INTERNATIONAL FINANCE SPRING 2010
MATERIALS PACKET 8: LEGAL RISK AND INSOLVENCY
Caroline Bradley[1]

In these cases courts in England and the US considered the relationship between contractual provisions (In contracts governed by English law) relating to events of default, and bankruptcy law (where the bankruptcy was taking place in the US). Although English law and US law aim to protect creditors of an insolvent debtor by denying effect to certain contractual arrangements which remove assets from the bankruptcy estate (in England this is known as the anti-deprivation principle, in the US as a rule against ipso facto clauses), the courts in the different jurisdictions reached different conclusions as to the effect (or lack of effect) of the contractual provisions in question.

The cases thus illustrate cross-border legal risk. Not only does insolvency threaten to disrupt contractual relationships, but differences in insolvency law in different jurisdictions mean that the application of provisions of a contract can vary

[1] Professor of Law, University of Miami School of Law, PO Box 248087, Coral Gables, FL, 33124, cbradley@law.miami.edu ; http://blenderlaw.umlaw.net/ .

depending on the jurisdictions which might be relevant in the context of a contracting party's insolvency.

Perpetual Trustee Co. Ltd V BNY Corporate Trustee Services Ltd (Ch) [2009] EWHC 1912 (Ch)

1 In October 2002 Lehman Brothers International (Europe) ("LBIE") established a multi-issuer secured obligation programme, called the Dante Programme. Its purpose was to provide, in effect, a form of credit insurance in respect of loans or other obligations owed to LBIE or another company in the Lehman Brothers Group ("a Lehman company") by debtors called reference entities. For the purpose of the issues before me the essential elements of the Dante Programme were:

(1) the issue of notes to investors by a special purpose vehicle ("the issuer") formed by a Lehman company in a tax friendly jurisdiction;

(2) the purchase by the issuer with the subscription money paid for the notes of government bonds or other secure investments ("the collateral") vested in a trust corporation;

(3) a swap agreement entered into by a Lehman company and the issuer under which the Lehman company paid the issuer the amounts due by the issuer to the noteholders in exchange for sums equal to the yield on the collateral;

(4) the amount by which the sum payable under the swap agreement by the Lehman company exceeded the yield on the collateral represented the premium for the, in effect, credit insurance provided by the noteholders;

(5) the amount payable by the Lehman company to the issuer on the maturity of the notes (or on early redemption or termination) was the initial principal amount subscribed by the investors less amounts calculated by reference to events defined as credit events occurring during a specified period by reference to one or more reference entities, thereby giving effect to the effective insurance aspect of the programme;

(6) the collateral was charged by the issuer in favour of the trust corporation to secure its obligations to the noteholders and the Lehman company on terms which changed their respective priorities on the occurrence of certain specified events, including the insolvency of the Lehman company,

(7) each of the transactions summarised above (except the purchase of the collateral) is governed by English law.

2 The claimants in these proceedings (respectively "Perpetual" and "Belmont") are or represent noteholders in respect of issues made under the Dante Programme by three issuers, namely Saphir Finance Public Limited Company, Zircon Finance Ltd and Beryl Finance Ltd, established by the Lehman Brothers Group in the Republic of Ireland or in the Cayman Islands. The first defendant, BNY Corporate Trustee Services Ltd ("the Trustee") is the trust corporation, incorporated in England as a wholly-owned subsidiary of the Bank of New York Mellon, in which is vested the collateral in respect of each of the relevant issues and the chargee in respect of the charges granted by the issuers. The second defendant, Lehman Brothers Special Financing Inc ("Lehman BSF"), is the Lehman company concerned in the relevant issues and the counterparty under the swap agreements connected with them. It is incorporated in Delaware and has its principal office in New York.

3 On 15th September 2008 Lehman Brothers Holdings Inc, the parent company of the Lehman Brothers Group, applied to the United States Bankruptcy Court, Southern District of New York for protection under Chapter 11 US Bankruptcy Code. Lehman BSF did likewise on 3rd October

2008. After 15th September 2008 the periodic payments due by the respective issuers to the noteholders and by Lehman BSF to the issuers were not made. On 13th May and 9th June 2009 Perpetual and Belmont issued part 8 claims against the Trustee for orders designed to procure the realisation of the collateral held by the Trustee in respect of each of the relevant issues and its application in favour of the respective noteholders in priority to any claim of Lehman BSF. They rely on the provision in the trust deed under which each issue was made which confers priority on the noteholders if:

"...an Event of Default (as defined in the Swap Agreement) occurs under the Swap Agreement and the Swap Counterparty [Lehman BSF] is the Defaulting Party (as defined in the Swap Agreement)..."

4 Lehman BSF does not accept that the noteholders are entitled to the priority they claim. On 20th May 2009 it issued a complaint in the US Bankruptcy Court, Southern District of New York against the Trustee contending that the provisions on which the noteholders rely are forbidden by ss. 362(a)(3), 365(e)(1) and 541(c)(1)(B) US Bankruptcy Code in that they modify the interest of a debtor in a contract because of a bankruptcy filing or they exercise control over the property of Lehman BSF's estate in breach of the protection afforded by Chapter 11. In addition Lehman BSF intervened in the actions commenced by Perpetual and Belmont, has been joined as the second defendant and has applied for both actions to be stayed pending the resolution of the proceedings between Lehman BSF and the Trustee in the US Bankruptcy Court, Southern District of New York.

5 On 10th June 2009 Lehman BSF, having been duly authorised to do so by the judge, Hon. James M. Peck, filed a motion for summary judgment on its claim in the US Bankruptcy Court. On 22nd June 2009 the Trustee applied to the same court to dismiss the complaint or to stay it on the grounds, amongst others, that the Perpetual is a necessary party to the proceedings but has not been joined by Lehman BSF, that that court is not the appropriate forum and that it should abstain from adjudicating on the issues in the interest of justice and on the basis of comity. Both applications were due to come on before Judge Peck on 15th July but have been, I understand, adjourned. The Trustee's motion to dismiss is due to be heard on 11th August 2009.

6 Perpetual and Belmont resist the application to stay their part 8 claims on the grounds that as all the relevant transactions are governed by English law and this court has no power to decline its jurisdiction over the claims it cannot and should not stay them. Lehman BSF responds by indicating that it seeks only a temporary stay. In addition it contends that the priority provisions on which the noteholders rely are invalid under English law by reference to the principle recognised by the House of Lords in British Eagle International Airlines Ltd v Compagnie Nationale Air France [1975] 1 WLR 758, namely that parties cannot, consistently with public policy, contract out of the mandatory provisions of the Insolvency Act 1986. The Trustee is concerned to obtain the indemnity to which it is entitled before it is required to take any of the steps the noteholders demand. It regards with apprehension the possibility that it might be faced with conflicting requirements imposed by the US Bankruptcy court and this court.

7 Thus the issues for my determination are whether to grant a stay of these part 8 claims and if not what, if any, order to make in respect of them. In order to reach any conclusion on either of those broad issues it is necessary to explain the complex documents which underlie these transactions and resolve a number of issues which arise in respect of them.

The relevant documents

8 The Perpetual claim concerns two notes issues made by Saphir Finance Public Limited Company, a company incorporated in the Republic of Ireland, Saphir I and Saphir II. The

Belmont claim concerns five notes issues made by Zircon Finance Ltd, a company incorporated in the Cayman Islands, one by Saphir Finance Public Limited Company and four by Beryl Finance Ltd, also incorporated in the Cayman Islands. It is agreed that the documentation in relation to all twelve issues is for all relevant purposes in the same form. Accordingly I shall consider the documentation relating to Saphir I which in argument was taken as the paradigm.
9 The issue of each of the twelve series of notes is governed by three documents (1) the Principal Trust Deed made on 10th October 2002 between Dante Finance Public Limited Company (the first issuer under the programme) and the Trustee, (2) a Supplemental Trust Deed and Drawdown Agreement made between the particular issuer be it Saphir, Zircon or Beryl, the Trustee (together with its associated custodian and paying agent), Lehman BSF (described as the swap counterparty) and LBIE and (3) the Terms and Conditions of the Notes which were attached to the prospectus sent to potential investors. The swap agreement associated with each issue is regulated by two documents, namely (1) an ISDA Master Agreement originally dated 10th October 2002 but amended and restated from time to time made between Dante Finance Public Limited Company and Lehman BSF and (2) a swap confirmation in respect of each issue.

The Principal Trust Deed

10 The Principal Trust Deed has effect in relation to any specific note issue as amended by the Supplemental Trust Deed relating to that issue. By clause 5.1 the issuer granted "as continuing security" the charge and security interest set out in the Supplemental Trust Deed. Clause 5.5 provides that the security so granted shall become enforceable

"...if (i) any amount due in respect of the Notes is not paid or delivered when due or (ii) a Swap Agreement terminates with sums due to the Swap Counterparty [Lehman BSF]."

Clause 5.6 provides for the Trustee to take possession of the mortgaged property. The Trustee is bound "at any time after any security...shall have become enforceable" if requested by at least one fifth of the noteholders, directed by extraordinary resolution of the noteholders or directed by the Swap Counterparty in certain specified events or otherwise at its discretion to enforce the security over the collateral. But, in every case, its obligation is "subject to it having been indemnified to its satisfaction against any loss [etc] which may be incurred or made against it in connection therewith".

11 Clause 6 deals with the application of the moneys received by the Trustee. Clause 6.1 relates to moneys received otherwise than in connection with the realisation or enforcement of the security. Such moneys are to be held by the Trustee on trust to apply them in payment first of the Trustee's costs, second the amounts due to the Swap Counterparty or the noteholders and others pari passu and rateably and thirdly to the issuer. Clause 6.2 directs the Trustee

"to apply moneys received by it under this Principal Trust Deed and the relevant Supplemental Trust Deed in connection with the realisation or enforcement of the security as follows.."

There then follow four orders of priority, which are defined in detail, respectively entitled "Swap Counterparty Priority", "Pari Passu Ranking", "Noteholder Priority" and "other priority". One of such respective priorities is to be applied "if [it] is specified in the relevant Supplemental Trust Deed."

12 Clause 7.2.1 provides that the liability of the issuer to the Swap Counterparty is to be satisfied out of the mortgaged property, that is the collateral, so as to exclude any personal liability. Clause 9.17 provides for an indemnity for the Trustee from the mortgaged property, as envisaged by clause 5.6. Clause 20.1 specifies that the Principal Trust Deed and the Notes shall be governed by and construed in accordance with English law. Clause 20.2 confers a non-exclusive jurisdiction on the courts in England.

13 Schedule 2 Part C to the Principal Trust Deed contain terms and conditions of the notes to be applied to all notes of any series but subject to the terms of the Supplemental Trust Deed in relation to that series. Condition 6(d)(ii) provides for the early redemption of the notes if a swap agreement is terminated. In that event the issuer is required to give an irrevocable notice of not more than 45 nor less than 15 days to the Trustee, noteholders and swap counterparty and at its expiration to redeem all the notes of that issue at their early redemption amount. The early redemption amount is defined in terms which are not material to these claims. Condition 10 defines events of default in relation to the notes to include default in payment of any sum due in respect of the notes for a period of 14 days or more.

The Supplemental Trust Deed

14 Clause 5.2 of the Supplemental Trust Deed contains the charge by the issuer "as continuing security in favour of the Trustee" over the collateral and other property representing it from time to time. Clause 5.3 provides that such security

"is granted to the Trustee as trustee for itself and/or the holders of Notes and the Swap Counterparty...as continuing security (i) for the payment of all sums due under the Trust Deed and the Notes (ii) for the performance of the issuer's obligations (if any) under the Swap Agreement..."

Clause 5.5 is central to the issues in these claims. It provides:

"The Trustee shall apply all moneys received by it under this Deed in connection with the realisation or enforcement of the Mortgaged Property as follows:

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

15 Swap Counterparty Priority and Noteholder Priority have the meanings ascribed to them in clause 6.2 of the Principal Trust Deed. After providing for payment of certain specified costs and charges, in the former the claims of swap counterparty are payable in priority to the claims of the noteholders, in the latter the claims of the noteholders are payable in priority to the claims of the swap counterparty. Clauses 5.9, 6, 9.3 and 14.2 contain provisions to the like effect of the clauses of the Principal Trust Deed to which I have referred in paragraph 12 above. Clause 9.3, entitled 'Dealings in Collateral' provides, so far as material:

"The Swap Counterparty hereby agrees that, if an Event of Default (as defined in the ISDA Master Agreement) occurs under the Swap Agreement and the Swap Counterparty is the Defaulting Party (as defined in the ISDA Master Agreement)....and Unwind Costs are payable by the Issuer to the Swap Counterparty, the Issuer shall apply the net proceeds from the sale or realisation of the Collateral (1) first in redeeming the Notes in an amount as set out in the Conditions and (2) thereafter in payment of such Unwind Costs to the Swap Counterparty."

Terms and Conditions of the Notes

16 These are attached to the prospectus issued in relation to each series. The prospectus points out that the notes are 'credit-linked' to what are described as Reference Entities. These are the entities whose credit is being, in effect, insured primarily, but not exclusively, because such entity is obliged to a Lehman company under a loan or similar transaction. The prospectus points out that, in addition the Notes have exposure to the value of the collateral so that "Impairment of the Collateral may result in a negative rating action on the Notes". Condition 6 contains the details of how and by how much the principal amount due on the notes is reducible in the event of credit events affecting a reference entity, the details of which are not material.

17 Condition 40 deals with what is described as "Security Arrangements". Paragraph (i) relates

to the collateral and provides for it to consist of the proceeds of the issue and the security to be bought with it. Paragraph (ii) sets out the priorities in the same terms as clause 5.5 of the Supplemental Trust Deed. Paragraph (iii) sets out the payments to be made under the swap Agreement, defined as the ISDA Master Agreement and the relevant confirmation, the effect of which I have summarised in paragraph 1(3) and (6) above.

18 Condition 43 concerns the calculation of the redemption amount to be paid by the swap counterparty on the maturity of the notes. Condition 44 deals with the early redemption amounts referred to in the Principal Trust Deed Schedule 2 part C condition 6(d)(ii) I have referred to in paragraph 13 above. It also includes a definition of "Unwind Costs" as the amounts due to or by the swap counterparty under the swap agreement at its termination.

The ISDA Master Agreement

19 As I have already mentioned it was made between Dante Finance Public Limited Company (1) and Lehman BSF (2) on 10th October 2002 but has been amended and restated from time to time in relation to its application to particular swaps. Lehman BSF is defined as Party A and the issuer as Party B. Clause 2 provides for each party to make the payments to each other specified in the relevant confirmation but in each case

"subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement."

20 Events of Default and Termination Events are defined in clause 5(a) and (b) respectively. Clause 5(a), entitled Events of Default, provides so far as relevant that:

"The occurrence at any time with respect to a party or, if applicable, any Credit Support Provider of such a party...of any of the following events constitutes an event of default...with respect to such party:-

(i) Failure to pay or deliver. Failure by the party to make, when due, any payment under this Agreement...if such failure is not remedied on or before the third local business day after notice of such failure is given to the party;

[(ii) - (vi)]

(vii) Bankruptcy. The party, any Credit Support Provider of such party or....:-

[(1) – (3)]

(4) institutes or has instituted against it a proceeding seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency law or other similar law affecting creditors rights...and in the case of any such proceeding … (A) results in a judgment of insolvency or bankruptcy or the entry of an order for relief...or (B) is not dismissed, discharged, stayed or restrained in each case within 30 days of the institution thereof;

[(5) – (7)]

(8) causes or is subject to any event with respect to it which, under the applicable laws of any jurisdiction, has an analogous effect to any of the events specified in clauses (1) to (7)(inclusive); or

(9) takes any action in furtherance of, or indicating its consent to, or approval of, or acquiescence in, any of the foregoing acts;

[(viii)]

21 Clause 6 deals with early termination and provides in (a) that:

"If at any time an Event of Default with respect to a party (the "Defaulting Party") has occurred and is then continuing, the other party (the "Non-defaulting Party") may, by not more than 20 days notice to the Defaulting Party specifying the relevant Event of Default, designate a date not earlier than the day such notice is effective as an Early Termination Date in respect of outstanding transactions..."

Clause 6(e) deals with the calculation of the sums due to each party in the event of an Early Termination the details of which are not material to these claims. Clause 13(a) and Schedule Part 4 para (i) provides that the Master Agreement is to be governed by and construed in accordance with English law. In accordance with Clause 13(b) each party to the Swap Agreement submitted to the non-exclusive jurisdiction of the English Courts. In Part 5(g) of that Schedule each party to the swap agreed that it was bound by the terms of the Principal Trust Deed. In addition it was agreed that the liability of Party B (the issuer) to Party A (Lehman BSF) under the swap agreement was limited to the assets on which it was charged without recourse to Party B personally.

The Swap Confirmation

22 The swap confirmation supplements the Master Agreement and is subject to it as amended and restated for the purposes of a specific issue and swap agreement. It is accepted for the purposes of these claims that the Swap Confirmation dated 6th June 2007 in relation to the Zircon Series 2007-9 Tranche A AUD 30m synthetic portfolio notes due 2013 should be taken as sufficiently representative of all swap confirmations relevant to the 12 notes issues with which I am concerned.

23 The Swap Confirmation deals in paragraph 2 in great detail with the Reference Entities and Obligations which it is the purpose of the transaction effectively to insure. Paragraphs 3 and 4 deal with the payment obligations of the buyer (Lehman BSF) and the seller (the issuer) under the swap agreement. They and the remaining provisions of the confirmation give effect to the purposes I have summarised in paragraph 1(3) and (6) above. Clause 10(iv) provides that in relation to Party A, which is both the buyer and Lehman BSF, the credit support provider is Lehman Brothers Holdings Inc. Clause 10 also includes an acknowledgement by the issuer and Lehman BSF that the transaction is not intended to constitute insurance business so that payments by each party under the transaction are independent and not dependent on proof of economic loss of the other.

The relevant events

24 It is convenient at this stage to refer to the events relevant to the application of the terms and conditions of the five documents regulating the respective notes issues and swap agreements. They are as follows:

(1) On 15th September 2008 Lehman Brothers Holdings Inc filed for Chapter 11 protection. As it was specified in Clause 10(iv) of the Swap Confirmation in respect of each issue with which I am concerned as the Credit Support Provider of Lehman BSF the filing constituted an event of default for the purposes of the swap agreements, see ISDA Master Agreement clause 5(a)(vii)(4) described and quoted in paragraph 20 above. Prima facie, that event also gave rise to Noteholder Priority under clause 5.5 of the Supplemental Trust Deed, see paragraph 14 above.

(2) From 15th September 2008, interest payments due under all series of Notes (except Beryl 2008-14) were not paid on their respective due dates and remain unpaid. Such non-payment constituted an event of default in respect of each of those notes issues, see Condition 10 set out in the Principal Trust Deed Schedule 2 Part C referred to in paragraph 13 above. Prima facie such non-payments also rendered the security for those issues enforceable in accordance with clause 5.5 of the Principal Trust Deed set out in paragraph 10 above.

(3) On 3rd October 2008 Lehman BSF filed for Chapter 11 protection. Such filing also constituted an event of default for the purposes of the swap agreements, see ISDA Master Agreement clause 5(a)(vii)(4) described and quoted in paragraph 20 above and, prima facie, gave rise to Noteholder Priority under clause 5.5 of the Supplemental Trust Deed, see paragraph 14 above.

(4) Between 28th November and 3rd December 2008 the noteholders in respect of each issue except Beryl 2008-14 gave notice to the Trustee in reliance on the event of default constituted by the filing for Chapter 11 relief effected by Lehman BSF on 3rd October 2008. In the case of Saphir I and II the notice asserted an event of default and designated 1st December 2008 to be the Early Termination Date under clause 6(a) ISDA Master Agreement. In respect of the Saphir I and II series, the Trustee caused the issuer to serve swap termination notices in those terms on Lehman BSF on 1st December 2008. In the case of all the others, except Beryl 2008-14, the notice asked the Trustee to enforce its rights over the collateral under clause 5.6 of the Principal Trust Deed by requesting the issuer to give a termination notice to Lehman BSF in respect of the swap agreement and, on its termination, to convene a meeting of noteholders to consider the realisation of the collateral.

