THE IMPACT OF INSOLVENCY ON CORPORATE CONTRACTS:

A COMPARATIVE STUDY OF THE UK AND US INSOLVENCY LAW REGIMES

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ABSTRACT

Parties who contract at arm's length are bound by the terms of their contracts, provided the contracts do not contravene a rule of law or public policy. The commencement of formal insolvency proceedings may however limit the ability of a debtor to perform its pre-petition contractual obligations, resulting to liabilities to creditors. Accordingly, a formal insolvency procedure ensures an orderly and efficient resolution of the debtor's affairs -- maximising realisations to creditors or rescuing the corporate debtor as a going concern. To achieve this purpose, unilateral contract enforcement efforts and rights are replaced by a mandatory regime characterised by collectivity and equality in treatment of similarly situated creditors.

This thesis comparatively evaluates the impact of the commencement of formal insolvency proceedings on corporate contracts in the UK and US. It examines the extent to which pre-petition contractual bargains are suspended, adjusted or avoided by the supervening insolvency law regime in the jurisdictions. The thesis adopts a thematic approach to examine how the legal frameworks in the jurisdictions manage the inevitable conflict between the policy considerations of contract law and those of insolvency law.

The extent to which insolvency law should interfere with pre-insolvency contractual arrangements and entitlements has always been a contentious and keenly debated issue. No doubt, insolvency law has a greater number of interests to protect outside the interests of pre-petition contracting parties. These include the general body of creditors, employees, post-petition creditors etc. Nevertheless, in the absence of compelling and well-articulated policy justification, formal insolvency ought not to be a forum for the stripping of property rights or the pursuit of redistributional goals.

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INTRODUCTION

i. Background

Companies play a significant role in market and mixed economies. They are the primary wheels of investment in economies and the major drivers of economic growth. Companies generate direct and indirect revenues for their host countries through their business operations, payment of various taxes and royalties, and undertaking diverse corporate social responsibilities. Companies also generate employment opportunities that positively influence other standard-of-living metrics in the country such as the poverty rate, personal disposable income, foreclosure rates and the overall quality and affordability of housing, healthcare and education.

Corporate failures are inevitable in market or mixed economies. Insolvency may be due to reasons ranging from adverse market conditions, human error or negligence to incompetence or outright recklessness of managers. Accordingly, the nature of a jurisdiction's corporate insolvency law regime as well as the effectiveness of the collective debt resolution and value-maximisation regime will have significant influence on investment decisions. An inefficient and unpredictable corporate insolvency regime will have negative consequences on

investment decisions.[1] Such a regime will constitute a disincentive to prospective investors and will adversely affect lending decisions by banks and other financial institutions.[2]

Generally, a company is deemed to be insolvent when it is either unable to pay its debts as they fall due or the value of its debts is greater than the value of its assets.[3] The commencement of formal insolvency will have a number of consequences on the debtor company, its subsisting and future contracts and its creditors and counterparties. Insolvency often limits the ability of the debtor company to fulfill all its contractual and financial obligations. Creditors will understandably be desperate to unilaterally extract as much as they can from the company in order to minimise or avoid their individual losses.

Accordingly, a primary objective of corporate insolvency law is to ensure an orderly resolution of the company's debt crisis. Insolvency law discourages individual enforcement efforts and imposes a mandatory collective regime on all stakeholders. This enhances the achievement of insolvency law's goals of efficiency and equity in treatment of claims and maximisation of realisations.[4] Against this

[1] Philippe Froute, "Theoretical foundation of a debtor-friendly bankruptcy law in favour of Creditors" (2007) E.J.L. & E. 201, 204.
[2] ibid.
[3] s. 123 Insolvency Act; s. 101(32)(A) Bankruptcy Code; *BNY Corporate Trustee Services Ltd v Eurosail-UK* [2013] 1 W.L.R. 1408.
[4] Elizabeth Warren, "Bankruptcy Policy" (1987) 54 Univ. of Chicago L. Rev. 775, 785: "In bankruptcy, with an inadequate pie to divide and the looming discharge of unpaid debts, the disputes center on who is entitled to shares of the debtor's assets and how these shares are to be divided."

background, the debtor's pre-petition contracts are often interfered with by the supervening insolvency regime. This is inevitable considering the inability of the debtor to fulfill all its pre-petition obligations to the letter.

In the contract law regime, parties are bound by the terms of contracts they have entered into at arm's length. Contract law favours certainty of contracts as well as autonomy of parties.[5] Accordingly, settled contracts can only be modified or terminated in accordance with the terms and conditions of the contract or as provided for by legislation. The law does not set out specific and detailed contractual terms for contracting parties. The law merely sets out regulatory frameworks within which parties can contract.[6] In consequence, contract law sanctions freedom of contract so long as contracts are not against public policy or in breach of a rule of law.[7]

The commencement of formal insolvency significantly alters the above position.[8] The insolvency regime takes prime position in the debtor's

[5] Seana Shiffrin, "The Divergence of Contract and Promise" (2007) 120 Harvard L. Rev. 708, 709.
[6] John Smith, *The Law of Contract* (4h edn, Sweet & Maxwell 2002) 2: "The distinguishing feature of contractual obligations is that they are not imposed by law but undertaken by the contracting parties."
[7] Benjamin Hermalin, "The Law and Economics of Contracts," Columbia Law and Economics Working Paper No 296 http://ssrn.com/abstract=907678 (accessed on 22 February 2011).
[8] *Hindcastle v Barbara Attenborough Associates* [1997] AC 70, 86: "Disclaimer will inevitably have an adverse impact on others; those with whom the contract was made and those who have rights and liabilities in respect of the property."

affairs, displacing the applicable non-insolvency law.[9] Rajak sums up this position as follows:

> "The phenomenon of insolvency may render nugatory the clearest and most cast-iron of legal rights ... A contract giving undeniable rights to one party in a jurisdiction with the most efficient system of enforcement of rights may be worthless where the other party is insolvent."[10]

Hence at the commencement of formal insolvency, hitherto valid and binding contracts of the debtor may be modified, suspended or terminated by the new regime.[11] The insolvency law framework will dictate the capacity and ability of the debtor to engage in post-insolvency contracts.

Notwithstanding Rajak's assertion above, it is imperative for a balance to be struck between the policy objectives of contract law and those of insolvency law. An approach which is overly protective of debtors will be detrimental to trade and commerce. In recognition of this point, the *United Nations Commission on International Trade Law Working Group V* has rightly proposed in its draft legislative guide on insolvency law that,

> "Although insolvency law generally forms a distinctive regime, it ought not to produce results that are fundamentally in conflict with the premises upon which the general law is based. Where the insolvency law does seek to achieve a result that defers or fundamentally departs from the general law (e.g. with respect to treatment of contracts, avoidance of antecedent acts and transactions or treatment of the rights of secured creditors) it is highly desirable that that result be the

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[9] *Fontainebleau Hotel Corporation v Simon* 508 F.2d 1056, 1059 (5 Circuit 1975): "The purpose of Bankruptcy Code is to suspend the normal operation of rights and obligations between the debtor and his creditors."

[10] Harry Rajack, *Insolvency Law Theory and Practice* (Sweet & Maxwell 1993) 4.

[11] *In the Matter of Whitcomb & Keller Mortgage Co*. 715 F.2d 375 (7th Cir. 1983): "In the first place, it may be noted that general principles governing contractual benefits and burdens do not always apply in the bankruptcy context."

> product of careful consideration and conscious policy in that direction."[12]

The above point is highly imperative especially in the treatment of property rights of creditors. In this regard, insolvency law ought not to be used as a platform to pursue redistributional goals. The status of parties at insolvency ought to be determined by reference to their pre-petition positions and the applicable non-insolvency law. Accordingly, there should only be a deviation where there is a clear and justifiable insolvency law policy which necessitates same so as to fulfill specific goals of insolvency law e.g. the statutory moratorium and avoidance of certain vulnerable pre-petition contracts which are both evaluated in this thesis.

ii. Objectives

The objective of this thesis is to develop a sound and in-depth understanding of the impact of insolvency on a corporate debtor's contracts. This thesis evaluates how insolvency affects the pre and post-petition contractual rights and obligations of a corporate debtor, as well as those of its creditors. It examines the conflict that often arises between the policy objectives of contract law and those of insolvency law after the commencement of the formal procedure. It also evaluates the mechanisms for managing these conflicts in the jurisdictions.

[12] United Nations Commission for International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law (2004) 9.

The above is carried out through a thematic and comparative study of the corporate insolvency law systems of the US and the UK (England and Wales). The themes of corporate insolvency law analysed in this thesis are the anti-divestiture rules, the statutory moratorium, the disclaimer provisions, rules against contracts at an undervalue and post-petition finance contracts.

Against this background, this thesis is designed to develop a sound insight into this area of corporate insolvency law. Significantly there is a dearth of academic work which deal extensively with the impact of insolvency on corporate contracts, let alone, from a comparative perspective. This thesis therefore seeks to make original and substantial contributions to legal knowledge in the areas it has covered.

iii. Methodology

This thesis is predominantly a comparative study. Generally, comparative legal research proceeds from doctrinal research perspectives. This thesis therefore heavily relies on primary sources of law from the three jurisdictions such as case law, statutes and other statutory instruments in addition to secondary sources of law: mainly academic literature. The doctrinal approach aids in the description and analysis of the domestic laws of the jurisdictions.

Comparative law is the study of the relationship of a national legal system with one or more other national systems.[13] It includes the analysis of the nature of such a relationship, the reasons for the similarities and/or differences and the significance of such similarities and/or differences.[14] This thesis utilises the functional approach, which is the standard research method of comparative law.[15] Functionality is premised on the notion that legal systems face essentially the same problems and solve these problems by quite different means, though very often with similar results.

Having this principle in mind will aid in avoiding any legal transplanting of the rules of one jurisdiction to another without due consideration of the peculiar socio-political and economic climate of that jurisdiction. Functionality is also hinged on the notion that *incomparables* cannot be usefully compared and that in law the only things that are comparable are those which fulfil the same function.[16] Accordingly this thesis focuses on the corporate insolvency law systems of two jurisdictions; these systems have the

[13] Mary Glendon, Paolo Carozza, *Comparative Legal Traditions, Texts, Materials and Cases* (2nd end, West 1994) 6.
[14] ibid.
[15] Christopher Whytock, "Legal Origins, Functionalism and the Future of Comparative Law" (2009) Brigham Young University L Rev: http://ssrn.com/abstract=1596271 (accessed on 22 February 2011); Ralph Michaels, "The Functional Method of Comparative Law" (2006) *Duke Law Faculty Scholarship* Paper 1249: http://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2033&context=faculty_scholarship (accessed on 9 July 2013); Mathias Reimann, "The Progress and Failure of Comparative Law in the second half of the 20th Century" (2003) 50 Am J Comp L 671, 679. Antonios Platsas, "The Functional and the Dysfunctional in the Comparative Method of Law: Some Critical Remarks" EJCL http://www.ejcl.org/123/art123-3.pdf (accessed on 9 July 2013).
[16] Konrad Zweigert, Hein Kotz, *An Introduction to Comparative Law* (Clarendon Press 1998) 34.

same central objective i.e. a collective and orderly resolution of insolvency.

The choice of the corporate insolvency law systems of UK and US for this comparative analysis is premised on very cogent reasons. As previously noted, comparative law often involves the study of relationships between national systems of law. Subsequently, where there is no relationship between the legal systems compared, there can be no comparative law and any comparison drawn between rules will be arbitrary and worthless.[17] UK's corporate insolvency law shares a common heritage with the US legal regimes in US. The two insolvency law regimes belong to the same legal family with the English regime being the parent system.

The first US bankruptcy law enacted in 1800 substantially adopted the English Bankruptcy law of 1782.[18] In addition, the relationship between the UK and US insolvency law regimes can be traced back further to the 15th century. In *Bay Plastics Inc. v BT Commercial Corporation,*[19] it was noted that the modern US fraudulent provisions under the US bankruptcy law owe their origin to the Statute of Elizabeth (the Statute of Fraudulent Conveyances).[20]

[17] Mary Glendon, Paolo Carozza, *Comparative Legal Traditions, Texts, Materials and Cases* (fn. 13).
[18] David Epstein, Steve Nickles, *Bankruptcy* (West 1993) 1. Charles Tabb, "History of the Bankruptcy Laws in the United States of America" (1995) 3 Am. Bankr. Ins. L. Rev. 5, 6.
[19] 187 B.R. 315 (CD. Cal. 1995).
[20] 13 Eliz. Ch. 7 (1570).

The UK corporate insolvency law system has since maintained its so-called "creditor-friendly" approach. In addition, the UK regime has undergone a number of revisions over the years, developing certain distinctive features. Despite sharing a common heritage with the UK system, the US corporate bankruptcy law regime has been revised and developed in a distinctive manner. These revisions have transformed the regime into the leading debtor-oriented corporate bankruptcy system in the world today.[21]

iv. Chapter outline

Chapter one of this thesis comparatively evaluates the anti-divestiture rules under UK and US corporate insolvency regimes. The chapter examines the policy objectives of the common law anti-deprivation rule and the Bankruptcy Code's anti-ipso facto rules. It critically evaluates the efficacy of the rules in fulfilling their objectives as well as their effect on pre-petition contractual arrangements.

