TRAVERS SMITH

Belmont Park Investments PTY Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc.

Supreme Court decision

On 27 July 2011 judgment was handed down by the Supreme Court in *Belmont* [2011] UKSC 38. The case considered the scope and application of the "anti-deprivation" rule, which provides that contractual terms purporting to dispose of property on bankruptcy may be invalid for public policy reasons, as being an evasion of bankruptcy[1] law. The Supreme Court decision marks the final chapter, in the UK, of the long-running *Perpetual v BNY* dispute. Proceedings in relation to notes held by Perpetual were, however, settled before the Supreme Court appeal was heard.

The judgment clarifies the factors that the courts will consider when determining whether the anti-deprivation rule will apply to invalidate contractual provisions which purport to transfer property from the bankrupt's estate on bankruptcy. The judgment emphasises that the chief purpose of the rule is to prevent evasion of the insolvency laws, and recognises that, where there is no intention to evade these laws, it is desirable that, so far as possible, the courts should give effect to commercial arrangements agreed in good faith between the parties.

The facts

The case concerned a credit-linked note programme established by Lehman Brothers International (Europe) in 2002. Notes were issued by SPVs in tax-friendly jurisdictions; subscription proceeds paid by investors were used to purchase secure investments (the "collateral") which then vested in a trustee pursuant to a trust deed and supplemental trust deed. The SPV issuers entered into a swap agreement with Lehman Brothers Special Financing Inc ("LBSF") under which LBSF received the income on the collateral and in return paid the issuers the interest due to noteholders.

The case related to a provision in the supplemental trust deed dictating the priority ranking that would apply between the noteholders and LBSF in relation to realisation of the collateral. The relevant clause provided that LBSF would have priority unless there were an Event of Default in respect of which LBSF or Lehman Brothers Holdings Inc. ("LBHI") were the Defaulting Party (as defined in the swap agreement) in which case the noteholders would have priority. The relevance of this was that on early termination of the swap agreement, certain "Unwind Costs" were to be paid either to LBSF or the issuer. At the time of the Lehman collapse, the swap had a positive mark-to-market value in favour of LBSF. If it retained priority, LBSF could have recourse to the collateral in settlement of its claims to the Unwind Costs.

"The anti-deprivation principle is essentially directed to intentional or inevitable evasion of the principle that the debtor's property is part of the insolvent estate."

Per Lord Collins

[1] "Bankruptcy" is used to mean bankruptcy or insolvency.

The Events of Default under the swap agreement were numerous and included filings by LBHI and LBSF for Chapter 11 protection (on 15 September 2008 and 3 October 2008 respectively). LBSF sought to challenge the resulting priority "flip" under the supplemental trust deed on the basis that it breached the anti-deprivation rule.

The decision

Both the High Court and the Court of Appeal had previously upheld the contractual arrangements described above. Underscoring the importance of the case, seven Justices of the Supreme Court heard the case rather than the usual five. The Supreme Court unanimously dismissed LBSF's appeal. In his leading judgment, Lord Collins (with whom all of the Justices except Lord Mance expressly agreed) emphasised the restrictive scope of the anti-deprivation rule in complex commercial arrangements such as in *Belmont*. He stated that the policy behind the rule is to prevent parties from deliberately evading the insolvency laws by depriving the bankrupt, on bankruptcy, of property which would otherwise be available to creditors, and indicated that *"it is possible to give that policy a common sense application which prevents its application to bona fide commercial transactions which do not have as their predominant purpose, or one of their main purposes, the deprivation of the property of one of the parties on bankruptcy."* The intention is to be assessed objectively, and may therefore be inferred in obvious cases.

Lord Collins indicated that the general principle of party autonomy is fundamental to English commercial law and that courts should, so far as possible, give effect to contractual terms which parties have agreed, especially in cases of complex financial instruments. He also suggested that in "borderline cases" the courts should not hold as invalid provisions which form part of commercially sensible transactions entered into by the parties in good faith. The answer to the question whether the anti-deprivation rule applied in this case was therefore *"to be found in the fact that this was a complex commercial transaction entered into in good faith"*.

Lord Collins also considered, in this context, that where the source of the assets is the person to whom they are to go on bankruptcy, this may well be an important and sometimes decisive factor in a conclusion that the transaction was a commercial one entered into in good faith. Lord Mance disagreed with this part of Lord Collins' analysis.

Lastly, Lord Collins considered, though the point had been rendered academic, whether LBHI's prior bankruptcy could have constituted an Event of Default under the swap agreement, with the result that the anti-deprivation rule could have no application in any event as any deprivation was not by reason of LBSF's bankruptcy. He concluded that it could. Lord Mance expressed no concluded view on this point.

Key points from the judgment

- The anti-deprivation rule will only apply where there is an intention to evade the insolvency rules. The intention is assessed objectively, so it is irrelevant whether or not the parties subjectively intended to evade the law.
- The courts should, to the extent possible, seek to give effect to contractual terms which parties have agreed, especially in cases of complex financial instruments.
- Therefore, provisions in commercial transactions entered into in good faith and without an intention to evade insolvency laws will generally fall outside the scope of the anti-deprivation rule.
- The anti-deprivation rule will not apply if the deprivation takes place for events other than bankruptcy (e.g., in this case, the preceding bankruptcy of a related entity).
- The anti-deprivation rule is not prevented from applying merely because the source of the bankrupt's assets is the person to whom they are to transfer on bankruptcy, although this may be an important factor in determining that the rule does not apply (Lord Mance dissented on this point).

Implications of the judgment

The Supreme Court has held that the commercial sense of a transaction, good faith and the absence of intention to evade insolvency laws are the key factors that the courts should consider when determining whether a particular provision offends the anti-deprivation rule, and that courts should, to the extent possible, seek to give effect to contractual terms which parties have agreed.

"It is desirable that, so far as possible, the courts give effect to contractual terms which parties have agreed. And there is a particularly strong case for autonomy in cases of complex financial instruments such as those involved in this appeal."

Per Lord Collins

"The anti-deprivation principle…[must be] applied in a commercially sensitive manner, taking into account the policy of party autonomy and the upholding of proper commercial bargains."

Per Lord Collins

This is obviously a helpful decision and one which should provide some comfort both that genuine transactions will avoid the application of the anti-deprivation rule and that contractual freedom will be respected, particularly in complex transactions. However, it remains to be seen exactly where the line will be drawn, particularly at the "borderline" where, while a transaction might be said to have been in good faith, it may arguably have had, as one of its purposes, the deprivation of the property of one of the parties on bankruptcy.

It should also be noted that in January 2010, in parallel proceedings, the US Bankruptcy Court for the Southern District of New York had granted summary judgment in favour of LBSF on its application for a declaration that the "flip clauses" were in breach of the US Bankruptcy Code. Accordingly, whilst we have some clarity as to the position from an English law perspective, there are currently inconsistent judgments in relation to these clauses from the English and US courts.

How can we help?

This briefing is not intended to provide legal advice, which should be sought in relation to particular matters. If you would like to understand more about the *Belmont* decision or would like advice about insolvency generally, please contact Caroline Edwards or Peter Hughes or your usual contact at the firm.

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