(5) On 22nd December 2008 the Trustee caused the issuer to give notice to Lehman BSF to terminate the swap agreement in respect of the Zircon 2007-9B issue with effect from 2nd January 2009 but, absent an indemnity from the noteholders, the Trustee refused to give notice in relation to any other issue with which Belmont is concerned. Such termination is also, arguably, an event of default for the purposes of clause 5.5 of the Principal Trust Deed given that, as Lehman BSF contends, sums were then due to Lehman BSF.

(6) On 20th and 24th March 2009 the noteholders in all the series with which Belmont is concerned passed resolutions to ratify or authorise swap termination. On 24th March 2009 for one series and 16th April 2009 for the others, the Trustee caused the remaining issuers in respect of all the series with which Belmont is concerned to give notice to Lehman BSF terminating those swaps.

(7) On 6th May 2009, the Trustee issued Condition 10 notices in respect of all the series with which Belmont is concerned (other than Beryl 2008-14) declaring the notes to be due and payable.

(8) On 8th May 2009 Perpetual as the noteholder in Saphir I and II passed extraordinary resolutions requiring the Trustee to serve notice on the issuer to the effect that the notes were immediately due and requiring the Trustee to enforce its security.

The validity of clause 5.5 of the Supplemental Trust Deed to confer Noteholder Priority

25 Given the provisions of the relevant documents and the facts to which I have referred it is convenient to consider first the submission of Lehman BSF to the effect that the provision on which the claimants rely, namely clause 5.5 of the Supplemental Trust Deeds, is void under English law. If the submission is well made then the claims fail irrespective of the position in the US Bankruptcy Court. In that event the application of Lehman BSF for a stay will not arise. If, on the other hand, I reject the submission it will mean that the provision on which the claimants rely is valid under English law, the system of law by which all the relevant documents are to be governed and construed. Accordingly the application for a stay will have to be considered in that context.

26 Counsel for Lehman BSF relies on what it describes as the "anti-deprivation principle" examined by Neuberger J in Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd [2002] 1 WLR 1150. In paragraphs 1, 36, 87 and 116 Neuberger J formulated the principle in a number of slightly different ways, but his basic proposition as expressed in

paragraph 87 was that:

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

Counsel for Lehman BSF submits that clause 5.5 of the Supplemental Trust Deeds falls squarely within that proposition and is invalid. In argument he also contended that the same fate befell Condition 44 of the Note Conditions, to which I have referred in paragraph 18 above, but agreed that they stood or fell together. Accordingly I shall only consider this submission in the context of clause 5.5 of the Supplemental Trust Deeds.

27 Counsel for Lehman BSF submitted that the principle on which he relies invalidates contractual provisions which have the effect of prejudicing creditors of a company in the event of insolvency by the actual or effective removal of an asset from the insolvent estate. Counsel for both Perpetual and for Belmont submit that Lehman BSF's formulation is too wide and would, if applied in those terms, undermine a large number of commercial transactions, the validity of which has not, so far, been doubted. They contend that the principle goes no further than invalidating a contract which, by reason of the insolvency proceedings, seeks to remove from the estate of the bankrupt an asset which was his property at its commencement. They contrast such a contract with an asset in which the bankrupt's interest is limited to cease on his bankruptcy. Counsel for the claimants also submit that, even on the formulation advanced by Lehman BSF, clause 5.5 is valid and, in the events which have happened, has operated to divest Lehman BSF of priority under the charge over the collateral because, first, there has been no insolvency process concerning Lehman BSF in England and, second, the clause was not triggered by any insolvency of Lehman BSF.

28 Accordingly there are three basic issues, namely, the breadth of the principle, whether it applies if there is no insolvency process in relation to Lehman BSF in England and whether it applies if the clause operates on an event other than the bankruptcy of Lehman BSF. I will deal with them in that order.

29 I have been referred by each party to a number of reported cases on the extent and application of the principle. In chronological order they are Ex parte Mackay (1873) LR 8 Ch App 643; Ex parte Jay (1880) 14 Ch D 19; British Eagle International Airlines v Compagnie Nationale Air France [1975] 1 WLR 758; Carreras Ltd v Freeman Matthews Ltd [1985] 1 Ch 207; Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd [2002] 1 WLR 1150; Peregrine Investments Holdings Ltd v Asia Infrastructure Fund Management Co Ltd [2004] 1 HKLRD 598; Squires v AIG Europe (UK) Ltd [2006] BCC 233; and IATA v Ansett Australia Holdings Ltd [2008] BPIR 57.

30 The authority on which counsel for Lehman BSF placed great reliance is Ex parte Mackay. In that case Jeavons sold a patent to Brown in consideration of the payment to him of royalties. At the same time he borrowed £12,500 from Brown on terms that he, Brown, might retain, in repayment of the loan, half the royalties due to Jeavons, but if Jeavons went bankrupt his right of retention should extend to all the royalties. Jeavons went bankrupt. Jeavons' trustee in bankruptcy claimed that the provision entitling Brown to retain all the royalties was a fraud on the bankruptcy law and void. That contention was upheld by the Court of Appeal. James LJ considered that (p.647):

"If it were to be permitted that one creditor should obtain a preference in this way by some particular security, I confess I do not see why it might not be done in every case — why, in fact, every article sold to a bankrupt should not be sold under the stipulation that the price should be doubled in the event of his becoming bankrupt.

It is contended that a creditor has a right to sell on these terms; but in my opinion a man is not allowed … to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides. It appears to me that this is a clear attempt to evade the operation of the bankruptcy laws."

Mellish LJ agreed. At page 648 he added, after considering the decision of Lord Eldon in Higginbotham v Holme 19 Ves.88, 92:

"a person cannot make it part of his contract that, in the event of bankruptcy, he is then to get some additional advantage which prevents the property being distributed under the bankruptcy laws."

31 These dicta must be read in context. Thus, the decision of James LJ was based on the proposition enunciated in the first paragraph of the quotation, namely the stipulation for a preference in the event of the other contracting party's bankruptcy. The second was dealing with the argument summarised in the first line. It was not dealing with the facts of the case, unless the reference to "a man" is read as a reference to the bankrupt, because the seller was the bankrupt, not his creditor. Similarly the quotation from the judgment of Mellish LJ represented his summary of the principle to be extracted from the judgment of Lord Eldon. His decision was on the basis set out in the second paragraph of his judgment, namely:

"In the simple case of a man lending money on mere personal security, and making a bargain that, in the event of his debtor becoming bankrupt, he should then have a security upon a certain portion of his property, it would be an absurd contention that he should be allowed to have the benefit of the security under the bankruptcy law."

32 In Ex parte Jay a builder was let into occupation of land to build houses and to accept leases of the same once built. The agreement stipulated that the owner might re-enter in the event of either a breach of any stipulation to be performed by the builder or in the event of the bankruptcy of the builder. In the event of any such re-entry the building materials on the land should be forfeit to the owner of the land. The builder filed a liquidation petition but was not in breach of any stipulation on his part. The Court of Appeal held that the materials had not been forfeit to the owner but were the property of the trustee in bankruptcy. The relevant proposition was stated by James LJ in these terms (p.25):

"a simple stipulation that, upon a man's becoming bankrupt, that which was his property up to the date of the bankruptcy should go over to someone else and be taken away from his creditors, is void as being a violation of the policy of the bankrupt law … I think we cannot escape from applying that principle to the present case."

Similar statements are to be found in the judgments of Brett and Cotton LJJ.

33 The case is also relevant for the proposition that if a particular provision is exercisable on one of a number of events, including bankruptcy, its invalidity in relation to bankruptcy does not invalidate it in relation to the other events. Thus, at page 26, Brett LJ said:

"It appears that there was no default on the debtor's part up to the filing of the petition, and the Respondent cannot, therefore, succeed except by virtue of the provision for forfeiture on bankruptcy, and according to the authorities such a stipulation is void."

Brett LJ appears to accept that had the owner sought to re-enter for breach of stipulation the provision for re-entry would have been valid and enforceable to that extent. The judgment of Cotton LJ was even clearer. He said (p.25):

"One of the two events is not hit by the decided cases. But, as to the other, though the contract is good between the parties to it, it is on principle void in the event of the builder's bankruptcy."

This is relevant to the third of the issues I have summarised in paragraph 28 above.

34 British Eagle International Airlines v Compagnie Nationale Air France concerned the IATA clearing house under which debts owed by and to some 74 airlines were set off against each other in the clearing house and only the net balance was paid by an airline to the clearing house or vice versa. One of the members ceased trading and went into liquidation. Its liquidator

sought to recover a balance due by the defendant airline without any further set off under the clearing system. He contended that the clearing house system excluded the mandatory provisions of s.302 Companies Act 1948 and was void against him. He succeeded in the House of Lords by a majority. Lord Cross of Chelsea, with whom Lords Diplock and Edmund-Davies agreed, considered the decision of the Court of Appeal in Ex parte Mackay and concluded (p. 780) that:

"...what the respondents are saying here is that the parties to the "clearing house" arrangements by agreeing that simple contract debts are to be satisfied in a particular way have succeeded in "contracting out" of the provisions contained in section 302 for the payment of unsecured debts "pari passu." In such a context it is to my mind irrelevant that the parties to the "clearing house" arrangements had good business reasons for entering into them and did not direct their minds to the question how the arrangements might be affected by the insolvency of one or more of the parties. Such a "contracting out" must, to my mind, be contrary to public policy. The question is, in essence, whether what was called in argument the "mini liquidation" flowing from the clearing house arrangements is to yield to or to prevail over the general liquidation. I cannot doubt that on principle the rules of the general liquidation should prevail."

35 In Carreras Ltd v Freeman Matthews Ltd Peter Gibson J was concerned with a case similar in effect to British Eagle. The principle he derived from it was (p.226):

"where the effect of a contract is that an asset which is actually owned by a company at the commencement of the liquidation would be dealt with in a way other than in accordance with s.302 Companies Act 1948, then to that extent the contract as a matter of public policy is avoided, whether or not the contract was entered into for consideration and for bona fide commercial reasons and whether or not the contractual provision affecting that asset is expressed to take effect only on insolvency."

36 In Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd the defendant Stock Exchange was a mutual company. Its assets were held by another company which issued B shares to the members of the Stock Exchange. Under the articles of association of the latter company the holders of the B shares were liable to transfer them back to the issuer or the Stock Exchange if he ceased to be a member. Under the rules of the Stock Exchange a member who was unable to fulfil its obligations under a stock exchange contract might be declared to be a defaulter in which event he would cease to be a member of the Stock Exchange. The claimant, a company incorporated in the Republic of Ireland, was wound up by the High Court in Dublin pursuant to a resolution of its members, declared to be a defaulter and ceased to be a member of the Stock Exchange. Thereafter the Stock Exchange caused the B shares held by the claimant to be retransferred. Subsequently the B shares became valuable and the liquidator of the claimant claimed reinstatement as a member or compensation for the loss of the shares. The claim was dismissed by Neuberger J. I shall have occasion to refer to his judgment in respect of each of the issues to which I have referred in paragraph 28 above. At this stage I do so only in relation to the basic principle to be applied.

37 Neuberger J recorded the issue before him in paragraph 43 in these terms:

"While accepting that there is a principle that certain transactions will be held invalid or unenforceable in so far as they may result in an asset being taken away on insolvency, [counsel for the Stock Exchange] contends on behalf of LSE that it does not apply to a provision inherent in the asset which provides for its forfeiture or removal, even in the event of an insolvency....He contends that an arrangement whereby A divests himself of an asset in favour of B on terms, or in such a way, that the ownership of the asset is forfeited or lost in a certain event is enforceable even if B becomes insolvent. He says that it is permissible to create a property, an interest or a right which is, in effect, validly limited in a certain event (including insolvency), provided that it is so limited at the outset, i e so that it never existed free from that limitation. By way of illustration, he refers to leases with provisos for re-entry in the event of insolvency (or on other grounds), and protective trusts, which are expressly condoned by section 33 of the Law of Property Act 1925."

Neuberger J then considered a large number of authorities, most of which I have already referred to.

38 He accepted in paragraphs 89 and 90 that the principle did not apply to two established categories. The second is the right of the lessor to forfeit a lease in the event of the insolvency of the tenant. The first he described in these terms:

"...an interest granted on the basis that is inherently limited on insolvency is recognised by the court. In other words, a determinable interest, that is an interest with a limitation until insolvency, is valid: see the discussions in Snell's Equity, Underwood & Hayton and Professor Goode's book and the passage quoted above from Fry LJ in Ex p Barter 26 Ch D 510, 519-520. It must, I think, follow that an interest granted on the basis that it is inherently limited on some other event is effective, even if that event occurs on or after an insolvency."

Neuberger J then considered the ambit of that established category and concluded in paragraph 100:

"I do not consider that the suggestion that a deprivation provision on insolvency or otherwise is valid provided it is included as part of the initial bargain (or as an inherent part of the asset) is correct; nor do I consider that the more refined version of this analysis, involving a superadded requirement that the asset in question must have been acquired for no consideration or for consideration which was itself subject to a deprivation provision, can be supported. However, as is common ground, it seems that the converse proposition is correct: if a person has a specific asset which is not subject to a deprivation provision, then a deprivation provision to which he subsequently agrees to make it subject is unenforceable in the event of insolvency: see the passages quoted above from Snell and from Underwood & Hayton."

His conclusion, after considering further authorities, is expressed in paragraphs 117 and 118 as follows:

"117. First, there is no doubt that the principle exists: it has been applied or approved in a number of cases, and fairly recently in the House of Lords. Secondly, the principle is essentially based on a common law rule of public policy, which is itself based on the long-established approach of the English law to the treatment of assets and creditors on insolvency. Thirdly, there are circumstances in which the principle does not apply. Fourthly, it is not possible to discern a coherent rule, or even an entirely coherent set of rules, to enable one to assess in any particular case whether such a provision (a "deprivation provision") falls foul of the principle. Fifthly, and perhaps not surprisingly, it is not entirely easy to reconcile the conclusions, and indeed the reasoning, in some of the cases. Sixthly, there are some rules, of a somewhat "piecemeal" nature which can be derived from the cases.

118. It seems to me that one can extract the following rather limited propositions from the cases: (i) a person cannot validly arrange his affairs so that what is already his own property becomes subject to being taken away in the event of his insolvency; (ii) subject to the first proposition, the transfer of an asset for an interest coming to an end on the transferee's insolvency (or on some other event) is apparently effective even if the transferee is insolvent; (iii) subject to the following propositions, the transfer of an asset on the condition that the asset will revest in the transferor in the event of the transferee's insolvency is generally invalid; (iv) a proviso in a lease for determination, i e for forfeiture or re-entry, even in the event of the lessee becoming insolvent, is enforceable where the lessee is insolvent; (v) in deciding whether a deprivation provision, exercisable other than on insolvency, offends against the principle, one is

primarily concerned with the effect of the provision and not with the intention of the parties, but it may be that, if the deprivation provision is exercisable for reasons which are not concerned with the owner's insolvency, default or breach, then its operation will not be within the principle; (vi) however, if the intention of the parties when agreeing the deprivation provision was to evade the insolvency rules, then that may invalidate a provision which would otherwise have been valid, and if the intention of the parties was not to evade the insolvency laws, the court will be more ready to uphold the deprivation provision if it provides for compensation for the deprivation; (vii) the court will scrutinise with particular care a deprivation provision which would have the effect of preferring the person to whom the asset reverts or passes as against other unsecured creditors of the insolvent person whose estate is deprived of the asset pursuant to the provision; (viii) where the deprivation provision relates to an asset which has no value, or which is incapable of transfer, or which depends on the character or status of the owner, then it will normally be enforceable on insolvency; (ix) a deprivation provision which might otherwise be invalid in light of the principle may be held to be valid if the asset concerned is closely connected with or, more probably, subsidiary to a right or other benefit in respect of which a deprivation provision is valid; (x) if the deprivation provision does not offend against the principle, then (subject to there being no other objection to it) it will be enforceable against a trustee in bankruptcy or on a liquidation just as much as it would have been enforceable in the absence of an insolvency."

In the event Neuberger J concluded that the principle did not apply to invalidate the retransfer of the B share from the claimant to the Stock Exchange.

39 In Peregrine Investments Holdings Ltd v Asia Infrastructure Fund Management Co Ltd the Court of Appeal in Hong Kong was concerned with a right of pre-emption exercisable by non-defaulting shareholders over the shares of a defaulting shareholder. A defaulting shareholder was defined as one who committed a material breach of the shareholders agreement, made an assignment of his property for the benefit of his creditors generally, failed to pay his debts as they fell due, suffered a distress or a petition was presented for its or an order was made or a resolution passed for its winding up. A petition was presented against a shareholder on which a winding up order was made. Non-defaulting shareholders then exercised the right of pre-emption. Such exercise was challenged by the liquidator on a number of grounds and the challenge was upheld by the judge and, by a majority, the Court of Appeal. Rogers V-P referred to a number of authorities, including those to which I have referred. He considered (para 27) the principle to be derived from them to be "no one can be allowed to derive a benefit from a contract that is in fraud of the insolvency laws". Later he identified the mischief sought to be avoided by the application of that principle to be "permitting contractual arrangements taking effect which would give the contractors an advantage at the expense of creditors where there was an insolvency".

40 Later still, in paragraph 33 Rogers V-P considered the argument that the principle only applied to cases where the owner of property had made the offending contract in respect of his property. In his view such an argument missed the point and added:

