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ARTICLE

On to Pastures New? Some Observations of Germany's Intended Insolvency Law Reforms

David Marks QC, Barrister, South Square, Gray's Inn, London, UK, and **Dr Robert Hänel**, Partner, anchor Rechtsanwälte, Peißenberg, Germany

It is well known that Germans love cars. German lawyers at least, love codified law. The pleasures of driving are sometimes constrained by speed limits and heavy traffic, not to mention the limitations of other drivers. But what the Germans really love about cars is the way in which they are made, repaired and even washed rather than the actual driving. Some of the same considerations apply to law reform.

In October 2009, there was a coalition agreement published by the then incoming German government. It contained a number of substantial declarations with regard to yet another attempt to reorganise insolvency law. In particular it addressed the need to promote the restructuring of businesses capable of being saved and with it, the much more important consideration of keeping people in employment. These aims were to be effected by improving the framework for out of court solutions in the case of companies and enterprises facing imminent insolvency and also by the related means of simplifying proceedings regarding what is called the insolvency plan procedure. Next, it was thought necessary to inhibit the assaults on insolvency legislation made by the finance ministries as well as the social security institutions insofar as such attacks impeded a proper and equal distribution among creditors. In addition there was felt a need to tighten up the regulations regarding the appointment and conduct of insolvency administrators as a whole. Finally, particular attention was concentrated upon the need to create some mechanism whereby there could be an effective restructuring of banks that might otherwise be facing financial difficulties at a relatively early stage. With regard to this last intention a new Restructuring Code came into force on 9 December 2010 dealing with the restructuring of financial institutions. This article, however, will not deal with that particular development but instead will attempt to provide an overview with regard to the contents of a draft bill which the German Government has recently put forward in an attempt to address the other matters which are listed above. These intended changes may well have a considerable impact upon German insolvency law and indeed European insolvency law as a whole.

Appointment of insolvency administrators

This topic will be taken first given its overall importance. Once upon a time and indeed as late as the second half of the 20th century, when insolvency cases were relatively few, lawyers would often work as administrators no doubt reflecting the fact that it was probably easier for them to take the job given their ability to access the courts more efficiently and more easily than their financial counterparts such as accountants. By the end of the 20th century, however, and certainly at the beginning of this century the number of insolvency cases and their size vastly increased. The insolvency market became more and more crowded. Quite apart from the need for administrators (whether they be lawyers or otherwise) to become more 'professional', the issue arose as to how to chose the right administrator and in particular how to regulate access to such appointments and the profession as a whole. Many insolvency courts developed their own and indeed sometimes quite diverse practices. For a long time the legislature did not step in to impose its own regulatory system. There remains even today no formal régime with regard to the licensing of practitioners. The only statutory requirements with regard to the appointment of an administrator in insolvency proceedings are that the administrator must be an individual who is experienced in business affairs, qualified for the case in question and who is independent of the creditors and of the debtor.

The general procedure can be shortly summarised. After a petition with regard to the opening of insolvency proceedings is filed, the judge will appoint an external expert to check whether the debtor is technically insolvent and whether there are sufficient assets to cover the costs of the proceedings as a whole. These are the basic pre-conditions for opening the proceedings. If necessary and invariably in the case of a going concern, the court will order certain security measures to be put in place in the sense that there will be the appointment of a provisional administrator to preserve the business. When the fully fledged insolvency proceeding is opened at a later stage, which could be as late as 3 months after the appointment of the provisional administrator, the latter will almost always be appointed as the administrator. It is only at the first meeting of the creditors' assembly that the creditors themselves can appoint their own nominee. There is a need for there to be in effect a double majority both in terms of numbers of creditors in favour of the appointment and in terms of the total amounts of their claims. However in reality when this first formal meeting takes place (which might be at any time between 6 weeks and 3 months after the opening of proceedings), it will almost invariably be too late to influence the course of the proceedings by replacing the initial appointee who would have been the provisional administrator.

Each court will chose from its list of local or supra-regional administrators. There are of course informal approaches reflecting particular pressures present in any particular insolvency. The needs of the creditors or the debtor have no statutory reflection entitling them to make suggestions. Everything often turns upon the whims of the particular judge and whether any attempt to influence his choice stands any chance of success or indeed is likely to trigger the opposite effect. In any event, reflecting an overall need to avoid some form of basic conflict, any prior involvement in the insolvency would disqualify a practitioner from being appointed as an administrator.

The unpredictability referred to in the preceding paragraph can be viewed either as an advantage within the system or as a major drawback depending on which viewpoint is taken. The new draft bill now attempts to tackle this problem by taking a small step towards creditor involvement even though in terms of the German insolvency culture, as it might be called, this represents, some would say, a huge step into an abyss with an uncertain depth.

The formal name for the draft bill can be roughly translated into the following, namely a Law for the Further Simplification of Restructuring of Businesses i.e. '*Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen*'. The underlying idea is to reflect an increased influence on the part of the parties involved with regard to the choice of an administrator. This underlying idea can be seen as blending in with the concept reflected in the formal title of the bill, namely the effecting of a reduction of any form of unpredictability and of any consequential risks which might arise to the prejudice of stakeholders by virtue of any uncertainty stemming from the choice of a suitable appointee. Any such risks are, at least from the draft bill's point of view, regarded as likely to impact upon a successful restructuring and the viability of the restructuring tools available to the business and the administrator.

At the moment, in Germany, there seems to be a fighting shy of any form of concurrent statutory out of court restructuring proceeding by adopting or even contemplating procedures which might omit or at least not allude to the actual notion of 'insolvency'. There seems to be some basic distaste for having, or even contemplating, the promotion of restructuring in formal insolvencies on the one hand, together with on the other, offering some form of extra judicial restructuring procedure which might adversely affect the chances of success for resurrecting a company or enterprise. In practical terms, this means that whenever an out of court restructuring or some form of informal basis does not work, then the stakeholders will have to revert to existing and prospective possibilities as adumbrated by the new bill.

The draft bill does however contain specific features with regard to the choice and selection of a potential administrator. First, the new provisions still adhere to the concept that the administrator must be independent of all stakeholders. However the draft does in some way water down the relevant requirements in the process. In future, specific suggestions by the parties or indeed the prior involvement of a practitioner will not automatically disqualify the latter from becoming an appointee. This does not necessarily mean that his independence is in some way threatened; the touchstone appears to be that as long as the appointee only provided general advice about the cause and the effect of an insolvency proceeding, then he can still remain a fit and proper appointee at the hands of the creditors or indeed by dint of the nomination of the debtor. The same applies, if the nominee drafted an insolvency plan with the involvement of the debtor and that of the creditors prior to the presentation of the petition which opens the insolvency proceeding.

Second, in high profile insolvency cases it has not been unusual for the management of the debtor and indeed for the main creditors, to seek to discuss the question of an appointment with the court prior to the petition opening the proceedings as a whole. As indicated above, some courts and certain judges are more open to suggestions of this sort than others. The draft bill therefore tries to codify what could be said to be a set of guidelines for judges with regard to their entering into discussions with the main creditors. According to the draft bill, the judge is now supposed to consult with the main creditors before deciding upon the appointee. If a provisional creditors' committee has already been installed (which represents another suggested change), then the court is supposed to consult the committee. It may only decline a unanimous proposal put forward by the committee on the basis of a written explanation, as to why the nominee (without mentioning his name) is not qualified to take the appointment. It could be said that this desirable aim is somewhat curious given its assumption that there is a provisional creditors' committee in place prior to the appointment of the provisional administrator himself.

The draft bill also increases the formal requirements for a debtor's petition to open insolvency proceedings. In future the petition will not only have to be in written form and comment on the grounds for the insolvency; the debtor will in addition among other things have to provide a list of the main claims against him in particular the main secured claims and the claims of tax and social security authorities in order for the court to identify key creditors or key nominees for the purposes of a provisional creditors' committee. It can only be assumed that some judges might consider it more urgent in any particular case first to appoint a provisional administrator and then a provisional creditors' committee, given the prospect that the latter's ideas regarding the provisional administrator might not correspond with the Judge's own and therefore cause the whole process to be slowed down.