Chapter two comparatively evaluates UK insolvency law moratorium regime and the

[21] The Chapter 11 reorganisation procedure where after the commencement of the insolvency procedure, the company is left under the control of the existing directors or management, known as the debtor-in-possession. Nathalie Martin, "Common-Law Bankruptcy Systems: Similarities and Differences" (2003) 11 Am. Bankr. Inst. L. Rev. 367, 367-368: "Despite large-scale transplantation of English law into the US, long after the revolutionary war, the US diverged from England in the area of bankruptcy, for economic and philosophical reasons. The US never adopted the English's unforgiving and highly administrative bankruptcy process."

corresponding automatic stay regime under US bankruptcy law. The chapter identifies and evaluates the policy objectives of the statutory moratorium in the jurisdictions and their impact on enforcement of pre-petition contractual rights and remedies. The chapter also examines the efficacy of the relief provisions as a mechanism for striking a balance between contending interests in the insolvency forum.

Chapter three evaluates the purpose and effect of the disclaimer or rejection of pre-petition executory contracts in the jurisdictions. The chapter also evaluates the two principal tests for determining the burdensome nature of contracts in the US regime – against the background of the objectives of the disclaimer/rejection mechanism.

Chapter four of this thesis comparatively evaluates the rules against transactions at an undervalue and fraudulent contracts under UK and US insolvency regimes respectively. The chapter explores the measures adopted by the jurisdictions to safeguard genuine contracts from the avoidance rules. The chapter also specifically explores the application of these rules on two notable contracts which often raises undervalue concerns, namely leveraged buyouts and intra-group guarantee agreements.

Chapter five analyses post-petition contracts in UK and US insolvency law. The chapter highlights the imperative of post-petition financing arrangements

and proceeds to evaluate the legal frameworks for post-petition financing contracts in the jurisdictions. It assesses the approaches of the jurisdictions towards incentivising and compensating prospective post-petition lenders and their effect on the contractual and property interests of other creditors.

CHAPTER ONE
THE ANTI DIVESTITURE RULES

1.0. Introduction

Companies engage in multiple contractual arrangements in the course of their business operations. The commencement of a formal insolvency procedure may limit the ability of companies to perform some of their contractual obligations. Accordingly, contracting parties often adopt a variety of measures to evade or minimise the potential losses that insolvency may inflict on solvent parties. A common means of minimising or avoiding the harsh consequences of insolvency is adopting contractual clauses for the modification or termination of contracts once formal insolvency proceedings commence. In other instances, parties may agree for a transfer or retransfer of assets to the solvent party at the commencement of formal insolvency or the occurrence of an insolvency-related event such as default in the performance of an obligation or a very high debt-to-equity ratio.

Although some of these arm's length contracts are valid prior to insolvency, they may be incapable of achieving the objectives of the parties in the insolvency regime. This will be the case if they offend certain mandatory rules of insolvency law. Primarily,

they may constitute an attempt at contracting out of the mandatory insolvency law scheme. This has two consequences; firstly the debtor's estate is deprived of the benefits of the terminated contract or transferred asset. Secondly, some of such arrangements may be contrary to insolvency law's pari passu regime which favours the equal treatment of similarly ranked creditors.

A significant introduction to the US Bankruptcy Reform Act[1] was the anti-divestiture provisions, commonly referred to as the *anti-ipso facto rules*.[2] Ipso facto clauses permit contracting parties to either modify contractual rights or terminate the contract upon insolvency.[3] The Bankruptcy Code's anti-ipso facto rules render such clauses invalid and unenforceable at insolvency.[4] Under UK corporate insolvency law, the 200-year-old common law anti-deprivation rule performs a similar (but not identical) role. The rule invalidates agreements for transfer of assets of the debtor to a third party at the commencement of formal insolvency proceedings.[5]

[1] Bankruptcy Code 1978.
[2] H.R. Rep. No. 595, 95th Congress 1st Session 347-348 (1997); s.365 (e), (b), (c) and 541(c) of the Code; *In re Lafayette Radio Electronics* 7 B.R. 189, 191 (Bankr. ED N.Y. 1980); *In re Sapolin Paints Inc*. 5 B.R. 412, 417 (Bankr. E.D.N.Y. 1980).
[3] *Dumont v Ford Motor Credit Co*. 581 F.3d 1104, 1115 (9th Cir. 2009); *In re Suncruz Casinos* 342 B.R. 370, 376 (Bankr. S.D. Fla. 2006); *In re Texaco Inc*. 73 B.R. 960, 964, 965 (Bankr. S.D.N.Y. 1987).
[4] s. 365(e) and s. 541(c) of the Code.
[5] *Yates Development Inc*. *v Old Kings Interchange Inc*. 241 B.R. 247, 253 (Bankr. M.D. Fla. 1999).

Over the years, there have been varying (and sometimes conflicting) judicial attitudes and academic opinions in the UK and the US in relation to insolvency-related contractual forfeiture clauses. Prior to the enactment of the Bankruptcy Reform Act,[6] ipso facto clauses were valid and enforceable.[7] This notwithstanding, some bankruptcy courts deviated from this general rule.[8] This was often the case where such forfeiture caused substantial injustice or frustrated a debtor's reorganisation process.[9] With the introduction of provisions that invalidate all ipso facto clauses, the 1978 insolvency law reform has ensured consistency in judicial decision-making in this regard.

The scope and application of the common law anti-deprivation rule has remained uncertain. The conflicting decisions of English courts and the numerous exceptions to the rule clearly illustrate this point. In *Lomas v JFB Firth Rixson,*[10] Briggs J. rightly noted that although the rule is a useful public policy principle, it had been characterised and disfigured by the several distinctions that have eroded its efficacy

[6] Bankruptcy Code 1978.
[7] Bankruptcy Acts 1898, 1938 and 1970; *Days Inn of America Inc. v 161 Hotel Group Inc*. 55 Conn. App. 118, 124-125 (739 A.2d 280 1999); *In re B. Siegel Company* 51 B.R. 159, 164 (Bankr. E.D. Mich. 1985); *Kopelman v Halvajian* 663 F.2d 463, 466 (3d Cir. 1981); *John Harry Trigg v The U.S.A* 630 F.2d 1370, 1374 (10th Cir. 1980); *In re Great Scott Food Market* 1 B.R. 223, 224 (Bankr. D.R.I. 1979); *Smith v Hoboken R.R. Warehouse* 328 U.S. 123 (1946).
[8] *Holtsinger Inc. v Cordaro* 20 B.R. 814, 816 (Bankr.M.D.Fla.1982); *In re Great Scott Food Market* (fn. 7) 225; *In the Matter of Queens Boulevard Wine and Liquor Corporation* 503 F.2d 202, 204 (2nd. Cir. 1974); *B.J.M Reality Corporation v Joseph Ruggieri* 326 F.2d 281, 282 (2 Cir. 1963); *Finn v Meighan* 325 U.S. 300 (1945); *Model Dairy Company v Foltis Fischer Inc*. 67 F.2d 704, 706 (2 Cir. 1933).
[9] *Dicello v USA* 133 B.R. 578, 582 (Bankr. D. Del. 1991); *In re Traders Compress Corp*. 381 F. Supp 789, 794 (1973); *In re Rosenbaum Grain Corp*. 13 F.Supp 601, 604 (1935); *Environmental Properties Corporation v Allied Supermarket Inc*. 20 B.R. 897, 899.
[10] [2010] EWHC 3372 (94).

and efficiency. [11] Also in *Money Markets International Stockbrokers Ltd v London Stock Exchange*,[12] Neuberger J. observed that,

> "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...it is not entirely easy to reconcile the conclusions, and indeed the reasoning, in some of the cases."[13]

Similar sentiments have been expressed by a number of courts that have applied the rule.[14] Accordingly, this chapter attempts to explore ways of possibly achieving coherence in the application of the rule.

This chapter also critically evaluates the underlying policy objectives of the anti-divestiture rules in both jurisdictions and their effect on contracts at the commencement of formal insolvency proceedings. The chapter evaluates the approaches of the two legal systems in resolving the conflicts between the policy considerations of contract law, which favour freedom and enforceability of contracts and those of insolvency law, embodied in the anti-divestiture rules, which favour a collective procedure and equality of similarly ranked creditors.

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[11] ibid. at (95).
[12] [2002] 1 W.L.R. 1150, 1182.
[13] ibid. at 1182. He also noted that "It is equally clear from the authorities that there are occasions where a provision which, at least on its face, appears to offend the principle has been upheld. I do not find it easy to discern any consistent approach in the authorities as to the application of the principle." (1173).
[14] *Belmont Park Investments Pty Ltd and ors v BNY Corporate Trustee Services Ltd* [2011] 3 W.L.R. 521, 539; *Butters and ors v BBC Worldwide Ltd and ors* [2010] 3 W.L.R. 87, 118 (Neuberger J.): "...it is difficult to define precisely what sort of deprivation provisions are caught by the rule."

1.1. Scope and policy objectives

1.1.1. Bankruptcy Code's anti-ipso facto rules

a. The statutory provisions

The two primary anti-ipso facto rules are contained in s. 365(e) and s. 541(c) of the Bankruptcy Code. Section 365(e) invalidates contractual provisions that modify or terminate executory contracts or unexpired leases at the commencement of insolvency.[15] For a contractual clause to be vulnerable under s. 365(e), the termination must be conditioned upon any of the following insolvency events: [16]

i. the insolvency or financial condition of the debtor at any time before the closing of the insolvency case; [17]

ii. the commencement of the insolvency case;[18]

iii. the appointment of or taking possession by a trustee in the bankruptcy case or a custodian before the commencement of the case.[19]

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[15] *Mims v Fidelity Funding Inc*. 307 B.R. 849, 858 (N.D.Tex. 2002); *In re Schwegmann Gaint Supermarkets* 287 B.R. 649, 657-658 (Bankr.E.D.La. 2001); *Forlini v North East Savings* 200 B.R. 9, 12; *In re Warren Siegal* 190 B.R. 639, 643-644 (Bankr. D. Ariz. 1996); *Broyhill v Deluca* 194 B.R. 65, 75 (Bankr. E.D. Va. 1996); *In re Bernie Grablowsky* 180 B.R. 134, 137 (1995); *In re Child World Inc*. 161 B.R. 349, 354, 355 (Bankr. S.D.N.Y. 1993); *Hawai Leasing v Sergio Inc*. 16 B.R. 898, 910 (Bankr. D. Hawaii 1981); *Phillips v First City Texas-Tyler* 966 F.2d 926, 935 (5th Cir. 1992); *In re Rittenhouse Carpet Inc*. 56 B.R. 131, 133 (Bankr. E.D. Pa. 1985).

[16] *In re United Airline Ltd Corp*. 346 B.R. 456, 467 (Bankr. N.D. Ill. 2006); *In re Howard Margulis* 323 B.R. 130, 136-137 (Bankr. S.D.N.Y. 2005); *Summit Investment and Development Corporation v Leroux* 69 F.3d 608, 611; *Prime Motor Inns Inc. v First Fidelity Bank* 123 B.R. 104, 108 (Bankr. S.D. Fla. 1990).

[17] s. 365(e)(1)(A) of the Code.

[18] s. 365(e)(1)(B).

[19] s. 365(e)(1)(C).

These provisions ensure that clauses for termination of contracts that are not conditioned on the insolvency of the debtor but merely coincide with the commencement of the case, are not unfairly invalidated by the rule.[20]

Similarly, s. 541(c) invalidates ipso facto clauses that have the effect of transferring the debtor's assets to other parties at the commencement of insolvency.[21] Under the Bankruptcy Code, a "bankruptcy estate" is automatically created once an insolvency petition is filed.[22] This bankruptcy estate comprises all legal or equitable interests of the debtor in property.[23] Accordingly, s. 541(c) ensures that the debtor's pre-petition interests in any property fall into the bankruptcy estate at the commencement of the bankruptcy case.[24]

The wide nature of the s. 541(c) anti-ipso facto provision clearly indicates a manifest Congressional

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[20] *Spieker Properties LP v Southern Pacific Funding Corp*. 268 F.3d 712, 717 (9th Cir. 2001).

[21] *In re Robert Helms Construction Corp*. 139 F.3d 702, 705 (9th Cir. 1998); *In the Matter of GP Express Airlines Inc*. 200 B.R. 222, 233 (Bankr. D. Neb. 1996); *In re Jones Truck Lines Inc*. 172 B.R. 602, 611-612 (Bankr.W.D.Ark.1994); *In re Olympia Holding Corp*. 188 B.R. 287, 294, 295 (M.D. Fla. 1994); *Tambay Trustee Inc. v Florida Progress Corp*. 67 B.R. 94, 96 (Bankr. M.D. Fla. 1986).

[22] s. 541(a) of the Code.

[23] s. 541(a); *In the Matter of Daugherty* 188 B.R. 607, 611 (Bankr. D. Neb. 1995); *In re Tudor Motor Lodge Ltd* 102 B.R. 936, 949 (Bankr. D.N.J. 1989); *Counties Contracting & Construction Co. v Constitution Life Insurance Company* 855 F.2d 1054 (3d Cir. 1988); *In re Wegner Farms Corp*. 49 B.R. 440, 442-443 (Bankr. N. D. Iowa 1985); H.R. Rep 595, 95th Cong., 1st Sess. 367 (1977), U.S.C.C.A.N. 1978, 5787, 6323. The legislative history of the section describes the estate as consisting of "all kinds of property…tangible or intangible."