"In the first place, the anti-deprivation policy looks to whether a person can insist on retaining an unfair advantage to himself at the expense of creditors in a bankruptcy. In any event, whether it is the insolvent himself, or itself, who disposes of his property or its value to the detriment of the creditors or whether it is a trustee of the insolvent's property or whether it is whoever is in charge of the insolvent's asset or the maintenance of the value of an asset for the ultimate benefit of the insolvent (in this case the directors of PII whose duty it was to maintain the value of PII for the ultimate benefit of PIH), matters not. It is the dealing with property the benefit of which the insolvent is ultimately entitled to and the diminution of the value therein that

is important."
The same point was dealt with by Woo V-P in paragraph 86 in these terms:
"In my view, however, if the subject matter is an asset of the company, although not strictly property of the company within the ambit of section 182, if the effect of a contractual provision is to deprive the company of it or reduce its value to the detriment of the company's general creditors in insolvent liquidation, that must equally be contrary to the public policy of equitable and fair distribution amongst unsecured creditors in insolvency."
41 In Squires v AIG Europe (UK) Ltd the issue was whether an agreement that the inter-company debts of a group of petrol retailers should be subordinated to the debt due to a company which had provided a bond to HM Customs & Excise for payment of the relevant excise duty was valid. Lloyd J considered that it was. In paragraph 45 of his judgment he said:
"In my judgment, the application of the pari passu principle has to be considered separately in relation to each insolvency. As between the creditors of Stations, the subordination, by their agreement, of the debts due to Group and to other members of the Save group does not infringe the principle. It is valid because they have agreed to it, as the junior creditor did in the Horne case. Nothing turns on the question whether the subordination arises from the initial terms of the transaction creating the debt or from a later agreement, nor on whether the debtor is a party to such an agreement (though in the present case the debtor, Stations, was such a party). Equally, in the liquidation of Group there is no breach of the principle, and the assets which Group's liquidators are able to collect in would, if sufficient, be applied rateably between all its relevant creditors. The fact that Group will not be able to collect in its main asset, namely the inter-company debt, does not interfere with this principle. The situation is therefore quite different from that in the British Eagle case, or in Ex p Mackay and other cases of that kind."
The decision of Lloyd J was upheld in the Court of Appeal. At paragraph 66 Chadwick LJ said:
"It seems to me to be commercially important that, if group companies enter into subordination agreements of this nature with their creditors while solvent, they and the creditors should be held to the bargain when the event for which the agreement was intended to provide (insolvency) occurs."
42 Finally on this part of the case I should refer to IATA v Ansett Australia Holdings Ltd. It concerned a clearing house system between airlines similar to but not the same as that with which the House of Lords was concerned in British Eagle. The difference lay in the fact that as between members of the clearing house there were no debts inter se. Instead the right and obligation of a member was to the clearing house alone. One of the members became insolvent and the liquidator sought to recover sums alleged to be due by another airline member of the clearing house on the basis that the clearing house rules were, to that extent, unenforceable. The High Court of Australia rejected that contention. As Gleeson CJ said (paragraph 16):
"The purpose of the amendment made to reg 9(a) was to remove the premise upon which the reasoning of the majority in the House of Lords proceeded (that, at the time of its insolvency, British Eagle owned property in the form of a debt owed to it by Air France), and to restore the contractual position found at first instance, and in the Court of Appeal, and accepted by the minority in the House of Lords. If there never was any property of British Eagle in the form of a debt owed to it by Air France, then there was no attempt to dispose of or deal with such property in a manner inconsistent with the insolvency laws."
On that basis (paragraph 23):
"...the property of Ansett did not include debts owed to it by other airline operators and the liabilities of Ansett did not include debts owed by it to other airline operators. The relevant property of Ansett was "the contractual right to have a clearance in respect of all services which had been rendered on the contractual terms and the right to receive payment from IATA if on

clearance a credit in favour of the company resulted."
In paragraph 27 Gleeson CJ emphasised the importance of applying the principle to the agreement the parties made.
"Public policy may render a contractual provision invalid; but it cannot create a contract to which the parties have never agreed."
43 That it is contrary to public policy and therefore void, by contract to exclude the mandatory provisions of the Insolvency Act 1986 is clear enough. It is also clear that there exists an exception to that principle for the grant of an interest in property determinable on the insolvency of the grantee, but not of the grantor. Between those two extremes there exists an uncertain area. I share the views of Neuberger J expressed in the first five propositions in Money Markets para 117 which I have quoted in paragraph 38 above. In any given case it is necessary to construe the relevant documents in the light of the decided cases to ascertain whether the transaction falls into the first category or the second.
44 In this case counsel for Lehman BSF relies strongly on the words in clause 5.5 of the supplemental trust deeds to the effect that Swap Counterparty Priority obtains "unless" there is an event of default and the swap counterparty is the defaulting party. This, he submits, is a clear case of forfeiture by condition subsequent, the condition being the insolvency of Lehman BSF and the result the removal of the benefit of the swap counterparty priority from the bankrupt estate. Counsel for Perpetual and for Belmont rely on the structure of the transaction as a whole as demonstrating that Lehman BSF never had an interest greater than one determinable on those events. They contend that the right of Lehman BSF both before and after its insolvency was to compel the Trustee to carry out the trusts of the Principal and Supplemental Trust Deeds. Counsel for Belmont suggests that if I accede to the submissions of counsel for Lehman BSF it will create uncertainty in a number of significant commercial areas, not least because, except for British Eagle, the principle has not been previously applied to executory contracts.
45 In my view clause 5.5 of the Supplemental Trust Deeds is not contrary to public policy on the grounds relied on or at all. I reach that conclusion for a number of reasons. First it is necessary to consider the structure of the transaction as a whole, not the terms of clause 5.5 of the Supplemental Trust Deed in isolation. The security conferred by that clause is in respect of the collateral. The collateral was bought by the issuer with the money subscribed by the investors for the notes. In no sense was it derived directly or indirectly from Lehman BSF as the swap counterparty. Second, on general principles the court should not be astute to interpret commercial transactions so as to invalidate them, particularly when, as counsel for Belmont suggested, consequential doubt might be cast on other long-standing commercial arrangements. Third, the involvement of Lehman BSF is the consequence of the swap agreement under which it sought and obtained, in effect, credit insurance in respect of the Reference Entities. As long as that agreement was being performed it was appropriate for Lehman BSF to have security for the obligations of the issuer as the other party to the swap agreement in priority to security in respect of the issuer's obligations to the noteholders under the trust deeds and the terms and conditions of the notes. It is plain that the intention of all parties was that the priority afforded to Lehman BSF was conditional on Lehman BSF continuing to perform the swap agreement. Fourth, so regarded, the priority of Lehman BSF never extended to a time after the event of default in respect of which it was the defaulting party had occurred. Fifth, it follows that such beneficial interest by way of security as Lehman BSF had in the collateral was, as to its priority, always limited and conditional. As such it never could have passed to a liquidator or trustee in bankruptcy free from those limitations and conditions as to its priority.

46 Such a conclusion is consistent with all the authorities to which I have referred. There is no attempt to oust the mandatory provisions of the Insolvency Act (cp British Eagle International Airlines v Compagnie Nationale Air France and IATA v Ansett Australia Holdings Ltd). There is no springing security for the obligations of Lehman BSF because the security enjoyed by the noteholders is security for the obligations of the issuer (cp Ex parte Mackay). There is no determination of an unlimited interest in property owned by the insolvent at the commencement of the insolvency process by virtue of his insolvency (cp Ex parte Jay, Carreras Ltd v Freeman Matthews Ltd, Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd and Peregrine Investments Holdings Ltd v Asia Infrastructure Fund Management Co Ltd).
47 In those circumstances neither of the other two issues referred to in paragraph 28 arises. Nevertheless, as this case is likely to go further it may help if, briefly, I express my views on them. The second issue focuses on the fact that Lehman BSF is not subject to any insolvency process in England. As the principle is based on public policy in England in relation to the Insolvency Act so, it is said, it cannot apply when the company in question is only subject to insolvency processes in another state under different legislation. I am not, it is said, entitled to take account of the public policy of other states in respect of other legislation. A similar submission was, at one stage, made to Neuberger J in Money Markets. In that case the company in question was being wound up by the High Court in Ireland. He rejected it on the grounds that the law of insolvency in the Republic of Ireland was essentially the same as the law of England, on grounds of comity and in reliance on provisions of the EC Treaty.
48 The logic of the submission that the principle of British Eagle is based on the insolvency law of England, not that of any foreign state, and therefore requires some insolvency process in England appears to be impeccable. But it leads no where. Both the common law and the UNCITRAL model law of insolvency, given statutory force in the United Kingdom by Insolvency Act 2000 and Cross-Border Insolvency Regulations 2006 SI 2006 No 1030, invite this court to co-operate with the insolvency regimes of foreign states, see Barclays Bank plc v Homan [1993] BCLC 680, 687 and 691 and Cambridge Gas Transportation Corporation v Unsecured Creditors of Navigator Holdings plc [2007] 1 AC 508, 518 paras 20 to 22. It is common ground that in exercise of that jurisdiction this court can assume that the insolvency proceedings in the US are insolvency proceedings in England. But, if that is not enough, those in control of Lehman BSF can procure that it is wound up in England on a petition presented either by the Company itself or by its foreign representative appointed by the US Bankruptcy Court and recognised in England under Article 15 of the UNCITRAL Model Law of Insolvency. In those circumstances a conclusion to the effect that the principle in British Eagle is not applicable in the circumstances of this case would be absurd; not least because it is Lehman BSF which contends that it applies and which, if I concluded that it did not apply, could ensure that it did.
49 The other issue is whether, if the British Eagle principle were capable of applying, it would do so where the event which caused the switch to Note-holder Priority was not the commencement of the relevant insolvency process. The point arises from the facts that under clause 5.5 of the Supplemental Trust Deeds priority is changed if there is "an Event of Default (as defined in the Swap Agreement) and the Swap Counterparty is the Defaulting Party (as defined in the Swap Agreement)". The "Events of Default" are set out in clause 5(a) of the Swap Agreement of which I have quoted the material passages in paragraph 20 above. The bankruptcy events include those occurring in relation to the credit support provider of Lehman BSF, defined in paragraph 10(iv) of the Swap Confirmation as Lehman Brothers Holdings Inc (see paragraph 23 above). "Defaulting Party" is defined in clause 6(a) of the swap agreement as the party in respect of which the event of default occurs. Accordingly I do not think there can be any doubt that an event of default, as defined, arose on 15th September 2008, Lehman BSF

was the defaulting party in respect of it and that that was an event other than the insolvency of Lehman BSF.

50 The effect of the termination of an interest on two or more events, one of which was the insolvency of the holder of the interest has arisen in two cases in the Court of Appeal. The first was Ex Parte Jay to which I have referred in detail in paragraphs 32 and 33 above. In that case bankruptcy was only one of the events on which forfeiture occurred. The fact that forfeiture on that event would have been void did not render ineffective forfeiture on one of the others. That seems to me to be direct and binding authority for the proposition that the invalidity of a forfeiture on one of the several events on which it might be made was not affected by the fact that a forfeiture on another of those events, namely bankruptcy, would have been contrary to public policy and void. The second was Ex Parte Newitt (1881) 16 ChD 522. In that case the interest of a builder in his building materials on site was forfeited to the owner of the land in the event of non payment of rent, failure to perform and observe the terms of the building agreement or failure to complete the buildings. The builder went into liquidation and the owner re-entered. The Court of Appeal, being the same constitution as in Ex Parte Jay, followed their own earlier decision.

51 This point was considered by Neuberger J in Money Markets paragraphs 104 to 109. There he considered that the decision in Ex Parte Newitt supported the proposition that a provision applicable on events other than the insolvency of the person concerned if exercised for such other reason would be valid. However he was concerned whether it was consistent with the reasoning of the majority in British Eagle. Counsel for Belmont submits that the decision of the Court of Appeal in Ex Parte Jay is a decision binding on me to the effect that a forfeiture provision exercisable on a number of events of which bankruptcy is one is valid if exercised in reliance on such other events notwithstanding that it would have been invalid if exercised on the ground of insolvency. Neuberger J did not consider whether that aspect of Ex Parte Jay was binding on him. Had he done so then he would have had also to consider whether it was open to him, rather than the Court of Appeal, to treat it as inconsistent with the decision of the House of Lords in British Eagle. In my view there is no sufficient inconsistency between the decision of the Court of Appeal in Ex Parte Jay and of the House of Lords in British Eagle to entitle me to decline to follow the former.

52 The response of counsel for Lehman BSF is that the alternative priorities for which clause 5.5 of the Supplemental Trust Deed provides apply only to the application of the moneys received from the realisation or enforcement of the collateral. Under clause 5.5 of the Principal Trust Deed the security over the collateral is not enforceable unless and until either an amount due under the notes has not been paid or the swap agreement has been terminated with sums due to the swap counterparty. He points out that the termination of the swap agreement depends not only on the occurrence of the same event of default but also the giving of a notice in accordance with clause 6(a) of the swap agreement. That provides that the notice must specify the relevant event of default. It is not in dispute that the notices given by Perpetual and Belmont only specified the chapter 11 filing by Lehman BSF, not the earlier filing by Lehman Brothers Holdings Inc.

53 The response of counsel for Perpetual and Belmont is to point out that their clients' termination notices were expressly without prejudice to any earlier rights. In addition they rely on a general principle entitling a party to justify his actions by reference to facts then existing but only discovered later said to be illustrated by the decision of the Court of Appeal in Byblos Bank SAL v Khudairy [1987] BCLC 232 and Chitty on Contracts 13th Ed. para 24-014.

54 In my view the resolution of this issue depends on the proper construction of the relevant documents. The submission for Lehman BSF involves the proposition that an event of default

sufficient to trigger a change of priority under clause 5.5 of the Supplemental Trust Deed must also be the event of default relied on to trigger the realisation or enforcement of the security. That is not an express requirement of clause 5.5 but is said to be implicit in the fact that the opening words of clause 5.5 show that the clause as a whole is dealing with the application of the proceeds of realisation or enforcement.

55 I do not accept that submission. The security may become enforceable under clause 5.5 of the Principal Trust Deed otherwise than on the termination of the swap agreement. Had it been intended that the priorities should depend on any such termination, clause 5.5 of the Supplemental Trust Deed could easily have so provided. Plainly the event of default sufficient to trigger clause 5.5 of the Supplemental Trust Deed must precede the termination of the swap agreement. I see no reason why, given the forms of their respective notices, Perpetual and Belmont should not be entitled to rely on the event of default constituted by Lehman Brothers Holdings Inc filing for Chapter 11 protection as triggering clause 5.5 of the Supplemental Trust Deed. Accordingly had I considered that the British Eagle principle did apply I should also have held that it was not, on the facts of this case, engaged so as to invalidate the operation of clause 5.5 of the Supplemental Trust Deed.

56 It was agreed at the hearing that I should defer all questions relating to the indemnities to which the Trustee is entitled as a condition for the enforcement of the security. It follows that the hearing of these claims will have to be adjourned for further argument in the light of my conclusions so far. Counsel for Perpetual and Belmont invited me, if I came to the conclusion I have, to make appropriate orders subject only to the resolution of the outstanding issues in relation to indemnities. But whether or not that would be appropriate must await my conclusion on the applications of Lehman BSF for these claims to be stayed. It is to those applications I now turn.

The Stay Applications

57 The applications issued by Lehman BSF invoke CPR 3.1(2)(f) and the inherent power of the Court. They seek a stay "pending the resolution of proceedings" between Lehman BSF and the Trustee in the US Bankruptcy Court, Southern District of New York. The reasons for the application stated in the application notices are:

"The issues to be addressed in the Bankruptcy Court proceedings are whether and if so to what extent the agreements in issue in this claim are valid and binding against Lehman BSF which is a debtor subject to Chapter 11 of the US Bankruptcy Code. Those issues ought to be determined prior to the determination of this claim in order that the parties' rights and obligations in relation to the agreements can be properly understood. As a matter of the just and efficient management of this case and/or in the interests of comity, it is therefore appropriate for this Court to make its determination after and in the light of the judgment of the Bankruptcy Court. Furthermore these proceedings are brought in breach of the automatic stay which is in place over claims against Lehman BSF and its estate pursuant to chapter 11 of the US Bankruptcy Code."

58 The responses of Perpetual and Belmont were that the applications should be dismissed on three grounds. They were that (1) under the Judgments Regulation (Council Regulation EC 44/2001) I have no jurisdiction to grant a permanent stay; (2) even if I had jurisdiction I should not do so as the provisions of a foreign bankruptcy code cannot be applied when determining the interpretation of a contract governed by English law; and (3) if and in so far as the stay sought is a temporary one the court's power to grant one on case management grounds should be exercised only in rare and compelling cases, which these are not.

59 In the event the application made by counsel for Lehman BSF was much more limited than

that presaged by the application notices and on substantially different grounds, thereby rendering much of the written arguments of Perpetual and Belmont redundant. The grounds advanced by counsel for Lehman BSF were to the effect that this court should not by its order inhibit the US Bankruptcy Court from determining the complaint made to it by Lehman BSF and Lehman Brothers Holdings Inc. Nor should it grant relief in these claims which might disable it from requesting this court for assistance either under its general jurisdiction or under UNCITRAL Model Law of Insolvency. Accordingly he seeks only a temporary stay.
60 Counsel for Perpetual and Belmont complained that the extent to which the stay sought might be temporary would depend on what use Lehman BSF sought to make of any judgment it obtained from the US Bankruptcy Court. It was suggested that I should require, as a condition for the grant of a temporary stay, an undertaking that Lehman BSF would not seek to obtain or use any judgment obtained from the US Bankruptcy Court so as to bind the Trustee.
61 The nature and purpose of the stay sought by counsel for Lehman BSF was clarified in oral argument to be the co-ordination of the insolvency jurisdictions of the US and the UK. That was further limited to the giving of time for the US Bankruptcy Court to formulate and transmit to this court such request or requests for assistance as it might think fit under either the common law or the UNCITRAL Model Law. The response of counsel for Perpetual and Belmont is to the effect that there is no assistance which the US Bankruptcy Court might request this court to give which it would be entitled to give. This submission was based on the fact, as to which there is no issue, that s.426 Insolvency Act 1986 does not apply so the only entitlement to render assistance would be under the common law or the UNCITRAL Model Law. Counsel for Perpetual and Belmont submit that neither of those jurisdictions would entitle this court to apply foreign law to the dispute before it.
62 Whether or not under the common law this court would be entitled to give effect to foreign law was doubted by the Privy Council in Cambridge Gas Transportation Corporation v Unsecured Creditors of Navigator Holdings plc [2007] 1 AC 508, 518 para 22. But the arguments of counsel showed that there is an important issue as to the extent of this Court's powers under the UNCITRAL Model Law. Article 21(1) provides that:
"upon recognition of a foreign proceeding, whether main or non-main, where necessary to protect the assets of the debtor or the interests of creditors, the court may, at the request of the foreign representative, grant any appropriate relief, including..."
Similarly, Article 25(1) provides that:
"In matters referred to in paragraph 1 of Article 1, the court may co-operate to the maximum extent possible with foreign courts or foreign representatives, either directly or through a British insolvency officeholder."
The matters referred to in paragraph 1 of Article 1 include:
"where –
(a) assistance is sought in Great Britain by a foreign court or a foreign representative in connection with a foreign proceeding; or
[(b)] or
(c) a foreign proceeding and a proceeding under British insolvency law in respect of the same debtor are taking place concurrently;or
(d) creditors or other interested persons in a foreign State have an interest in requesting the commencement of, or participating in, a proceeding under British insolvency law."
63 Counsel for Lehman BSF submitted that those provisions could entitle this court to apply provisions of the US Bankruptcy Code. In the course of his reply he informed me that it was intended to seek the appointment of a foreign representative. No doubt such representative, when appointed, will consider whether by himself under Article 9 of the UNCITRAL Model Law

or through the US Bankruptcy Court pursuant to Article 25 to make any and what requests for assistance from this court. It would be premature and academic for this court to decide on the extent of its powers under the UNCITRAL Model Law or the common law in the absence of a specific request or requests. Similarly it would be inappropriate for me now, as counsel for Perpetual and Belmont invited me to do, to make the orders and declarations that they seek subject only to the provision to the Trustee of appropriate indemnities. Such relief would effectively preclude any request or other application made by the foreign representative or the US Bankruptcy Court. As these claims have to be adjourned to enable the issue of indemnities to be agreed or determined and as they cannot be listed for any further hearing before October 2009 that ought to give the foreign representative and the US Bankruptcy Court sufficient time to determine what they wish to do in relation to these proceedings and in the light of my conclusion on the validity of clause 5.5 of the Supplemental Trust Deeds under English law by which all the relevant documents are governed and are to be interpreted.

64 In all these circumstances and for the reasons I have explained I will adjourn these proceedings to a date to be fixed through the usual channels, such date not to be earlier than 1st October 2009.

Perpetual Trustee Co. Ltd V BNY Corporate Trustee Services Ltd (CA) 2009] EWCA Civ 1160

The Master of the Rolls [2]

Introductory

1. The main issue raised on these appeals concerns the extent of the so-called anti-deprivation rule ("the rule"). This rule, which has been expressed in slightly different ways in the cases, was put in these terms in Ex p Jay; In re Harrison (1880) 14 Ch D 19, 26 by Cotton LJ: "there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors."

2. In the Perpetual appeal, those administering the estate of Lehman Brothers Special Financing Inc ("LBSF") contends that the Chancellor was wrong to hold that the rule did not apply to a number of so-called synthetic collateralised debt obligations, set up through the medium of a special purpose vehicle ("SPV"), so as to vitiate provisions which, on an insolvency event, (a) switched the priority, which was enjoyed over the assets in the SPV between the credit default swap counterparty (LBSF) and the Noteholders, in favour of the Noteholders, and (b) changed the allocation of the so-called "unwind costs" in favour of the Noteholders to the potential detriment of LBSF. The Chancellor held that the rule did not apply for two reasons. First, the nature of the disadvantage suffered by LBSF did not fall within the rule; secondly, even if the rule would otherwise have applied, the two provisions were operated by an event before LBSF filed for Chapter 11 US Bankruptcy Code ("Chapter 11") protection in the US Bankruptcy Court (which is agreed to be the equivalent of the making of a winding up order for the purposes of the application of the rule). Perpetual Trustee Co Ltd ("Perpetual") and Belmont Park Investment Pty Ltd ("Belmont"), representing the Noteholders, say the Chancellor was right on each of those two grounds in holding that the rule did not apply. The Trustee adopted a neutral position on the appeal....

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[2] Lord Neuberger has been Master of the Rolls since 1 October, 2009. The judgment in this case was issued 6 November 2009.

4. I propose first to describe the relevant documentation and events which give rise to the issues in the Perpetual appeal ... next, I shall turn to the cases on, and general approach to, the anti-deprivation rule; I shall then discuss the application of the rule to the facts ...