Finally, the reforms expand the debtor's possibilities in what can be called a form of self administration. Should the debtor file his or its own petition to open insolvency proceedings at a stage when illiquidity is only imminent, and should he or it do so joined with an application for a self administration, coupled with formal confirmation on the part of an accountant or lawyer that illiquidity is imminent as contended for, and that restructuring will obviously not be futile, then the court has to grant a three-month period in which an insolvency plan must be drafted. In this constellation or pre- requisites the debtor has the possibility to put forward his or its own nominee as a (provisional) custodian – the (provisional) administrator's equivalent in self administration proceedings. The court can only decline to accept the debtor's nominee, if the latter is obviously unqualified.

A moment's thought in considering these changes should show that not all these features are going to be welcomed with open arms by all those involved in insolvency law in Germany. Germany's biggest association of insolvency practitioners, namely the VID (*Verband Insolvenzverwalter Deutschlands e.V.*) has already informally suggested, that big law firms specialising in advisory work are negotiating take-overs with practitioners specialising in administration in order to put themselves in what could be called a 'full service' position. This would enable them to cover not only out of court restructurings but the more formal insolvency administrations procedures for the same clients as well. At least one judge in the German Supreme Court has expressed the fear that should the draft bill become law, it might indeed sign the end of the era of independent insolvency administrators.

Alongside all the above there remains an ongoing discussion about whether and how to regulate access to the profession. One aspect of that discussion is the Ministry of Justice's view that according to the EU Services Directive, Germany will have to allow for the fact that, apart from individuals who can take appointments, corporate bodies can also become administrators. Furthermore, there are efforts especially by the VID in effect to seal off the market. VID members who are already part of that organisation have just gone through a quality management certification procedure voluntarily. There is in addition an aim to institute a binding professional code of conduct. These discussions have also led to the formal suggestion that there be access tests or formal examinations with regard to the qualification of insolvency practitioners as a whole.

Amendments to Insolvency Plan Proceedings

When the present German Insolvency Code came into force on 1 January 1999, it did so as a result of reform efforts that were started more than 20 years beforehand. After intensive discussions and two reports on the part of a specifically established commission of scholars and practitioners, the end result could be seen to be deeply influenced by the ideas of Thomas Jackson who had authored a work published in 1986 by the Harvard University Press entitled *The Logic and Limits of Bankruptcy Law* as well as by US Chapter 11 proceedings as a whole. However, the reforms in Germany went well beyond the US-American model. In the wake of Jackson's ideas, one of the main characteristics of German insolvency law is that there is only one kind of proceeding that is solely aimed towards satisfying the creditors of an insolvent debtor on an equal and rateable basis either by means of a liquidation and/or sale and/or restructuring of the underlying business depending on the best outcome thought to be achievable for the creditors as a whole. The German insolvency code includes the possibility of a plan proceeding known as the insolvency plan procedure ('*Insolvenzplanverfahren*') which can be started at any time within an insolvency proceeding. The right to present a plan lies with the debtor or with the administrator. The creditors' assembly can take the initiative by commissioning the administrator to draw up a plan as to which the assembly can determine the objectives. The difference between the German model and its equivalent in other jurisdictions is that an insolvency plan is supposed to remain a very flexible tool, not simply geared towards the restructuring of a business. In this respect the plan proceeding is broadly similar to that envisaged and set up under the US Bankruptcy Code Chapter 11, including the formation of and voting in and by groups of creditors together with a cram-down rule for dissenting minorities should the latter not suffer a loss by comparison with the situation that might arise without a plan.

Initially at least, and for a while after its implementation, the plan proceeding concept aroused high expectations. Those expectations might have been relatively unsophisticated, perhaps inevitably so, and for a while remained so, given the fact that the plan proceeding formula was only sparsely used in practice for quite a long time. This could be said to reflect a typical form of German reserve towards things which are otherwise strange and unfamiliar. One other explanation is that the new instrument just did not fit with regard to most of the cases that came up in the sense that the latter simply did not qualify for any formal plan solution. Where a business was already moribund at the time the petition for an insolvency proceeding was filed or was in its death throes, it was arguable that even the most creative insolvency plan could offer little, if any alternative treatment for the patient. However, in time it came to be seen that the real drawback of the present plan proceeding is the inherent danger that it takes too long and is prone to excessive risks of appeal and other legal uncertainties. Moreover, critics of the current position increasingly came to demand a workable option whereby debt could be exchanged for equity by means of the plan itself.

The draft bill now seeks to solve at least the last mentioned issue. Among other things, it is now possible for the first time under German law to involve shareholders of the debtor in an insolvency proceeding by virtue of reconstituting the debtor as a 'group' with its own identity within the insolvency plan and then effecting or allowing the effecting of a change in the shareholders' ownership rights by means of a debt to equity swap. The draft provisions therefore grant shareholders the right to vote on the plan should their ownership rights be affected. There is therefore a new-found ability on the part of shareholders to form groups within the overall categories of creditors and shareholders as a whole, and, in particular, groups representing small claim creditors and shareholders who might hold less than 1% or EUR 1,000 worth of the available equity. If no member of a shareholder group participates in the voting on the plan, that fact shall be counted as denoting agreement by that group. The draft provisions also contemplate the shortening of deadlines with regard to court activities and with regard to hearings generally with a view to speeding up the process. In addition, the requirements for admissible appeals are being increased. Furthermore, single creditors are no longer able to block the plan coming into force by means of an appeal on their own score, should the plan otherwise provide for a proper reserve for such creditors.

The draft bill also includes what can be viewed as a solution statement in an attempt to resolve the often intractable problem of how to deal with potentially unknown creditors who have not lodged their claims in the proceedings. The provisions relating to and the limitations of the plan are now made to apply with regard to such creditors. Their claims are to be time barred after one year following the date on which the plan comes into force.

Most of the provisions described above are largely to be welcomed and indeed are not regarded as controversial by scholars and practitioners alike. Nonetheless, some critics still point out that the provisions regarding the inclusion of shareholders might unnecessarily be said to complicate matters. It is claimed there is simply no justification to grant shareholders who have worthless ownership rights the same participation possibilities as other creditors.

The intended changes to the plan proceedings are accompanied by an organisational change with regard to the internal jurisdiction of the insolvency court. According to the draft bill, jurisdiction with regard to the governance of insolvency plan proceedings is to be with the judge and is to remain so. This issue requires some explanation. In Germany, what can be regarded as a question of jurisdiction or competence with regard to insolvency proceedings is split as between the judge and the registrar. Each has a temporary role in that the judge as distinct from a registrar makes a decision as to the petition to open an insolvency proceeding and with regard to the governance of the proceedings up to the point. As soon as the proceeding is opened, the relevant jurisdiction or competence switches to the registrar for the rest of the proceeding unless the judge decides to retain jurisdiction, which hardly ever happens. The suggested changes which are designed to give the judge rather more responsibility reflect the fact that the work of insolvency judges is largely administrative and of limited interest, and many judges do not work full time in the insolvency department. Shifting the jurisdiction with regard to running of an insolvency plan to the judge can be seen as an attempt to make his or her job more interesting and more particularly to motivate suitable candidates to specialise and thereafter stay within that area. Needless to say, the official rationale is that a judge is likely to be more capable than a registrar in handling the economic implications of plan proceedings as a whole. Remarkably the draft bill explicitly seeks to codify the fact that judges as well as registrars working in the insolvency department are supposed to have or shortly will have to acquire specialised knowledge in the fields of insolvency law, commercial and corporate law as well as basic knowledge of insolvency related aspects with regard to labour, social, tax law and accountancy issues. Additionally, there are plans to reduce the number of insolvency courts in Germany presently standing at 187. This, too, was designed to improve expertise amongst core personnel and also to create more full time jobs with a correspondingly higher degree of confidence.

Paradigm changes in respect of debtor in possession proceedings

Debtor in possession proceedings can also be described as a form of self administration. This possibility within an insolvency proceeding was invented in 1999 but has hardly ever been used in practice. One of the main reasons centres on the fact that a debtor without any specific knowledge of insolvency law and practice will usually not be able to administer his or its own insolvency proceeding in any adequate manner. The other attendant reason was one of psychology and indeed of culture. For centuries, bankruptcy has been considered as a social stigma in Germany rather than as a chance for a new start. This is why German insolvency law has always favoured creditors' interests, rather than those of the debtor. This is also why German legal and commercial culture has always been extremely hesitant in allowing (to revert to the analogy set out at the beginning of this article) the driver to remain in the driver's seat given that he was considered responsible for crashing the car.