[24] s. 541(c) of the Code; *In re Forth Worth Osteopathic Hospital Inc*. 387 B.R. 706, 712-713 (Bkrtcy N.D. Tex. 2008); *In re Gregory Ehmann* 319 B.R. 200, 206 (Bankr. D. Ariz. 2005); *In re Garrison Ashburn* 253 B.R. 700, 709 (Bankr. E.D. Va. 2000); *Forlini v NorthEast Savings* 200 B.R. 9, 12 (D.R.I. 1996); *In re Cutler* 165 B.R. 275, 280 (Bankr. D. Ariz. 1994); *In re Winters* 69 B.R. 145, 146 (Bankr. D. Or. 1986); *In re Gaslight Village Inc*. 6 B.R. 871, 875 (Bkrtcy. D. Conn.1980).

intention to transfer all property interests of the debtor to the bankruptcy estate, regardless of any pre-existing agreement to the contrary.[25] Hence it specifically frustrates any form of dissipation of the assets in the bankruptcy estate by invalidating any stipulation, agreement, transfer instrument or applicable non-bankruptcy law which at the commencement of insolvency:

i. is conditioned on the typical ipso facto events under s. 365(e)(1)(A),(B) and (C);[26] and
ii. effects or gives an option to effect forfeiture, modification, or termination of the debtor's interest in property.[27]

b. Policy objectives

The policy objective for the anti-ipso facto rules is well explained in the Code's legislative statement. The legislative history of s. 365 (e) describes the policy rationale of the rule as being to enable trustees to assume or assign useful executory contracts or leases that will aid the company's rehabilitation or liquidation.[28] Hence in the case of *Yates Development Inc. v Old Kings Interchange,*[29] the rationale for invalidating ipso facto clauses was

[25] *Brock v American Security Bank* 23 B.R. 998, 1002; *In re Probulk Inc.* 407 B.R. 56, 61 (Bankr. S.D.N.Y. 2009).
[26] *In re Government Securities Corp.* 101 B.R. 343, 350 (Bankr. S.D. Fla. 1989) where a termination was held not to infringe s. 541(c)(1)(B) as the termination clause and the termination were not conditioned upon any insolvency event.
[27] *Prime Motor Inns Inc. v First Fidelity Bank* (n 16) 108; *American Druggists Insurance v Jeanes Mechanical Contractors* 32 B.R. 657, 659 (Bankr.W.D.Ky.1983).
[28] Senate Report No. 989, 95th Congress 2nd Session 59, (1978).
[29] 241 B.R. 247, 253 (1999).

given as being that,

> "They deprive the Chapter 11 estate of valuable property rights, such as the opportunity to receive the benefits of a contract, at the very time the debtor and the estate may need these rights the most in order to further rehabilitation efforts."[30]

Accordingly, contractual or statutory provisions for the termination or modification of contracts or contractual rights upon a company's insolvency are invalidated with the aim of giving the debtor the opportunity to perform them and utilise the benefits for the general body of creditors.[31]

Notwithstanding that executory contracts consist of unperformed obligations, it would seem that the US lawmakers view these unperformed obligations as *contingent assets* which have the potential of yielding value for creditors. This aligns with one of insolvency law's principal goals namely, the maximisation of realisations for the creditors. Priority is given to what would benefit the general body of creditors as against the risk that an individual creditor would avoid by terminating an executory contract with an insolvent counterparty. It can be argued that this approach furthers corporate insolvency law's policy towards a collectivised system of administration, asset distribution and risk sharing.

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[30] ibid. at 253, per Proctor J.

[31] *Spieker Properties LP v The SPFC Liquidating Trust* (fn. 20) 716; *Yates Development Inc. v Old Kings Interchange* 241 B.R. 247, 253 (Bankr. M.D. Fla. 1999); *Summit Inv. & Development Corp v. Leroux* (fn. 16) 610; *In re Seven Hills Inc.* 403 B.R. 327, 335 (Bankr.D.N.J. 2009); *Liberty Mutual Insurance Co. v Greenwich Insurance Co.* 417 F.3d 193, 198 (1st Cir. 2005); *McGlockling v Chrysler Financing Co.* 296 B.R. 884, 889 (Bankr. S.D. Ga. 2003); Andrea Coles-Bjerre, "Ipso Facto: The Pattern of Assumable Contracts in Bankruptcy" (2010) 40 N.M.L.R. 77, 87, 88.

1.1.2. Common law anti-deprivation rule

a. The rule

As a matter of general principle, assets that are vested in a debtor at the commencement of insolvency proceedings fall into the insolvent estate for the benefit of the general body of creditors. The anti-deprivation rule invalidates contracts that provide for a transfer of such assets to creditors or non-creditors upon insolvency.[32] Accordingly, in *Whitmore v Mason*,[33] one of the early cases where the rule was applied, Page Wood V-C expressed the rule as being that,

> "No person possessed of property can reserve that property to himself until he shall become bankrupt, and then provide that in the event of his becoming bankrupt, it shall pass to another, and not to his creditors..." [34]

The anti-deprivation rule is part of insolvency law's rules against contracting out. Its purpose is to frustrate unjust withdrawal of assets from the insolvent estate; hence its ultimate goal is the maximisation of realisations. As will be explained, it operates *on* insolvency and not prior to insolvency. This is significant, given that the contrary would result in an overlap of the anti-deprivation rule and

[32] *Perpetual Trustee Co. Ltd. v BNY Corporate Trustees Trustee Services* [2010] 3 W.L.R. 87, 122; *Higinbotham v Holme* (1812) 19 Ves 88; *Ex parte Barter* (1884) L.R. 26 Ch.D. 510, 519-520; *Borlands Trustees v Steel Brothers & Co.* [1901] 1 Ch. 279, 290; *Ex parte Mackay* (1872–73) L.R. 8 Ch. App 643, 647, 648.
[33] (1861) 2 J & H 204.
[34] ibid. *at* 212-213; cited with approval in *Ex parte Williams* (1877-78) L.R. Ch.D 138, 143; *Ex parte Jay* (1880) L.R. 14 Ch.D. 19, 25.

the well-established avoidance provisions.[35] Thus the suggestion by the presiding Judge in *Fraser & Ors v Oystertec Plc*.[36] that the anti-deprivation rule can apply even when no bankruptcy or winding up order has been made[37] was overruled by the Court of Appeal in *Perpetual Trustee Co Ltd. and another v BNY Corporate Trustee Services Ltd*.[38]

The nature and scope of the anti-deprivation rule has been rightly described as "easy to state, but difficult to apply in particular in relation to sophisticated dealings between modern financial and commercial entities."[39] The foregoing situation has been made worse by a consistent lack of coherence in the application of the rule over the years.[40] The consequence of this is that it is often difficult to ascertain the types of contracts and contractual clauses that will be in breach of the anti-deprivation rule.[41]

In *Perpetual Trustees Company Ltd v BNY Corporate Trustee Services*,[42] Neuberger L.J. rightly observed the above point, noting that:

> "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 judgements in which the rule

[35] e.g. s. 238 and s. 239 IA.
[36] [2004] B.C.C. 233.
[37] ibid. at 253-254.
[38] [2010] 3 W.L.R. 87, 113 (per Neuberger L.J.) and 127 (per Patten L.J.).
[39] *Lomas v JFB Firth Rixson* (fn. 10) (94).
[40] *Money Markets Int'l Stockbrokers Ltd v LSE* [2002] 1 W.L.R. 1150, 1182.
[41] *Butters and Ors v BBC Worldwide Ltd* (fn 14) 118 (per Neuberger J.): *"it is difficult to define precisely what sort of deprivation provisions are caught by the rule."* Fidelis Oditah, "Assets and the Treatment of Claims in Insolvency" (1992) 108 L.Q.R. 459, 476.
[42] [2010] 3 W.L.R. 87.

> has been considered is often a little opaque, and some of the judgements are hard to reconcile."[43]

This notorious fact will be illustrated and evaluated in detail throughout this chapter.

The anti-deprivation rule operates in a similar manner as s. 541(c) given that both provisions invalidate contracts which have the effect of clawing back assets from the insolvent estate at insolvency. English insolvency law has no equivalent of the s. 365(e) ipso facto rule. This means that contractual clauses for the termination or modification of ordinary executory contracts are unobjectionable in English law. The Supreme Court has recently affirmed this position in the *Belmont case*, where Lord Mance noted that,

> "There is in my opinion no basis for any such rule. Where a contract provides for the performance in the future of reciprocal obligations, the performance of each of which is the quid pro quo of the other, I see nothing objectionable or evasive about a provision entitling one party to terminate if the other becomes bankrupt." [44]

In contrast to the US regime, English insolvency law adopts a different approach to executory contracts of insolvent companies. This is notwithstanding the *prospective* benefits which may be derived from such contracts, especially where the liquidator is able and willing to perform.

English insolvency law often gives effect to the pre-insolvency contractual intention of parties --

[43] ibid. at 102; *BNY Corporate Trustee Services Ltd v Belmont Park Investments Pty Ltd* (fn. 14) 539; *Butters & Ors v BBC* (fn. 14) 118.
[44] *BNY Corporate Trustee Services Ltd v Belmont Park Investments Pty Ltd* [2011] B.C.C. 734, 780.

which is for the solvent party to have the right of termination at insolvency. The general principle is that the liquidator stands exactly in the same position as the debtor itself stands in.[45] Given that there has not been any performance from either of the parties but mere unfulfilled obligations, it can hardly be argued that assets have been removed from the insolvent estate.

This can be contrasted with a case where the debtor has utilised its assets in performing and has not received any performance before its insolvency. Hence in the *Belmont case*, Lord Walker had observed thus,

> "I would accept that the forfeiture of contractual rights on the bankruptcy of the party enjoying them is in some circumstances capable of constituting a deprivation of property within the principle precluding evasion of the bankruptcy law. This is so not only with accrued rights, but may also be the case with other rights, as, for example, where the bankrupt has performed his part before going bankrupt or the right can fairly be treated as independent of any as yet unperformed obligation."[46]

Furthermore, as would be seen in the course of this chapter, giving effect to pre-insolvency contractual intentions of the parties with reference to the applicable non-insolvency law, also accords with what ought to be the touchstone of the regime in applying the anti-deprivation rule.

b. Policy objectives

[45] *In re Scheibler* (1874) L.R. 9 Ch. 722, 727.
[46] ibid at 780.

Over the years, two broad policy justifications have been proffered for the common law anti-deprivation rule. One school of thought views the policy objective of the rule as being to promote or protect the pari passu principle of asset distribution.[47] In line with this reasoning, in *Lomas v JFB Firth Rixson*,[48] Briggs J. noted that,

> "The part of the insolvency legislation which the anti-deprivation rule exists mainly to protect is what is generally called the principle of *pari passu* distribution, namely that all the property owned by the company as at the commencement of its relevant insolvency process should, subject to the prior payment of preferential liabilities and expenses, be applied in satisfaction of its liabilities in proportion to the size of those liabilities."[49]

The pari passu rule reflects the principle that statutory provisions for pro rata distribution may not be excluded by a contract that gives one creditor more than its proper share. It ensures a pro rata distribution of assets to unsecured creditors subject to the interests of floating charge-holders and preferential creditors.[50]

It is admitted that the anti-deprivation rule supports the pari passu principle, to the extent that it maximises realisations for distribution.[51] However, the proposition that the anti-deprivation rule is premised on the pari passu rule or exists mainly to protect it, is doubtful. This position is supported by

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[47] *Perpetual Trustees Co Ltd v BNY Corporate Trustees* (fn. 32) 125-126 (118)-1(23); Roy Goode, *Principles of Corporate Insolvency Law* (3rd edn, Sweet and Maxwell 2005) 186; Richard Calnan, *Proprietary rights and Insolvency* (OUP 2010) 4-15.

[48] [2010] EWHC 3372 (Ch.).

[49] ibid at (97).

[50] The pari passu provisions can be found in ss.107 and 328(3) of the Insolvency Act 1986, Rules 2.69 and 4.181 of the Insolvency Rules.

[51] *Lomas v JFB Firth Rixson Inc* [2012] 1 C.L.C. 713, 750: "The anti-deprivation principle therefore protects the value of the estate from attempts to evade the insolvency laws and, as a consequence, facilitates the application of the pari passu rule."

the observation of the Court of Appeal in *Lomas v JFB Firth Rixson Inc*.[52] where Longmore L.J. stated that,

> "The relationship between the anti-deprivation principle and the pari passu rule is both *dependent* and *autonomous*. The former is concerned with contractual arrangements which have the effect of depriving the bankrupt estate of property which would otherwise have formed part of it. The *pari passu* rule governs the distribution of assets within the estate following the event of bankruptcy."[53]

First, given that the pari passu principle is a principle of asset distribution in insolvency, and the rule has no relevance in the absence of a distribution,[54] the implication of this is that the anti-deprivation rule will not apply in insolvency proceedings where there is no distribution to creditors.[55] This runs counter to the settled position that the rule applies equally in administration – and this is regardless of whether there is distribution or not.[56]

Secondly, in some cases, assets that have been recouped by virtue of the application of the anti-deprivation rule may not necessarily be subject to the pari passu distribution principle. This will be the case where there are floating charge holders and even preferential creditors, who will all have priority over unsecured creditors. In consequence, the pari passu principle may actually have nothing to bite on, as

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[52] [2012] 1 C.L.C. 713.
[53] ibid. at 750.
[54] *Commissioner For Her Majesty's Revenue & Customs v The Football league Ltd* [2013] B.C.C. 60, 80 (87).
[55] *Lomas and ors v JFB Firth Rixson Inc*. (n 10) 750 (96); John Amour, "The uncertain flight of British Eagle" (2003) 62 Cambridge Law Journal 39, 40.
[56] *Commissioners For Her Majesty's Revenue & Customs v The Football League Ltd* (fn. 54) 78, 80; *Butters v BBC Worldwide Ltd* [2010] B.C.C. 59.

there may not be dividends to be shared among unsecured creditors to whom the pari passu principle applies.