The facts in the Perpetual appeal

5. In his judgment, [2009] EWHC 1912 (Ch), the Chancellor set out in summary form the effect of the documentation involved in the Perpetual case, in the following terms:

"(1) the issue of Notes ("the Notes") to investors by an SPV ("the issuer") formed by a Lehman company in a tax friendly jurisdiction;

(2) the purchase by the issuer with the subscription money paid for the Notes of government bonds or other secure investments ("the collateral") vested in a trust corporation;

(3) a swap agreement entered into by a Lehman company and the issuer under which the Lehman company paid the issuer the amounts due by the issuer to the Noteholders in exchange for sums equal to the yield on the collateral;

(4) the amount by which the sum payable under the swap agreement by the Lehman company exceeded the yield on the collateral represented the premium for the, in effect, credit insurance provided by the Noteholders;

(5) the amount payable by the Lehman company to the issuer on the maturity of the Notes (or on early redemption or termination) was the initial principal amount subscribed by the investors less amounts calculated by reference to events defined as credit events occurring during a specified period by reference to one or more reference entities, thereby giving effect to the effective insurance aspect of the programme;

(6) the collateral was charged by the issuer in favour of the trust corporation to secure its obligations to the Noteholders and the Lehman company on terms which changed their respective priorities on the occurrence of certain specified events, including the insolvency of the Lehman company,

(7) each of the transactions summarised above (except the purchase of the collateral) is governed by English law."

6. It is necessary, for present purposes, to describe in a little more detail the relevant provisions in the voluminous documentation in which the terms of these arrangements were recorded, and to set out briefly the events which give rise to the dispute.

7. There are twelve relevant issues of Notes, two being the subject of claims by Perpetual, and ten by Belmont. Subject to a few small exceptions, the documentation in relation to all twelve Notes issues is essentially in the same form, and the facts relating to the Notes are, with one or two possible exceptions, the same so far as they affect the disputes in this appeal. Accordingly, I shall limit myself, for the moment, to the documentation and facts relating to one of the Notes issues in Perpetual's case, known as Saphir I. Some provisions are in more than one document, and I shall not identify such provisions more than once.

8. Saphir I was governed by three documents, (i) a Principal Trust Deed ("the PTD") between Dante Finance Public Limited Company ("Dante", the first issuer under the programme) and the BNY Corporate Trustee Services Limited ("the Trustee"), (ii) a Supplemental Trust Deed and Drawdown Agreement ("the STD") made between the issuer, the Trustee (together with its associated custodian and paying agent), LBSF (described as the swap counterparty) and the Lehman company which established these Notes issues, Lehman Brothers International Europe ("LBIE"), and (iii) the Terms and Conditions ("the T & C") which were attached to the prospectus sent to potential investors. The swap agreement was regulated by two documents, (i) an ISDA Master Agreement ("the ISDA") between Dante and LBSF, and (ii) a swap confirmation.

9. By clause 5.1 of the PTD, the issuer granted "as continuing security" the charge and security interest set out in the STD. Clause 5.5 of the PTD provided that the security so granted shall become enforceable "if (i) any amount due in respect of the Notes is not paid or delivered when due or (ii) a Swap Agreement terminates with sums due to the Swap Counterparty [i.e. LBSF]." Clause 5.6 provided that the Trustee was bound "at any time after any security...shall have become enforceable" to enforce the security over the collateral, if requested by at least one fifth of the Noteholders, or by LBSF, in certain specified events, or otherwise at its discretion.

10. Clause 6.1 of the PTD stated that moneys, received otherwise than in connection with the realisation or enforcement of the security, were to be held by the Trustee, after payment of the Trustee's costs, on trust to pay, first, the amounts due to LBSF, the Noteholders and others pari passu, and, secondly, the amounts due to the issuer. Clause 6.2 of the PTD directed the Trustee "to apply all moneys received by it under [the PTD] and the [STD] in connection with the realisation or enforcement of the security as follows…". There followed a number of orders of priority, which were defined in detail, two of which were "Swap Counterparty Priority" and "Noteholder Priority". The priority which was to apply in any particular case was that specified in the STD.

11. Condition 6(d)(ii) of Part C of Schedule 2 to the PTD provided for the early redemption of the Notes if a swap agreement was terminated. In that event, the issuer was required to give the Trustee, the Noteholders and LBSF notice, at the expiration of which the Notes were to be redeemed at their early redemption amount. Condition 10 defined events of default in relation to the Notes as including default in payment of any sum due in respect of the Notes for a period of 14 days or more.

12. Clause 5.2 of the STD contained a charge by the issuer "as continuing security in favour of the Trustee" over the collateral and other property representing it from time to time. Clause 5.3 provided that such security was "granted to the Trustee as trustee for itself and/or the holders of Notes and [LBSF] as continuing security (i) for the payment of all sums due under the Trust Deed and the Notes (ii) for the performance of the Issuer's obligations (if any) under the Swap Agreement...". Clause 5.5 of the STD ("clause 5.5") is of particular relevance, and it was in these terms:

"The Trustee shall apply all moneys received by it under this Deed in connection with the realisation or enforcement of the Mortgaged Property as follows: Swap Counterparty Priority unless … an Event of Default … occurs under the Swap Agreement and the Swap Counterparty is the Defaulting Party…in which case Noteholder Priority shall apply."

13. Clause 6.2 of the PTD provided that "Swap Counterparty Priority" meant that the claims of LBSF were payable in priority to the claims of the Noteholders, whereas "Noteholder Priority" meant the converse, in each case after providing for payment of certain specified costs and charges. Clause 9.3 of the STD stated, so far as material:

"[LBSF] hereby agrees that, if an Event of Default … occurs under the Swap Agreement and [LBSF] is the Defaulting Party ....and Unwind Costs are payable by the Issuer to [LBSF], the Issuer shall apply the net proceeds from the sale or realisation of the Collateral first in redeeming the Notes in an amount as set out in the Conditions and thereafter in payment of such Unwind Costs to [LBSF]."

14. The T & C were included in the prospectus, which pointed out that the Notes were 'credit-linked' to the reference entities (i.e. the securities whose credit was being, in effect, insured). The prospectus also pointed out that, in addition, the Notes had exposure to the value of the collateral so that "Impairment of the Collateral may result in a negative rating action on the Notes". Condition 6 of the T & C contained the details of how and by how much the principal amount due on the Notes was reducible in the event of credit events affecting a reference

entity, the details of which are not material. Condition 38 provided that early redemption would be triggered by the issuer serving a notice, which was required to be done on the happening of an Event of Default under the Notes. Condition 43 of the T & C concerned the calculation of the redemption amount to be paid by the swap counterparty on the maturity of the Notes.

15. Condition 44 of the T & C, like clause 5.5, is of central significance. It dealt with the early redemption amounts referred to in condition 6(d)(ii) of Part C of Schedule 2 to the STD. It also included a definition of "Unwind Costs". These were the amounts due to or, as the case may be, from LBSF, as the swap counterparty under the Swap Agreement at its termination. These costs were to be assessed by reference to quotations taken in the market, when the Swap Agreement terminated, for what a third party would pay to enter into a swap arrangement on similar terms, or, alternatively, what the issuer would have to pay a third party to enter into such a swap arrangement.

16. The first paragraph of Condition 44 ("Condition 44.1") provided that the amount payable on the Notes should be the amount equal to the Notes' pro rata share of the proceeds from the sale or realisation of the collateral, "plus (if payable to the Issuer) or minus (if payable to [LBSF]) the amount of any Unwind Costs". So, under that paragraph, if termination occurred early, an early redemption amount was to be calculated, and if Unwind Costs were payable under the swap to LBSF on termination, they were to be deducted when calculating any amount which would be due to the Noteholders, and if such Unwind Costs were payable the other way, they were to be added to the amount payable to the Noteholders.

17. The second paragraph, rather than the first paragraph, of Condition 44 ("Condition 44.2") applied "if an event of default as defined in the ISDA … occurs under the Swap Agreement and [LBSF] is the Defaulting Party". In that event, the Noteholders' pro rata share of the proceeds from the sale or realisation of the collateral was no longer to be subject to a deduction on account of the Unwind Costs that would be payable to LBSF, but, if the Unwind Costs were payable by LBSF to the issuer, the amount was still to be added to the amount payable to the Noteholders.

18. Clause 5 of the ISDA defined an event of default as being "[t]he occurrence [of certain specified events] at any time with respect to [LBSF] or any Credit Support Provider" of LBSF, namely, according to 10(iv) of the swap confirmation, the ultimate parent of LBSF, Lehman Brothers Holdings Inc ["LBHI"]". Those events included failure to pay any sums due under the ISDA (after 3 days' notice of such failure), and the institution of any proceedings seeking a judgment of insolvency or bankruptcy or any other relief under any bankruptcy or insolvency or other similar law affecting creditors' rights …".

19. Clause 6 of the ISDA dealt with early termination and provided that:

"If at any time an Event of Default with respect to a party (the "Defaulting Party") has occurred and is then continuing, the other party … may, by not more than 20 days notice to the Defaulting Party specifying the relevant Event of Default, designate a date not earlier than the day such notice is effective as an Early Termination Date in respect of outstanding transactions..."

20. Clause 10 of the swap confirmation included an acknowledgement by the issuer and LBSF that the transaction was not intended to constitute insurance business so that payments by each party under the transaction were independent and not dependent on proof of economic loss of the other.

21. As to the facts giving rise to the dispute, I gratefully adopt the Chancellor's summary of them (in a slightly modified form) as regards Saphir I:

(1) On 15 September 2008, LBHI filed for Chapter 11. As it was specified in Clause 10(iv) of the Swap Confirmation as the Credit Support Provider of LBSF, the filing constituted an Event

of Default for the purposes of the swap agreements, by virtue of clause 5(a)(vii)(4) of the ISDA. Prima facie, that event gave rise to Noteholder Priority and triggered Condition 44.2.

(2) From 15 September 2008, interest payments due under the Notes were not paid on their respective due dates and remain unpaid. Such non-payment also, at least prima facie, constituted an Event of Default by virtue of Condition 10 in Part C of Schedule 2 to the PTD.

(3) On 3 October 2008 LBSF filed for Chapter 11. Such filing also constituted an Event of Default for the purposes of the swap agreements, and, prima facie, gave rise to Noteholder Priority and triggered Condition 44.2.

(4) Between 28 November and 3 December 2008 the Noteholders gave notice to the Trustee in reliance on the Event of Default constituted by the filing for Chapter 11 effected by LBSF on 3 October 2008, designating 1 December 2008 as the Early Termination Date under clause 6(a) of the ISDA. The Trustee caused the issuer to serve swap termination notices in those terms on LBSF on 1 December 2008.

(5) On 8 May 2009 Perpetual passed extraordinary resolutions requiring the Trustee to serve notice on the issuer to the effect that the Notes were immediately due and requiring the Trustee to enforce its security.

22. LBSF contended that Perpetual and Belmont, as Noteholders, were not entitled to rely on these Events of Default as triggering Noteholder Priority under clause 5.5, or triggering Condition 44.2, as this would fall foul of the rule. This argument was rejected by the Chancellor on two grounds. First, he held that, even if the triggering event had been the Chapter 11 filing by LBSF, there would have been nothing to which the rule applied; secondly, he held that, even if that was wrong, as the Event of Default which effected the trigger was the Chapter 11 filing by LBHI, which preceded the Chapter 11 filing of LBSF, so the rule did not apply....

The anti-deprivation rule

The 19th century and early 20th century authorities

32. The rule has been considered and applied in a number of cases at first instance and the Court of Appeal going back into the 18th century, and probably earlier, although the observations of Lord Eldon LC in Wilson v Greenwood (1818) 1 Sw 471, 482 have often been taken as the starting point. It is not entirely easy to identify the rule's precise limits, or even its precise nature, from these cases, as the reasoning in the various judgments in which the rule has been considered is often a little opaque, and some of the judgments are a little hard to reconcile.

33. The majority of reported cases on the extent and application of the rule to which we were referred were decided between 1860 and 1930. They were Whitmore v Mason (1861) 2 J&H 204, Ex p Mackay. Ex p Brown. In re Jeavons (1873) LR 8 Ch App 643, Ex p Williams. In re Thompson (1877) 7 Ch D 138, Ex p Jay 14 Ch D 19, Ex p Newitt. In re Garrud (1880) 16 Ch D 522, Ex p Barter. Ex p Black. In re Walker (1884) 26 Ch D 510, In re Detmold. Detmold v Detmold (1889) 40 Ch D 585, Borland's Trustee v Steel Brothers & Co Limited [1901] 1 Ch 279, and In re Johns [1928] 1 Ch 737.

34. Whitmore 2 J&H 204 concerned a provision in a partnership deed which stated that, in the event of the "bankruptcy or insolvency" of a partner, an account was to be taken, and the bankrupt partner was to lose his interest in the partnership assets at a market valuation (save that his interest in a mining lease was to be excluded from the valuation). Page Wood V-C held that, only in so far as it related to the lease, the provision was void. At 2 J&H 204, 212, he identified the rule as being "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." He also made it clear that his

decision would have been different if the other partners had provided the £500 which the bankrupt partner in that case had paid for his interest in the lease - see 2 J&H 204, 212 and 214-5 (and per Giffard QC in argument at 210). He also made it clear that the rule did not extend to invalidate a provision for the determination of a lease on insolvency – on the basis of the maxim cuius est dare eius est disponere – see 2 J&H 204, 212-213. Page Wood V-C also held that the fact that the triggering event was Smith's insolvency rather than his bankruptcy, and therefore preceded his bankruptcy, did not enable the rule to be avoided: to hold otherwise, he considered, would mean that "the bankrupt laws might, in all cases, be defeated" – 2 J&H 204, 215.

35. Mackay 8 Ch D 643 involved two transactions: the first was the sale of a patent by A to B in return for B paying royalties; the second was a loan of £12,500 from B to A. The two transactions were connected, in that the parties agreed that (i) B would keep half the royalties towards satisfying the debt, and (ii) in the event of A's bankruptcy, B could also keep the other half of the royalties. It was held that, while (i) was valid against A's trustee, (ii) was not. As explained by James LJ at 8 Ch D 643, 647, (i) represented "a good charge upon one moiety of the royalties", but (ii) "is a clear attempt to evade the operation of the bankruptcy laws" as it "provide[d] for a different distribution of [A's] effects in the event of bankruptcy from that which the law provides". At 8 Ch D 643, 648, Mellish LJ put it this way: "a person cannot make it part of his contract that, in the event of bankruptcy, he is then to get some additional advantage which prevents the property being distributed under the bankruptcy laws."

36. The decision in Williams 7 Ch D 138 was, as I see it, simply based on the fact that the clause in question "was a mere sham, a mere contrivance and device" the purpose of which was to give a particular creditor additional security on bankruptcy or liquidation, and therefore preference against other creditors, only in the event of the debtor's bankruptcy – per James LJ at 7 Ch D 138, 143 (and similar language was used by Baggallay and Thesiger LJJ at 7 Ch D 138, 143 and 144).

37. In Jay 14 Ch D 19, the provision under consideration was a clause which entitled a landowner, who had granted a builder possession of her land, to re-take possession and to forfeit any of the builder's chattels which were on the land, in the event of the latter's bankruptcy. There was no challenge to the right of re-entry onto the land, but the right to forfeit the chattels was held to offend the rule. The fact that the landowner had had no interest in the chattels until the builder became bankrupt seems to have been an essential feature, as is clear from the judgment of Cotton LJ at 14 Ch D 19, 26, where he distinguished two earlier cases where the rule was held not to apply, so that the forfeiture provisions were valid. His ground for distinction was that, in those two cases, "the Court considered the effect of the contract was to give the landlord from the very time when the contract was entered into an equitable interest in the chattels".

38. The facts in Newitt 16 Ch D 522 were very similar to those in Jay 14 Ch D 19, but the provision was held to be valid. The difference between the two cases was that, in Newitt 16 Ch D 522, the bankrupt builder had breached the terms of his agreement with the landowner and it was provided in the agreement that the chattels would be forfeited to the landowner "as and for liquidated damages", whereas in Jay 14 Ch D 19, the builder was not in breach of contract, and the right to forfeit was not expressed to be in respect of any money claim. At 16 Ch D 522, 530, James LJ said that the court had "no power to add to the Act for the purpose of making this security for the performance of the contract, which was bona fide taken by the landowner, bad by reason of the bankruptcy of the builder." On the following page, he made the point that the "broad general principle is that the trustee in a bankruptcy takes all the bankrupt's property, but

takes it subject to all the liabilities which affected it in the bankrupt's hands, unless … added to by some express provision of the bankrupt law."

39. Barter 26 Ch D 510 is another example of the application of the rule. A prospective buyer of a ship had the right to take possession of the ship and use the shipbuilder's premises and chattels to complete the building work, in the event of the builder not proceeding with the shipbuilding or going bankrupt. The Court of Appeal applied the following proposition in Whitmore 2 J&H 204, 210:

"[T]he owner of property may, on alienation, qualify the interest of his alienee by a condition to take effect on bankruptcy; but cannot by contract or otherwise qualify his own interest by a like condition, determining or controlling it in the event of his own bankruptcy, to the disappointment or delay of his creditors. The jus disponendi, which for the first purpose is absolute, being, in the latter instance, subject to the disposition previously prescribed by law."

40. In Detmold 40 Ch D 585, the provision under consideration stated that the property in a marriage settlement (originating from the husband) should pass to the wife for life in the event of an alienation by, or the bankruptcy of, the husband. The provision was held valid against the husband's trustee in bankruptcy, on the ground that it had been triggered, prior to the commencement of the bankruptcy, by the alienation effected as the result of the appointment of a receiver of the property in the settlement.

41. In Borland [1901] 1 Ch 279, a provision in a company's articles of association, providing for the transfer of a shareholder's shares to the other shareholders in the event of his bankruptcy, would have been held to infringe the rule (consistently with the decision in Whitmore 2 J&H 204), but for the fact that, viewed in the context of the provisions of the articles governing the compulsory transfer of shares in other circumstances, the provision was "fair", as explained at [1901] 1 Ch 279, 291. In particular, although the provision limited the price payable for the shares to their par value, it did not "compel … persons to sell their shares in the event of bankruptcy at something less than the price that they would otherwise obtain"; had it done so, the provision would have been "repugnant to the bankruptcy law".

42. As for Johns [1928] 1 Ch 737, it concerned an artificial, transparent arrangement between mother and son, whereby the amount repayable by the son in respect of periodic loans made by the mother (which could not exceed £650, and might be as little as £10, in all) was to increase from £650 to £1,650 (plus interest) in the event of the son's bankruptcy. Unsurprisingly, the Judge described it as "a deliberate device to secure that more money would come to the mother if the son went bankrupt, than would come to her if he did not; and, that being so, … the device is bad".

The House of Lords' decision in British Eagle [1975] 1 WLR 758

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

44. In British Eagle [1975] 1 WLR 758, reversing Templeman J and a unanimous Court of Appeal, the House of Lords, by a bare majority, decided that a clearing house arrangement

between a large number of airline companies relating to debts arising as between them was ineffective as against the liquidator of one of the companies, British Eagle, which had gone into liquidation. As explained by Lord Cross of Chelsea (with whom Lord Diplock and Lord Edmund-Davies agreed), this conclusion was reached on the ground that, insofar as the arrangement purported to apply to debts which existed when the members of the company passed the resolution to go into creditors' voluntary liquidation, it would have amounted to contracting out of the statutory requirement that the assets owned by the company at the date of its liquidation should be available to its liquidator, who should use them to meet the company's unsecured liabilities pari passu, under section 302 of the Companies Act 1948 (now effectively re-enacted as section 107 of the Insolvency Act 1986).

45. British Eagle had gone into creditors' liquidation as a result of a members' resolution passed on 8 November 1968, having ceased carrying on business two days earlier - [1975] 1 WLR 758, 775H, 776D, and, at 778C Lord Cross said that the contention of the respondents "with regard to the September clearance must succeed" as "[c]learance in respect of business done in September was 'completed' … on November 4, before the winding up resolution was passed". In other words, he concluded that debts which had effectively ceased to exist by the date of the winding up resolution (8 November 1968), because they had already passed into the clearing house arrangement, were not caught by the rule, which only bit on debts which existed on or after the date of the winding-up.