The notions set out in the preceding paragraph can be inferred from the current provisions of the insolvency code. A pre-condition for self administration is, apart from the debtor making the application itself or himself, that, dependant on the circumstances, the proceedings and the creditors will not suffer any disadvantage should the debtor stay in possession. The court has an obligation to end self administration on the application of a creditor who demonstrates in a credible fashion that the said pre-condition has ceased to apply and indeed it must end self administration on an application made by the creditors' assembly without any pre-conditions.

The above means that self administration in effect represents the exception rather than the rule. The draft bill now seeks to reverse that state of affairs. A court is now supposed to allow a debtor's request for self administration if it knows of no circumstances that lead to the expectation of any disadvantage for the creditors. In the case of there being a provisional creditors' committee backing the debtor's application or in the event of there not being such a committee, should the main creditors do so, and if there is no indication that there exists any disadvantage with regard to the joint interests of all creditors, then the court must assume that self administration is not detrimental to the creditors as a whole. Furthermore, the court has to justify any decision to the contrary in a written judgment.

The draft bill also seeks to remove an existing inconsistency in the current provisions. If there is a debtor's application for self administration which is not obviously futile, the court must now consider installing a provisional custodian instead of a provisional insolvency administrator. Furthermore, the court is supposed not to deprive the debtor fully or his or its power to dispose of his or its assets.

Overall, the possibility of the debtor nominating his own, albeit provisional, custodian and receiving a grace period for the drafting of an insolvency plan, is supposed to make self administration and restructuring on the basis of an insolvency plan more attractive. It is also designed to motivate debtors to file a petition for insolvency proceedings at an early stage even though a pre-packaged plan may not have been drafted. This motivation is backed up by yet another provision: If, in the case of an illiquidity being only imminent, the court intends to reject a debtor's application for self administration, it has to notify the debtor and offer the possibility to withdraw the petition to open insolvency proceedings prior to the court's decision.

Co-operation of courts in cross-border cases

Everybody knows that in cross-border cases where there is more than one insolvency proceeding in one jurisdiction, it can be extremely helpful as well as time saving simply to pick up the phone and discuss problems and share information with colleagues or counterparts abroad. In a number of cases that was exactly what some German judges did, even though their influence in the actual course of the proceedings, apart from the appointment of the administrator, is and remains small. Nevertheless, and this may be considered typically German in a way, the problem was spotted that there was no legal basis for international phone calls by an insolvency Judge and therefore there may now be a reluctance to take such measures.

The draft bill takes up that problem and includes the Regulation that if according to German law an insolvency proceeding in another jurisdiction has to be acknowledge, the German insolvency court may co-operate with the foreign insolvency court and in particular may pass on information that may be of relevance for the purposes of the foreign proceeding.

An old saw: money against principle

Neither German jurisprudence nor its terminology includes the expression or concept 'priority claims' let alone 'preferential claims'. However, some types of claim have to be paid out prior to others, e.g. the costs of the proceedings prior to other debts created by activities of the insolvency administrator and the latter prior to claims that arose prior to the opening of insolvency proceedings. Overall, German thinking and terminology do not focus upon the order in which claims get paid: rather upon their legal status, mindful of the time at which such claims arise.

German insolvency law before 1999 knew of the concept of ranking amongst unsecured creditors whose claims arose prior to the opening of insolvency proceedings. In particular, tax claims and social security claims enjoyed a form of priority status. In 1999, the insolvency code abolished such a ranking and there was uniform praise for the new concept of equal treatment for all except of course on the part of certain disappointed beneficiaries. Since that time, nobody has seriously questioned the overall concept. On the contrary, many commentators consider this as one of the prime equitable achievements of the reforms in 1999. Years later, however, the insolvency battlefield now begins to reveal deep cuts suffered by the Government finance departments and by social security institutions. Those organs are normally the first to try and cut away body parts during the final writhings of the debtor whilst the debtor is in economic difficulties. Their advantage in comparison to other creditors is in particular that they can create their own executory titles and have their own enforcement staff. They are also however the preferred victims of the extensive claw back provisions under German insolvency law. That dangerous cocktail resulted in the finance ministries and the related departments together with the social security institutions imposing an increasing amount of pressure on the legislators to curtail the activities of administrators and of the courts. It all culminated in a series of events which perhaps should be kept secret from and remain unknown to all those who still seek to preserve some form of idealistic faith in the democratic systems of Western governments and the rule of law.

The coalition agreement created by the current German government in 2009 has already been mentioned. It agreed on the otherwise noble purpose of preserving the jewel of equal treatment of creditors on the one hand and on the other, defending it against any allegedly immoral attacks. Nobody really catered for, let alone foresaw, the fiscal implications of the recent and ongoing global crisis. The draft bill therefore contained provisions that would have resulted in the finance ministries becoming more or less the only beneficiaries of insolvency proceedings. Massive opposition from all sides was able to avoid the worst. There has been in this respect one particular new piece of legislation though coming into force on 1 January 2011 arising out of all the matters which have been described.

Prior to that date and during a preliminary insolvency proceeding, in which the full power of disposal of the debtor's assets is not transferred to the provisional administrator, German law allowed the debtor only to pay current liabilities where necessary to continue the business. This meant in practical terms that apart from other cash claims that the debtor had to defray, VAT for taxable turnover during that period could be ignored and the tax authorities had to lodge their claim after the opening of the insolvency proceedings as a normal unsecured creditor. According to the new regulations which have been passed at the beginning of 2011, this will no longer be possible and VAT has to be paid in full for the period of the preliminary proceeding.

There is no question but that this change will affect the liquidity of a debtor's business and thus make its continued existence more difficult. Furthermore, it seems openly to contradict the main principle of equal treatment of creditors as articulated and reflected in the Government's own promises in the coalition agreement, coupled with the explicit aim of the draft bill, promoting as it seeks to do , insolvency proceedings as a restructuring tool. However, it could have been worse. It may be said to represent an object lesson in how legislation really works. Reverting for the last time to the initial analogy at the beginning of this article, it may be better not to develop the perfect car. That would simply deprive us of the fun of constructing other ones.

CASE REVIEW SECTION

Balance Sheet Insolvency: A Commercial Approach

Charlotte Cooke, Barrister, South Square, London, UK

Introduction

In *BNY Corporate Trustee Services Limited v Eurosail-UK 2007-3BL Plc & Ors* [2011] EWCA 227 the Court of Appeal was called on to consider for the first time:

i) The test for whether a company is unable to pay its debts set out in section123(2) of the Insolvency Act 1986 ('section 123(2)') (the so-called 'balance sheet insolvency test') and, in particular, the requirement that a company's contingent and prospective liabilities are taken into account; and

ii) The relevance of a post-enforcement call option ('PECO') to the assessment of balance sheet insolvency under section 123(2).

Upholding the Chancellor's first instance decision, the Court of Appeal held that, notwithstanding that Eurosail's audited accounts showed it to have net liabilities, Eurosail was not unable to pay its debts within the meaning of section 123(2); it was not balance sheet insolvent. The Court of Appeal's decision on this first issue meant that it did need to address the relevance, if any, of the PECO, but it did so in any event, agreeing with the Chancellor that, although the effect of the PECO was to render Eurosail bankruptcy remote, it would not necessarily follow that it was not unable to pay its debts within the meaning of section 123(2).

Background

Notes ('the Notes') were issued to various classes of noteholders by Eurosail, a special purpose vehicle incorporated in England. The Notes provide that an 'Event of Default' occurs in the event of Eurosail being 'unable to pay its debts as they fall due, or within the meaning of Section 123(1) of (2) (as if the words 'it is proved to the satisfaction of the court' did not appear in Section 123(2)) of the Insolvency Act 1986 (as that Section may be amended from time to time), being deemed unable to pay its debts'.

The Notes also featured a PECO which gave a company under common control with Eurosail the option, following the realisation and distribution of Eurosail's assets, to acquire the remaining Notes for a nominal sum.

The Notes were denominated in sterling, euros and US dollars, with Eurosail hedging its currency exposure through swap agreements with Lehman Brothers Special Financing Inc ('LBSF'). Following the collapse of Lehman Brothers in 2008, payments ceased to be made by LBSF under the swaps and a dispute arose between various groups of noteholders as to whether Eurosail was unable to pay its debts within the meaning of section 123(2), meaning that an Event of Default had occurred.