The argument that the pari passu principle is the basis for the anti-deprivation rule can also be attacked on the ground that not every deprivation which the rule aims at is in favour of creditors. As will be seen in this chapter, the rule also targets transfers made to non-creditors, for example senior creditors in subordination agreements, co-shareholders in pre-emption agreements etc. In cases of this nature, it is the size of the pie which is affected by the deprivation and not necessarily the pro rata distribution of the pie among creditors.

A second school of thought views the policy objective of the anti-deprivation rule as being to protect the size and value of a debtor's assets at insolvency.[57] Given that the rule frustrates attempts to withdraw assets that would otherwise fall into the insolvent estate, its primary focus is seen as being that of asset preservation and the maximisation of realisations for creditors. Against the background of the previous evaluation of the views of the first school of thought, as well as the analysis below, this view is

[57] *BNY Corporate Trustee Services Ltd v Belmont Park Investments Pty Ltd* (fn 44) 739; Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet and Maxwell 2011) 217; Sarah Worthington, "Insolvency Deprivation, Public Policy and Priority Flip Clauses" (2010) I.C.R. 28-39; Roy Goode in "Perpetual Trustee and Flip Clauses in Swap Transactions" (2011) 127 L.Q.R. 1, 3–4. However, see an earlier contrary position by Professor Roy Goode stating that the pari passu rule was the basis of the application of the anti-deprivation rule in: Roy Goode, *Principles of Corporate Insolvency Law* (3rd edn. 2005) 175, 177-180. Professor Ritz Mokal had rightly disagreed with this position in "Priority as Pathology; The Pari Passu Myth" (2001) C.L.J. 581, 595-596, 598-600.

more persuasive.

In *Borland's Trustee v Steel Brothers & co.*,[58] the anti-deprivation rule was expressed as being that,

> "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 some one else and be taken away from his creditors, is void as being a violation of the policy of the bankruptcy law."[59]

The anti-deprivation rule focuses on attempts to withdraw assets on insolvency, thereby reducing the value of the insolvent estate to the detriment of creditors. It is not concerned with the pro rata distribution of assets among equally ranked creditors. Hence it has been rightly observed that while the anti-deprivation rule ensures that the size of the pie available for division is not improperly reduced, the pari passu rule focuses on the appropriate division or distribution of the pie.[60] The primary objective of the rule is asset preservation and the maximisation of realisations for the general body of creditors.[61]

It is suggested that the argument about the anti-deprivation rule being premised on the pari passu rule is due to the fact that the two principles are sub-rules of the general principle against contracting out of the insolvency law,[62] and may sometimes overlap.[63] This will be the case where a party in whose favour the deprivation is effected is a creditor.

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[58] [1901] 1 Ch. 279.
[59] ibid at 290.
[60] Roy Goode, *Principles of Corporate Insolvency Law* (fn. 57) 61.
[61] *Commissioners For Her Majesty's Revenue & Customs v The Football League Ltd* (fn. 54) 75
[62] ibid. at 739. Lord Collins endorsed the view of Professor Roy Goode in "Perpetual Trustee and Flip Clauses in Swap Transactions" (fn. 57) 3–4.
[63] *Lomas and Ors v JFB Firth Rixson Inc*. (fn. 51) 750 (96), (97).

In addition, a close look into some cases in the past will reveal that where some courts applied the anti-deprivation rule, they actually used descriptions which would suit the pari passu rule. For example in *Ex parte Mackay*, [64] James L.J., held that the vulnerable contract,

> "Provide(d) for a different *distribution* of his effects in the event of bankruptcy from that which the law provides."[65]

Prima facie, this statement expresses the pari passu principle. The facts of the case also showed that the pari passu rule had been breached. This is in view of the fact that the estate was clearly deprived of an asset (the royalties) but at the same time an unsecured creditor was effectively elevated in terms of recovery over all creditors.

In addition to the fact that the anti-deprivation rule is not concerned with distribution, the rule differs from the pari passu rule in other respects. As will be seen in this chapter, the anti-deprivation rule applies only if a deprivation is triggered by the commencement of formal insolvency.[66] On the other hand, the pari passu rule will apply regardless of whether insolvency is the trigger of the deprivation or asset transfer.[67] A detailed evaluation of this issue is dealt with in paragraph 1.2.3.

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[64] (1872–73) L.R. 8 Ch. App 643.
[65] ibid. at 647.
[66] *Belmont Park Investments Pty Ltd* v *BNY Corporate Trustee Services Ltd* (fn. 44) 734, 742.
[67] *Commissioner For Her Majesty's Revenue & Customs v The Football league Ltd* (fn. 54) 76 (65).

Lastly a further distinction between the two rules, which flows from the fact that the pari passu principle is restricted to asset distribution, is that the pari passu rule does not apply to deprivations in favour of non-creditors. This is necessarily so, given that non-creditors are not part of insolvency law's distribution scheme to which the rule is restricted. An example of a deprivation to a non-creditor will be the case of debt subordination where the subordinated creditor (i.e. the junior creditor) is not necessarily a creditor or debtor of the senior creditor. As a corollary, it can also be argued that the pari passu rule will not apply in the case of a fully secured creditor who receives an asset which ought to fall into the insolvent estate, such receipt being above his entitlement as a secured creditor.

Significantly and flowing from the above, Goode has argued that the anti-deprivation rule is restricted to non-creditors and does not apply when deprivations are in favour of creditors. Goode argues that,

> "Unfair preference of one creditor over the general body of creditors merely disturbs the statutory order of distribution; it has no impact on the net asset value of the company. This is because the amount lost to the company through a payment or transfer to a particular creditor in or towards repayment of the company's debt to him is precisely matched by a corresponding diminution in the company's liabilities, leaving its balance sheet unchanged."[68]

Goode further argues that a transfer to a creditor will only be in breach of the anti-deprivation

[68] Roy Goode, Principles of Corporate Insolvency Law (fn. 57) 218-219.

rule if he is paid more than he was owed. The deprivation will be to the extent of the excess he would not receive as a creditor – given that there will be a reduction in the company's net asset value in breach of the anti-deprivation rule.[69] Goode thus concludes that the two rules are mutually exclusive in relation to any particular payment or transfer.[70]

The wider implication of Goode's proposition would be that most previous authorities which were premised on the anti-deprivation rule would have to be viewed as pari passu authorities, given that the parties who received the assets were in one way or the other creditors of the insolvent parties.[71]

Again, his proposition can be disputed on the ground that although a preferential payment to a creditor does not amount to a withdrawal in favour of an *external* party – in which case the liabilities of the company are not correspondingly reduced. It nevertheless constitutes a withdrawal of assets which ought to be available to the general body of creditors. First, in a winding up procedure, reduction of a debtor's liabilities due to the preferential payment to an unsecured creditor, practically gives no benefit to other unsecured creditors. Secondly, the withdrawal will reduce the pro rata receipts of creditors generally. Thus it can be argued that this ultimately has the same

[69] ibid. at 218, 219
[70] ibid.
[71] e.g. *Ex p Mackay* (1872-73) L.R. 8 Ch. App 643; *Ex parte Williams* (1877) 7 Ch. App 138; *Worrell v Johns* [1928] Ch. 737; *In re Appex Suply Company* [1942] Ch. 108; *Carreras Rothmans Ltd v Freeman Matthews Treasure Ltd* [1983] 1 Ch. 207.

effect as a withdrawal by a non-creditor.

Nevertheless, from another perspective Goode's proposition may be considered as a good effort towards delineating the limits of two principles. This has the potential of ensuring clarity in their application and avoiding some of the inconsistencies that plague the application of the anti-deprivation rule.[72] In addition, it is arguable that Goode's proposition will not result in any transaction that would have otherwise been colourable being validated. On the contrary, it will ensure that the rules are in fact mutually exclusive. This will in turn ensure clarity in their scope and application.

1.2. Primary elements of the rules

1.2.1. Executory contracts

Section 365(e) of the Bankruptcy Code is confined to executory contracts, while s. 541(c) applies to both executory and executed contracts.[73] This point is well illustrated in the case of *General Motors Acceptance Corporation v Thomas Bell*[74] where s. 365(e) was held to be inapplicable because the contract was executed but s. 541(c) was held to apply.[75]

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[72] For example in *Money Markets International v LSE* (fn.12) 290 where Lord Neugberger stated that the decision *British Eagle v Air France* [1975] 1 W.L.R. 758 (where the pari passu principle was applied) had modified the ways in which the anti-deprivation rule was to be applied.
[73] *In re Perry* 25 B.R. 817, 820 (Bankr. D. Md. 1982); *Brock v American Security Bank* 23 B.R. 998, 1002 (1982).
[74] 8 B.R. 549 (Bkrtcy E.D. Mich. 1981).
[75] Ibid. at 551.

As previously noted, s. 365(e) has no equivalent in English insolvency law.[76] The anti-deprivation rule focuses on the divestment of property at insolvency and not termination of executory contracts.[77] In English commercial law, it is common practice for contracting parties to include clauses that enable a solvent party to either withhold performance or terminate the contract if the counterparty becomes insolvent.

In *Belmont Park Investment Pty Ltd v BNY Corporate Trustee Services,*[78] the Supreme Court upheld the validity of such ipso facto clauses in English law. The court rejected a proposition that clauses stipulating for the termination of contracts at insolvency breached the anti-deprivation rule given that the liquidator is deprived of the potential benefits of continuing the contract. The court reasoned that where a contract provides for the performance in the future of reciprocal obligations, the performance of each of which is the quid pro quo of the other, a termination-at-insolvency clause was unobjectionable.[79]

Much can be said about English law's approach to ipso facto clauses in executory contracts.

[76] *Belmont Park Investments Pty Ltd v BNY Corporate Trustees Services* [2011] 3 W.L.R. 521, 573 (174).
[77] ibid. Although where the 'termination-at-insolvency' contractual clause involves the divestment of property, the application of the anti-deprivation rule will inevitably terminate the contract too.
[78] [2011] B.C.C. 734.
[79] ibid. at 780 (per Lord Mance).

First, there is no doubt that some executory contracts may be beneficial to an insolvent company's successful rehabilitation or smooth winding up. Where the officeholder is able and willing to perform the debtor's obligations under the contract, the counterparty hardly stands to lose anything. On the contrary, such will potentially result in the maximisation of realisations for the general body of creditors.

Again, even if direct performance by the debtor or officeholder is not feasible, if such executory contracts are assignable, ipso facto terminations will have the effect of depriving the insolvent estate of the potential benefits that will accrue from possible assignment of the contracts. Hence it is arguable that permitting the termination of executory contracts upon insolvency denies the debtor the opportunity to maximise realisations. It may also have the effect of denying a faltering but potentially viable business the crucial advantage in attempting to reorganise.

It is suggested that the s. 365(e) ipso facto provision represents a strong Congressional intention favouring maximisation of the size of the insolvent estate to enable creditors to be paid as much as possible on their claims. From the perspective of the Code's distribution and asset maximisation perspectives, each executory contract is viewed as a contingent opportunity. Accordingly, a counterparty's

obligation to perform an existing contract also represents potential value that can be collected or assigned to maximise realisations to creditors.

However, the merits and case for invalidating ipso facto clauses in executory contracts at insolvency may only be plausible where the insolvent party is able and willing to perform. The contrary would amount to dragging an unwilling counterparty into further risky dealings with an already insolvent company with no assurance of reciprocal performance.

Regardless of the above, a possible argument in support of the anti-ipso facto regime may be that counterparties in executory contracts with insolvent companies ought to stand on the same footing with other unsecured creditors who were "unlucky" to have performed the obligations in their pre-insolvency contracts without receiving any performance before the commencement of the formal insolvency proceedings.

Take an example, On December 21, B enters into separate contracts with S1 Ltd and S2 Ltd. The contract with S1 is for the immediate supply of goods for payment on December 31. While the contract with S2 is for the supply of goods on December 25 for payment on December 31. If B Ltd files for liquidation on December 24, the argument is that S2 Ltd ought to be compelled to perform its obligation and thereafter claim as an unsecured creditor – given

that S2 Ltd, a contingent unsecured creditor, ought to stand in the same position as S1 Ltd by performing and subsequently claiming for dividends as an unsecured creditor. Note that this (extreme) scenario has only been avoided under the Code by the preconditions for the assumption of pre-insolvency contracts.[80]

However, the prospect of being forced into such a one-sided transaction will raise serious issues of fairness and equity, given that the solvent party's position would be altered even before performance. More significantly, there is the problem of the ipso facto clause. It is doubtful if a creditor who has promptly exercised a termination-at-insolvency clause in an executory contract should in fact be considered to be on the same footing with unsecured creditors who were "unlucky" to have performed their contractual obligations prior to insolvency.

The recognition of the right of a solvent party to terminate an executory contract accords with English insolvency law's inclination to party autonomy and giving effect to the terms of contracts of parties in the absence of an insolvency rule justifying a deviation. The assets-maximisation objective of insolvency law is opposed to creditors having fewer assets than should be available to them at insolvency. As a corollary, it is also arguable that creditors should not be able to recover more assets

[80] This is discussed in detail in chapter 3.

and acquire more contractual rights inside insolvency than they would outside – solely because of the happenstance of insolvency. Such a result will encourage forum shopping and recourse to insolvency proceedings without any real justification for maintaining a case.

Accordingly, English insolvency law respects the non-insolvency entitlements of parties. This point was well emphasised by Neuberger J. in *Perpetual Trustee Co Ltd and anor v BNY Corporate Trustee Services Ltd*,[81] when his Lordship noted that,

> "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 ... It is also desirable that, if possible, the courts give effect to contractual terms which parties have agreed."[82]

Lord Collins also expressed similar sentiments in the Supreme Court.[83] English insolvency law's approach is reinforced by the fact that what is actually in issue are mere unperformed or contingent obligations – as opposed to accrued rights.

