In Practice

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Belmont Park Investments and the anti-deprivation principle: wider implications?

This In Practice article considers the implications of the Supreme Court judgment in *Belmont Park* within and beyond the world of finance.

The recent, much anticipated decision of the Supreme Court in *Belmont Park Investments PTY Ltd v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc* [2011] UKSC 38 has finally clarified the interaction between complex financial arrangements and the anti-deprivation principle enshrined in English insolvency laws.

However, the decision has implications both within and beyond the world of finance. In the world of football, HMRC and the Football League/Premier League were eagerly anticipating clarity in their long-running dispute over the 'football creditor' rule. Similarly, in the broader commercial world, the decision may add impetus to the 'Holding rescue to Ransom' campaign led by R3 (the insolvency trade body) which has been highlighting the effect termination provisions triggered by insolvency have on the ability to turnaround insolvent businesses.

THE BACKGROUND

The background to the case was set out in the article by Jo Windsor published in the September edition of JIBFL ([2011] 8 JIBFL 451). In essence, the priority of payments waterfall reversed the position of the swap counterparty and noteholders on an insolvency of the swap counterparty (the 'flip'), which is a market standard provision in securitisations.

THE ANTI-DEPRIVATION PRINCIPLE

The nature and application of the anti-deprivation principle was considered at length in the judgment by Lord Collins and Lord Mance. The principle is derived from common law.

Put simply, the rule provides that a contractual term purporting to remove a debtor's assets on its insolvency may be invalid.

THE JUDGMENT

Lord Collins commented that the anti-deprivation principle is well established but he identified certain limits on the application of the principle. These limits were considered in Jo Windsor's article but include:

- The principle will only apply where there is an objective intention to evade the insolvency rules.
- Wherever possible the courts should seek to give effect to contractual terms which parties have agreed, particularly in cases of complex financial arrangements. Therefore, commercial transactions entered into in good faith and without an intention to evade insolvency laws will generally fall outside the scope of the anti-deprivation principle.
- There is a distinction between a limited interest determinable on insolvency (a 'Flawed Asset') and an absolute interest which is forfeited upon insolvency by a condition subsequent (an 'Outright Asset'). The former was found not to fall foul of the principle but the latter would and it was not up to the courts to amend this long-standing distinction.

FINANCING ARRANGEMENTS

The judgment has implications for financing arrangements, beyond the specifics of a priority flip in waterfall provisions.

More significantly, the position in this case was litigated in the US where the '*ipso facto*' rule was applied (which prevents termination of a contract by reason of a contracting party's insolvency) and the flip held to be invalid. Had the *Belmont* case, therefore, been decided in the US, there would have been an opposite result with the swap counterparty's priority remaining ahead of the noteholders.

This apparent conflict between insolvency laws in the US and England and Wales may lead to parties to complex financial arrangements 'forum shopping' and choosing England and Wales as the governing law for the transaction to ensure that their agreement is upheld.

Many financing arrangements are not confined by geographical borders and contracting parties are free to choose the governing laws which would best support the nature of the agreement between parties. However, conflict may remain where parties to a financing transaction have the required connection to the US to seek the protection of US insolvency laws.

COMMERCIAL CONTRACTS

Many commercial contracts (and the vast majority of construction and supply chain contracts) governed by English law contain a termination for default clause and cite the insolvency of one of the parties as being a default. The validity of these clauses has never been entirely beyond doubt and the distinction between whether the termination amounted to limiting a Flawed Asset or forfeiture of an Outright Asset has been blurred.

There was some concern that the outcome of the *Belmont* case may lead to an extension of the anti-deprivation principle into an '*ipso facto*' rule which invalidated these termination provisions. However, the judgment provided comfort that the anti-deprivation principle would not be extended in this way and that the courts would be reluctant to interfere where such provisions are negotiated in good faith and without an intention to evade the insolvency rules.

However, Lord Collins was reluctant to remove the distinction between the forfeiture of an Outright Asset and the limited Flawed Asset, which he suggested was the preserve of the legislature. Practitioners must, therefore, remain wary of any arrangement

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whereby title in an asset is expressed to pass to a different party on insolvency which (absent legislation) would continue to fall foul of the anti-deprivation principle.