46. At [1975] 1 WLR 758, 780A, there is reference to Mackay 8 Ch App 643, and to the respondents' argument that it "was a very different case from this", as "the provision which was impugned effected a change on bankruptcy", whereas in the case before the House, "there was no change whatever on the winding-up: the same 'clearing house' provisions applied". However, Lord Cross rejected that argument, and, at 780F-G, he relied on the decision in Mackay 8 Ch App 643, in which, he said, the court "could only [have] go[ne] behind [the charge on the second half of the royalties] if it was satisfied – as was indeed obvious in that case - that it had been created deliberately in order to provide for a different distribution of the insolvent's property on his bankruptcy from that prescribed by the law", on the basis that it was "irrelevant that the parties to the 'clearing house' arrangements had good business reasons for entering into them and did not direct their minds to the question of how the arrangements might be affected by the insolvency of one or more of the parties.". At [1975] 1 WLR 758, 780H, he said that "[s]uch a 'contracting out' must, to my mind, be contrary to public policy".

47. The main dissenting speech was given by Lord Morris of Borth-y-Gest, with whom Lord Simon of Glaisdale agreed. Lord Morris also cited Mackay 8 Ch App 643, and referred to Johns [1928] Ch 737, distinguishing them as cases where the relevant provisions were "a clear attempt to evade the operation of", or "a device for defeating", "the bankruptcy laws" (see [1975] 1 WLR 758, 770A-E).

48. British Eagle [1975] 1 WLR 758 was applied in Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd [1985] 1 Ch 207. At [1985] 1 Ch 207, 226E-F, Peter Gibson J said that "the principle that [he] extracted from" it was that "where the effect of a contract is that an asset which is actually owned by a company at the commencement of its liquidation would be dealt with in a way other than in accordance with section 302 … then to that extent the contract as a matter of public policy is avoided". He held that the rule did not apply to monies due to the company, but paid, with its agreement because of its financial difficulties, into an account for the benefit of third parties. But he went on to hold that the rule did apply to other sums.

49. The decision of the High Court of Australia in International Air Transport Association v Ansett Australia Holdings Ltd [2008] BPIR 57, where British Eagle [1975] 1 WLR 758 was discussed and distinguished, should also be mentioned. The agreement creating the clearing

house arrangement, as considered by the House of Lords, was redrafted so as to circumvent the rule. The majority of the High Court concluded that the document achieved its aim. At [2008] BPIR 57, para 76, Gummow, Hayne, Heydon, Crennan and Kiefel JJ suggested that the basis of the House of Lords' decision was simply that one could not contract out of section 302. In the following paragraph, they referred to the contention that "in insolvency law, the whole of the debtor's estate should be available for distribution to all his creditors, and that no one creditor or group of creditors can lawfully contract in such a manner as to defeat other creditors not parties to the contract". At [2008] BPIR 57, para 79, the Justices said that whether this contention was correct "depend[s] entirely upon what the relevant statute provides". They then rejected the suggestion inherent in the contention "that the public policy achieves what the statute otherwise does not achieve".

The Insolvency Act 1986

50. As explained in the more modern authorities, British Eagle [1975] 1 WLR 758, Carreras Rothmans [1984] 1 Ch 207 and Ansett Australia [2008] BPIR 57, the rule is essentially based on the proposition that one cannot contract out of the provisions of the insolvency legislation which govern the way in which assets are dealt with in a liquidation. It is therefore appropriate briefly to mention the relevant provisions for these purposes, which are, of course, in the Insolvency Act 1986.

51. Section 107 of the 1986 Act (the modern equivalent of section 302 of the 1948 Act relied on in British Eagle [1975] 1 WLR 758) provides that, subject to the provisions relating to preferential payments, "the company's property in a [voluntary] winding up [should] be applied in satisfaction of the company's liabilities pari passu", and rule 4.181 of the Insolvency Rules 1986 contains a similar provision where the winding up is pursuant to a court order. Sections 143(1) and 144(1) state that, where a company is subject to a winding up order, the liquidator must "secure that the assets of the company are got in, realised and distributed to the company's creditors ….", and, subject to that, he must "take into his custody or under his control all the property and things in action to which the company is … entitled".

52. Section 127 of the 1986 Act provides that "any disposition of the company's property … made after the commencement of the winding up is, unless the court otherwise orders, void." Sections 238 and 239 enable a liquidator to apply to the court for an order "restoring the position", where the company has "at a relevant time" "entered into a transaction with any person at an undervalue", or has done anything which, in the event of the company's insolvent liquidation, would put a creditor (or guarantor) of the company in a better position than he would otherwise be in. The relevant time is backdated from "the onset of insolvency" – i.e. the making of an administration application, the appointment of an administrator or the presentation of a winding up petition, and is 2 years where the person concerned is "connected with the company" and is otherwise six months in the case of a preference. Certain floating charges are avoided under section 245 if created in favour of a person "connected with the company" within 2 years, and otherwise within 1 year, of "the onset of insolvency".

The ambit of the rule: general approach

53. The present appeals raise a number of questions as to the precise ambit of the rule. When considering any question concerning the ambit of the rule, it seems to me that certain principles should be borne in mind.

54. First, Lord Cross's speech in British Eagle [1975] 1 WLR 758, especially at 780C-781B, is high authority for the proposition that the rule is based on public policy, but only to the extent that one cannot contract out of the insolvency legislation. That is supported by what was said by

James LJ in the Court of Appeal, in Mackay 8 Ch App 643 and, even more clearly, in Newitt 16 Ch D 522, and, more recently, by Peter Gibson J in Carreras Rothman [1985] 1 Ch 207 and by the majority in the Australian High Court in Ansett Australia [2008] BPIR 57.

55. Secondly, as to the nature of the rule, I cannot do better than cite from the majority judgment in Ansett Australia [2008] BPIR 57, para 78. The justices there explained that many of the cases where the rule has been considered "can be understood as depending upon the proper application of a … provision in the relevant statute requiring that all debts proved in an insolvency rank equally and, if the property of the insolvent is insufficient to meet them in full, they are to be paid proportionately", and some other cases "turned upon what was the 'property' of the company that was to be applied in satisfaction of its liabilities". In each case where the rule is invoked "it is essential to begin from the elementary proposition that insolvency law is statutory and primacy must be given to the relevant statutory text."

56. Thirdly, subject to one possible qualification, when considering whether the rule applies to a particular provision, there is, at least in principle, no difference between cases where the provision is expressed to apply on insolvency or liquidation and those where it is not so expressed. That appears to me to follow from the fact that the views expressed by Lord Cross (at 780F-H) prevailed over those of Lord Edmund-Davies (at 770A-E) in British Eagle [1975] 1 WLR 758. The possible exception is where the provision is an attempt artificially to avoid the insolvency regime (as in Williams 7 Ch D 138 and Johns [1928] Ch 737). However, such a case may be no more than an application of the principle that a court will not give effect to a sham transaction.

57. Fourthly, especially following the passing of the 1986 Act, the courts should not extend the rule beyond its present limits, save where logic or practicality otherwise require. Given that the rule is based on the proposition that one cannot contract out of the provisions of the insolvency legislation, it would be hard to justify going beyond the established limits of the rule, save to the extent required by legislation. Further, as Patten LJ said in argument, the 1986 Act, following the recommendations in the Cork Report, has more detailed and wide-ranging provisions with regard to undermining transactions, or the effect of transactions, entered into before winding up than the legislation in force when the English cases so far discussed were decided.

58. Fifthly, it is important that, so far as possible, judicial decisions in the insolvency field ensure that the law is clear and consistent. That has always been true, but the need for consistency and clarity is all the greater now that commercial contracts are becoming increasingly complex both in their underlying nature and in their detailed provisions, as is well demonstrated by the contracts in the instant cases, especially in the Perpetual appeal. It is also desirable that, if possible, the courts give effect to contractual terms which parties have agreed. Indeed, there is a particularly strong case for party autonomy in cases of complex financial instruments such as those involved in the Perpetual appeal and in arrangements involving large corporate groups, such as those who signed the agreements in the Butters appeal; in such cases, the parties are likely to have been commercially sophisticated and expertly advised.

The anti-deprivation rule and the Perpetual appeal

59. As mentioned, the Chancellor had two separate reasons for concluding that the rule did not prevent Perpetual and Belmont relying on Noteholder Priority and Condition 44.2. The first reason was based on the nature of the right triggered by the Insolvency Event, and essentially turned on the extent of the anti-deprivation rule. The second reason was based on the timing of the alleged deprivation, and turned on whether the rule applies to a deprivation effected prior to a winding up (or its equivalent). I shall consider these two arguments in turn.

Was there any "deprivation" which fell within the anti-deprivation rule?

60. There is obvious attraction in the argument, skilfully deployed by Mr Snowden QC on behalf of LBSF, that the "flip" from Swap Counterparty Priority to Noteholder Priority and the "flip" from Condition 44.1 to Condition 44.2 constituted deprivations which were, at least potentially, precluded by the rule. Assuming that the "flips" had applied on or after the Chapter 11 filing of LBSF, they would have had the consequence of (at least potentially) reducing the assets which would otherwise be available for distribution to the creditors of LBSF, which would appear, at least arguably, to be a "deprivation" of the company's assets, consequent on, and following, the Chapter 11 filing.

61. However, I have reached the conclusion that this argument is not correct. The essence of the arrangements embodied in the extensive documentation appears to me to be as follows: (i) The collateral, over which the rights in question were created, was acquired mainly with money derived from the Noteholders, through their subscription monies. (ii) LBSF provided little by way of subscription monies: it simply agreed to pay the interest and capital due to the Noteholders through the SPV in exchange for the interest and collateral, albeit that it was able to reduce the payments to the Noteholders by reference to failings in the credit standing of the "reference entities". (iii) So long as there was no risk of default, the Noteholders were prepared for the scheme to provide that LBSF would have priority when it came to "unwinding" the transaction. (iv) However, the scheme provided, and was sold on the basis that, if LBSF or LBHI defaulted so that they could not, or did not, pay the interest and the capital on the Notes, then it would be the Noteholders who would have priority both in relation to repayment and in relation to the Unwind Costs. (v) The effect of the "flips" would not be to entitle the Noteholders to more than they had subscribed (with interest), and, if there was no shortfall, LBSF would not have been out of pocket as a result of the "flips".

62. The effect of the "flip" provisions was thus not to divest LBSF of monies, property, or debts, currently vested in it, and to revest them in the Noteholders, nor even to divest LBSF of the benefit of the security rights granted to it. It was merely to change the order of priorities in which the rights were to be exercised in relation to the proceeds of sale of the collateral in the event of a default. Further, as Mr Moss QC, for Perpetual, and Mr Salter QC, for Belmont, pointed out, the right granted to LBSF was a security right over assets purchased with the Noteholders' money, and, from the very inception, the priority, and the extent of the benefits, enjoyed by LBSF in respect of the security were contingent upon there being no Event of Default. Thus, the security rights, as granted to LBSF, included the "flip" provisions, and even at the date the "flips" operated, the priority enjoyed by LBSF was no more than a contingent right. As Patten LJ points out in his judgment, the effect of the "flip" provisions in clause 5.5 and Condition 44.2 is merely to ensure that, as far as possible, the proceeds of sale of the collateral are used to repay the Noteholders their subscription monies in full, before LBSF recovers any sums from those proceeds. There is no question of the "flip" provisions giving the Noteholders more than they subscribed, at least before LBSF is paid the sums which are secured in its favour on the collateral.

63. In other words, the position, when the transaction came to be redeemed early, and "unwound", following an Event of Default, was not that LBSF had agreed, subsequent to the grant of the right, that it would lose the right it had been granted in relation to the proceeds of sale of the collateral as a result of the Default. Notwithstanding the Default, it retained its right, but, as had always been an agreed feature of that right, as a result of the Default, LBSF had to rank behind, rather than ahead of, the Noteholders, no doubt because it was those Noteholders whose money had been used to purchase the collateral.

64. Three principles which can be derived from the cases come into play. The first is that the

rule has been held to apply to assets which were vested in the person on whose bankruptcy the deprivation is to occur. By contrast, this is a case where all that is changing is the priorities relating to the right, pursuant to a provision in the very document creating the right. Secondly, there is authority for the principle that the rule may have no application to the extent that the person in whose favour the deprivation of the asset takes effect can show that the asset, or the insolvent person's interest in the asset, was acquired with his money – see Whitmore 2 J&H 204, 212 and 214-215. In this case, the collateral was effectively purchased exclusively with the Noteholders' money. The third principle is that the rule cannot apply to invalidate a provision which enables a person to determine a limited interest, such as a lease or a licence, which he has granted over or in respect of his own property, in the event of the lessee's or licensee's bankruptcy - see Whitmore 2 J&H 204, 210 and 212-213 and Barter 26 Ch D 510. While not identical to a lease or licence, a charge, or provision for priorities for repayment, has features of similarity to a lease or licence, and differs from ownership.

65. In my view, if one applies those principles to the facts of this case, they support the Chancellor's conclusion that the rule does not apply to the operation of the "flips" in clause 5.5 and Condition 44.2. The proper analysis is that, when it came to redemption, in relation to the proceeds of sale of the collateral, whose purchase had been entirely funded with their money, the Noteholders had been prepared to permit LBSF to enjoy priority over them, in terms of Swap Counterparty Priority and under Condition 44.1, so long as there had been no Event of Default; however, in the event of a Default, the Noteholders had provided from the start that they would no longer cede priority, and that Noteholder Priority and Condition 44.2 would apply. In other words, the effect of the documentation was that the Noteholders were granting to LBSF rights over assets derived from their monies, which rights were liable to be modified on the happening of an Event of Default. In my opinion, that was a valid arrangement, enforceable even on or after LBSF's Chapter 11 filing.

66. Patten LJ has reached the same conclusion on the simple basis that the "flip", that is, the reversal of the order of priority against a company as the holder of a charge, in favour of another chargee over the same assets, cannot be caught by the rule, even if it operates after the liquidation of the company, at least if such a reversal was an original feature of the company's charge when it was granted. I have considerable sympathy with that view, which has the merit of simplicity, and seems to be supported by what Lloyd J said in Re SSSL Realisations (2002) Ltd (in liquidation) [2005] 1 BCLC 1, paragraph 45. Further, it is fair to say that the principle of party autonomy, referred to above, supports his view.

67. However, while that view may well indeed be right, I prefer to rest my conclusion in this case on the more limited ground that, in addition to the facts relied on by Patten LJ, the assets over which the charge exists were acquired with money provided by the chargee in whose favour the "flip" operates, and that the "flip" was included merely to ensure, as far as possible, that that chargee is repaid out of those assets all that he provided (together with interest), before the company receives any money from those assets pursuant to its charge. It seems to me that there may be room for argument that, in the absence of these additional facts, the arrangement in this case would have fallen foul of the analysis in Mackay 8 Ch App 643 (which was arguably approved in British Eagle [1975] 1 WLR 758), on the basis that the right in that case to retain the second half of the royalties in the event of bankruptcy was, like the "flip" provisions here, an original feature of the contractual arrangement, and the right to recoup money under a change in priority to another chargee is every bit as much of an asset as the right to monies (in the form of royalties) arising in the future. There is also a danger that the simple analysis adopted by Patten LJ could, in the light of the very limited circumstances in which the court will hold a transaction to be a sham, make it very easy to dress up sale

transactions in such a way as to enable the rule to be circumvented.

68. Accordingly, while I am far from saying that I disagree with the simple and compelling basis upon which Patten LJ would dispose of LBSF's argument on this part of the case, I have reached the same conclusion on the rather more limited ground that I have indicated.

If there was a deprivation, does the rule apply in the light of the timing of the deprivation?

69. Even if the "flips" from Swap Counterparty Priority to Noteholder Priority and/or from Condition 44.1 to Condition 44.2 had constituted a deprivation within the rule, I do not consider that the rule would have been engaged in the present case, because the triggering event was LBHI filing for Chapter 11 which occurred on 15 September 2008, some 18 days before LBSF filed for Chapter 11. As it is common ground that filing for Chapter 11 is for the purposes of the rule equivalent to the making of a winding up order, the deprivation occurred before, not on or after, the liquidation or its equivalent.

70. In the light of an argument raised on behalf of the administrators in the Butters appeal, it is right to consider an argument that, if LBSF was clearly insolvent on 15 September 2008, when Noteholder Priority and Condition 44.2 appear to have been triggered, this would have been sufficient to engage the rule even though LBSF did not file for Chapter 11 until 3 October. I do not consider that a deprivation that takes effect before a winding up order (or its equivalent, Chapter 11 filing or an administration order) is caught by the rule, (unless the deprivation is effected pursuant to a sham transaction). It is true that, at least on one view, Page Wood V-C appears to have taken the opposite view in Whitmore 2 J&H 204, 215. However, all that he was dealing with was the point that the deprivation provision applied on "bankruptcy or insolvency", and it may well have been that he was saying that, on its true construction, the clause only applied on bankruptcy. Further, it may be that the deprivation in that case was not actually effected until after bankruptcy. If the observations of Page Wood V-C do support LBSF's case, then it is worth mentioning that another of the first instance 19th century cases, Detmold 40 Ch D 585, appears to support the converse proposition.

71. More importantly, in my judgment, the basis of the rule as explained in British Eagle [1975] 1 WLR 758, 780F-H, and considered in Carreras Rothman [1985] 1 Ch 207, 226E-F, makes such an argument difficult to sustain. There is nothing inconsistent with the provisions of the 1986 Act about a contractual agreement which effects a deprivation of an asset of a company before it goes into liquidation, save to the extent that the deprivation falls within the reach of a provision such as sections 238 and 239, which do not apply in this case. This is supported by the fact that Lord Cross made it clear at [1975] 1 WLR 758, 778C, that any deprivations effected prior to the winding up of British Eagle were not caught by the rule, even though it seems very likely that British Eagle had been insolvent some time before it was wound up. Further, it is also clear from what Lord Cross said at [1975] 1 WLR 758, 780F-G that the fact that the triggering event for the deprivation in the present case is based on insolvency or failure to pay makes no difference.

72. In addition, it seems to me that it would, or at least could, lead to uncertainty if we did not adhere to the simple proposition that, if the deprivation occurs before winding up, it does not fall within the scope of the rule, whereas if it occurs after the winding up, it does so – at least potentially. It would often be difficult for the parties involved, particularly the party with the right to effect the deprivation, to know whether the company concerned was insolvent at a particular time prior to liquidation: in some cases, it may be difficult to ascertain even after the event. No such difficulty arises in determining when a company went into liquidation. And what would happen in a case where, at the time the deprivation was to take effect, the company concerned was insolvent, but it subsequently recovered? It is hard to see how the rule, dependent as it is

on the operation of the 1986 Act, could apply in such a case, but that means that, in some cases, the parties could not know whether the deprivation fell foul of the rule for some time after it had purportedly taken effect. Further, many deprivation rights may be triggered by breach or even by notice, and it is hard to see why, or by reference to precisely what standards, it should be decided that a right to deprive for breach or by notice should be defeated simply because the company to be deprived was insolvent, but not subject to the liquidation process (or other procedures) in the 1986 Act.

73. Quite apart from this, in the Perpetual case, unlike in Whitmore 2 J&H 204, it is the liquidation (or its equivalent) of a party other than the company which would suffer the deprivation which gives rise to the deprivation. Even if the reasoning in Whitmore 2 J&H 204 that the rule applies to any deprivation effected after the onset of insolvency were correct, I would find it hard to see how the rule could apply because of the insolvency of a party other than the company which would suffer the deprivation. Subject to any other arguments, to which I will turn, it is equally hard to see how the insolvency of a third party (even if closely connected with the company in question) can engage the rule. First, as the rule is based on the principle that one cannot contract out of the statutory insolvency regime, there appears to be no room for it to be invoked simply because the deprivation results from the insolvency of a third party. Secondly, such an extension of the rule would not be in line with the authorities. Thirdly, if the rule were so extended, it really would lead to confusion, as its limits would be hard to predict.