1.2.2. Assets and divestiture

As a matter of principle, assets of a debtor must be available for the general body of creditors at insolvency. For the anti-deprivation rule to be

[81] [2010] 3 W.L.R. 87, 107.
[82] ibid. at 107.
[83] *Belmont Park Investments Pty Ltd* v *BNY Corporate Trustee Services Ltd* (fn. 44) 760.

applicable, it must be shown that an asset that was vested in the debtor in a way that it ought to be available to the general body of creditors, has been removed from the insolvent estate.[84] Another principle of English insolvency law is that only the assets of the company are available for distribution to creditors. English law respects security interests and property rights of third parties. Hence at insolvency, subject to few exceptions,[85] such parties are not impeded from enforcing their security rights or taking their properties.

It has been rightly suggested that the primary questions in the application of the anti-deprivation rule is to what extent insolvency law should follow the general law's characterisation of pre-insolvency claims of creditors as proprietary, quasi-proprietary and personal. Such characterisation will in turn determine other relevant questions such as what constitutes an asset, ownership of asset and deprivation.

It is suggested that in English law, a possible touchstone for resolving these questions is for courts to take an objective view of the contractual intentions of parties at the time of contracting as indicated in the terms of their agreement, with a view to ascertaining the rights and obligations that the parties had

[84] *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* (n 76) 555; *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd* [1985] Ch. 207, 217.
[85] E.g. the transaction avoidance rules, moratorium and floating charges.

conferred on themselves.[86] These rights and obligations must accord with the applicable non-insolvency law governing such transactions. Hence where the denomination given to the contract by the parties does not represent the actual contracts entered into, courts should be able to re-characterise such contracts to bring them in accord with their recognised effect. The diverse contracts and contractual clauses evaluated under this section clearly illustrate this process.

Just like the anti-deprivation rule, s. 541(c) of the Bankruptcy Code frustrates bankruptcy-termination clauses that purport to terminate or forfeit a debtor's assets upon the filing of a bankruptcy petition. The effect of this provision is that such assets will fall into the estate notwithstanding the existence of a termination clause. However, in contrast to the anti-deprivation rule, s. 541(1) does not necessarily respect the proprietary or security interests of other parties in an asset. Accordingly, in the case of *In re Forth Worth Osteopathic Hospital Inc*.[87] it was held that for s. 541(a) and (c) to be operative, the debtor must have either a legal or equitable interest in the asset as of the commencement of the case.[88] On the other hand, the provisions will not be applicable if the debtor had ceased to hold any legal or equitable interest in the property prior to the commencement of

[86] This is the approach taken to the recharacterisation of a charge as fixed or floating in *National Westminster Bank plc. v. Spectrum Plus Ltd*. [2005] B.C.C. 694.
[87] 387 B.R. 706 (Bkrtcy N.D. Tex. 2008).
[88] ibid. at 714.

formal insolvency proceeding.[89] This position accords with that of the anti-deprivation rule where interest in property is imperative to establish deprivation.

The anti-ipso factor rule under s. 365(e) does not focus on invalidating contracts for the withdrawal of assets from the insolvent estate at insolvency. It invalidates clauses in executory contracts for the termination or modification of the contractual rights of the debtor. A divestiture of property interest is therefore not a prerequisite for the provision to be engaged. As previously noted, this provision has no equivalent in English law and is one of the primary distinctions between the two regimes. Again, this also explains the differences in the treatment of executory contracts by the two regimes previously analysed above.

Against this background, the anti-ipso facto rules do not respect the security or proprietary interests of creditors. This is not to suggest that the Bankruptcy Code engages on an asset confiscation spree at insolvency. The practical implication of the foregoing is that clauses that limit, modify or terminate any contractual, possessory or limited proprietary interests of the debtor in agreements or assets will be invalidated. Accordingly, the officeholder will be able to continue with such contracts on the same footing as the debtor.

[89] *Chrysler Credit Corp. v Schweitzer* 19 B.R. 860, 867 (Bankr.E.D.N.Y.1982).

At this point it is pertinent to evaluate English law's approach to insolvency-termination clauses in diverse contracts. These examples will illustrate the regime's possible approach in determining the questions as to what constitutes an asset, ownership of assets and what constitutes deprivation of assets. In addition to illustrating the complexity in determining when the anti-deprivation rule has been engaged, these examples also show the readiness of English courts to give effect to the pre-insolvency contractual intentions of parties as shown in the terms of their contracts – with reference to the applicable pre-insolvency law or rule.

a. Conditional sale contracts

A conditional sale agreement is an agreement for the sale of goods under which the purchase price or part of it is payable by instalments, and the property in the goods remains in the seller (notwithstanding that the buyer is to be in possession of the goods) until such conditions as to the payment of instalments or otherwise as may be specified in the agreement are fulfilled.[90]

A seller who acts on an ipso facto clause in a conditional sale agreement by repossessing his goods

[90] s. 1(1) Hire-purchase Act 1965 or 29(1) Hire-purchase Act 1964; s. 1(2), (3) Sale of Goods Act; *In Re Anchor Line Ltd* [1937] Ch. 1, 11. A conditional sale agreement qualifies as an "agreement to sell" under the Sale of Goods Act. It only becomes a contract of sale when the time elapses of the conditions are fulfilled subject to which property in the goods is to be transferred. s. 2(4) and s. 2(5) SGA respectively.

will not be in breach of the anti-deprivation rule.[91] This is on account of the fact that title to the goods remains in the seller, the debtor will not be deprived of any assets which ought to be available to its creditors at insolvency.

Goode has argued that termination clauses in conditional sale agreements may be objectionable where the insolvent buyer has already given substantially complete payment or other performance.[92] Assuming (without conceding) that Goode's position is plausible, it is suggested that what would pass to the insolvent estate would be the contract or goods subject to the precondition of completing payments-- not just the goods. However, it is difficult to envision how an argument for a deprivation will be sustained in the absence of complete payment, given that title remains in the seller, until the completion of payment.

Goode's position is appealing given the fact that allowing a seller to repossess the goods and also keep sums paid already will grant the seller a windfall. This can be contrasted with the harsh effect it will have on the buyer's creditors. However, it is suggested that the pertinent question is this; can the sums paid under the conditional sale agreement be considered as assets that ought to be available to the

[91] Roy Goode, "Flip Clauses: The End Of The Affair?" (2012) L.Q.R. 171, 177.
[92] ibid. For example in *Folgate London Market Ltd v Chaucer Insurance Co Plc* [2011] EWCA Civ 328, where the insolvent company had paid for a right of indemnity and had almost no continuing obligations, a provision for termination of that right on the company's liquidation was held to constitute a breach of the anti-deprivation rule.

buyer's creditors at insolvency? Going by the terms of a typical conditional sale, the answer would be 'no.' Property only passes after the completion of payment.

By way of mitigating the hardship the foregoing will inflict on the insolvent estate, previous payments can be recovered on the ground of total failure of consideration.[93] This will be based on the ground that the goods that were the primary aim of the contract are no more available. This will however be subject to any agreement in the contract to the contrary.

b. Hire-purchase agreements

A hire-purchase agreement is an agreement where goods are bailed or hired in return for payment of instalments by the person to whom they are bailed or hired (the hirer) with an option to purchase at the end of the bailment.[94] Property in the goods remains in the owner,[95] usually a finance company, and only passes to the hirer if he exercises the option to purchase.[96]

It is common practice for contracting parties to insert an insolvency-termination clause in hire-purchase agreements for the benefit of the finance

[93] *Dies v British and Int'l Mining* [1939] 1 KB 724, 743.
[94] *Helby v Matthews* (1895) A.C. 471, *Belsize Motor Supply Company v Cox* [1914] 1 K.B. 244, 251.
[95] In *McEntire v Crossley Bros Ltd* (1895) A.C. 457, 469.
[96] s. 29(1) Hire-purchase Act 1964.

company.[97] Such terminations are capable of giving rise to diverse considerations. This section will focus on three specific issues vis-à-vis the anti-deprivation rule namely, the interest of the hirer in the agreement, the validity of the termination and the availability or otherwise of equitable relief from forfeiture.

The character of the hirer's interest is important for two reasons. First, in determining if the anti-deprivation rule has been breached. If the interest of the hirer in the goods, by reason of the option to purchase, is not an interest in property, then the loss of that interest on insolvency does not offend the rule. The mere contractual (and contingent) right to have the option exercised is subject to the "flaw" that in certain events that right is not to arise.[98] Secondly for the purposes of equitable relief from forfeiture.

There is a division in judicial and academic opinion as to what interest a hirer has in a hire-purchase agreement. The debate centres on whether the hirer's instalment payments and/or his option to purchase confer a limited proprietary interest in the goods on him – as opposed to a mere contractual possessory right.[99]

Guest and Oditah have both offered separate

[97] *Re Apex Supply Co*. [1942] 1 Ch. 108; *McEntire v Crossley Bros Ltd* (fn. 95); *Re Gelder* (1881) 50 L.J. Ch. 293, *Re Yarow* (1889) 61 L.T. 642.
[98] Anthony Zacaroli, Fidelis Oditah, "Chattel Leases and Insolvency" (1997) 1 C.F. Insol. Rev. 1, 29, 35.
[99] Goode argues that Carey J's decision was incorrectly decided as it runs directly counter to the then highest authority (i.e. *Re Appex Supply Co*. (fn. 97); *McEntire v Crossley Bros Ltd* (fn. 95)) - Roy Goode, *Hire-Purchase Law and Practice* (2nd edn, London Butterworths 1970) 578.

extensive analyses on the above issue with special focus on the judgment of Judge Evans Carey in *Re Piggin, Dicker v Lombank*[100] in which the learned county court Judge examined the validity of a bankruptcy termination clause in a hire-purchase agreement. In giving judgment for the bankruptcy trustee on behalf of the hirer, Judge Carey based his decision on two grounds. First he concluded that under the terms of the hire-purchase agreement and prior to its bankruptcy, the insolvent hirer had the right to retain possession as well as the right to exercise the option to purchase – both contractual advantages acquired for valuable consideration. Relying on the rule in *Ex parte Mackay,*[101] Judge Carey concluded that these rights ought to pass to the bankruptcy trustee for the benefit of the hirer's creditors.

Secondly, Judge Carey noted that the court could invoke its equitable jurisdiction against penalties to prevent the insolvent hirer or an assignee of his right from forfeiting the benefit of the hire-purchase agreement. The possibility or otherwise of equitable intervention is considered at the concluding part of this section. The next paragraphs will evaluate the validity of an insolvency-triggered termination of a hire purchase agreement.

Guest and Oditah have rightly noted that

[100] [1962] 112 L.J. 424.
[101] (1873) L.R. 8 Ch. App. 643.

whatever interest the hirer has in the hire-purchase agreement (i.e. a right to retain possession and to exercise the purchase option) is limited or determinable in nature. Given the fact that as a general rule, insolvency law respects non-insolvency entitlements, the rights which pass to the hirer's trustee in bankruptcy are only those which would remain in the hirer when insolvent, not those he would have had if solvent.[102]

In addition, Oditah has argued that Judge Carey's decision can be supported on grounds analogous to the ones the learned Judge relied on.[103] Oditah argues that, contrary to the widely held assumption that a hirer's rights are purely contractual;[104] the hirer's option is a valuable asset for which he pays instalments. He submits that this is evident from the fact that the hirer is usually entitled to recover all sums paid for total failure of consideration in cases where a person claiming a superior title displaces his possession,[105] and this is inconsistent with the theory that a hirer's only rights are to use and which can be terminated by agreement.