If an Event of Default had occurred, and was deemed by the trustee for the noteholders ('the Trustee') to be 'materially prejudicial' to the noteholders' interests, the consequence would be the service of an Enforcement Notice and, crucially, a change in the order of priority in which the noteholders were to be paid.

In order that this dispute could be resolved, proceedings were issued by the Trustee, with the relevant noteholders being added as parties, and the Trustee taking a neutral position. The key issues between the various groups of noteholders were firstly whether, without regard to the PECO, Eurosail was unable to pay its debts within the meaning of section 123(2) and secondly, whether, if without regard to the PECO Eurosail was unable to pay its debts, the existence of the PECO meant that in fact Eurosail was not unable to pay its debts within the meaning of the same section.

The balance sheet insolvency test under section 123(2)

Section 123(2) provides that a company is deemed unable to pay its debts 'if it is proved to the satisfaction of the court that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities'.

The Court of Appeal noted that there was no previous case law addressing the interpretation of section 123(2), although this is perhaps not that surprising given that what normally concerns creditors is whether they are being paid and, if they are not, they are able to rely in presenting a winding-up petition on the so-called 'cash-flow insolvency test' contained in section 123(1)(e) of the Insolvency Act 1986 ('the company is unable to pay its debts as they fall due'). Helpful guidance as to the interpretation of section 123(2) was however found in the Report of the Review Committee Insolvency Law and Practice Cmmd 8558m, 1982 ('the Cork Report') and a later white paper entitled 'A revised framework for insolvency law, Cmmd 9175'.

Consideration of the history and purpose of section 123(2), and in particular of the Cork Report, led the Court of Appeal to reject the argument put forward by some of the noteholders to the effect that section 123(2) simply required an offsetting of a company's assets against its liabilities, with the company's assets and liabilities being taken at their values as set out in the company's accounts. Section 123(2) did not represent a 'wholly new, relatively mechanical 'assets-based' basis for seeking to wind up a company' (per Lord Neuberger), otherwise there would follow the 'extraordinary' consequence that many companies early on in their lives, and indeed many successful companies, would not be able to pay their debts within the meaning of section 123(2). The only protection for such companies would be the Court's discretion not to making a winding up order but, as the presentation of a winding up petition itself can have serious detrimental consequences for a company, such protection would be inadequate.

As such the Court of Appeal clearly took a commercial approach in rejecting the assets-based interpretation of section 123(2) and this commercial approach also underpins its positive account of what the test contained in section 123(2) does amount to, it being stated that section 123(2) applies to a company whose assets and liabilities (including contingent and future liabilities) are such that it has reached 'the point of no return, 'the end of the road' or in respect of which 'the shutters should be put up'. Such a conclusion, Lord Neuberger MR says, is supported by commercial common sense.

As to when a company can be said to have reached 'the point of no return', Lord Neuberger admits that the test is imprecise, judgment-based and fact specific. Indeed, whilst he states that the decision 'is to be determined with a firm eye on commercial reality and on commercial fairness', he goes on to say that it would be 'positively dangerous' to give much further guidance as to the approach to be adopted by a court in deciding whether section 123(2) applies to a set of facts. That said, it is clear from the judgment that a company's audited accounts are a starting point and should be given weight, although that is it, such accounts showing only one true and fair view of a company's financial situation (being an historical view, based on accounting conventions). Further the length of time before a debt will become due and the likelihood or otherwise of a contingency occurring are also factors which may need to be taken into account in assessing whether section 123(2) applies on a particular set of facts.

On the facts before the Court of Appeal, Eurosail's audited accounts showed a net deficit. Further taking into account Eurosail's claim in LBSF's bankruptcy, which was not provided for in its audited accounts, was in effect cancelled out by the fact that its net liabilities were understated in its audited accounts as they were prepared on the basis that the PECO rendered the Notes limited recourse. Crucially though, Eurosail's deficit was, for the most part, the result of the cost of currency following the failure of its currency swap agreements with LBSF. As many of Eurosail's liabilities would not fall due until well into the future, there was potential for significant changes in Eurosail's position due to currency fluctuations. As such, taking a commercial approach to assessing Eurosail's financial situation, it could not be said that it has reached 'the end of the road' and it was not therefore unable to pay its debts within the meaning of section 123(2); it was not balance sheet insolvent.

Effect of the PECO

In order that issuers of notes can satisfy rating agency requirements, they need to be 'bankruptcy remote', by which is meant that they will not be put into insolvency proceedings. One way of satisfying such requirements is to limit claims against the issuer to whatever proceeds are realised on the enforcement of security, so-called 'limited recourse'. However, in light of concerns as regards the tax consequences of limited recourse structures, PECOs have in some cases been used as an alternative, the effect of the PECO being that in practice noteholders would never have recourse against the issuer save to the extent of its assets.

The question that was raised in the present case was whether, if without reference to the PECO Eurosail was unable to pay its debts within the meaning of section 123(2), the existence of the PECO, which in effect meant that the noteholders would never have recourse against Eurosail, save to the extent of its assets, entailed that Eurosail was not in fact unable to pay its debts within the meaning of section 123(2). The Court of Appeal having decided that section 123(2) did not apply, even without reference to the PECO, it was not necessary for the Court of Appeal to address this issue, though the arguments having been made it chose to do so in any event.

The view taken by the Court of Appeal was that the PECO did not have the same effect as limited recourse provisions in that, although the PECO renders Eurosail bankruptcy-remote, it does not follow that it is insolvency-remote or, in other words, that it cannot be unable to pay its debts within the meaning of section 123(2). The key point is that the PECO does not limit the recourse of noteholders prior to the option being enforced.

Conclusion: a commercial approach

Given the dearth of case law as to the interpretation of section 123(2), the Court of Appeal's decision is a welcome clarification that the test contained in that section is not an assets-based test but a test of whether a company has reached the end of the road, to be approached with a firm eye on the commercial reality. This would appear to be good news for debtors generally, as well as issuers of notes more specifically, as it gives more scope for companies trading out of financial difficulties than might otherwise have been the case.

That said, as it readily acknowledged, the Court of Appeal did not provide much by way of guidance as to how the balance sheet insolvency test set out in section 123(2) is to be applied in other cases. At least in the structured finance context then, it may be that we see customised provisions replacing references to section 123(2) in order that the uncertainty that the Court of Appeal's decision entails can be remedied.

Finally, it is worth considering, in light of the Court of Appeal's decision, the relationship between the tests for balance sheet and cash flow insolvency. It would still seem to be the case that a company can be balance sheet insolvent without being cash flow insolvent in that it is still able to pay its debts as they fall due, but the Court of Appeal's decision would also seem to have had the effect of bringing these tests closer together, even to the extent of the tests becoming blurred at the edges, though looking at matters with a firm eye on commercial reality and commercial fairness, as Lord Neuberger MR urged, this consequence might be welcomed.

At the time of writing it is not known whether there will be an appeal to the Supreme Court.

CASE REVIEW SECTION

Re Rodenstock GmbH [2011] EWHC 1104 (Ch)

Barry Isaacs QC, Barrister, South Square, London, UK[1]

The decision of Mr Justice Briggs in *Re Rodenstock GmbH* [2011] EWHC 1104 (Ch) follows several recent cases in which solvent foreign companies have been restructured using schemes of arrangement under Part 26 of the Companies Act 2006 (the '2006 Act').[2] The decision is important because it is the first to consider in detail:

i) the effect on the court's jurisdiction created by the passing into English law of the Judgments Regulation[3] and the Insolvency Regulation;[4] and

ii) whether an English law legal relationship is a sufficient connection for the purposes of exercising the court's jurisdiction to sanction a solvent scheme.

For the reasons set out below, the Judge concluded that the court had jurisdiction to sanction a solvent scheme in respect of a foreign company and, in the exercise of his discretion, he sanctioned the Scheme.

The jurisdictional issues arose from the following facts:

i) Rodenstock is incorporated in Germany and has its centre of main interest there;

ii) Rodenstock has no establishment in the UK nor any assets in the UK likely to be affected by the Scheme;

iii) there is no comparable jurisdiction under German law to sanction solvent schemes;

iv) a recent decision of a German court[5] has declined to recognise an English judgment sanctioning a solvent scheme pursuant to the Judgments Regulation.