74. In the present case, it appears to me that the way in which clause 5.5 of the STD operated, and the terms in which Condition 44 of the T&C was expressed, mean that, when, on 15 September 2008, an Event of Default, namely LBHI's filing for Chapter 11, occurred, Noteholder Priority automatically replaced Swap Counterparty Priority and Condition 44.2 automatically replaced Condition 44.1 on that date, which, crucially, was before LBSF filed for Chapter 11. It is true that the consequences of these two replacements were only enjoyed, in terms of their financial effect, after LBSF had filed for Chapter 11. However, the essential point seems to me to be that the replacement rights were vested on 15 September. Mr Snowden's argument that either or both replacement rights should be treated as occurring after 3 October (when LBSF filed for Chapter 11) presents him with a logical difficulty. If the replacement rights (i.e. Noteholder Priority and Condition 44.2) were not vested before 3 October, then ex hypothesi the original rights (ie. Swap Counterparty Priority and Condition 44.1) were never vested, and, if that is right, it is hard to see how LBSF could say that they had been deprived of those rights. This conclusion is inconsistent with some of the views expressed in Fraser v Oystertech plc [2004] BPIR 486, by Mr Peter Prescott QC, sitting as a Deputy Judge of the Chancery Division, which must therefore be treated as, to that extent, overruled.

75. It was also suggested that the argument that LBHI's filing for Chapter 11 operated to effect a deprivation of an asset owned by one of its subsidiaries, LBSF, and so fell foul of the rule. This was advanced on two grounds. The first ground, which appealed to Peter Smith J in the Butters case at first instance, was that, particularly in these days of group company cross-guarantees, it was unrealistic to treat members of the same group of companies as separate entities. That has some commercial attraction, but, as Robert Walker J concluded in Re Polly Peck International plc [1996] BCC 486, 498B-G, it is not open to the court to treat "a closely-integrated group of companies as a single economic unit" as a matter of law (save if the rather limited grounds for piercing the veil of incorporation exist). As he explained, the need to treat such companies as separate entities is "particularly important when creditors become involved", namely on an insolvency. The second ground was that the rule should not permit LBHI, as a company in liquidation (or Chapter 11), to have the value of one of its assets, namely its shareholding in LBSF, diminished as a result of a deprivation of property owned by

LBSF, following its, LBHI's, Chapter 11 filing. That cannot be right; it is unsupported by any case, and cannot be said to be consistent with the principle on which the rule is based as explained in British Eagle [1975] 1 WLR 758. In any event, LBHI is not a party to the Perpetual proceedings.

Differences relating to some of the other eleven issues of Notes

76. I have mentioned that the provisions and facts relating to Saphir I, which I have been considering, were not in all respects repeated in relation to all the other eleven issues being considered in the Perpetual appeal. In relation to Saphir 2006-5, Condition 38 of the T & C was slightly more prescriptive in relation to the application of Condition 44. I do not consider that this makes any difference. Similarly, Condition 44 in the case of another of the Notes issues, Beryl 2008-4, was in slightly different terms to that in the case of the other Notes issues, but, again, nothing hangs on that difference in this appeal.

77. Further, in the case of three of the Belmont issues, LBSF did contribute towards the subscription for the issue of the Notes. However, as Mr Salter said, in one of these cases, the contribution represented a very small proportion of the total amount subscribed: while not de minimis, it was certainly far less than the amount subscribed by the Noteholders. In two of the three cases, the LBSF payments were more substantial, but that was because it was settling claims made by the Noteholders. I do not think that this point gets near justifying a different outcome in relation to any of those three Notes Issuers.

78. What happened on and after 15 September 2008 in relation to the ten Notes issues where Belmont represents the Noteholders was rather different from the events relating to the two Notes issues where Perpetual represents the Noteholders. I do not propose to describe those different events, as it has not been contended that they affect the outcome of the appeal. The facts are usefully summarised in the Chancellor's judgment at [2009] EWHC 1912 (Ch), paragraph 24.....

Concluding remarks on the rule

90. The decision of the House of Lords in British Eagle [1975] 1 WLR 758 is not without its critics, which is scarcely surprising given that six of the nine Judges who expressed views on the point were effectively out-voted by the other three. However, it remains the leading case on the rule in this jurisdiction, and the basis and reach of the rule is reasonably clear from the leading speech of Lord Cross, and, as Patten LJ says, there is little between Lord Cross and Lord Morris so far as principle is concerned (although, as mentioned above, they seem to have differed on the question of whether it was relevant to the application of the rule that the deprivation provision is provided to take effect on liquidation or on the happening of some other event).

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

92. It is true that the conclusion on the second issue in each appeal, namely that a deprivation will not (at least normally) be caught by the rule if it is completed before liquidation or bankruptcy (or its equivalent), means that it may be reasonably easy in many cases to devise schemes to avoid the rule. However, as Mr Moss said, the decision in Ansett Australia [2008] BPIR 57 shows that the effect of the rule can often be avoided by careful drafting. It is ultimately up to Parliament to legislate against anti-avoidance devices in the insolvency field, as

it has done in sections 238 and 239 of the 1986 Act. Especially in an area where Parliament has intervened so substantially and so significantly, it can only be very rarely, if ever, that it would be right for the court to invent its own anti-avoidance policies and frustrate the terms of commercial contracts freely entered into by sophisticated parties.

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

94. It is strictly unnecessary to decide what would happen if a third party had a right to acquire an interest owned by a company (either on notice or on the happening of a breach or other event) which was only exercised after the company went into liquidation. However, in agreement with Patten LJ, it seems to me that the logic of the decision in British Eagle [1975] 1 WLR 758 must mean that the right could not be enforced, as it would deprive the company of an asset which should be available to the liquidator for distribution, unless it was a right to acquire the asset at or above market value. However, the loss of the ability to exercise the right might well be something for which the third party could prove in the liquidation.

95. I should also add that we were referred to Peregrine Investments Holdings Ltd v Asia Infrastructure Fund Management Co Ltd [2004] 1 HKLRD 598, a decision of the Hong Kong Court of Appeal; for the reasons given by Patten LJ, I agree with the minority judgment and disagree with the majority. Finally, on this aspect, it is right to acknowledge that the above analysis is not quite the same as, and is (I hope) rather more focussed than, the analysis which I proffered in Money Markets International Stockbrokers Ltd (in liquidation) v London Stock Exchange Ltd [2002] 1 WLR 1150. It would not be profitable to analyse the rather detailed discussion at [2002] 1 WLR 1150, paras 87 to 118, but, while there is not much to challenge in the "rather limited propositions" summarised at [2002] 1 WLR 1150, para 118, proposition (iii) may be rather misleading...

Lord Justice Longmore :

99. I agree with the Master of the Rolls that the appeals should be dismissed ...

Lord Justice Patten :

111. I agree with the order proposed by the Master of the Rolls but, because of the general interest of these appeals and the importance of the issues which they raise, I add some observations of my own.

112. In both these appeals we are concerned with claims that significant parts of the contractual arrangements between the parties have been invalidated by the application of what has been termed the anti-deprivation rule. In the Woolworths appeal the agreements were made in England between English companies. In the Lehman appeals the companies are not English but the agreements are governed by English law and it is common ground that, for the purposes of applying the anti-deprivation rule, the court should treat the US Chapter 11 filings

as if they were insolvency proceedings in England.

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

114. So in British Eagle International Airlines Ltd v Compagnie Nationale Air France [1975] 1 WLR 758 the majority in the House of Lords held that, under the IATA clearing house arrangements, debts due from Air France to British Eagle in respect of services rendered between October 1st and November 6th, 1968 which had not yet been closed off under the clearing house procedures fell to be dealt with in the liquidation of British Eagle following its winding-up on 8th November and could therefore be recovered by its liquidator in full. Had it been permissible to deal with these liabilities under the IATA rules, the existence of set-offs would, on closure, have produced a nil balance in favour of British Eagle.

115. The House of Lords were split as to whether the liquidator could claim the benefit of the sums due from Air France without giving credit for the reductions which the application of the IATA rules required to be made. Lord Morris (giving the speech for the minority) accepted that the company's receivables had to be dealt with by the liquidator for the benefit of its creditors generally. But his view was that the receivable in this case was no more than the net balance (if any) due after the operation of the clearing house arrangements. This appears from two passages in his speech at p. 761E and 769H:

"When a liquidator takes over the property of a company in order to apply it according to law he may disregard an arrangement pursuant to which there would be application of the property contrary to law: but he cannot disregard or ignore or alter the features of and the nature of the property itself by describing it as something that genuinely it is not.

So in the present case if the defendant company had owed money to the plaintiff company but if there was a direction to the defendant company which required them in the event of a liquidation to pay the money to some particular persons rather than for the benefit of all the creditors the liquidator could prevent what would be an evasion of the law (see Ex parte Mackay (1873) 8 Ch. App. 643). But if an airline company makes a contract with a number of other airline companies (the contract being in no way colourable but made for commercially beneficial reasons) for the mutual rendering of services on the terms that no money is to become payable between the various parties inter se, I do not think that a liquidator while seeking to rely on and to extract a benefit from the contract can do so on the basis of ignoring or transforming some of its terms or on the basis of requiring a breach of its terms.

..... I see no reason to think that the contracts which were entered into by the members of the clearing house offended against the principles of our insolvency laws. Services rendered before the end of September 1968 were as I have stated the subject of "clearances" within the scheme before the date of the liquidation. "Clearance" differs from "settlement" (see regulations B.12, 14 and 15) and "clearance" in regard to the September items was complete before November 8. Services rendered during October and the first few days of November were in my view rendered under perfectly lawful contracts which were made in the same way as contracts had been made for years past. Because of the terms of the contracts which were made the appellants had no claims against and no rights to sue other individual members of the clearing house. It is a general rule that a trustee or liquidator takes no better title to property than that which was possessed by a bankrupt or a company. In my view the liquidator in the present case cannot remould contracts which were validly made. He cannot assert or assume or surmise that different contracts could or might have been made and then advance claims on the basis that such different contracts had in fact been made."

116. The majority view is set out in the speech of Lord Cross at p. 780C to 781B:

"It is true that if the respondents are right the "clearing house" creditors will be treated as though they were creditors with valid charges on some of the book debts of British Eagle. But the parties to the "clearing house" arrangements did not intend to give one another charges on some of each other's future book debts. The documents were not drawn so as to create charges but simply so as to set up by simple contract a method of settling each other's mutual indebtedness at monthly intervals. Moreover, if the documents had purported to create such charges, the charges - as the judge saw (see [1973] 1 Lloyd's Rep. 433) - would have been unenforceable against the liquidator for want of registration under section 95 of the Companies Act 1948. The "clearing house" creditors are clearly not secured creditors. They are claiming nevertheless that they ought not to be treated in the liquidation as ordinary unsecured creditors but that they have achieved by the medium of the "clearing house" agreement a position analogous to that of secured creditors without the need for the creation and registration of charges on the book debts in question. The respondents argue that the position which, according to them, the clearing house creditors have achieved, though it may be anomalous and unfair to the general body of unsecured creditors, is not forbidden by any provision in the Companies Act, and that the power of the court to go behind agreements, the results of which are repugnant to our insolvency legislation, is confined to cases in which the parties' dominant purpose was to evade its operation. I cannot accept this argument. In Ex parte Mackay, 8 Ch.App. 643, the charge on this second half of the royalties was - so to say - an animal known to the law which on its face put the charge in the position of a secured creditor. The court could only go behind it if it was satisfied - as was indeed obvious in that case - that it had been created deliberately in order to provide for a different distribution of the insolvent's property on his bankruptcy from that prescribed by the law. But what the respondents are saying here is that the parties to the "clearing house" arrangements by agreeing that simple contract debts are to be satisfied in a particular way have succeeded in "contracting out" of the provisions contained in section 302 for the payment of unsecured debts "pari passu." In such a context it is to my mind irrelevant that the parties to the "clearing house" arrangements had good business reasons for entering into them and did not direct their minds to the question how the arrangements might be affected by the insolvency of one or more of the parties. Such a "contracting out" must, to my mind, be contrary to public policy. The question is, in essence, whether what was called in argument the "mini liquidation" flowing from the clearing house arrangements is to yield to or to prevail over the general liquidation. I cannot doubt, that on principle the rules of the general liquidation should prevail. I would therefore hold that notwithstanding the clearing house arrangements. British Eagle on its liquidation became entitled to recover payment of the sums payable to it by other airlines for services rendered by it during that period and that airlines which had rendered services to it during that period became on the liquidation entitled to prove for the sums payable to them. So, while dismissing the appeal so far as concerns the September clearance, I would allow it so far as concerns the period from October 1 to November 6."

117. What is clear from this passage is that the IATA clearing house arrangements did not survive the liquidation of British Eagle because they amounted to an attempt to administer debts due to the company otherwise than in accordance with what was then s.302 of the Companies Act 1948: i.e. a pari passu distribution amongst all of the company's general

creditors. Although the rules of the scheme prohibited member airlines from suing each other to recover the money due and instead required them to obtain payment through the clearing house system, Lord Cross considered that the sum due from Air France was nonetheless a chose in action having some but not all of the characteristics of a debt: see p. 778H. It was this chose in action which constituted the property of the company on liquidation and therefore fell to be dealt with under the Companies Act rather than in accordance with the IATA scheme.

118. Once one moves beyond the particular issue in that case of whether the Air France debt or the end balance represents the property of British Eagle on liquidation there is no real difference between the majority and minority views. Both Lord Cross and Lord Morris accepted that s.302 and the pari passu rule apply to the administration of the company's property in liquidation and that it is impossible to contract out of that. The common law rule of public policy applied in that case was therefore no more than the application of s.302 to the property of the company at the date of liquidation with the necessary corollary that a contract to administer the debts in some other way was unenforceable. The IATA scheme (which of course operates generally and has no special provisions dealing with insolvency) simply ceased to apply to the debts due to British Eagle once the liquidation took effect.

119. This view of the limited scope of the decision in British Eagle is confirmed by the recent decision of the High Court of Australia in IATA v Ansett Australia Holdings Ltd [2008] HCA 3. The rules of the clearing house scheme were modified following British Eagle so as to exclude any liability or right of action for payment between member airlines. The only liabilities of the airlines in respect of services rendered to each other are now to the clearing house for the balances due on closure. The administrators of Ansett sought a declaration that the clearing house scheme was unenforceable against the company post administration and that the only debtor-creditor relationship was between it and the other airlines.

120. The High Court decided by a majority that the rule changes were effective to make IATA the sole creditor of Ansett and that the revised system did not therefore have the effect of administering debts due to an insolvent company otherwise than in accordance with the mandatory pari passu rule imposed on the company by a deed of arrangement made under the powers contained in the Australian Corporations Act. After quoting the passage from Lord Cross referred to above, Gummow J (at paragraphs 76-79) said this:

"[76] ….. … There appear to be two strands of thought in this passage. One is that the Clearing House arrangements, as they then stood, so operated as to give British Eagle an asset, the money claim against Air France, and that in the face of the mandatory operation of s 302 of the Companies Act 1948 (UK), this asset could not be captured for the netting-off system. This conclusion would flow from the operation of s 302 and would be analogous to the situation in Re Jeavons, ex parte Mackay discussed above. No recourse to 'public policy' would be called for. The second strand of thought is apparent in the references to 'mini liquidation', 'contracting out' and 'public policy'. But the critical point is that there was 'property' of British Eagle to which s 302 applied and a contractual provision negating that outcome could not prevail against the terms of the statute. Hence it perhaps is not surprising that Lord Cross did not spell out the content of any relevant public policy.

[77] Subsequently, however, in Horne v Chester & Fein Property Developments Pty Ltd [1987] VR 913, at 919, the rule was expressed as being that, 'in insolvency law, the whole of the debtor's estate should be available for distribution to all creditors, and that no one creditor or group of creditors can lawfully contract in such a manner as to defeat other creditors not parties to the contract' (emphasis added). And Ansett submitted that this formulation of the rule captures the essence of a public policy said to have been recognised and applied as a 'fundamental tenet of insolvency law generally' in various common law jurisdictions.

[78] It is not necessary to examine in any detail the several cases in which the rule is said to have been recognised and applied. Many can be understood as depending upon the proper application of a generally expressed provision in the relevant statute requiring that all debts proved in an insolvency rank equally and, if the property of the insolvent is insufficient to meet them in full, they are to be paid proportionately, See, for example, Corporations Act 2001 (Cth) (the Corporations Act), s 555. Others, including British Eagle, turned upon what was the 'property' of the company that was to be applied in satisfaction of its liabilities (Companies Act 1948 (UK), s 302; cf the Corporations Act, s 478). Instead, it is essential to begin from the elementary proposition that insolvency law is statutory and primacy must be given to the relevant statutory text.
[79] Whether the whole of the debtor's estate is available for distribution to all creditors, and whether all creditors are to participate equally in the distribution of that estate, are questions that depend entirely upon what the relevant statute provides. What is advanced as a rule of public policy assumes that there can be both an affirmative and a negative answer to each of those questions. To the extent that the rule of public policy depends upon there being universal and invariable rules that the whole estate is available to all creditors and all creditors are entitled to participate equally, the rule of public policy depends upon an affirmative answer to both of the identified questions. Yet by asserting that the public policy achieves what the statute otherwise does not achieve, the rule assumes that the questions identified have been answered in the negative. This contradiction suggests that the rule that is asserted is unsound."
121. A similar view of what was decided in British Eagle was expressed by Peter Gibson J in Carreras Ltd v Freeman Matthews Ltd [1985] 1 Ch 207 at p. 226F:
"Thus the principle that I would extract from that case is that where the effect of a contract is that an asset which is actually owned by a company at the commencement of its liquidation would be dealt with in a way other than in accordance with section 302 of the Companies Act 1948, then to that extent the contract as a matter of public policy is avoided, whether or not the contract was entered into for consideration and for bona fide commercial reasons and whether or not the contractual provision affecting that asset is expressed to take effect only on insolvency."
122. **Before the law can strike down a commercial contract on grounds of public policy it needs, in my judgment, to be certain of two things. The first is what the rule of public policy which is sought to be enforced actually is. The second is whether the invalidity or unenforceability of the contract is necessary in order to give effect to the policy objective enshrined in the rule.**[3]
123. On the authority of the decision in British Eagle the anti-deprivation principle is little more than the direct application of the provisions of the Insolvency Act to the transaction under consideration. Compliance with the statute is both the foundation for the rule prohibiting the enforcement of contracts which are in conflict with the application of the statutory provisions and is its only rationale. Consistently with this, it is difficult to see how a contract can offend against the principle unless there is both property of the bankrupt or the company in liquidation to which it relates and its treatment of that property produces a result which is inconsistent with the provisions of the Act.
124. For this reason alone the suggestion made by the Deputy Judge (Mr Peter Prescott QC) in Fraser v Oystertec PLC [2004] BPIR 486 that the anti-deprivation rule can apply to invalidate contracts even when no bankruptcy or winding-up order is ever made seems to me to be wrong

[3] Emphasis added.

in principle and should not be followed.

125. Rule 4.181 of the Insolvency Rules 1986 provides for a pari passu distribution of the assets of a company to the unsecured creditors who are not preferential creditors. A similar rule is contained in s.107 of the Act for voluntary liquidations and in s.328(3) for bankruptcy. The functions of the liquidator are "to secure that the assets of the company are got in, realised and distributed to the company's creditors, and if there is a surplus, to the persons entitled to it": see s.143(1). In bankruptcy the estate of the bankrupt vests in the trustee on appointment (s.306) and includes all property belonging to the bankrupt at the commencement of the bankruptcy together with any property treated as falling within the estate under the provisions of the Act: see s.283(1). The second limb of this formula is a reference to the provisions of ss.339-342F which enable the court to set aside certain specified types of prior transactions including transactions at an undervalue and preferences. Similar provisions relating to companies in liquidation can be found in ss.238-246 of the Act.

126. Where a winding-up or bankruptcy order is made the operation of the pari passu rule relates to property of the company or the bankrupt from the commencement of the relevant insolvency process. In the case of companies, winding-up commences from the date of the presentation of the petition or, in a voluntary liquidation, from the date of the resolution to wind-up: see IA s.129. Consistently with this, s.127(1) of the Act invalidates any disposition of the company's property or any alteration in the status of the company's members made after the commencement of the winding-up unless the court orders otherwise.