With respect, it is doubtful if the decision in *Warman v Southern Counties Car Finance Corp*[106] supports the notion that the hirer has a proprietary

[102] Fidelis Oditah, "Assets and the treatment of claims in insolvency," (1992) 108 L.Q.R. 459, 483-4; A.G. Guest, *The Law of Hire-purchase* (Sweet & Maxwell 1966) 381.
[103] Oditah (fn. 102) 484.
[104] i.e. a right to use the bailed goods until the option to purchase is exercised or the agreement is terminated.
[105] *Warman v Southern Counties Car Finance Corp* [1949] 2 KB 576.
[106] [1949] 2 K.B. 576.

interest. On the contrary, it can be viewed as authority for the proposition that failure of consideration, due to a purported owner's lack of title to the goods and consequent inability to offer the hirer the option to purchase will constitute total failure of consideration – entitling the hirer to a full refund of his instalments. This long excerpt from the judgement of Finnemore J. supports this position:

> "This car was not, at any time, the property of the defendants. I do not think that the plaintiff in any circumstances could be called on to pay to the defendants hiring money for a car which belonged to somebody else. I should have thought it was quite plain that if A. purports to hire a car to B., and in fact delivers to B. a car which belonged not to himself but to C., to which he had no right whatever in law, and during the currency of the agreement C. intervenes and asserts his right to the car, and if, in those circumstances, B. does not pay the hiring charges, A. would have no possible claim for them … I do not see here how the defendants, because they delivered to the plaintiff somebody else's car, can claim any kind of money from him for the use of that car." [107]

Although this signals the importance of the option in the agreement, it does not suggest that an unexercised option confers a proprietary interest on the hirer. This position is also consistent with and can be contrasted with the reasoning of Lord Denning L.J. in *Kelly v Lombard Banking Co. Ltd*[108] where his Lordship dismissed an argument by the hirer to the effect that there was total failure of consideration because a hire-purchase agreement was terminated before he could exercise the option to purchase.[109]

In furtherance of his argument, Oditah also argues that the approach of the courts in the

[107] *Warman v Southern Counties Car Finance Corp* (fn. 105) 582-583.
[108] [1959] 1 W.L.R. 41.
[109] ibid. per Lord Denning.

assessment of damages where the hirer has irreversibly converted the goods shows that the hirer has more than merely contractual rights.[110] The general principle for assessment of damages is that where goods have been irreversibly converted, the measure of damages is the value of the goods at the time of conversion, but where the defendant has an interest in the goods the measure of damages is limited to the plaintiff's interest in the goods.[111]

Oditah posits that judicial authorities suggest that in actions for irreversible conversion of goods bailed, the owner can only recover his interest in the goods, not the full value of the goods at the time of conversion - an indication of the sums outstanding under the hire purchase agreement.[112] He concludes that this approach is not consistent with the absence of any proprietary interest in the goods inhering in the hirer.[113]

With respect, this position is also doubtful. It is pertinent to briefly consider the authorities cited. In *Whitely Ltd v Hill*[114] the decision was based on the ground that in the absence of a no-assignment clause, the hirer had validly assigned his possessory interest

[110] Fidelis Oditah, "Assets and the treatment of claims in insolvency," (1992) 108 L.Q.R. 459, 485.
[111] *Solloway v Mclaughlin* [1938] A.C. 247; *BBMB Finance Ltd v Eda Holdings Ltd* [1990] 1 W.L.R. 409.
[112] *Belvoir Finance Co. Ltd v Stapleton* [1971] 1 Q.B. 210; *Belsize Motor Supply Co. v Cox* [1914] 1 K.B. 244.
[113] Oditah however admits the possibility of disputations to the effect that this approach does not necessarily show that the hirer has a proprietary interest *in* the goods but only that the bailor has not lost the full value of the goods.
[114] [1918] 2 K.B. 808. Bridge has also cited this case as an authority for the argument that the option to purchase contains a proprietary element. Michael Bridge, Louise Gullifer et. al, *The Law of Personal Property* (Sweet & Maxwell 2013) 121.

under the hire-purchase agreement to the third party. In consequence, the third party was held to have acquired all the rights and obligations of the hirer in the original hire-purchase agreement before the contract could be terminated.[115] The owner's interest in the goods (a piano) also remained the same; hence he was only entitled to the remaining payments under the original agreement. Accordingly, Swinfen Eady M.R. observed that:

> "The contract was in my opinion assignable by the hirer, but the assignee could only retain possession of the chattel upon the terms of the contract … The defendant therefore acquired all the interest of the vendor, and moreover she had the right in equity to compel the vendor to pay the remaining instalments to the plaintiffs and enforce for the benefit of the defendant all rights conferred..." [116]

Significantly, Warrington L.J. also noted that,

> "The agreement therefore, or rather the contractual interest of the hirer in the chattel by virtue of the agreement, was assignable in equity. The result of that is not, of course to give to the assignee any interest greater or other than that which was possessed by the assignor, but the effect is to give to the assignee as between him and the other contracting party exactly the same interest as that which the assignor had as between himself and the other contracting party." [117]

In the earlier case of *Belsize Motor Supply Company v Cox*,[118] also cited by Oditah, although there was a no-assignment clause which had been breached by the hirer, the court ruled that since the

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[115] ibid. at 816, Swiinfen Eady M.R.: "the defendant (third party) acquired the right of Miss Nolan (the hirer) under the agreement before anything was or could be done to terminate it, no instalment then in arrear, and that the measure of the plaintiffs' damage was the amount of instalments unpaid."

[116] *Whiteley Ltd v Hilt* [1918] 2 K.B. 808, 818.

[117] ibid at 821. As observed by Oditah, His Lordship notably stated (at 822) that "But in a complex contract of this nature it by no means follows that because that part of the contract which is a contract of bailment is at an end the other part of the contract, which confers a proprietary interest, is also at an end." It is submitted that here, he was merely pointing to the fact that the option to purchase, if exercised, would confer a proprietary interest. This should not therefore be taken to mean that the mere presence of the option confers a proprietary interest, whether exercised or not.

[118] [1914] 1 K.B. 244.

owner had not terminated the agreement on the ground of the hirer's default, the hire-purchase agreement subsisted. The consequence of this was that the contractual interest of the hirer was passed to the pledgee who stood in the same position as the former against the owner.[119]

In *Wickham Holdings Ltd* v *Brooke House Motors Ltd*,[120] as Oditah has rightly pointed out, Denning L.J. explored the possibility of the hirer having a limited proprietary interest. While Dankwerts and Winn LJJ, held that the finance company was estopped from denying that they would accept £274 in settlement and, therefore, that was the measure of their loss.[121] Denning L.J. in limiting the damages to the amount outstanding under the hire-purchase agreement rather than the value of the car, stressed that "in a hire-purchase transaction there are two proprietary interests, the finance company's interest and the hirer's interest."[122]

This proposition is inconsistent with earlier authorities. For instance in *Kelly* v *Lombard Banking Co*,[123] the finance company was permitted to recover the goods and also keep all the hire payments. This was after Lord Denning observed the hardship that the

[119] ibid. at 252, per Channell J.
[120] [1967] 1 W.L.R. 295.
[121] Danckwerts L.J.: "Whether it is put on the ground of estoppel or on the. Ground of waiver, it does not matter very much; it comes to very much the same thing. I think the result was to waive the provisions od clauses 12 and 15 od the HP agreement." at 301
[122] [1967] 1 W.L.R. 295, 300.
[123] [1959] 1 W.L.R. 41.

decision inflicted on the hirer.[124]

In *Helby* v *Matthews*,[125] the reasoning was that the "hire" instalments paid by the hirer were not consideration for purchasing the goods but merely considerations for hiring the goods. Lord Macnaghten observed that,

> "It was the intention of the parties - an intention expressed on the face of the contract itself - that no one of those monthly payments until the very last, should confer upon the customer any proprietary right in the piano or any interest in the nature of a lien or any interest of any sort or kind beyond the right to keep the instrument and use it for a month to come"[126]

Contrary to Lord Macnaghten's assertion, it seems Lord Denning had treated the hire-purchase agreement in *Wickham Holdings* v *Brook House Motors* as a secured sale (in substance), given that he regarded the finance company's interest in the good as being reduced with each hire payment.

In *Belvoir Finance v Stapleton* [127] which involved the measurement of damages for irreversible conversion, although Lord Denning echoed his position in *Wickham* in respect of the measurement of damages for hire-purchase cases, [128] Megaw L.J. viewed the figure which the court ordered the owner to be paid as,

> "Recognising and giving effect to the mere fact of the payments and to the fact that those payments can fairly be assumed to represent the actual diminution of the value of the cars in consequence of the fact of this

[124] ibid at 44: "I see the hardship on the hirer. I often think it is hard under these hire-purchase agreements when the hirer has parted with his money and the finance company take both the car and the money: but there is the law."
[125] (1895) A.C. 471.
[126] ibid. at 481.
[127] [1971] 1 Q.B. 210.
[128] ibid. at 217.

> bailment - this bare bailment - to Belgravia during the periods prior to the respective conversions."[129]

In practical terms, by subtracting the hire rents paid for diminution, the Court recognised that the finance company still had absolute ownership of the cars, but took into consideration the fact that the value of the cars must have diminished through use during the pendency of the hire-purchase agreement. This by no means recognised the hirer's proprietary interest.

In *Transag Haulage Ltd v. Leyland DAF Finance Plc*.[130] Knox J. simply stated that "a contingent right to exercise an option appears to me to be properly described as a 'proprietary right."[131] Significantly, his Lordship neither gave any basis or precedent for this conclusion nor did he expatiate on it.

Against this background, it cannot be asserted with certainty that the hirer has a limited proprietary right as opposed a mere possessory right.[132] No doubt, the attempts to explore means of recovering sums paid by hirers in terminated hire-purchase agreements are well-intentioned considering that such repayments grant finance companies a windfall to the detriment of innocent creditors of the hirers.[133] It would seem that

[129] ibid. at 221.
[130] [1994] B.C.C. 356.
[131] ibid. at 365.
[132] *Clough Mills v Martin* [1985] 1 W.L.R. 111, 116 112, 125, *Hendy Lennox (Industrial Engines) Ltd. v Grahame Puttick Ltd*. [1984] 1 W.L.R. 485, 492; Anthony Zacaroli, Fidelis Oditah, (fn 98) 29, 34: "There does not appear to be any basis for suggesting that the beneficiary of an option to purchase goods has any legal proprietary interest in the goods, prior to the exercise of that option."
[133] In *Kelly v Lombard Banking Co. Ltd* [1959] 1 W.L.R. 41, 44, Lord Denning noted thus: "I see the hardship on the hirer, I often think it is hard under these hire agreements when the hirer has parted with his money and the finance

the problem lies in the very nature of hire-purchase transactions and the solution could lie in the treatment of hire-purchase agreements in accordance to their economic function, namely, as secured sales – this is however beyond the purview of this research.[134]

The general rule is that assets of a bankrupt are to be available to its creditors at the commencement of insolvency. Given that the finance company retains absolute property in the goods subject to the exercise of the option to purchase,[135] the goods will not be available the hirer's creditors. In the absence of an insolvency-termination clause, what ought to pass to the insolvent estate is the obligation to pay the instalments and the option to purchase. This position is underpinned by the principle that the liquidator stands exactly in the same position as the debtor itself stands in.[136]

However, the contractual right of the hirer is subject to or limited by the bankruptcy termination clause. This makes the hirer's contractual right a

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company takes both the car and the money, but there is the law." Guest admits, "It is certainly unfair that the hirer's creditors should be deprived both of the goods themselves and of the benefit of the installments already paid." A.G. Guest, *The Law of Hire-purchase* (fn. 102) 382. Oditah describes this position as being "hideously harsh for the hirer, and even more so for his creditors when he becomes insolvent, for the loss of both the goods and any pre-payments erodes his estate."

[134] The *Crowther Committee Report* on Consumer *Credit* had recommended a change in the law to recognize that "the extension of credit in a hire-purchase transaction is in reality a purchase-money loan and that the reservation of title under a hire-purchase agreement is in reality a chattel mortgage securing a loan. The Diamond Report of 1989 on Security Interests in Property echoed this position. Cf. *Bridge v Campbell Discount Co. Ltd* [1962] AC 600, 626.

[135] *Shogun Finance Ltd v Hudson* [2004] 1 A.C. 919, 941: "The hire-purchaser has no title to the goods and no power to convey any title to a third party. The title to the goods and the power to transfer that title to any third party remains with the hire-purchase company and with it alone." per Lord Hobhouse. *Forthright Finance Ltd v Carlyle Finance Ltd* [1997] 4 All ER 90.

[136] *In re Scheibler* (fn. 45) 727.

determinable interest – the termination clause therefore sets the boundary to the hirer's rights.[137] The validity of the clause is underpinned by the distinction between determinable and defeasible interests which is settled in English law - the former being valid and enforceable.[138] Accordingly, the hirer is not deprived of any asset which ought to fall into the insolvent estate.

Finally it is it is suggested that a hirer who is on the verge of forfeiting the goods as well as the sums paid as instalments can seek equitable relief from forfeiture. It is settled that equitable intervention will be available to a debtor who has either a proprietary and/or a possessory right.[139] The hirer undoubtedly has possessory right which would effect the court's equitable jurisdiction.[140] Whether relief from forfeiture will be granted or not will depend on the facts of each case.[141]

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[137] Guest argues that by virtue of the insolvency termination clause, it would seem that there is no interest in the hire-purchase agreement that could pass to the trustee. A.G. Guest, *The Law of Hire-purchase* (fn 102) 381. This is at variance with Oditah's position that although the proprietary interest can be forfeited for breach; it cannot be made to vanish upon his becoming bankrupt as this will constitute a fraud upon the bankruptcy laws. Fidelis Oditah, "Assets and the treatment of claims in insolvency," (1992) 108 L.Q.R. 459, 486.

[138] Evaluated in detail in 1.4.1.

[139] *BICC Plc. v Burndy Corp*. [1985] 1 All E.R. 417; *Bridge v Campbell Discount* (fn 134) 631; *Stockloser v Johnson* [1954] 1 QB 476; A. L. Diamond, "Equitable Relief for the Purchaser of Hire-Purchase Goods" (1958) 21 M.L.R. 199. On the other hand, contrary opinions have been previously expressed in *Galbraith v Mitchenall Estates* (1965) 2 Q.B. 473; *Campbell Discount v Bridge* [1961] 1 Q.B. 445; E.J. Prince, "Equitable Relief in Law of Hire-Purchase" (1957) 20 M.L.R. 620. The notion that equity's jurisdiction does not extend beyond contracts "not involving any transfer of proprietary or possessory rights" was applied (without comment) by the House of Lords in *Sport International Bussum BV v Inter-Footwear* [1984] 1 W.L.R. 776

[140] *On Demand Information Plc. v Michael Gerson (Finance) Plc*. [2003] 1 A.C. 368.