The judgment has not, however, served to aid the R3 'Holding rescue to Ransom' campaign. This campaign has focussed on the barrier provided by such termination clauses to corporate rescue in the UK. While utility companies are prevented by statute from terminating their services on the insolvency of their customer, this does not extend to other essential suppliers (particularly IT, computer and accounting software suppliers). In order to secure continuation of these essential services whilst a rescue plan is put in place, often ransom payments in the form of higher tariffs or upfront payment terms are demanded.

While utility companies are restricted from terminating their supplies, they are also not currently restricted from changing pricing and payment terms. The campaign believes a change in the law to restrict these practices would lead to a significant increase in company rescues and the saving of thousands of jobs (without putting such suppliers at risk).

As the *Belmont* judgment has not resulted in a widening of the anti-deprivation principle into an '*ipso facto*' rule, the R3 campaign will need to focus on its lobbying for an appropriate extension to s 233 of the Insolvency Act 1986 to cover other essential suppliers and ransom payments.

HMRC AND THE FOOTBALL LEAGUE

Both HMRC and the Football League were also awaiting the judgment with interest in the hope that it would end their long running dispute relating to the position of 'football creditors' in the insolvency of a football club. Indeed both sides made representations to the Supreme Court and postponed their own case in anticipation of the outcome.

The background to their dispute relates to the so-called 'football creditor' rule by which the Football League/Premier League require that a club, in order to retain its place in the league, must emerge from administration via a company voluntary arrangement ('CVA') in which all football creditors (ie players, managers, the league and other clubs) are paid in full and in priority to all other creditors. Following the Enterprise Act in 2002, HMRC lost its status as a preferential creditor and instead became an ordinary unsecured creditor and are therefore now paid *pari passu* (ie on an equal footing) with other unsecured creditors.

As a result, in certain high-profile football club administrations, HMRC has received a fraction of what was due to it along with other local businesses whilst football creditors have been paid in full. While such arrangements require the approval of 75 per cent of creditors at the CVA creditors' meeting, HMRC would need to prove it has an ascertained or liquidated debt large enough to block the arrangement. Given that other creditors have appeared willing to be subordinated to football creditors in order to see their local club survive, in many cases HMRC has not been able to block the application of the football creditor rule.

Unfortunately, any hopes that this long-running dispute would be resolved by the *Belmont* case proved unfounded as the Supreme Court determined that the two cases hinged on different insolvency rules. While the validity of the flip in *Belmont* brought into question the anti-deprivation principle, the football creditor issue related to the *pari passu* rule (also known as the rule in *British Eagle* after a case of the same name ie the rule that all creditors on an equal footing should be treated equally in the context of formal insolvency).

HMRC will, therefore, have to wait at least until its hearing in November to get clarity in this dispute. Moreover, the dispute seems to go beyond a clarification of the *pari passu* rule as ultimately the football creditor rule is reliant on creditor approval. The position of the Supreme Court in the *Belmont* case in refusing to encroach on the position of the legislature in amending long-standing insolvency rules

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may mean that HMRC will ultimately need to rely on the intervention of Parliament.

However, HMRC does seem to have some high-profile allies. Indeed the Culture Media and Sport Committee has recently called for the scrapping of the football creditor rule by any means necessary. Press reports of overpaid players being paid in full in priority to (and arguably at the expense of) normal trade creditors has only fuelled debate on fairness and application of the rule.

CONCLUSIONS

The rare look by the Supreme Court into certain core principles of insolvency law in the *Belmont* case has, therefore, provided a little clarity as well as provoking further debate in areas that go beyond the narrow confines of the case.

The judgment was not only welcomed in the financing world in upholding the validity of flip arrangements in waterfall provisions, but suggests a divergence from US practice which may have consequences for the future legal forum for these arrangements. The judgment can also be welcomed as further support for Flawed Asset termination clauses in ordinary construction, supply chain and other commercial contracts (while not removing the distinction preventing the forfeiture of an Outright Asset on insolvency).

However, despite the representations from HMRC and the Football League, the case has not ended the football creditor debate which has been postponed for the time being until their hearing in November and potentially until the intervention of Parliament. The case has also not provided any support to the R3 'Holding rescue to Ransom' campaign which will also need to look for Parliamentary backing. ■