127. On an application for a validation order in the period between the presentation of the petition and its hearing, the court will need to be satisfied that it is in the interests of the creditors generally that the transaction should be allowed to proceed: see Re Gray's Inn Construction Co Ltd [1980] 1 WLR 711 at p. 717. In Denney v John Hudson & Co [1992] BCLC 901 Fox LJ (at p. 904) set out the following principles derived from that earlier decision of the Court of Appeal:

"(1) The discretion vested in the court by s 522 is entirely at large, subject to the general principles which apply to any kind of discretion, and subject also to limitation that the discretion must be exercised in 'the context of the liquidation provisions of the statute.

(2) The basic principle of law governing the liquidation of insolvent estates, whether in bankruptcy or under the companies' legislation, is that the assets of the insolvent at the time of the commencement of the liquidation will be distributed pari passu among the insolvent's unsecured creditors as at the date of the bankruptcy.

In a company's compulsory liquidation this is achieved by s 227 of the 1948 Act (now s.127 of the Insolvency Act 1986 of the current legislation).

(3) There are occasions, however, when it may be beneficial not only for the company but also for the unsecured creditors, that the company should be able to dispose of some of its property during the period after the petition has been presented, but before the winding-up order has been made. Thus, it may sometimes be beneficial to the company and its creditors that the company should be able to continue the business in its ordinary course.

(4) In considering whether to make a validating order, the court must always do its best to ensure that the interests of the unsecured creditors will not be prejudiced.

(5) The desirability of the company being enabled to carry on its business was often speculative. In each case the court must carry out a balancing exercise.

(6) The court should not validate any transaction or series of transactions which might result in one or more pre-liquidation creditors being paid in full at the expense of other creditors, who will only receive a dividend, in the absence of special circumstances making such a course desirable in the interest of the creditors generally. If, for example, it were in the interests of the

creditors generally that the company's business should be carried on, and this could only be achieved by paying for goods already supplied to the company when the petition is presented (but not yet paid for) the court might exercise its discretion to validate payments for those goods.

(7) A disposition carried out in good faith in the ordinary course of business at a time when the parties were unaware that a petition had been presented would usually be validated by the court unless there is ground for thinking that the transaction may involve an attempt to prefer the disponee – in which case the transaction would not be validated.

(8) Despite the strength of the principle of securing pari passu distribution, the principle has no application to post-liquidation creditors; for example, the sale of an asset at full market value after the presentation of the petition. That is because such a transaction involves no dissipation of the company's assets for it does not reduce the value of its assets."

128. As I shall explain later, propositions (6) and (8) are particularly relevant to the issues canvassed on these appeals.

129. If validation is sought after a winding-up order is made it is likely to be even more difficult to justify any disposition which is in conflict with the operation of the pari passu principle. The party in whose favour the disposition was made may seek to plead that he received the property or payment without notice of the petition but, where in a contract the event which triggers the disposition is expressly the bankruptcy or liquidation of the counterparty, it is difficult to see how the transaction could ever be regarded as anything but an agreement to prefer one creditor to the detriment of the general creditors as a whole. The strongest evidence will be the terms of the agreement itself.

130. Bankruptcy commences from the date of the making of the bankruptcy order (see IA s.278) but again any payments or dispositions by the bankrupt of his property made between the presentation of the petition and the bankruptcy order are rendered void by s.284 unless the property was received in good faith before the making of the bankruptcy order and without notice of the presentation of the petition: see s.284(4).

131. "Property" includes money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property: see IA s.436.

132. A straightforward application of these provisions to the contracts under consideration on these appeals would not bring them within the anti-deprivation rule. In the two Lehman cases the charge over the collateral provided by clause 5.3 of the Supplemental Trust Deed was granted to the trustee on behalf of both the Noteholders and the swap counterparty to secure payment of the sums due from the issuers to the Noteholders under the Notes and the payment to the swap counterparty of the sums due to it from the issuers under the swap agreement. The Noteholders were not parties to the swap agreement and their only contractual rights were to payment under the Notes.

133. Clause 5.5 of the Supplemental Trust Deed gave the swap counterparty priority in every distribution of the proceeds obtained from the realisation of the security unless it was the Defaulting Party under the swap agreement in respect of an Event of Default. During the continuance of the swap agreement it therefore enjoyed priority over the collateral purchased with the Noteholders' money so long as it continued to perform its obligations by paying to the issuers the sums due from them to the Noteholders. If those payments ceased and an Event of Default occurred which would leave the issuers to pay the sums due under the Notes without the financial assistance of the swap counterparty then the Noteholders became entitled to priority over the proceeds from the collateral to meet any shortfall.

134. The definition of an Event of Default in the ISDA Master Agreement to include the

bankruptcy of either the swap counterparty (LBSF) or a Credit Support Provider (Lehman Brothers Holdings Inc) ("LBHI") as well as a failure to pay meant that by the time that the first swap termination notices came to be served in late November 2008 there were at lease two (and possibly three) events which could be relied upon by the Noteholders as constituting events of default for the purposes of clauses 5.5 and 9.3 of the Supplemental Trust Deed. The first was the Chapter 11 filing by LBHI which occurred on 15th September 2008. The second was any non-payment under the swaps that constituted an Event of Default thereunder. The dates on which payments fell due and were missed under the swaps varied among the series but were in some cases before and some cases after 3rd October 2008. The third was the Chapter 11 filing by LBSF which occurred on 3rd October 2008.

135. Even if one accepts that the date for determining the order of priority under clause 5.5 is that of the realisation or distribution of the proceeds of the collateral (rather than 15th September as held by the Chancellor) and that it therefore post-dates the bankruptcy of LBSF, the consequence of the operation of clause 5.5 is not to deprive LBSF or its creditors of any property or asset which they would have been entitled to but for its bankruptcy. The only interest or property which the company ever enjoyed in the collateral was a charge granted by the issuers of the Notes on the terms of the Supplemental Trust Deed. That security interest remains part of the property of the company unchanged by the event of its bankruptcy. The reversal of the order of priority under clause 5.5 was always a facet of the security designed to regulate the competing interests over the collateral of LBSF and the Noteholders. To say that its operation in the event of the company's bankruptcy constitutes the removal of an asset from the liquidation is to confuse the security itself with the operation of its terms in the events prescribed by the charge. LBSF retains the same asset as it had before its bankruptcy and is free to deal with any recoveries for the benefit of its general creditors in accordance with the applicable statutory regime. Likewise the Noteholders do not obtain any security over the collateral which they did not have before. This was essentially the reasoning of the Chancellor and I agree with it.

136. The same point can be made about Mr Snowden's reliance on condition 44 of the terms and conditions attached to the prospectus which establishes the amounts due under the swap agreements if terminated on an Event of Default. Condition 44 is said to have the effect of increasing the amount payable to Noteholders in the event of LBSF being the defaulting party under the swap agreement by diverting to the Noteholders monies which would otherwise have been payable to it in order to discharge the issuers' liability for Unwind Costs. But the operation of condition 44 does not give to the Noteholders more than the right to recover the whole of the sums due under the Notes in priority to any claim over the collateral by LBSF for the Unwind Costs. It simply adjusts the balances on early termination to ensure that the Noteholders are paid the whole of what is due to them in priority to the sums payable to LBSF. If there is no shortfall in the security LBSF will recover the sums due to it in full. Condition 44 does not therefore remove an asset from LBSF. Nor does it give to the Noteholders security over an asset in which they previously had no interest. It merely regulates the order in which the company and the Noteholders are entitled to be recouped out of the security. Although the amount of the security available to meet LBSF's claims is obviously reduced in the event of a shortfall in the value of the security over what it would have been had no Event of Default occurred, that is simply a function of the change in priority which was always a feature of the security which the company enjoyed.

137. A change in priority consequent upon the insolvency or liquidation of a company is not prohibited by any express term of the Insolvency Act and, for the reasons I have given, does not amount to the disposition of any property of the company. If the anti-deprivation rule is to be

effective to invalidate the provisions of clause 5.5 and condition 44 then it has to be based on a wider principle than that applied by the House of Lords in British Eagle.....

170 ... In appropriate cases the court has always reserved to itself the power to look through a transaction and to pierce the corporate veil when the property in question is in substance that of the company in liquidation. But when that cannot be done the anti-deprivation rule has, in my judgment, to be confined to cases where property of the insolvent company or bankrupt within the meaning of the Insolvency Act is removed from the insolvent estate either for less than its market value or for no value at all.

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

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

174 .. in the Lehman appeals, it is not possible to strike down the provisions of clause 5.5 and condition 44 merely because their operation may affect the value of the security available to LBSF in the event of a shortfall. There is nothing in the English authorities which supports the extension of the anti-deprivation principle to encompass transactions which do not alter the property of the insolvent company in the asset in question and it would require, I think, a significant amendment to the provisions of the Insolvency Act before such transactions could be struck down. Although such provisions exist in other jurisdictions, they are not yet part of the

English statutory regime.

Lehman Brothers Special Financing Inc V BNY Corporate Trustee Services Limited (SDNY) 422 B.R. 407 (2010)

James M. Peck, US Bankruptcy Judge

This is a matter arising out of a complex financial structure that includes an added layer of complexity due to the pendency of parallel and potentially conflicting legal proceedings in this Court and the United Kingdom. The litigation in England (the "English Litigation") was first commenced in the High Court of Justice, Chancery Division (the "High Court") followed by an appeal to the Court of Appeal, Civil Division (the "Court of Appeal" and, together with the High Court, the "English Courts"). At issue both here and in the English Courts is the priority of payment to beneficiaries (one a noteholder and the other a swap counterparty) that hold competing interests in collateral securing certain credit-linked synthetic portfolio notes. The swap counterparty is Lehman Brothers Special Financing Inc. ("LBSF"), one of the Lehman entities whose chapter 11 case is before this Court.

The English Litigation was filed in the High Court by Perpetual Trustee Company Limited ("Perpetual"), as holder of various credit-linked synthetic portfolio notes, against BNY Corporate Trustee Services Limited ("BNY") seeking priority payment pursuant to so-called "Noteholder Priority" (as defined below) under the terms of certain swap agreements (each a "Swap Agreement") among LBSF and Dante Finance Public Limited Company ("Dante").

LBSF intervened in the English Litigation and has participated both in the English Litigation and in this adversary proceeding. After a trial, the High Court issued a judgment in which it held, inter alia, that LBSF's interest in the collateral securing the Swap Agreements (the "Collateral") was "always limited and conditional," and, therefore, payment pursuant to Noteholder Priority did not violate the so-called "anti-deprivation principle" under English law ... The High Court also noted that Noteholder Priority became effective on September 15, 2008, the date on which Lehman Brothers Holdings Inc. ("LBHI"), credit support provider for LBSF's payment obligations under each Swap Agreement, filed its petition in this Court for protection under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code").

During the pendency of the English Litigation in the High Court, on May 20, 2009, LBSF (collectively with LBHI and its affiliated debtors, the "Debtors") commenced this action by filing a two-count complaint (the "Complaint") against BNY. Count I of the Complaint seeks a declaratory judgment that the provisions in the Swap Agreements that modify LBSF's payment priority upon an event of default constitute unenforceable ipso facto clauses that violate Bankruptcy Code sections 365(e)(1) and 541(c)(1)(B), thereby enabling LBSF to retain its right to receive a priority payment under the Swap Agreements ("Swap Counterparty Priority"). Count II seeks a declaratory judgment from this Court that any action to enforce the provisions purportedly modifying LBSF's right to priority of payments as a result of its bankruptcy filing violates the automatic stay under Bankruptcy Code section 362(a).

The interplay between this litigation and the English Litigation has been obvious from the start, and both this Court and the English Courts have been aware of the potential for conflicting rulings due to differences in the law being applied by each tribunal to the underlying dispute. With this trans-Atlantic aspect of the cases in mind, LBSF requested and received permission to file its motion for summary judgment prior to the deadline for BNY to file a responsive pleading so that it could be used in the English Litigation.. LBSF filed its motion for summary judgment on June 10, 2009. On June 22, 2009, BNY filed a motion to dismiss the Complaint, arguing that Perpetual, as the real party-in-interest in this matter, is an "indispensable party" under Federal Rule of Civil Procedure 19, made applicable to this proceeding by Federal Rule of Bankruptcy Procedure 7019. LBSF opposed the motion to dismiss.

At a hearing held on August 11, 2009, the Court found that BNY had the capacity to adequately represent Perpetual's interests in this litigation and denied the motion to dismiss.. Thereafter, pursuant to a briefing schedule ordered by the Court, BNY filed a cross motion for summary judgment. In addition, the official committee of unsecured creditors appointed in the Debtors' bankruptcy cases requested and received permission to intervene in this matter and has filed various statements in support of LBSF's pleadings.

LBSF filed a notice of appeal of the High Court's judgment on August 17, 2009. On November 6, 2009, the Court of Appeal issued a unanimous judgment in which it affirmed the holding of the High Court.. Specifically, the Court of Appeal determined that (i) the LBHI bankruptcy filing on September 15, 2008 gave rise to the application of Noteholder Priority and triggered the calculation of a subordinated Early Termination Payment (as defined below) to LBSF under Condition 44 of the Terms and Conditions of the Notes ("Condition 44"), and (ii) this was independent of the early termination of the Swap Agreements effected by Saphir Finance Public Limited Company ("Saphir"), as issuer of the credit-linked synthetic portfolio notes at issue. The Court of Appeal also determined that LBSF lost no property right or interest as a result of the shift to Noteholder Priority and the subordinated Early Termination Payment, because LBSF's interest in the Collateral always had been contingent. Stated differently, LSBF was not deprived of any right by virtue of the fact that the applicable payment priority had shifted to Noteholder Priority because it "had always been an agreed feature of that right, as a result of [an event of default on its part], LBSF had to rank behind, rather than ahead of, [Perpetual]." On November 13, 2009, the Court of Appeal issued an order denying LBSF's motion for leave to appeal to the Supreme Court of England and Wales.

Throughout these proceedings, the parties have kept the Court apprised of the progress of the English Litigation. In addition, the Court has exchanged various communications with the High Court regarding coordination of and cooperation with respect to the litigation here and in London. Most recently, this Court received a letter from the High Court (i) explaining that "[t]he English court has confined itself to making a declaration that the relevant contractual provisions are 'valid, effective and enforceable as a matter of English law as the proper law of such contracts, so as to give effect to Noteholder Priority,'" and (ii) requesting that if this Court concludes that "the relevant provisions are void or otherwise unenforceable under U.S. bankruptcy law" it "go no further at that stage than to make a declaratory judgment to that effect." At a hearing on the cross motions for summary judgment on November 19, 2009, the parties agreed that it is appropriate for this Court to determine at this time only whether declaratory relief is appropriate in this matter and to further coordinate with the High Court should it become necessary after a decision is rendered.

It is in this context that the Court has evaluated the motions for summary judgment and has decided to grant LBSF's motion for summary judgment and to deny the cross motion of BNY. This Court concludes that the relevant provisions purporting to reverse the priority of payment on account of the occurrence of a default due to commencement of a case under the Bankruptcy Code are unenforceable and violate the ipso facto provisions of the Bankruptcy Code.

Standard

Summary judgment is appropriate where there is "no genuine issue as to any material fact," so that the moving party is entitled to "judgment as a matter of law." Fed. R. Civ. P. 56(c). The court must view the facts in the light most favorable to the non-moving party, and must resolve all ambiguities and draw all inferences against the moving party. .. In determining whether to grant a motion for summary judgment, the court is not to "weigh the evidence and determine the truth of the matter but to determine whether there is a genuine issue for trial." .. The parties acknowledge that there are no genuine issues of material fact and that the questions presented purely involve the application of relevant provisions of the Bankruptcy Code to undisputed facts.

Background

On October 10, 2002, BNY's predecessor entered into a Principal Trust Deed (the "Principal Trust Deed") with Dante, pursuant to which a multi-issuer secured obligation program (the "Dante Program") was established. BNY currently serves as Trustee under the Dante Program. Under the Dante Program, Saphir, a special purpose entity created by Lehman Brothers International (Europe), issued various series of credit-linked synthetic portfolio notes. At issue for purposes of this litigation are two series of such notes held by Perpetual: (i) Series 2004-11 AUD 75,000,000 Synthetic Portfolio Notes Due 2011, and (ii) Series 2006-5 AUD 50,000,000 Synthetic Portfolio Notes due 2011 and Extendable Up to 2016 (collectively, the "Notes").

The Notes are secured by the Collateral, which BNY holds in trust for the benefit of creditors of Saphir, including Perpetual (as holder of the Notes) and LBSF (as swap counterparty). The Collateral comprises various assets and secured obligations. Each series of Notes is governed by a Supplemental Trust Deed (each, a "Supplemental Trust Deed" and collectively with all agreements underlying the Notes, the "Transaction Documents"). Each Supplemental Trust Deed, in turn, references a Swap Agreement. The events of default under each of the Swap Agreements include the bankruptcy filing of any party.

Pursuant to the terms of the Transaction Documents, the rights of LBSF in the Collateral ordinarily take priority ("Swap Counterparty Priority") over those of Perpetual. However, if an event of default occurs on the part of LBSF under a Swap Agreement, the Transaction Documents call for a reversal of priorities so that Perpetual would then be entitled to priority over amounts otherwise payable to LBSF ("Noteholder Priority"). In addition, Condition 44 modifies the calculation of the Early Redemption Amount (i.e., the amount payable upon the early redemption of a Note) in the event that LBSF defaults under the related Swap Agreement. LBHI commenced a voluntary case under chapter 11 of the Bankruptcy Code on September 15, 2008. LBSF commenced its own voluntary case under the Bankruptcy Code on October 3, 2008 (the "LBSF Petition Date"). On November 25, 2008, counsel to the Debtors sent a letter to Bank of New York Mellon Trust Company, National Association, and Bank of New York Mellon stating that (i) any action with respect to transactions in which BNY serves as trustee may be subject to the automatic stay provisions of section 362 of the Bankruptcy Code, and (ii) any provisions purporting to subordinate any amounts payable to LBSF would be unenforceable and unlawful. .. On December 1, 2008, Saphir sent notices to LBSF terminating the Swap Agreements designating (i) the filing by LBSF of a chapter 11 petition as the relevant event of default and (ii) December 1, 2008 as the Early Termination Date under section 6(a) of each ISDA Master Agreement. (LBSF Br. Supp. Exs. H, I). Under the terms of the Principal Trust Deed, such termination obligated Saphir to redeem the Notes.

Motions for Summary Judgment

In its motion for summary judgment, LBSF argues that the contractual provisions in the Transaction Documents that modify the scheme for payment priority are unenforceable ipso facto clauses that inappropriately modify a debtor's interest in a contract solely because of a bankruptcy filing in violation of Bankruptcy Code sections 365(e)(1) and 541(c)(1)(B). LBSF also maintains that any attempt to modify its payment priority violates the automatic stay, in violation of Bankruptcy Code section 362(a)(3), because it improperly seeks to exercise control over the property of LBSF's estate. Finally, LBSF argues that the so-called "safe harbor" provisions of the Bankruptcy Code do not protect the purported modification of the payment priority.

In its motion, BNY argues that because the Transaction Documents are to be governed by and construed in accordance with English law, this Court must defer to the determination by both the High Court and the Court of Appeal that Noteholder Priority and subordinated payment under Condition 44 became effective automatically on September 15, 2008. If the Court defers to such finding, LBSF's interests already were governed by Noteholder Priority and subordinated to the interests of Perpetual under Condition 44 as of the date it filed its chapter 11 petition. Under this theory, LBSF never had the right to claim Swap Counterparty Priority or its preferred method of calculation of the Early Redemption Amount under Condition 44. BNY maintains that LBSF cannot use its status as a bankruptcy debtor to attempt to garner any greater rights with respect to the Collateral than it possessed prepetition.

BNY also argues that even if the payment modification provisions at issue constitute unenforceable ipso facto clauses, inasmuch as they are the agreed mechanisms pursuant to which the parties' transactions are liquidated, the provisions fall within the scope of the protections provided by the safe harbor provisions of the Bankruptcy Code. Finally, BNY asserts that Noteholder Priority and Condition 44 constitute subordination agreements, which agreements have been found by the English Courts to be enforceable under applicable non-bankruptcy law. Given that subordination agreements are enforceable under the Bankruptcy Code "to the same extent that such agreement[s] [are] enforceable under applicable nonbankruptcy law," BNY submits that Noteholder Priority and Condition 44 are enforceable against LBSF. See 11 U.S.C. § 510(a).