Rodenstock is the main operating company in the Rodenstock group, which is Europe's fourth largest manufacturer of spectacle lenses and frames. Its headquarters are in Munich, its main production facilities are in Europe and Thailand and its products are, outside Germany, distributed across the globe by Rodenstock's subsidiaries. Rodenstock's turnover is approximately EUR 258 million, of which some EUR 4 million is generated from customers in England. Rodenstock has outstanding senior debt of approximately EUR 305 million ('the Senior Debt') which was advanced under a facilities agreement ('the Agreement') governed by English law and containing an exclusive jurisdiction clause in favour of the English courts.

The purpose of the Scheme was to bind the lenders of the Senior Debt ('the Senior Lenders') to a variation of their rights under the Agreement sufficient to enable Rodenstock to implement a restructuring. The dissentient Scheme Creditors consisted of entities which were either managed by Alchemy Special Opportunities LLP ('Alchemy') or which had sold their beneficial interest in the Senior Debt to one of those Scheme Creditors managed by Alchemy. Alchemy voted against the Scheme, but shortly before the hearing it notified its intention no longer to oppose it.

Jurisdiction to sanction solvent schemes

The starting point for the court's analysis of the jurisdiction to sanction the Scheme was the meaning of 'company' in section 895 of the 2006 Act. This provides (so far as relevant) as follows:

> '(1) The provisions of this Part apply where a compromise or arrangement is proposed between a company and … its creditors, or any class of them.
>
> (2) In this Part … "company" means any company liable to be wound up under the Insolvency Act 1986 …'

Notes

1 Barry Isaacs QC acted for the Coordinating Committee of Senior Lenders of Rodenstock GmbH.

2 Recent cases include *Re Drax Holdings Ltd* [2004] 1 WLR 1049; *Re La Mutuelles du Mans Assurances IARD* [2006] BCC 11; *Re DAP Holding NV* [2006] BCC 48; *Re Sovereign Marine & General Insurance Co Ltd* [2006] BCC 774; *Re La Seda de Barcelona SA* [2011] BCLC 555; *Re Tele Columbus GmbH*, unreported, December 2010 (Briggs J); *Re Metrovacesa SA*, unreported, 29 March 2011 (Vos J).

3 Council Regulation (EC) No 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters.

4 Council Regulation (EC) No 1346/2000 on insolvency proceedings.

5 Case 8U46/09, Oberlandesgericht Celle.

So the first question was whether Rodenstock is 'liable to be wound up' under the Insolvency Act 1986 ('the 1986 Act'). Sections 220 and 221 of the 1986 Act provide (so far as relevant) as follows:

> '220 Meaning of "unregistered company"
>
> For the purposes of this Part, the expression "unregistered company" includes any association and any company, with the exception of a company registered under the [2006 Act] in any part of the United Kingdom.
>
> 221 Winding up of unregistered companies
>
> (1) Subject to the provisions of this Part, any unregistered company may be wound up under this Act; and all the provisions of this Act about winding up apply to an unregistered company with the exceptions and additions mentioned in the following subsections.
>
> (4) No unregistered company shall be wound up under this Act voluntarily, except in accordance with the [Insolvency] Regulation.
>
> (5) The circumstances in which an unregistered company may be wound up are as follows –
>
> (a) if the company is dissolved, or has ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs;
>
> (b) if the company is unable to pay its debts;
>
> (c) if the court is of opinion that it is just and equitable that the company should be wound up.'

These provisions have not been treated as giving the court carte blanche to wind up a foreign company. On the contrary, there evolved three judge-made conditions for the making of a winding up order in relation to a foreign company, namely:

i) that the company had a sufficiently close connection with England (usually, but not invariably, in the form of assets within the jurisdiction);

ii) that there was a reasonable possibility of benefit accruing to creditors from the making of a winding up order; and

iii) that one or more persons interested in the distribution of assets were persons over whom the English court could exercise jurisdiction.[6]

In *Re Drax Holdings Ltd* [2004] 1 WLR 1049, Lawrence Collins J concluded that these requirements went to discretion rather than to jurisdiction in relation to the winding up of a foreign unregistered company.

European legislation

Lawrence Collins J held in *Re Drax Holdings Ltd* that, in relation to a Cayman or Jersey company, the Judgments Regulation was not engaged. That conclusion was consistent with *Re Harrods Buenos Aires Ltd* [1992] Ch 72 (CA), to the effect that the Judgments Regulation was concerned only to resolve issues as to jurisdiction between member states, leaving otherwise intact the common law doctrine of forum conveniens in relation to conflicts of jurisdiction between England and non-member states. This decision has been overruled by the ECJ in *Owusu v Jackson* [2005] QB 801, so Briggs J had to address this issue unaided by *Re Drax Holdings Ltd*.

In relation to insolvent companies, the combined effect of Articles 2(a), 3.1 and 3.2 of the Insolvency Regulation is that, in relation to a company with its COMI in a member state other than the UK, the English courts have jurisdiction to wind up only if the company possesses an establishment within the UK. Such a winding up is to have effect only in relation to the assets of the debtor situated within the UK.

Briggs J held that the position in relation to English court's jurisdiction to wind up a solvent company is less clear. The winding up of a solvent company is not excluded by Article 1.2(b) of the Judgments Regulation. However, Briggs J held, in reliance on the Schlosser Report, that proceedings to wind up a solvent company are 'Proceedings which have as their object ... the dissolution of companies' within the meaning of Article 22.2 of the Judgments Regulation. It follows that exclusive jurisdiction to wind up a solvent company is given to the courts of the member state (if any) in which the company has its seat. So the English court has no jurisdiction to wind up Rodenstock, whether solvent or insolvent.

Following the lead given in *Re Drax Holdings Ltd*, Lewison J concluded in *Re DAP Holding NV* [2006] BCC 48 that the expression 'liable to be wound up' did not depend upon transient considerations which might change from time to time, such as whether the company was or was not solvent. He held that the locations of a debtor's COMI or establishments were transient in the same way, because the debtor could properly choose to relocate its business or open an establishment in the territory of another member state. Since there was no warrant for distinguishing between transient matters of that kind and transient matters such as the day-to-day financial position of the corporation, there was nothing in the Insolvency Regulation which precluded the court from concluding that a foreign corporation was liable to be wound up.

Notes

6 See *Real Estate Development Co* [1991] BCLC 210, per Knox J at 217, approved by the Court of Appeal in *Re Latreefers Inc* [2001] BCC 174.

Lewison J held that, by virtue of Article 1.2(b) of the Judgments Regulation, the sanction of a scheme of arrangement was excluded from the scope of the Judgments Regulation. He drew comfort from the similar conclusion reached by Pumfrey J in *Re La Mutuelles du Mans Assurances IARD* [2006] BCC 11.

Briggs J disagreed. He held that proceedings seeking the court's sanction of a solvent scheme did fall within the scope of the Judgments Regulation, for the following reasons:

i) As is asserted in the Schlosser Report, the Judgments Regulation and the Insolvency Regulation were 'intended to dovetail almost completely with each other'.

ii) The German language version of Article 1.2 of the Judgments Regulation excluded only such judicial arrangements, compositions and analogous proceedings as arise in a bankruptcy or insolvency context.

iii) If solvent schemes were excluded from the Judgments Regulation, they would not be not capable of being recognised or enforced under Chapter III. This conclusion would be likely to detract from the utility of the sanction by an English court of a scheme relating to a solvent company having its COMI, establishments or assets in other member states.

It did not follow that, because Article 22.2 of the Judgments Regulation deprived the English court of jurisdiction to wind up any solvent company which had its seat in a member state other than the UK, the meaning of 'liable to be wound up' as the touchstone for the court's scheme jurisdiction was impacted. This was because neither the Insolvency Regulation nor the Judgments Regulation appeared on their face to have been directed at restricting the English court's jurisdiction in relation to solvent schemes, and because company law consolidation since they were introduced as part of English law had re-enacted the 'liable to be wound up' touchstone for jurisdiction in an unaltered form.

For these reasons, Briggs J concluded that Rodenstock is a company 'liable to be wound up' under the 1986 Act, in accordance with the meaning which that phrase, purposively construed, has in section 895(2)(b) of the 2006 Act, and nothing in either the Judgments Regulation or the Insolvency Regulation had narrowed the scope of the meaning of that phrase, or, therefore, the definition of 'company' which it provides.

