[2] that such a flip clause did not breach the rule against divestiture and was consequently enforceable. In dismissing the appeal, Neuberger LJ attempted to clarify the ambit of the anti-deprivation rule and made some helpful statements regarding the application of the rule and its scope.

"Although the amount of the security available to meet LBSF's claims is obviously reduced in the event of a shortfall in the value of the security over what it would have been had no Event of Default occurred, that is simply a function of the change in priority which was always a feature of the security which [LBSF] enjoyed."
Perpetual v BNY, Patten LJ, para 136

The facts

Perpetual and Belmont (the "**Claimants**" and the "**Noteholders**") are (or represent) noteholders of various credit-linked notes issued by SPVs (each an "**Issuer**") under a multi-issuer secured note issuance programme. The first defendant, BNY Corporate Trustee Services Ltd (the "**Trustee**"), is the trustee for these notes. The second defendant, Lehman Brothers Special Financing Inc ("**LBSF**"), is the swap counterparty for the programme.

Under each series of notes, the note proceeds were used to purchase securities which were held as collateral by the Trustee on the terms of the Principal Trust Deed, as supplemented by a Supplemental Trust Deed, to secure the obligations of the relevant Issuer to the noteholders and the swap counterparty (LBSF).

In respect of each series of notes in question, LBSF also entered into an ISDA Master Agreement and confirmation (the "**Swap Agreement**") with the Issuer under which LBSF pays the Issuer the amounts due under the notes and the Issuer, in return pays LBSF amounts equal to the payments on the collateral held by the

[1] The judgments of the Court of Appeal also ruled on the appeal from the decision of Smith J in ***Butters and Ors v BBC Worldwide Ltd and Ors*** [2009] EWCH 1954. This briefing only considers the judgment in respect of the *Perpetual* case.

[2] Please refer to our client briefing of 31 July 2009 for a summary of the High Court decision.

Issuer and, on maturity, also pays an amount calculated by reference to any credit events occurring during the term of the notes in respect of one or more reference entities.

All relevant documentation was governed by English law.

Lehman Brothers Holdings Inc (“**LBH**”), the Credit Support Provider of LBSF, entered into insolvency proceedings in the US on 15 September 2008 and LBSF entered into insolvency proceedings in October 2008, each of which constituted an Event of Default under the Swap Agreement with LBSF as Defaulting Party. There was no dispute as to the occurrence of an Event of Default.

The main provisions under scrutiny were Clause 5.5 of the Supplemental Trust Deed and Condition 44.2 of the Terms and Conditions of the Notes. Clause 5.5 provides that on an enforcement of the security the Trustee shall apply all moneys in accordance with:

> "Swap Counterparty Priority unless an Event of Default (as defined in the Swap Agreement) occurs under the Swap Agreement and the Swap Counterparty is the Defaulting Party (as defined in the Swap Agreement) or […] in which case Noteholder Priority shall apply."

"Swap Counterparty Priority" provides for payment of any termination payment due to LBSF under the Swap Agreement to be paid in priority to the redemption amount payable to noteholders and "Noteholder Priority" provides for noteholders to be paid in priority to the claims of LBSF under the Swap Agreement.

Condition 44 provides that the early redemption amount payable in respect of the Notes is the *pro rata* share of the proceeds of sale of the collateral plus (if payable to the Issuer) or minus (if payable to LBSF) the Swap Agreement Unwind Costs (essentially, the mark-to-market value of the Swap Agreement). However, Condition 44.2 provides that if an Event of Default occurs under the Swap Agreement and LBSF is the Defaulting Party, the Noteholders *pro rata* share of the proceeds from the sale or realisation of the collateral is no longer subject to the deduction of the Unwind Costs payable to LBSF.

Due to the credit-linked nature of the notes and the amounts payable under the Swap Agreement on the occurrence of certain credit events, amounts are due to LBSF under the Swap Agreement and the swap has a positive mark-to-market value in favour of LBSF (i.e. the Unwind Costs are payable to LBSF). Consequently, the change in priority of payments under Cl 5.5, and the switch to provide that Unwind Costs are not deductible under Condition 44.2, if upheld, would result in LBSF receiving less than it would otherwise have received.

“It is common ground that the rule [against divestiture] also applies … 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.”
Perpetual v BNY, Neuberger LJ, para 44

Summary of High Court proceedings

The Claimants issued claims in the High Court against the Trustee to procure realisation of the collateral held by the Trustee pursuant to the Trust Deed and its application in accordance with Clause 5.5 and Condition 44.2, i.e. payment to the noteholders in priority to paying the claims of LBSF.

LBSF contended that the Claimants were not entitled to rely on the insolvency Event of Default as triggering Noteholder Priority under Clause 5.5 or triggering Condition 44.2 as this would fall foul of the anti-deprivation principle, the rule that a contractual provision that applies on insolvency to divest the insolvent company of an asset is contrary to insolvency law and, therefore, void (the "**rule**").