The Court will examine in turn each of these issues -- ipso facto, automatic stay, safe harbor and Bankruptcy Code section 510.

Ipso Facto/Automatic Stay

The Bankruptcy Code of 1978 effected a change in the treatment of contract or lease clauses that would seek to modify the relationships of contracting parties due to the filing of a bankruptcy petition -- so-called ipso facto clauses... It is now axiomatic that ipso facto clauses are, as a general matter, unenforceable... Under Bankruptcy Code section 365(e)

an executory contract . may not be terminated or modified, and any right or obligation under such contract . may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract . that is conditioned on . the commencement of a case under this title ..11 U.S.C. § 365(e)(1).

Bankruptcy Code section 541, in addition to describing what constitutes property of the bankruptcy estate, also invalidates ipso facto clauses, providing that a debtor's interest in property

becomes property of the estate . notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law . that is conditioned on . the commencement of a case under this title . and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property. 11 U.S.C. § 541(c)(1)(B).

The intriguing question presented is whether it is the bankruptcy filing of LBHI or the later filing of LBSF that is the relevant commencement of a case for purposes of invalidating the shifting of priorities under the Transaction Documents. Before reaching that question, the Court needs to determine whether the Transaction Documents constitute executory contracts and, therefore, whether LBSF is entitled to the protections provided by Bankruptcy Code section 365. BNY, in its papers, baldly states that "the only performance due [under the Transaction Documents] -- if any -- is payment" and, therefore, the Transaction Documents are not executory contracts. (citing cases that found contracts were not executory where the only performance remaining was payment). BNY does not offer any additional analysis or make any further argument on the issue, relying on the assertion that Noteholder Priority and subordination under Condition 44 took effect prior to the date on which LBSF filed its bankruptcy petition.

Regardless of whether and when Noteholder Priority and subordination under Condition 44 took effect, there is no question that the parties' obligations under the Transaction Documents are continuing, that performance remains outstanding and that the Transaction Documents satisfy the functional definition of executory contracts.

The Bankruptcy Code does not define the term "executory contract." The Second Circuit has characterized.an executory contract as one "on which performance remains due to some extent on both sides," Eastern Air Lines, Inc. v. Ins. Co. of Pa.... In COR Route 5 Co., LLC v. Penn Traffic Co. (In re Penn Traffic Co.), 524 F.3d 373, the Second Circuit addressed the question of the extent to which performance must remain due on both sides for a contract to be treated as executory under section 365. The Penn Traffic court adopted the so-called "Countryman" approach to its determination; that is, "an executory contract is one 'under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.'"

The language and structure of the ISDA Master Agreement that forms a central part of the Swap Agreement demonstrate that these contracts are executory. Paragraph 9(c) of each ISDA Master agreement expressly provides that the obligations of the parties under the relevant Swap Agreement shall survive the termination of any transaction.. Given that all obligations of the parties under the ISDA Master Agreement remain outstanding, the failure of either party to complete performance would constitute a material breach excusing the performance of the other. In addition, each of LBSF and BNY has unsatisfied contractual obligations to make various payments. These outstanding obligations to make payments pursuant to the Swap Agreement constitute sufficient grounds to find that the contract in question is executory. Given the foregoing, the Transaction Documents are executory contracts and the provisions of section 365 are applicable to the Swap Agreement.

This leads to an examination of how to apply the ipso facto prohibitions of section 365 to the unusual challenges presented by the current facts and circumstances. In particular, the Court must consider the shifting priorities under the Transaction Documents caused by the separate defaults that occurred when LBHI and LBSF filed for bankruptcy, the distribution priorities that were in effect as of the LBSF Petition Date and any impact of the ipso facto provisions on the legal rights of the parties to enforce those priorities. The cross-border procedural posture further complicates this already challenging question of statutory interpretation.

In its motion, BNY argues that because the Transaction Documents are to be governed by and construed in accordance with English law, under the principles of comity and res judicata, this Court must defer to the determination by both the High Court and the Court of Appeal that September 15, 2008 should be viewed as the operative date with respect to the reversal in payment priorities under the Transaction Documents.

The English Courts authoritatively have interpreted the Transaction Documents in accordance with applicable English law. The Court, while respecting that determination as valid and binding between the parties, is not obliged to recognize a judgment rendered by a foreign court, but instead may choose to give res judicata effect on the basis of comity... In deciding whether to recognize the decision of the English Courts in relation to the determination that Perpetual is entitled to a distribution based on Noteholder Priority, this Court will evaluate whether the English Courts, in rendering their respective decisions, sufficiently considered the applicability and impact of section 365 of the Bankruptcy Code. It appears that the English Courts did not take into account principles of United States bankruptcy law and understood, as did the parties themselves, that the outcome of the dispute might well be different in this Court. Indeed, BNY has been concerned from the very outset of this litigation about the prospect of being caught in the middle between conflicting decisions as to the rights of Perpetual and LBSF to the Collateral. From BNY's perspective, consistent guidance from courts of competent jurisdiction on both sides of the Atlantic would be highly desirable and would avoid the unwanted result of conflicting judgments as to which party is entitled to the Collateral.

As a general matter, "courts will not extend comity to foreign proceedings when doing so would be contrary to the policies or prejudicial to the interests of the United States." Pravin Banker Assocs., Ltd. v. Banco Popular Del Peru, 109 F.3d 850, 854 (2d Cir. 1997). It is relevant that in adjudicating this dispute the English Courts addressed only (i) the breadth of the English common-law anti-deprivation principle in the context of the shift in payment priorities under the Transaction Documents based on LBSF's bankruptcy filing; (ii) if such shift is invalid under the anti-deprivation principle, whether it still is applicable if LBSF is not in insolvency proceedings in England; and (iii) if such shift is invalidated under the anti-deprivation principle, whether it still is applicable if the shift in payment priorities operates on account of an event other than the bankruptcy of LBSF.. Upon considering the identified issues, the High Court (as confirmed by the Court of Appeal) determined that the relevant provisions of the Transaction Documents are valid and enforceable under English law and do not violate the anti-deprivation principle. The English Courts did not consider any provisions of the Bankruptcy Code in connection with their decisions. Importantly, neither of the English Courts purported to bind this Court in any respect, and the High Court explicitly declined to "preclude any request or other application made by the . US Bankruptcy Court." Therefore, the English Courts have been most gracious in allowing room for this Court to express itself independently on matters of importance to the administration of the LBHI and LBSF bankruptcy cases. In applying the Bankruptcy Code to these facts, this Court recognizes that it is interpreting applicable law in a manner that will yield an outcome directly at odds with the judgment of the English Courts.

Despite the resulting cross-border conflict, the United States has a strong interest in having a United States bankruptcy court resolve issues of bankruptcy law, particularly in a circumstance such as this where the relevant provisions of the Bankruptcy Code provide far greater protections than are available under applicable provisions of foreign law... Given the responsibility of the Court to interpret and apply the Bankruptcy Code, the thoughtful and otherwise binding decisions of the English Courts do not prevent this Court from examining relevant provisions of the Transaction Documents under the broad protections afforded to debtors by the Bankruptcy Code. Accordingly, the Court declines to give preclusive effect to the respective judgments rendered by the High Court and the Court of Appeal and will apply relevant provisions of the Bankruptcy Code to determine the questions presented in the pending motions for summary judgment.

Under section 541, the bankruptcy estate is comprised of, inter alia, "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1) (emphasis added). The Second Circuit has recognized that "[t]his definition is broad and includes even strictly contingent interests.".. When determining whether a debtor has a property interest in an executory contract as of the commencement of a bankruptcy case so that the contract constitutes property of the estate, courts examine whether "termination requires the non-debtor party to undertake some post-petition affirmative act." .. BNY's position is that Noteholder Priority replaced Swap Counterparty Priority as of the date of LBHI's bankruptcy, such that the property right claimed by LBSF already was lost before the date of commencement of its own bankruptcy case. That interpretation is inconsistent with the structure of the Transaction Documents.

As of the LBSF Petition Date, the Transaction Documents required certain affirmative acts be to taken prior to the effectiveness of any modification of payment priority or method of calculation of the Early Termination Payment. No provision in any of the Transaction Documents automatically causes a change in legal rights immediately upon an event of default.

Pursuant to the terms of the Principal Trust Deeds, Noteholder Priority becomes effective only when there are amounts to be paid "in connection with the realisation or enforcement of the [Collateral]." Similarly, Condition 44 requires certain payments to be made, which payments may be made only after the "sale or realisation of the Collateral." It is undisputed that the Collateral had not been sold as of October 3, 2008, nor has it been sold to date. Indeed, Perpetual commenced the English Litigation on the grounds that BNY had failed to enforce rights in the Collateral.

Certain other payments required by Condition 44 cannot be calculated until after termination of the relevant Swap Agreement. The relevant termination events took place after commencement of the LBSF case. Saphir sent termination notices to LBSF on December 1, 2008 and such notices designated the filing of LBSF's chapter 11 petition as the triggering event of default.

Given these undisputed facts, LBSF held a valuable property interest in the Transaction Documents as of the LBSF Petition Date and, therefore, such interest is entitled to protection as part of the bankruptcy estate.

This sequence of events supports the conclusion that the relevant date for purposes of testing whether any shifting of priorities occurred under the Transaction Documents is the LBSF Petition Date, and not the commencement of the LBHI case on September 15, 2008. However, even if LBHI's petition date were to be considered as the operative date for a claimed reversal of the payment priority under the Transaction Documents, the ipso facto protections provided by sections 365(e)(1) and 541(c)(1)(B) of the Bankruptcy Code would bar the efficacy of such a change in distribution rights. Each of these sections of the Bankruptcy Code prohibits modification of a debtor's right solely because of a provision in an agreement conditioned upon "the commencement of a case under this title." 11 U.S.C. §§ 365(e)(1), 541(c)(1)(B) Notably, the language used is not limited to the commencement of a case by or against the debtor. Given the legislative history, the absence of such precise limiting language is significant.

The legislative history of section 365(e)(1) and section 541(c)(1)(B) provides helpful guidance in understanding the meaning of these sections and in analyzing how to interpret the words "a case" as used in these sections. An early version of what eventually became section 365(e)(1) referred to "the commencement of a case under this Act by or against the debtor." Pub. L. No. 91-354, § 4-602(b). Similarly, a draft of the language that became section 541(c)(1) at one time referred to "the commencement of a case under this title concerning the debtor." H.R. 6, 95th Cong. § 541(c). This initial use and later rejection of limiting language demonstrates that Congress considered, but ultimately rejected, drafting sections 365(e)(1) and 541(c)(1)(B) in a manner that would have expressly restricted their application to the bankruptcy case of the debtor counterparty.

The language used -- "commencement of a case under this title" -- appears simple enough at first reading, but what has been left out raises a number of questions. The plain meaning of the words applies to the commencement of a case (presumably any case that is related in some appropriate manner to the contracting parties). If the words are not tied to the case filed by the particular debtor that is party to a specified executory contract, under what circumstances is the bankruptcy case of another debtor sufficiently related to rights of the parties to such an executory contract that it is reasonable to trigger the ipso facto protections of these sections? Opening up the subject to cases filed by debtors other than the counterparty itself has the potential of opening up a proverbial "can of worms" that may lead to speculation as to the nature and degree of the relationship between debtors that is needed in order to properly apply the provision.

The Court recognizes the potential for future disputes over the interpretation of this language but declines here to make any broad pronouncements, interpret the language in the abstract or to expand on the various relationships between or among debtor entities that would make it appropriate for one debtor to invoke ipso facto protection due to the filing of another affiliated member of a corporate family. The description of the kind of relationship that is sufficient to trigger such protections affecting the rights of contracting parties is best left to a case-by-case determination. With this principle of restraint in mind, the Court will apply the language of these sections of the Bankruptcy Code to the situation presented by the sequential filings of the LBHI and LBSF bankruptcy cases and confine its conclusions to the Debtors' business structure and circumstances.

This Court has been presiding over the Debtors' bankruptcy cases for just over 16 months. During the multiple hearings and status conferences that have taken place during this period, the Court has learned that the Debtors are perhaps the most complex and multi-faceted business ventures ever to seek the protection of chapter 11. Their various corporate entities comprise an "integrated enterprise" and, as a general matter, "the financial condition of one affiliate affects the others." ... The LBHI chapter 11 petition was filed without adequate advance planning as the first of multiple related filings, each of which necessarily impacted the Lehman corporate family. Everyone knows that together these filings constitute the largest business bankruptcy in history.

Due to the sheer size of the corporate family and to the emergency, unplanned nature of the Debtors' bankruptcy cases, the impact of each bankruptcy case in the Lehman chain on non-debtor affiliates has yet to be fully determined. The Debtors continue to discover that certain non-debtor affiliates need to seek the protections of the Bankruptcy Code. For example, two LBHI affiliates filed chapter 11 petitions as recently as December 21, 2009.... Under these circumstances, the first filing at the holding company level of the corporate structure has significance, especially in the context of the ipso facto provisions that speak in terms of the commencement of "a" case under this title. Regardless of how this language may be interpreted in other settings, the Court is convinced that the chapter 11 cases of LBHI and its affiliates is a singular event for purposes of interpreting this ipso facto language. Nothing in this decision is intended to impact issues of substantive consolidation, the importance of each of the separate petition dates for purposes of allowing claims against each of the debtors or any other legal determination that may relate to the date of commencement of a case. However, for purposes of applying the ipso facto provisions of 365(e)(1) and 541(c)(1)(B), what happened on September 15, 2008 was a bankruptcy filing that precipitated subsequent related events. LBHI commenced a case that entitled LBSF, consistent with the statutory language, fairly read, to claim the protections of the ipso facto provisions of the Bankruptcy Code because its ultimate corporate parent and credit support provider, at a time of extraordinary panic in the global markets, had filed a case under the Bankruptcy Code.

The Court finds that the provisions in the Transaction Documents purporting to modify LBSF's right to a priority distribution solely as a result of a chapter 11 filing constitute unenforceable ipso facto clauses. Moreover, any attempt to enforce such provisions would violate the automatic stay. The stay is triggered upon the filing of a bankruptcy petition, and it operates to prevent "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." 11 U.S.C. § 362(a)(3). Thus, any attempt by any party to enforce Noteholder Priority or subordinated payment under Condition 44 would violate the automatic stay because it would deprive LBSF and its creditors of a valuable property interest.

Safe Harbor

BNY argues that if Noteholder Priority and subordination under Condition 44 are deemed not to have taken effect prior to the LBSF Petition Date, they nonetheless are enforceable as part of an integrated "swap agreement" that qualifies for the safe harbor protections set forth in section 560 of the Bankruptcy Code.

The safe harbor provisions of Section 560 of the Bankruptcy Code protect a non-defaulting swap participant's contractual rights to (i) liquidate, terminate or accelerate "one or more swap agreements because of condition of the kind specified in section 365(e)(1)" or (ii) "offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements." 11 U.S.C. § 560. These provisions specifically permit termination solely "because of a condition of the kind specified in section 365 (e)(1)" -- that is, the insolvency or financial condition of the debtor and the commencement of a bankruptcy case. 11 U.S.C. §§ 560, 561.

BNY maintains that the Noteholder Priority provision and Condition 44 comprise part of the Swap Agreements as "terms and conditions incorporated by reference and all documents that the market deems part of the parties' transaction" in accordance with Bankruptcy Code section 101(53B)(A). A review of the components of each Swap Agreement -- the ISDA Master Agreement, schedules and written confirmation - reveals that there is no reference at all to the Supplemental Trust Deeds, the Noteholder Priority provision or Condition 44. The provisions at issue dictate the means by which the proceeds of each Swap Agreement will be distributed, but do not comprise part of the Swap Agreements themselves. Because the provisions of section 560 deal expressly with liquidation, termination or acceleration (not the alteration of rights as they then exist) and refer specifically to "swap agreements," it follows that the Noteholder Priority provision and Condition 44 do not fall under the protections set forth therein.

11 U.S.C. § 510

BNY argues that Noteholder Priority and Condition 44 constitute subordination agreements, which agreements have been found by the English Courts to be enforceable under applicable non-bankruptcy law. Given that subordination agreements are enforceable under the Bankruptcy Code "to the same extent that such agreement[s] [are] enforceable under applicable nonbankruptcy law," then, according to BNY, Noteholder Priority and Condition 44 are enforceable against LBSF. See 11 U.S.C. § 510(a).

Although not defined in the Bankruptcy Code,.a subordination agreement is an "agreement by which one who holds an otherwise senior interest agrees to subordinate that interest to a normally lesser interest . ." BLACK'S LAW DICTIONARY (8th ed. 2004). The Noteholder Priority provision and Condition 44 may be construed as subordination agreements -- that is, LBSF agreed that upon the occurrence of certain conditions precedent, its interest in the Collateral and in the Early Termination Payment would be subordinated to the interest of

Perpetual. Nonetheless, BNY cannot overcome the shifting nature of the subordination that is being activated by reason of a bankruptcy filing. This subordination agreement differs, as result, from those enforceable agreements that establish lien or payment priorities that are permanently fixed without regard to the unenforceable future contingency of a bankruptcy filing. Were it not for the bankruptcy filings of LBHI and LBSF, the provisions at issue in the Transaction Documents would be enforceable as expressions of the intent of the parties to allocate the priority for distributing the Collateral between them. [4] However, the shift in payment priority upon the commencement of a bankruptcy case renders unenforceable this aspect of the subordination agreement. BNY has cited no case law or provision of the Bankruptcy Code that would allow a contract that is otherwise valid under Bankruptcy Code section 510(a) to escape application of the disabling ipso facto provisions of sections 365 and 541.

Conclusion

The Court finds that there is no material undisputed fact with respect to unenforceability of Noteholder Priority and subordination under Condition 44 and that LBSF is therefore entitled to judgment as a matter of law. The Court will enter a declaratory judgment that (i) the provisions in the Swap Agreements that seek to modify LBSF's payment priority upon an event of default constitute unenforceable ipso facto clauses that violate Bankruptcy Code sections 365(e)(1) and 541(c)(1)(B) and (ii) any action to enforce such provisions as a result of LBSF's bankruptcy filing violates the automatic stay under Bankruptcy Code section 362(a). LBSF is directed to submit a draft order consistent with this decision for the Court's consideration.

The issues presented in this litigation are, as far as the Court can tell, unique to the Lehman bankruptcy cases and unprecedented. The Court is not aware of any other case that has construed the ipso facto provisions of the Bankruptcy Code under circumstances comparable to those presented here. No case has ever declared that the operative bankruptcy filing is not limited to the commencement of a bankruptcy case by the debtor-counterparty itself but may be a case filed by a related entity -- in this instance the counterparty's parent corporation as credit support provider. Because this is the first such interpretation of the ipso facto language, the Court anticipates that the current ruling may be a controversial one, especially due to the resulting conflict with the decisions of the English Courts.

One of the distinguishing characteristics of the Lehman bankruptcy cases is the complexity of the underlying financial structures many of which are being analyzed for the first time from a real world bankruptcy perspective. It is to be expected, as a result, that the cases of LBHI and LBSF on occasion would break new ground as to unsettled subject matter. This is one such occasion.

This decision places BNY in a difficult position in light of the contrary determination of the English Courts confirming that Noteholder Priority applies to claims made against it in England by Perpetual. This is a situation that calls for the parties, this Court and the English Courts to

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[4] Footnote 9 to the judgment reads:" The Court recognizes that there is an element of commercial expectation that underlies the subordination argument. LBSF was instrumental in the development and marketing of the complex financial structures that are now being reviewed from a bankruptcy perspective. The Court assumes that a bankruptcy affecting any of the Lehman entities was viewed as a highly remote contingency at the time that the Transaction Documents were being prepared. At that time, LBSF agreed to a subordination of its Swap Counterparty Priority in the hard-to-imagine event that it should be in default at some time in the future. Capital was committed with this concept embedded in the transaction. But the ipso facto protections of sections 365 and 541 of the Bankruptcy Code apply uniformly, regardless of prepetition market expectations. They exist and should be enforced to preserve property interests for the benefit of all creditor constituencies."

work in a coordinated and cooperative way to identify means to reconcile the conflicting judgments. The Court directs that the parties attend a status conference to be held on the next available omnibus hearing date in the Debtors' cases for purposes of exploring means to harmonize the decisions of this Court and the English Courts.