[141] In deciding whether the court had jurisdiction to grant relief, claimants must show that their application falls into at least one of the three categories identified by Lord Wilberforce in *Shiloh Spinners Ltd v Harding* [1973] AC 691. The three categories are (a) where the object of the transaction and the forfeiture provision is to secure payment of money; (b) where there is fraud, accident or mistake; and

As a general principle, relief is not available where rights are purely contractual. [142] The unwillingness of English courts to extend equity's jurisdiction to commercial contracts creating purely contractual rights is perhaps premised on considerations of policy, namely that the parties have bargained on equal terms and have contemplated a degree of certainty in their dealings with one another.

c. Retention of title clauses

Retention of title clauses are primarily aimed at providing "security" for a seller where the buyer becomes insolvent and part or whole of the purchase price is unpaid.[143] The bid to maximize the usefulness of retention of title clauses has led to the creation of diverse types of complex retention of title clauses. These devices are based on the same property/contract law principle which underpins the earlier evaluated hire purchase and conditional sale agreements – that a debtor is not deprived of an asset that never belonged to it in law or equity. Consequently, the manner in which a retention of title clause is drafted will give rise to diverse considerations. This section will focus on three broad types of retention of title clauses namely the simple retention of title clause, all-moneys

(c) where the primary object is to secure a stated result. *Celestial Aviation Trading 71 Ltd v Paramount Airways Pte Ltd* [2010] 1 C.L.C. 165.

[142] *Crittall Windows Ltd v Stormseal Window Systems* [1991] R.P.C. 265; *Sport Int'l Bussum BV v Inter-Footwear* (fn. 139).

[143] "The main purpose of the retention of title clause is to protect an unsecured creditor against the insolvency of the buyer." *Clough Mill v Martin* (fn. 132) 122 per Oliver LJ.

clause and proceeds clause, and evaluate their validity vis-à-vis the anti-deprivation rule.

While English courts will uphold the validity of simple retention of title clauses and has shown readiness to uphold all-moneys clauses, the same cannot be said of other complex clauses where sellers attempt to extend their proprietary rights beyond the original goods supplied. These latter types of clauses stand the risk of being re-characterised as charges. Retention of title clauses purporting to retain title to products and/or proceeds of original goods are characterised as charges on the basis of construction of the contract leading to an (objective) determination of the intentions of the parties – i.e., if the seller's interest in the product/proceeds is defeasible by payment of the purchase price, that interest will be viewed as being intended to provide security rather than ownership, thus constituting a charge which will be void for non- registration.[144]

i. Simple retention of title clause

Section 19(1) of the Sale of Goods Act provides a doctrinal basis for the simple retention of title clause. Here the seller will retain ownership in the goods delivered as against the buyer until the latter completes payment of the full purchase price.[145]

[144] s. 850H Companies Act 2006.
[145] *Armour v Thyssen Edelstahlwerke A.G.* [1991] 2 A.C. 339, 347 per Lord Keith of Kinkel.

It is now settled that these types of clauses are effective to protect the seller upon the buyer's insolvency.[146] In addition, the validity of the clause will not be affected even if the buyer is permitted to resell, transform or consume the goods before payment is made.[147]

Given that ownership remains vested in the seller, a termination of the agreement and repossession of the goods based on an insolvency-termination clause will not be objectionable. The simple retention of title clause is a veritable means with which creditors (suppliers of goods) can insulate themselves from the mandatory insolvency rules. However, the extent of its effectiveness is questionable given the narrowness of its scope. For instance if a buyer sub-sells the goods to a sub-buyer who buys in good faith and without notice, the clause will be worthless in the light of s. 25(1) of the Sale of Goods Act which confers a good title on such a sub-buyer.

An insolvent buyer that has made payments towards the acquisition of an asset under the transaction may recover the sums for total failure of consideration – given that the asset for which it had paid for is no longer available.[148]

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[146] *Clough Mill v Martin* (fn. 139).
[147] *Re BA Peters* [2008] EWHC 2205 (Ch.) (86), *Hendy Lennox v Grahame Puttick* [1985] 1 W.L.R. 485, 489; Michael Bridge, *The Sale of Goods* (3rd edn, Oxford University Press 2014) 126.
[148] *Dies v British and Int'l Mining* (fn. 93) 743.

ii. All-moneys clause

In the all-moneys clause the seller retains the property in the goods until all debts or other obligations owed by the buyer have been discharged. In practical terms, where a seller supplies the buyer with goods on a recurring basis, the seller can bring the buyer's past indebtedness forward and attach to any goods of the seller in the buyer's possession.

The unique advantage of this clause to the seller is that, like a general as opposed to a particular lien, it extends the category of debts against which title is retained. The validity of current account clauses has been affirmed in *Armour v Thyssen Edelstahlwerke AG*[149] where the retention of title clause stipulated that:

> "All goods delivered by us remain our property (goods remaining in our ownership) until all debts owed to us including any balances existing at relevant times - due to us on any legal grounds - are settled."

The House of Lords ruled that the provisions of the Sales of Goods Act making the passing of property a matter of contractual intention was not confined to payment of the contract price. Accordingly, s. 17(1) and s. 19(1) of the Sale of Goods Act gives a seller "security" for the unpaid debts of the buyer through a legitimate retention of title and not by any other right over his property.[150]

[149] [1991] 2 AC 339.

[150] ibid. at 342 and 347 per Lord Keith. Whilst s. 17 allows for party autonomy as to the passing of title to goods sold, s. 19 allows for the 'reservation of the right of disposal' until certain conditions are fulfilled. Michael Bridge, *The Sale of* Goods (3rd edn, Oxford University Press 2014) 127.

Accordingly, the all-moneys clause was upheld as having the effect of retaining property in the assets in the seller, thereby preventing it from forming part of the assets of the insolvent buyer available to its creditors. In the light of this, an all-moneys clause will not violate the English anti-deprivation rule.

iii. Proceeds of sale clause

This retention of title clause provides for a seller to retain title in the unmixed goods after a sale, as well as any proceeds obtained from a sub-sale of the goods by a buyer. The Court of Appeal confirmed the validity of this clause in *Aluminium Industrie Vaassen B.V. v Romalpa Aluminium Ltd* [151] notwithstanding that there was no express clause in the contract for the retention of title to the proceeds, a term retaining such title was implied into the contract as the Court ruled that it was clear that the parties had intended that the buyers would be allowed to resell the goods in its original, unmixed state. [152]

Significantly, a fiduciary relationship was found based on the concession by the defendant's counsel that the defendant held the goods as a bailee. Consequently, the clamant was able to trace into the defendants account by virtue of the rule laid down by

[151] [1976] 1 W.L.R. 676.
[152] ibid. at 690.

Thesiger L.J. in *Hallett's Estate Knatchbull v. Hallett*[153] to the effect that,

> "Wherever a specific chattel is intrusted by one man to another, either for the purposes of safe custody or for the purpose of being disposed of for the benefit of the person intrusting the chattel; then, either the chattel itself, or the proceeds of the chattel, whether the chattel has been rightfully or wrongfully disposed of, may be followed at any time, although either the chattel itself, or the money constituting the proceeds of that chattel, may have been mixed and confounded in a mass of the like material."[154]

Accordingly, a seller who claims the proceeds of a sub-sale of goods by a buyer cannot establish an equitable right by merely relying on a retention of title to the goods sub-sold. He must be able to trace the title of his goods to the proceeds of a sub-sale. As a precondition to tracing in equity, he must be capable of establishing that the buyer holds those proceeds as the seller's fiduciary. In the absence of this, the clause will be re-characterised as a charge on the proceeds, with the consequence of being void for non-registration. It is instructive to note that even where a fiduciary relationship is established, tracing may not be possible where the buyer pays the proceeds of the sub-sale into an overdrawn account. The general rule is that equitable tracing does not extend to tracing through an overdrawn bank account – whether at the time the money is paid in or subsequently.[155]

Significantly, subsequent claims to proceeds have been unsuccessful. The seller's rights in the proceeds are often characterised as arising by way of

[153] (1880) 13 Ch. D. 696.
[154] ibid. at 723.
[155] *Bishopsgate Investment Mgt. Ltd v Homan* [1995] Ch. 211, 220-221, 222.

security (charge) and void for non-registration. This is an indication that either the *Romalpa* decision turned on its special facts or a subtle disapproval of the decision by English courts.

For instance in *Re Bond Worth*[156] where a term in the contract of sale stipulated that "our beneficial entitlement shall attach to the proceeds of resale or to the claims for such proceeds,"[157] Slade J. held that the fact that the buyer was going to be able to use the proceeds in the ordinary course of business made the arrangement inconsistent with a fiduciary relationship and indicated a mere debtor-creditor relationship. This case was further distinguished from the *Romalpa case* on the ground that in *Romalpa*, the goods were held separately and the proceeds were to be properly segregated.[158] Notably, the clause purported to retain equitable title, which could only arise by way of grant rather than retention Accordingly, the clause was held to create a charge which was void for non-registration.

Hendy Lennox v Grahame Puttick Ltd[159] was decided on the ground that the buyer did not properly store the seller's goods in a manner that showed that it was the seller's and that they had no express obligation to do so. Slaughton J. noted the stipulation for repossession ruled out any implied right to the proceeds. His lordship also observed that there was no express mention of the buyer as "fiduciary owner"

[156] [1980] Ch. 228.
[157] ibid. at 235.
[158] ibid. at 265.
[159] [1984] 1 W.L.R. 485.

and that the one-month credit period provided neutralised any fiduciary relationship and any implied obligation to keep the proceeds in a separate account.[160] In *Re Andrabell*[161] where the buyer mixed the proceeds of the sub-sale with other moneys, it was held that the relationship was that of a debtor and creditor.

Again in *Pfeiffer GmbH v Arbuthnot Factors Ltd*[162] there was a clause retaining title for the seller and nevertheless authorizing the buyer to make sub-sales. Just like in the *Romalpa case*, the agreement required the buyer to pass on to the seller all the buyer's rights under the sub-sales contracts, however, it requested this to be done only up to the amount of the amount of the buyer's outstanding indebtedness to the seller. Phillips J. held that when a buyer resells goods in the ordinary course of business, he does so on his own account and will not hold the proceeds received in a fiduciary capacity on behalf of the seller.[163] The court subsequently ruled that the nature of the interests which the seller was to have by way of security in respect of debts created by sub-sales and its terms were incompatible with a fiduciary relationship and created a charge in favour of the seller which was void for non- registration.[164]

[160] ibid. at 499. Curiously, in the *Romalpa case*, there was a 75-day credit period for the buyers.
[161] [1984] 3 All ER 407
[162] [1988] 1 W.L.R. 150
[163] ibid. at 159.
[164] ibid. at 160.

In *Tatung (UK) Ltd v Galex Telesure Ltd*[165] two sets of conditions were used by the seller. The first condition provided that the proceeds of sale were to belong to the seller absolutely, while the second placed an obligation on the buyer to keep the proceeds of resale in a separate account for the benefit of the seller. Phillips J held that the clause was the source of the parties' obligations rather than the equitable principles that would have applied in its absence. Hence a charge was created over the proceeds of sale.[166]

Finally in *Compaq Computer Ltd v Abercorn Group Ltd*[167] the clause provided that the seller's goods should be stored separately so as to be identifiable and that the buyer held the goods as "bailee and agent" of the seller and was obligated to account as a bailee and agent for the full proceeds of sale and to keep a separate account of the proceeds. Mummery J. ruled that the seller's interest in the proceeds was limited to the amounts owing by the buyer and was determinable once the original purchase price and any outstanding expenses had been discharged.[168]

The foregoing cases illustrate the seeming reluctance of English courts to enforce proceeds of

[165] [1989] 5 B.C.C. 325.
[166] ibid. at 335. Significantly, Phillips J also questioned the correctness of the decision at first instance by Mocatta J in the finding that a charge was not created. at 337
[167] [1991] B.C.C. 484.
[168] ibid. at 496.

sale clauses.[169] Oditah has rightly summarised the debate on the efficacy of proceeds clauses as being whether the clause is an ancillary security by which the seller perfects his title to that which in equity belongs to him (i.e. the goods), or a substantive assignment.[170] If the former, the clause is valid and not open to attack as an unregistered charge, If the latter, the clause is invalid as an unregistered charge.[171]

A successful *Romalpa* clause (although highly unlikely) ought to shield the seller from the anti-deprivation rule, given that the title to goods and the proceeds are effectively reserved by the seller. This position is underpinned by the same principle which is applicable to the earlier evaluated conditional sales and hire-purchase agreements – being that the debtor cannot be deprived of asset that never belonged to it.[172] It is instructive to note that the failure of proceeds clauses to insulate sellers from insolvency is not based on a wrongful withdrawal of assets from the insolvent estate, in contravention of the anti-deprivation rule. Rather, English courts proceed on the basis that in a bid to retain title to proceeds, the

[169] "The question is this: what form of words will be sufficient to make a proceeds clause an ancillary security? The evidence from the cases suggests that the answer is "None." - Fidelis Oditah, "Assets and the treatment of claims in insolvency," (1992) 108 L.Q.R. 459, 481; [169] Fidelis Oditah, *Legal Aspects of Receivables Financing* (Sweet & Maxwell, London 1991) 90 - "A perusal of the clause in *Tatung (UK) Ltd v Galex Telesure Ltd* shows the extent of judicial hostility to retention of title agreements. If the clause in that case failed, as it did, one is compelled to conclude that "proceeds" clauses will inevitably be characterized as unregistered charges."

[170] Fidelis Oditah, *Legal Aspects of Receivables Financing* (Sweet & Maxwell, London 1991) 90-95.

[171] ibid. at 481.

[172] See 1.2.2. a and b.

affected seller has created a charge without due registration as required by law.[173]

d. Construction contracts

This section will examine the validity of three types of clauses commonly included in construction contracts namely plant and material property vesting clauses, direct payment clauses and retention funds in relation to the anti-deprivation rule.

i. Plant and material property vesting clauses

Generally, building equipment brought onto a construction site remain the property of the contractor unless and until it is affixed to land.[174] However it is common practice for construction contracts to include contractual clauses which vests the plant and other building materials brought to the building site upon the employer even before they are fixed to the land.