The High Court rejected this argument on two grounds:

Firstly, assuming the event which triggered the switch in priority was the Chapter 11 filing by LBSF, the rule did not apply as the right granted to LBSF was a determinable interest and consequently there was no deprivation of an asset to which LBSF was entitled; and

Secondly, even if the court was wrong on the determinable interest, as the Event of Default which was first in time was the Chapter 11 filing of LBH, it was this that triggered the switch in priority, so the rule did not apply as it did not operate on the insolvency of LBSF.

These two grounds were considered by the Court of Appeal.

"It is not entirely easy to identify the rule's precise limits or even it precise nature … as the reasoning in the various judgments in which the rule has been considered is often a little opaque and some of the judgments are a little hard to reconcile." *Perpetual v BNY, Neuberger LJ, para 22*

Court of Appeal

Neuberger LJ, handing down the leading judgment, started by confessing that it is not easy to identify the rule's precise limit or its precise nature, and that the judgments which have considered the rule are difficult to reconcile.

Before addressing the two grounds upon which the High Court upheld the flip clause, Neuberger LJ went through the line of authorities, including the modern authority on the rule, ***British Eagle International Airlines v Compagnie National Air France*** [1975] 1 WLR 758 ("**British Eagle**"), and attempted to define the precise ambit of the rule. Referring to the 2008 decision of the High Court of Australia in ***International Air Transport Association & Ansett Australia Holdings Ltd*** [2008] BPIR 57, he stated that the rule is essentially based on the proposition that one cannot contract out of the provisions of the insolvency legislation which govern the way in which assets are dealt with on a liquidation. His judgment sets out the following principles to assist in understanding the rule:

First, the rule is based on public policy *but* only to the extent that one cannot contract out of the insolvency legislation.

"[the rule] can be understood as depending upon the proper application of a … provision in the relevant statute requiring that all debts proved in an insolvency rank equally." *International Air Transport Association & Ansett Australia Holdings Ltd*

Second, in each case where the rule is invoked it is essential to begin from the proposition that insolvency law is statutory and primacy must be given to the relevant statutory text.

Third, when considering whether the rule applies to a particular provision there is, in principle, no difference between cases where the provision is expressed to apply on insolvency or liquidation and those where it is not.

Fourth, the courts should not extend the rule beyond its present limits, save where logic or practicality otherwise require.

Fifthly, it is desirable that, if possible, the courts give effect to contractual terms which parties have agreed, particularly in cases of complex financial instruments as in such cases the parties are likely to be commercially sophisticated and expertly advised.

The first ground: no deprivation

Upholding the decision of Morritt J and following a similar line of reasoning, Neuberger LJ rejected the argument of LBSF that the flip clause was a deprivation of assets of LBSF consequent on the Chapter 11 filing of LBSF. He held that the effect of the flip provision was not to divest LBSF of assets currently vested in it and to re-vest them in Noteholders, nor even to divest LBSF of the benefit of the security rights granted to it. From the inception of the transaction, the priority which LBSF had in respect of the security was contingent on there being no Event of Default, in other words LBSF had no more than a contingent right to be paid out of the proceeds of the collateral in priority. Patten LJ, who gave a concurring judgment, agreed and stated simply that LBSF retains, post-bankruptcy filing, the same asset as it had before the bankruptcy filing and equally the Noteholders did not obtain any security over the collateral on the bankruptcy filing of LBSF which they did not have before.

Three further principles derived from the authorities were considered relevant to support this argument:

1. the rule applies to assets vested in the person on whose bankruptcy/liquidation the deprivation is to occur. By contrast, the right vested in LBSF did not divest on the Chapter 11 filing; LBSF retained the same contingent right post-bankruptcy as it had before.

2. The rule may have no application to the extent the person in whose favour the deprivation takes effect can show that the asset was acquired with his money.

3. The rule cannot apply to invalidate a provision which enables a person to determine a limited interest, such as a lease or a licence, which he has granted over or in respect of his own property.
This third principle has been firmly established by authority in respect of leases or licences, and even enshrined in statute[3].

“The anti-deprivation principle is little more than the direct application of he provisions of the Insolvency Act to the transaction under consideration” *Perpetual v BNY, Patten LJ, para 123*

“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.” *Perpetual v BNY, Patten LJ, para 172*

[3] s146(9) of the Law of Property Act 1925

Neuberger LJ drew a comparison between a lease or licence and a charge or provision for priorities for payment, which, while not identical, each have similar features and each confer an interest but do not confer ownership.

Neuberger LJ and Patten LJ both placed considerable weight on the second point above, referring several times in the judgment to the fact that the collateral over which security was granted in favour of LBSF and the Noteholders was acquired with the Noteholders' money (the subscription proceeds of the Notes). Neuberger LJ even went so far as to say that in the absence of this additional fact, the flip clause might well have fallen foul of the rule as presented in *Ex p. Mackay* (1873) LR 8 Ch App 643, a case involving the payment of royalties by B to A until bankruptcy and then by B to himself on the bankruptcy of A, this payment "reversal" having obvious similarities to the "flip" provisions.