Discretion

The case for a sufficient connection with this jurisdiction essentially depended upon the combination of the Senior Lenders' choice of English law and exclusive jurisdiction as governing their lending relationship with Rodenstock.

Briggs J held that the Senior Lenders' choice of English law had the consequence that their rights as lenders were liable to be altered by any scheme sanctioned by a court (whether or not the English court) to the extent that English law recognised the jurisdiction of that court to do so. The alteration of the English law contractual rights of the dissentient majority achieved by a scheme of arrangement sanctioned under Part 26 of the 2006 Act occurred because Parliament had legislated to that effect by conferring jurisdiction upon the English court.

The Judge therefore concluded, on a fairly narrow balance, that the connection with this jurisdiction constituted by the choice of English law and, for the benefit of the Senior Lenders, exclusive English jurisdiction were a sufficient connection for the purposes of permitting the exercise by the court of its scheme jurisdiction in relation to Rodenstock. This was not a case where, merely by happenstance, a majority or even all of the Scheme Creditors had separately chosen English law and/or jurisdiction to govern their individual lending relationships with Rodenstock. Rather, it was a case where they had collectively done so by a single agreement which governed what was in substance a single facility or set of facilities to which they had all contributed.

The Judge also considered whether the Scheme would be effective in binding the opposing creditors into a variation of their rights as Senior Lenders, bearing in mind that they would be prima facie entitled to enforce those rights by litigating in Germany, since the jurisdiction clause in the Agreement was exclusive only for the benefit of the Lenders and could therefore be waived by them. The principal difficulty with a conclusion that the Scheme would in practice be effective for this purpose was the decision of the Oberlandesgericht Celle in case 8U46/09. The German court had refused to recognise the sanctioning by the English court of a scheme relating to Equitable Life, as varying the German law rights of certain policyholders against the company. It had concluded that the English court's decision to sanction the scheme could not be characterised as a judgment within the meaning of Article 32 of the Judgments Regulation.

Rodenstock adduced the opinions of two German law experts that, in practice, a decision by the English court to sanction the Scheme would be legally effective in Germany because the German courts would, pursuant to the Rome Convention, apply English law to the question whether the Senior Lenders' rights against Rodenstock had been varied by the Scheme. It appeared therefore that in any litigation between the dissentient Senior Lenders and Rodenstock in Germany, their rights would be found to have been varied after a trial on the merits, rather than by the shortcut of automatic recognition of the Scheme under chapter III of the Judgments Regulation.

The merits of the scheme

Briggs J was satisfied that the court should sanction the Scheme, as being one which had been voted for by creditors acting bona fide in their interests and without coercion of the minority, and a Scheme which, objectively, an intelligent and honest creditor acting in its own interests might reasonably approve. He relied on five matters in particular, as follows:

i) The Scheme had emerged from a lengthy process of negotiation during which all reasonably practicable alternatives had been analysed, and their implications and consequences presented in detail to the Senior Lenders.

ii) No alternative restructuring involving the voluntary participation of the Senior Lenders had come near achieving majority support.

iii) The Scheme had received the support of an overwhelming majority, both by number and value, of the Senior Lenders and there was no evidence that any of them had been motivated in reaching a decision to support the Scheme by anything other than an independent and prudent perception of their own commercial interests.

iv) The alternative options, not involving voluntary participation by the Senior Lenders, all appeared to involve one or more types of insolvency process and none of them appeared to offer a combination of benefit and risk which was as attractive as that offered by the Scheme, and the restructuring of which it formed part.

v) The principal objection expressed by the dissentient creditors, namely that if their rights were left unaltered they would be likely to do better, was contradicted by the evidence.

Conclusions

This case brings considerable clarity to a jurisdictional issue relating to solvent schemes that has hitherto been lacking. It also establishes that the choice of English governing law and exclusive jurisdiction in a company's lending agreements constitutes a sufficient connection for the purpose of exercising the court's jurisdiction to sanction a solvent scheme of arrangement. The decision reinforces the important role English courts can play in relation to the restructuring of foreign companies whose lending arrangements are governed by English law and exclusive jurisdiction clauses.

The case leaves at least two important issues relating to solvent schemes to be decided on future occasions.

The first concerns a proposed scheme where none (or possibly only a minority) of the members or creditors of the scheme company are domiciled in the UK. Briggs J expressed a perception that Chapter II of the Judgments Regulation may have been intended to provide a comprehensive code regulating the international jurisdiction of each of the member states in relation to all civil and commercial matters within the scope of the Judgments Regulation. That code may have been the quid pro quo for the obligation on each member state to recognise and enforce, subject only to limited exceptions, every other member state's judgments, without (subject again to limited exceptions) its own examination of the originating court's jurisdiction. Generally speaking, but subject to important exceptions, Chapter II allocated jurisdiction by reference to the domicile of the intended defendants. None of the exceptions were apt to address the international jurisdiction of the courts of member states in relation to solvent schemes. The primary basis for the allocation of member states' international jurisdiction was ill-equipped to deal with proceedings for the sanctioning of schemes of arrangement, since they were not, at least in form, proceedings aimed at specific defendants at all.

Briggs J said that the solution to this conundrum may be that, where there appears a lacuna in Chapter II in relation to proceedings within the scope of the Judgments Regulation, then each member state may continue to apply its own private international law, by analogy with Article 4. Alternatively it may be necessary to shoehorn proceedings which do not in form involve suing anybody into the structure of Chapter II, by identifying the place or places of domicile of persons with a right to appear and oppose the relief sought, so as, for example, to apply Article 6.1 in a case where one or more members or creditors of a company affected by a proposed scheme is domiciled in the UK, as if such persons were all quasi defendants.

It was unnecessary for Briggs J to resolve this conundrum, because more than 50% (by value) of Rodenstock's Scheme Creditors were domiciled in England, so that the English court had jurisdiction whichever solution were to be adopted.

The second unresolved issue relates to the Judge's conclusion 'on a fairly narrow balance' that the connection with this jurisdiction constituted by the choice of English law and exclusive jurisdiction was a sufficient connection for the purposes of permitting the exercise by the court of its scheme jurisdiction.

The Agreement regulated not merely a series of individual creditor/debtor relationships between each lender and Rodenstock, but the relationship between each of the Senior Lenders inter se, and between them as a body and Rodenstock. The Judge suggested by way of contrast the case of a Japanese shipping company, a majority of whose creditors were shipowners based in various countries, each of whom separately chose to use charterparties governed, in accordance with typical maritime usage, by English law. Briggs J said that a structure of that kind would be a less persuasive candidate for supplying the necessary connection with this jurisdiction for the purpose of sanctioning a scheme of arrangement for the Japanese company.

Another contrast, not considered by the Judge, is the case of an overseas company whose lending agreements are governed by foreign law and/or a foreign jurisdiction clause. Suppose these provisions are amended in favour of English law and jurisdiction by majority consent, pursuant to the amendment provisions in the lending agreements. It remains to be seen whether or not this would constitute a sufficient connection with the jurisdiction for the purpose of sanctioning a solvent scheme in relation to the company.

CASE REVIEW SECTION

Belmont Park Investments Pty Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc. [2011] UKSC 38

Charlotte Cooke, Barrister, South Square, London, UK

Introduction

On 27 July 2011 the Supreme Court handed down judgment in *Belmont Park Investments Pty Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc* [2011] UKSC 38. This case called on the Supreme Court to consider the scope of the so-called anti-deprivation principle, pursuant to which contractual provisions purporting to dispose of property on bankruptcy or liquidation, thereby reducing the value of the insolvent estate to the detriment of creditors, may be invalid. The judgment provides welcome clarification as to the factors the courts will consider in deciding if the anti-deprivation principle is engaged in a particular case. Moreover, unanimously dismissing the appeal, the Supreme Court held that the contractual provisions in issue in this case did not infringe the anti-deprivation principle, a decision which should provide comfort to those working in the investment product market.

