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Pari passu rule on insolvency clarified and limited.

HMRC v The Football League Ltd and The Football Association Premier League Ltd

Introduction

This case concerned the much debated "*football creditor rule*" operated by The Football League, the effect of which is that, should a football club become insolvent, the claims of its players and other football clubs have priority over the claims of the insolvent club's other creditors. HMRC challenged the validity of this rule on public policy grounds, seeking a declaration that arrangements giving "football creditors" preferential treatment breached both the pari passu rule and the anti-deprivation rule.

The judgment, delivered yesterday by David Richards J, restricts the possible application of the pari passu rule (sometimes known as the rule in *British Eagle*). This rule, and the associated anti-deprivation rule, have recently been the subject of considerable legal debate, particularly given their potential impact on intercreditor, priority and subordination arrangements under which a creditor's rights are altered on a company's insolvency.

The relevant law

The anti-deprivation rule (which may invalidate an arrangement which deprives a company of an asset by reason its insolvency) and the pari passu rule (which broadly speaking requires the insolvent company's assets to be distributed equally among its creditors) were recently considered by the Supreme Court in *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* and by the Court of Appeal in *Lomas v JFB Firth Rixson Inc*.

As Lord Collins noted in the *Belmont* judgment, there is some overlap between these two common law rules (both of which are subject to specific exceptions which have evolved over time) but "*they are aimed at different mischiefs….The anti-deprivation rule is aimed at attempts to withdraw an asset on bankruptcy or liquidation or administration, thereby reducing the value of the insolvency estate to the detriment of creditors. The pari passu rule reflects the principle that statutory provisions for pro rata distribution may not be excluded by a contract which gives one creditor more than its proper share*."

Contents

The judgment

David Richards J rejected HMRC's arguments, holding that, in most circumstances, the arrangements giving effect to the football creditor rule would not contravene either the anti-deprivation rule or the pari passu principle.

Significantly, he considered that while the anti-deprivation rule applied to all companies in administration, with immediate effect from the commencement of the administration, **the pari passu principle only applied to companies in administration from the date on which the administrator gave notice to creditors of their intention to declare a dividend**.

The commercial relevance of this judgment

It follows from this judgment that a contractual provision, such as an intercreditor agreement or a deed of priorities under which the rights of an insolvent company are varied, would not breach the pari passu rule where the relevant provision took effect on administration, but before the administrators gave notice of their intention to distribute a dividend (which, if relevant, normally occurs some time after the administration is commenced).

This point is significant as the Supreme Court in *Belmont* only gave one reason for not applying the pari passu rule when considering the validity of an intercreditor "flip clause", namely that the beneficiaries of that particular arrangement were not technically creditors of the company in administration.

This left open the possibility that other priority, intercreditor and subordination arrangements which altered the rights of the insolvent company's creditors might still fall foul of this rule. If correct, this would be a real concern, given that the pari passu rule imposes a mechanical test, looking at the effects of an arrangement, rather than the intention of the parties. A contract contravening the pari passu principle would therefore be treated as being void, even entered into as part of a bona fide commercial arrangement. This judgment appears to remove this residual concern where administration is the relevant trigger event altering contractual rights.

Conclusion

While the potential scope of the anti-deprivation and pari passu rules has over the last few years been seen as a cause for concern, counterparties structuring transactions may now take some comfort from the guidance in this case that the pari passu rule does not normally apply simply because a company goes into administration, and from the guidance in the *Belmont* case that "*it is possible to give the [anti-deprivation rule] a common sense application which prevents its application to bona fide commercial transactions which do not have as their predominant purpose, or one of their main purposes, the deprivation of the property of one of the parties on bankruptcy*."

The circumstances in which these common law rules may apply to complex commercial transactions would appear to be becoming increasingly limited.

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