The second ground: trigger not LBSF insolvency

Neuberger also agreed with the High Court that even if there has been a deprivation, the rule would not have applied in any event because the triggering event was LBH filing for Chapter 11 bankruptcy, which occurred 18 days before LBSF filed for Chapter 11. On the basis of the rule as set out in the five principles above (i.e. a prohibition on contracting out of insolvency legislation), there is nothing inconsistent with the provisions of the Insolvency Act 1986 in a provision which effects a deprivation of an asset of a company before it goes into liquidation. This is supported by British Eagle, in which the clearing arrangement between airlines, under which debts owed by and to members were set off against each other, was upheld in respect of all debts cleared prior to the winding-up of British Eagle, even though it was very likely that British Eagle was technically insolvent at this time.

Following the authority of *British Eagle*, as the triggering event was the insolvency of a third party, LBH, and not of LBSF, the rule did not apply. On this point, Neuberger J disagreed with the recent judgment of Smith J at first instance in ***Butters and Ors v BBC Worldwide Ltd and Ors*** [2009] EWCH 1954.[4]

In this respect, Neuberger LJ has greatly clarified the timing of application of the rule; the rule only operates where the deprivation occurs after a winding-up, administration or analogous proceedings and not before. Consequently, deprivation provisions having effect upon an earlier insolvency related trigger, rather than a winding-up or administration, would not be caught by the principle.

Patten LJ, also considered, *obiter*, the statements of the Chancellor at first instance that a right of forfeiture exercisable on an event other than the insolvency of the counterparty may

"It is desirable that, if possible, the courts give effect to contractual terms which the parties have agreed. Indeed, there is a particularly strong case for party autonomy in cases of complex financial instruments such as those involved in the *Perpetual* appeal."
Perpetual v BNY, Neuberger LJ, para 58

[4] Smith J, considering whether the rule applied, was of the view that it was irrelevant that it was the insolvency of the parent that was relied upon to exercise the offending divestiture clause. The court could look at the overall position and if the result is to create a better position on insolvency by invoking a provision other than a default of the insolvent party, the rule against divestiture applies.

lawfully be exercised on the alternative grounds even if the counterparty is already subject to bankruptcy/liquidation proceedings. Patten LJ did not accept this proposition, particularly following *British Eagle,* where the IATA clearing scheme made no specific reference to operating on liquidation but was held to fall foul of the anti-deprivation principle all the same. *Ex parte Newitt* (relied on by the Chancellor at first instance) was therefore overruled on this point. This did not, however, impact the decision as the alternative ground relied on for triggering the priority flip clause operated prior to the insolvency of LBSF.

In his concluding remarks, Neuberger LJ refers to the inappropriateness of the courts extending the law in areas where Parliament has enacted extensive legislation. These remarks indicate a willingness to confine the rule to provisions which would represent a contracting out of existing insolvency legislation and to limit the 'public policy' scope of the rule which might otherwise operate to apply the rule to flawed asset provisions whose effect is economically the same as a deprivation clause.

"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."
Perpetual v BNY, Neuberger LF, para 92

This re-stating of the principle could result in the rule being relatively easily circumvented by drafting techniques, however Neuberger LJ was astutely aware of this possible effect of the judgment but considered that it is for Parliament to legislate against anti-avoidance devices in the insolvency field as it has done already in respect of transactions at an undervalue and preferences in ss239 & 258 of the Insolvency Act.

Conclusion

In clearly stating that the rule should not extend beyond its present limits and aiming to define those limits, this decision goes some way to setting out the scope and circumstances in which the anti-deprivation rule will apply. In his five principles on the ambit of the rule, Neuberger LJ has confined the rule more strictly to provisions which represent a contracting out of the insolvency legislation thereby preventing the public policy creep seen in earlier authorities. Certainly, the scope of the principle as set out by the Court of Appeal in *Perpetual* v *BNY* is narrower than the principle as set out in ***Peregrine Investments Holdings Ltd v Asia Infrastructure Fund Management Co Ltd*** [2004] 1 HKLRD 598, which referred to the anti-deprivation rule as looking to "*whether a person can insist on retaining an unfair advantage to himself at the expense of creditors in a bankruptcy*".

This judgment also clarifies that the rule only applies when statutory winding-up or administration proceedings, or analogous proceedings in another jurisdiction, have been instigated and not before, even if the company is technically insolvent at that time. It also confirms that the rule has no application on the winding-up of other companies in the same group as the company which suffers the deprivation, if that company is not subject to winding-up or administration proceedings.

This clarity is to be welcomed, however the difficulty remains in identifying exactly when a provision represents a contracting out

and the courts conclusions in this area are less clear. While the judgment on one hand quite clearly states that the flip clause is part of a "contingent right" and therefore not a divestiture, Neuberger J then opens the door for the possibility that if the facts had been different and the collateral had not been acquired with the Noteholders' money, this flip clause might have fallen foul of the rule. This reliance on the limited ground that the assets over which the rights of LBSF exist were acquired with the money of the person in whose favour the flip operates leaves considerable uncertainty regarding similar flawed asset provisions where this additional fact is absent.

Having ambitiously referred to the need for clarity and consistency in this area of law, Neuberger LJ himself admits that his reasoning on the first ground does not leave the law in a very clear state and concludes that "*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.*"

"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." *Perpetual v BNY, Neuberger LF, para 93*

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