Background

As part of the Lehman Brothers so-called 'Dante Programme' notes were issued by special purposes vehicles ('the Issuers'), with the subscription proceeds paid by investors being used to purchase government bonds and other secure investments ('the Collateral'), which vested in BNY Corporate Trustee Services Limited ('the Trustee') pursuant to a trust deed and supplemental trust deed. In addition the Issuers entered into a swap agreement ('the Swap Agreement') with Lehman Brothers Special Financing Inc ('LBSF'), pursuant to which LBSF received the income on the Collateral and, in return, paid to the Issuers the interest that was due to the noteholders.

Crucially, the supplemental trust deed contained a clause, which came to be referred to as the 'flip clause', providing that LBSF would have priority in relation to realisation of the collateral, unless one of the numerous 'Events of Default' under the Swap Agreement occurred, in which case the noteholders would have priority thereto.

The proceedings

On 15 September 2008 and 3 October 2008 respectively, Lehman Brothers Holding Inc ('LBHI') and LBSF filed for Chapter 11 protection, both events constituting Events of Default under the terms of the Swap Agreement.

Thereafter the parties who would become the first 29 Respondents in the Supreme Court case ('the Belmont Noteholders'), being the noteholders of a number of series of notes issued as part of the Dante Programme, issued proceedings in England against the Trustee for orders to procure the realisation of the Collateral and its application in favour of the Belmont Noteholders in priority to LBSF, by virtue of the application of the flip clause. Further English proceedings to similar effect were issued by Perpetual Trustee Co. Ltd ('Perpetual'), which also held notes issued as part of the Dante Programme.

In summary the position adopted by LBSF, which was joined as a party to these proceedings, was that its rights under the Swap Agreement and over the Collateral were the property of LBSF within the meaning of that term as defined in the Insolvency Act 1986 and formed part of LBSF's insolvent estate and moreover that it was illegitimate to provide for the alteration of those rights in reliance on LBSF's bankruptcy; to do so would breach the anti-deprivation principle.

Proceedings were also commenced by LBSF against the Trustee in the United States Bankruptcy Court for the Southern District of New York for a declaration that the flip clause altering LBSF's right to a priority distribution vis-à-vis Perpetual breached the United States Bankruptcy Code and, as such, was unenforceable.

On 28 July 2009 Sir Andrew Morritt at first instance held that the relevant contractual provisions did not in fact fall foul of the anti-deprivation principle and were valid as a matter of English law. He further held that, in any event, the anti-deprivation principle was not engaged because a prior Event of Default had occurred before the filing by LBSF for Chapter 11 protection, i.e. the filing by LBHI. On 6 November 2009 the Court of Appeal upheld Sir Andrew Morritt's judgment. However, in the US proceedings, in January 2011, Judge

Peck gave summary judgment in favour of LBSF, deciding that the flip clause breached the United States Bankruptcy Code.

Although permission to appeal to the Supreme Court was subsequently given, as well as permission to appeal Judge Peck's decision, the proceedings relating to the notes held by Perpetual were settled before those appeals were heard. As such, the appeal before the Supreme Court concerned only the notes held by the Belmont Noteholders.

The Supreme Court's decision

The Supreme Court unanimously upheld the Court of Appeal's decision and dismissed the appeal. The leading judgment was given by Lord Collins, with whom Lords Phillips, Hope, Walker and Clarke and Lady Hale agreed. Lord Mance agreed that the appeal should be dismissed, but for slightly different reasons.

Lord Collins engages in a thorough analysis of the case law on the anti-deprivation principle, considering cases, dating back to the eighteenth century, where the arrangements in issue were held to infringe the principle, as well as those where they were not. In view of all this case law the view was taken that 'the anti-deprivation rule is too well-established to be discarded despite detailed provisions set out in modern insolvency legislation, all of which must be taken to have been enacted against the background of the rule.'[1]

As to the all-important question of when the anti-deprivation principle is infringed, the emphasis is very much on the limited scope for engagement of the principle insofar as complex commercial transactions are concerned; in such cases, where possible, the courts should give effect to the contractual terms agreed by the parties. The key point to be taken from the judgment is perhaps encapsulated in Lord Collins' statement that 'It is possible to give that policy 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.'[2]

Lord Collins also considered whether, if, as in the present case, the property in question came from the person to whom it is to go to on bankruptcy, that is relevant to whether the arrangement in issue infringes the anti-deprivation principle.[3] Although, it is said, the anti-deprivation principle is not prevented from applying purely because the source of the relevant assets is the person to whom they are to be transferred on bankruptcy, this may be a factor pointing to the conclusion that the transaction was commercial one entered into in good faith, thus not infringing the anti-deprivation principle.

Applying this reasoning to the facts of the case before it, the Supreme Court considered that the transaction in issue was a complex commercial transaction entered into in good faith, there never having been any suggestion that the relevant provisions were deliberately intended to evade insolvency law.[4] That, it was said, was obvious from the wide range of non-insolvency circumstances capable of constituting an Event of Default under the Swap Agreement. The flip clause was intended to deal with the risk that LBSF might not be in a position to provide sufficient funds to the Issuer for it to pay the noteholders; the provision was intended to regulate the delicate relationship between the noteholders' risk and LBSF's risk.[5]

In view of the conclusions reached by the Supreme Court as to the scope of the anti-deprivation principle insofar as complex commercial transactions entered into in good faith are concerned, it was not necessary for the Supreme Court to decide whether LBHI's earlier filing for Chapter 11 protection constituted an Event of Default under the Swap Agreement, with the consequence that, as the deprivation did not occur by reason of LBSF's bankruptcy, the anti-deprivation principle was not engaged. Though Lord Mance did not express a view on this issue, Lord Collins concluded however that it did.

Conclusions

Three key points can be extracted from the Supreme Court's judgment in this case. First, the anti-deprivation principle only applies where there is an intention to evade insolvency law. Second, the source of the assets in question is not determinative, but may be relevant to whether the parties intended to evade insolvency law, or entered into the transaction in good faith. Third, the anti-deprivation principle does not apply where the deprivation takes place otherwise than by reason of the bankruptcy.

This is clearly welcome guidance as to the factors the courts will consider in deciding if the anti-deprivation principle is engaged in a particular case and should provide comfort to those working in the investment

Notes

1 At [99].
2 At [104].
3 Lord Mance disagreed with Lord Collins as to this part of his analysis.
4 At [109].
5 At [111]-[112].

product market. That said, the outer limits of the scope of the anti-deprivation principle remain, perhaps inevitably, difficult to define; it remains to be seen where the line will ultimately be drawn. Particular provisions are therefore still going to need consideration on a case by case basis as regards their enforceability.

A further continuing issue stems from the cross-jurisdictional nature of many transactions. Whilst a provision might not fall foul of the anti-deprivation principle as a matter of English law, it does not necessarily follow that it is enforceable in other jurisdictions that might be relevant. Again this is something that will continue to require consideration on a case by case basis.

Folgate London Market Limited v Chaucer Insurance PLC

Henry Phillips, Barrister, South Square, London UK

Any insolvency lawyer worth his or her salt will be familiar with the so-called 'anti-deprivation principle' and the mantra that 'a man cannot make it a part of his contract that, in the event of his bankruptcy, he is then to get some additional advantage which prevents the property being distributed under the bankruptcy law'.[1] Nevertheless, in light of the recent proliferation in cases citing and applying the principle, and in light of its antiquity,[2] it is likely to come as a surprise to many insolvency lawyers that, before the decision in *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758, there were only two reported twentieth century cases in which the principle was alluded to or applied.[3] Moreover, it was not until almost thirty years after *British Eagle*, in the decision of Neuberger J in *Money Markets International Stockbrokers Limited v London Stock Exchange Limited*,[4] that the principle was once again revisited.

Even the briefest of historical overviews tells that the torrent of cases on the anti-deprivation principle in recent years is without precedent. To be sure, this has been driven, in part, by an unprecedented global financial crisis which has provided lawyers with a number of high-profile and well funded insolvencies and administrations to level their arguments at. But it has also been driven by an uncertainty as to the ambit of the anti-deprivation principle and a worrying lack of clarity as to its policy-based justifications. The principle has thus been seen as a 'golden-bullet' which, as the *Perpetual*[5] case aptly demonstrates, administrators and liquidators are not afraid to discharge in order to unwind, on insolvency, highly complex transactions between sophisticated commercial counterparties.

Whatever the Supreme Court decides when the appeal in *Perpetual* is handed down and whatever clarification they give or fail to give as to the outer-limits of the anti-deprivation principle, its core-penumbra is tolerably clear. A person cannot agree to divest himself of a vested right in insolvency. The decision of the Court of Appeal in *Folgate London Market Limited v Chaucer Insurance PLC*[6] is, perhaps, a textbook illustration of this very simple principle.

The facts

In 2005 a company known as Milbank Trucks Limited ('Milbank') was successfully sued for damages arising out of a road traffic accident. Milbank was insured by Chaucer Insurance Plc ('Chaucer'), the respondent, but was not entitled to an indemnity on as the claim fell within an exception contained in the policy.

Milbank sued its insurance broker, Folgate London Market Limited ('Folgate'), the appellant, alleging negligence in arranging its insurance cover with the respondent. That claim was settled by agreement (the 'Indemnity Agreement'). Under the terms of the Indemnity Agreement Folgate agreed to indemnify Milbank in respect of its liability for damages on the 'Due Date for Payment', defined as falling 21 days after full and final determination of the quantum of damages payable by Milbank to the victim of the road traffic accident.

Before the Due Date for Payment, Milbank entered into administration. The administrators assigned Milbank's interest the Indemnity Agreement to Chaucer, which commenced a CPR Part 20 claim to enforce its terms. Folgate sought to defend the action by relying on clause 11 of the Indemnity Agreement, which provided:

> 'In the event that Milbank is placed in liquidation, administration or a receiver is appointed … at any time prior to the date upon which any payment made by

Notes

1 *Ex parte Mackay* (1873) LR 8 Ch App 643 at 648.

2 The earliest case I am aware of which applies a form of the anti-deprivation principle is a decision of Lord King in the 1720s in *Wise's Case* Ca. T. King 46.

3 The bankruptcy case of *Re Johns* [1928] Ch. 737 and the corporate insolvency case of *Re Apex Supply Company* [1942] Ch 108 where the principle was unsuccessfully relied upon.

4 [2002] 2 BCLC 347.

5 *Perpetual Trustee Company Limited v BNY Corporate Trustee Services Limited* [2010] BCC 59.

6 [2011] EWCA Civ 328.

[Folgate] … is due to be made, Milbank's right to an indemnity from Folgate will cease with immediate effect and [Folgate] will automatically be released from all and any further obligation under the terms of this agreement'

Chaucer claimed that clause 11 fell foul of the anti-deprivation principle and, accordingly, was unenforceable.

The first instance decision

At first instance, Folgate argued that clause 11 placed a time-limit on the obligation to make a payment under the agreement and that, as there was no reason why a time limit by reference to a date could not have been validly provided for in the agreement, there was no reason why such a time limit could not be imposed by reference to an event, namely the onset of Milbank's insolvency.

This argument was rejected by Sir Edward Evans-Lombe. There is an essential difference between a simple time limitation and a limitation by reference to the commencement of an insolvent liquidation. Indeed, this difference underpins the operation of the anti-deprivation principle. If Folgate's argument were correct, it would mean that the seminal case of *Ex Parte Mackay*[7] could have been decided differently. In that case, the parties agreed that an entitlement to receive certain royalties would be partially lost if the receiving party became insolvent. On one view, the agreement imposed nothing more than a time limit by reference to insolvency. Nevertheless, the anti-deprivation principle applied.

The appeal

On appeal Folgate adopted a different line of argument, placing significant reliance upon the observations of Briggs J in *Lomas and Others v JFB Firth Rixson Inc and Others.*[8]

In *Lomas*, Briggs J highlighted a distinction between choses in action 'representing the *quid pro quo* for something already done, sold or delivered before the onset of insolvency'[9] and choses in action which represent the '*quid pro quo* … for services yet to be rendered or something still to be supplied by the company in an ongoing contract'.[10] In the case of the former, the court would be slow to permit the insertion, even *ab initio*, of a flaw in that asset triggered by the onset of insolvency. In the case of the latter the court would readily admit the insertion of such a flaw, 'there being nothing contrary to insolvency law in permitting a party either to terminate or adjust what would otherwise be an ongoing relationship with an insolvent company'.[11]

Armed with this distinction, Folgate argued that a provision in the Indemnity Agreement requiring Milbank to provide it with assistance in conducting a defence of the road-accident victim's claim was commercially linked with the release of its payment obligation under clause 11. That is, the agreement recognised that the *quid pro quo* for Folgate paying an indemnity to Milbank was Milbank's assistance in defending the claim. It was argued that upon Milbank entering into an insolvency process, such assistance would cease. The purpose of clause 11 was, then, to release Folgate from a payment obligation in circumstances when the full consideration for such obligation was not going to be provided. As such, it did not fall foul of the anti-deprivation principle.

The Court of Appeal roundly rejected this argument. As a matter of construction, the Indemnity Agreement was not intended to release Folgate from its obligation to pay the indemnity in circumstance where Milbank was unable to offer assistance. If the parties had intended that to be the case, they could easily have provided so expressly.[12] The commercial reality was that Folgate's payment obligation was the *quid pro quo* for Milbank agreeing to stay its negligence claim.[13] The true position, according to the Court of Appeal, was that clause 11 was a 'naked attempt to provide that, whilst Milbank's right to payment and Folgate's obligation to pay were to survive so long as the payment would accrue exclusively to the benefit of [the victim], they were to be extinguished if such payment would instead such payment would instead be available for Milbank's creditors generally'.[14]

Folgate also submitted, although apparently without much conviction, that it was wrong to view Milbank's right to payment as an asset available to creditors, to which the anti-deprivation principle could apply, because it was of the essence of that asset that it was a chose in action in respect of which the clause 11 condition prevented it from being so available.[15] In short, it

Notes

7 (1873) LR 8 Ch App 643.
8 [2010] EWHC 3372 Ch.
9 *Ibid.* at [108].
10 *Ibid.* at [108].
11 *Ibid.* at [108].
12 [2011] EWCA Civ 328 at [19].
13 *Ibid.* at [21].
14 *Ibid.* at [22].
15 *Ibid.* at [23].

was argued the creditors were not deprived on the asset because it was not one to which they ever had a right. This argument is obviously fallacious as it is premised upon the validity of clause 11, the very thing it seeks to establish. It was rejected unequivocally by the Court of Appeal.[16]

Comment

There can be little doubt that the decisions both at first instance and on appeal were absolutely correct. It was hopeless to argue, as at first instance, that the anti-deprivation principle did not apply on the basis that the clause in question limited the right to receive payment by reference to an event, namely insolvency. Such argument in fact describes the quintessential conditions for the operation of the principle. As long ago as 1861 in *Whitmore v Mason* (1861) 2 J & H 204 Sir W. Page Wood V-C had held:[17]

> 'the law is too clearly settled to admit of a shadow of doubt that no person possessed of property can reserve that property to himself until he shall become bankrupt, and then provide that, in the event of his becoming bankrupt it shall pass to another and not to his creditors'

It was similarly futile to suggest that the *quid pro quo* for the agreement to indemnify had not yet been received by Folgate when Milbank had agreed to stay its claim in negligence in consideration for Folgate entering into the Indemnity Agreement.

The contention at the heart of *Folgate London Market Ltd v Chaucer Insurance Plc* was really whether the anti-deprivation principle applies to choses in action at all. The Court of Appeal was bound by the decisions in *Ex parte Mackay* and *British Eagle* to hold that it does and, insofar as the anti-deprivation principle is intended to defend the principle of pari-passu distribution, there are few grounds for arguing otherwise. The facts in *Folgate London Market Ltd v Chaucer Insurance Plc* were really on all fours with the decision in *Ex parte Mackay* and, as the Court of Appeal observed, represented 'an even more blatant example of the relevant vice'.[18] Whereas in *Ex parte Mackay* the debtor was only deprived of a right to receive royalties up to a certain limit, in *Folgate London Market Ltd v Chaucer Insurance Plc* the debt was, purportedly, wholly released.

Folgate London Market Ltd v Chaucer Insurance Plc ought, then, to be seen as an uncontroversial application of a controversial principal. Unlike the netting provisions in *British Eagle*, the relevant clause had no broader commercial justification. It was a bald attempt to effect the deprivation of an asset on insolvency and, as such, contrary to public policy.

Notes

16 *Ibid.* at [24], [29].
17 At 212.
18 [2011] EWCA Civ 328 at [28].

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