Vesting clauses provide security to the employer for the money he has advanced to the contractor for the building work. They also ensure that in the event of default, there is a seamless takeover of the project by a new contractor – devoid of claims from the original contractor or his assignees.

[173] s. 860 Companies Act 2006.
[174] The Latin maxim is *quicquid plantatur solo, solo cedit*. *Minshall & anor v Lloyd* (1837) 150 E.R. 834.

The question here is whether this will constitute a withdrawal of assets from the estate of the insolvent contractor in the event of insolvency.

It is suggested that whether or not vesting clauses will violate the anti-deprivation rule will depend on the manner in which they are drafted, which will determine how they will operate.[175] A vesting clause which is triggered by and comes into effect upon the contractor's insolvency will contravene the anti-deprivation rule as it will have the effect of depriving the insolvent estate of the contractor's valuable assets.[176] A number of the reported English cases on the anti-deprivation rule are in this character.[177]

Notwithstanding the above, employers can evade the anti-deprivation rule through deft drafting. First, the vesting clause could provide that all plants and material property of the contractor "shall become"[178] the property of the employer as soon as they are bought on the site. This would effectively vest ownership on the employer immediately the equipment is bought on the land.

In *Re Cosslett (Contractors) Ltd*[179] Parker J. distinguished between the clauses "shall be deemed to

[175] *In Garrud* (1880-1) 16 Ch. D. 522; *In Re Apex Supply Company Ltd* [1942] Ch. 108, 113-4.
[176] *In re Harrison* (1879) 14 Ch. D 19, 25.
[177] *In Garrud* (fn. 175); *In re Walker* (1884) 26 Ch. D. 510.
[178] *Re Cosslett (Contractors) Ltd* [1998] 2 W.L.R. 131, (1998) Ch. 495, 504, 505, 507-508, 511.
[179] [1997] Ch. 23.

be" and "shall become." While the former was held not to be effective in transferring ownership of the plant to the employer, but had the effect of creating an equitable charge, the latter did.[180] The Court of Appeal upheld this position but stated that a floating charge was created rather than fixed, because the restriction imposed upon the contractor was in place for operational purposes, rather than to preserve the asset for the purpose of satisfying the security.[181]

Secondly, where the vesting clause stipulates a number of events of default of which insolvency is only one of them, a forfeiture based on another event will not be in breach of the rule. This will be the case notwithstanding that the event coincides with insolvency and the forfeiture prima facie amounts to a withdrawal of asset from that which otherwise would have been available to creditors.[182] Hence in *In re Garrud*[183] the forfeiture provision which operated on breach and not on bankruptcy was held to be valid.[184] The bankrupt builder had broken 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. This can

[180] ibid. at 41-42.
[181] *Re Cosslett (Contractors) Ltd* (fn. 178).
[182] *In Re Apex Supply Company Ltd* (fn. 175) 113-4; *In re Garrud* (fn. 175) 522. *Perpetual Trustee Co Ltd and another v BNY Corporate Trustee Services Ltd* [2010] 3 W.L.R. 87, 103-4, per Lord Neuberger. "I agree with Lord Neuberger of Abbotsbury MR that, if the provisions in question can be and are operated on other grounds prior to the commencement of any bankruptcy proceedings, it is difficult to see why the anti-deprivation rule should apply. The property has been removed pursuant to a valid contractual provision on grounds other than the insolvency of the counterparty and cannot, on any view, form part of the insolvent estate." – Patten J, at 138-9.
[183] (1880-1) 16 Ch. D. 522.
[184] *BNY Corporate Trustee Services Ltd v Belmont Park Investments Pty Ltd* [2011] B.C.C. 734, 751.

be contrasted with *In re Harrison* [185] where the builder was not in breach of contract, and the right to forfeit was expressed to be triggered, inter alia, on the builder becoming bankrupt.

It is admitted that there can sometimes be a thin line in the distinction where the event of default coincides with insolvency. The approach of the judges in *In re Garrud* has generated a huge amount of debate.[186] In his judgment, James L.J. had pronounced that it was "immaterial at what particular moment the seizure was made" as "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."[187]

This approach was rejected by Patten J at the Court of Appeal in *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd*[188] where he rightfully stated that such a forfeiture provisions could not remain exercisable on grounds other than insolvency after the commencement of the procedure, as it was in breach of the pari passu principle. Perhaps the problem with *In re Garrud* is that it is not clear from the facts when the breach actually occurred. It is suggested here that the pronouncement of James L.J. would be plausible if the breach occurred prior to the commencement of insolvency – given that ownership

[185] (1879) 14 Ch. D 19.
[186] *BNY Corporate Trustee Services Ltd v Belmont Park Investments Pty Ltd* (fn. 184).
[187] *In re Garrud* (fn. 175) 531
[188] [2010] 3 W.L.R. 87, 103, 139.

would have been transferred on breach to the employer. The contrary would mean a transfer of ownership after the commencement of insolvency, in breach of the pari passu rule.

ii. Direct payment clauses

The purpose of direct payment clauses is to enable the employer to by-pass the contractor and make direct payments to sub-contractors on occasions where the contractors have been paid for work done by the sub-contractors but fail to remit the monies to the latter. The employer can set-off those sums with future sums due to the contractor. The issue for consideration here is whether, in the event of the contractor's insolvency, these payments will constitute assets which ought to be available to the contractor's general body of creditors.

As a matter of general principle, on insolvency, all assets of the debtor ought to be vested in the liquidator for the benefit of the general body of creditors. Funds used for such direct payments are assets of the contractor which ought to fall into the insolvent estate. An unpaid sub-contractor is entitled to prove in the insolvency as an unsecured creditor.[189]

[189] Stephen Furst, Vivian Ramsey, *Keating on Construction Contracts*, 9th edn, Sweet & Maxwell 2012, 601. Significantly, the Joint Contracts Tribunal (JCT) Standard Form does not permit direct payment of sub-contractors following a determination due to bankruptcy or liquidation.

It is suggested that *In re Tout & Finch Ltd*[190] and *In Re Wilkinson*,[191] where the validity of direct payment clauses were upheld after bankruptcy of the contractor, are no longer good law in this context.[192] In those cases the courts did not consider the validity of the arrangement against the background of the anti-deprivation rule and the pari passu principle. Indeed in *Mullan v Ross and London*,[193] the Irish Court of Appeal applied the rule in *British Eagle* and declined following the decisions in *Wilkinson* and *Tout and Finch Ltd*.

Finally, what if the employer who makes the direct payment claims to rely on the fact of the contractor's non-payment of the sub-contractors and not insolvency? It is crucial to note that the power to make direct payments is usually conditioned on failure of the main contractor to pay the sub-contractor and not necessarily on the main contractor's insolvency. Accordingly, the payment may not infringe the anti-deprivation rule – if it is shown that it was not actually triggered by insolvency.[194] This notwithstanding, the payment will be in contravention of the pari passu rule given that the sub-contractors would otherwise have been entitled to prove in the insolvency as unsecured creditors.

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[190] [1954] 1 W.L.R. 178.
[191] [1905] 2 K.B. 713, 721-2.
[192] *British Eagle v Air France* [1975] 1 W.L.R. 758.
[193] [1996] 86 B.L.R. 1 (a decision of the Court of Appeal of Northern Ireland with persuasive authority in England).
[194] *Lehman Brothers Special Financing Inc. v Carlton Communications Ltd* [2012] 1 C.L.C. 713, 749 (93); *Butters and ors v BBC Worldwide Ltd* [2010] 117 (88), 118 (92).

iii. Trust retention fund

A retention fund serves as a mechanism with which employers can build up money deposits during the course of construction work. The fund serves as an inducement to a contractor to remedy any defect during the liability period. Sub-contractors employed by the contractors may be paid from the fund to avoid interruptions due to non-payment by the contractor.

It is suggested that the question as to whether the anti-deprivation rule will be breached will depend on whether the retained funds constitute a trust by virtue of a retention trust clause. The retention trust clause will provide for the retention fund to be held by the employer as a fiduciary and trustee of the contractor and sometimes of the subcontractor.[195] For instance, in *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd*,[196] monies placed in a special account were held to be exempted from the pari passu rule of asset distribution as such assets did not belong to the company.

Hence, a trust fund that is properly established before liquidation and operated by an employer as soon as retention monies come into existence can be used to isolate monies from those available to the general body of creditors. A criticism against the retention of trust clause is the fact that, unlike other security interests, it does not require any registration.

[195] Roy Goode, "Flip Clauses: The End Of The Affair?" (2012) L.Q.R. 171, 9-10.
[196] [1985] Ch. 207; *Rayack Construction v Lampeter Meat* [1980] 12 B.L.R. 30.

Hence there is often no prior notice to creditors about the encumbered assets of the contractor. A more detailed consideration of how the trust device protects proprietary rights and consequently insulates creditors from the anti-deprivation rule is done in the next section.

e. Trust devices

From the analysis of trust retention funds in construction contracts, it has been shown that trust devices can be used in commercial situations to successfully isolate monies that would otherwise have been available to the general body of creditors at insolvency and divert them elsewhere. Accordingly a properly constituted trust will create an exception to the anti-deprivation rule.

A *quistclose* trust arises when a sum of money, on loan or otherwise is advanced to a recipient with a specific purpose stated as to the use of such monies.[197] When this purpose fails or if it is not complied with, the trust fastens on the monies,[198] and confers proprietary interest upon the transferor instead of a mere personal right which is contractual in nature.[199] Accordingly, the borrower or transferee cannot obtain any beneficial interest in the money, at least while the

[197] *Barclays Bank Ltd*. v. *Quistclose Investments Ltd* [1970] A.C. 567, 580.
[198] "In my judgment the principle in all these cases is that equity fastens on the conscience of the person who receives from another property transferred for a specific purpose only and not therefore for the recipient's own purposes, so that such person will not be permitted to treat the property as his own or to use it for other than the stated purpose." Per Gibson J. in *Carreras Rothmans Ltd*. *v Freeman Mathews Treasure Ltd* [1985] Ch. 207, 222.
[199] [2002] 2 A.C. 164. *Twinsectra Ltd v Yardley* [2002] 2 A.C. 164, 184; *Du Preez Ltd v Kaupthing Singer & Friedlander Ltd* [2011] W.T.L.R. 559.

designated purpose is still capable of being carried out. If for any reason the purpose cannot be carried out, in the event of insolvency, the money does not fall within the general assets of the debtor – as it is not its property.

The real implications of the trust mechanism are amplified at insolvency. Assets held on trust belong to the beneficiary and as such, are not available to the general body of creditors. Lord Millet confirmed this in *Twinsectra v Yardley*,[200] when he remarked in the context of the *quistclose* trust that,

> ''The whole purpose of the arrangements ... is to prevent the money from passing to the borrower's trustee-in-bankruptcy in the event of his insolvency"[201]

Viewed from another perspective, trust as a form of quasi-security device is unique in the sense that it is the return of the advance on the failure of the specified purpose which is being secured and not the failure to repay the monies itself, which is common in conventional security arrangements. Hence, the trust mechanism aids in securing the execution of the debtor's promise to perform the purpose contingent upon the advance of the monies. Accordingly, if that purpose is executed, the lender becomes an unsecured creditor.[202]

The trust can also be a snare for unsecured creditors given that even a detailed examination may sometimes not reveal its existence due to non-

[200] [2002] 2 A.C. 164.
[201] ibid. at 187-188.
[202] Significantly in *Re EVTR Ltd* (1987) 3 B.C.C. 389 it was held that the lender's proprietary right continues notwithstanding that the purpose has only partially failed.

registration. This places a trust beneficiary (alongside other retention of title creditors) in a more advantageous position than both traditionally and unsecured creditors. Bridge has rightly argued that that the absence of registration is justifiable in view of the emergency aspect of the matter as well as (sometimes) the non-professional character of the arrangements.[203] The case of *Paul v Constance*[204] also buttresses this point. In that case the Court of Appeal held that a trust need not be clearly expressed by the parties but can be found from the totality of one's conduct. In other words, a trust can be created by one without knowing or understanding the legal concept.

f. Subordination agreements

There are diverse kinds of debt subordination agreements. A secured creditor may agree to subordinate his security interest to that of a fellow secured creditor over whom he would otherwise have priority. An unsecured creditor may agree with a similarly ranked creditor not to take payment from the debtor until any debts owed by the debtor to the third party have been paid (i.e. a contingent debt subordination). Furthermore, a junior creditor may agree to hold proceeds of the junior debt on trust for a senior creditor (i.e. a subordination trust).

[203] Michael Bridge, "The Quistclose Trust In A World Of Secured Transactions" (1992) 12 O.J.L.S. No 3, 333, 345
[204] [1977] 1 W.L.R. 527.

It is now settled in English law that debt subordination among creditors does not violate the pari passu principle. [205] This is subject to the rule that a creditor and debtor cannot agree to subordinate the debts of another creditor who is not a party to the agreement or without its consent. The focus of this section will be an evaluation of whether, upon the insolvency of the junior creditor whose debt is being subordinated, these subordination agreements will amount to clawing back assets which should otherwise be available to creditors.

First, in the case of a creditor whose secured claim is being subordinated, it is suggested that where there is sufficient collateral to secure all claims, the anti-deprivation rule will not be contravened. However where the collateral of the debtor is insufficient, the subordination agreement will have the effect of making the insolvent junior creditor undersecured.

The practical effect of this is that in the event of the debtor's insolvency, the insolvent junior creditor stands the risk of not receiving dividends for the part of its debts that is unsecured. To this extent, it is suggested that the creditors of the insolvent junior creditor have been deprived of valuable assets. The extent of the deprivation can only be determined on the debtor's insolvency. As long as the debtor is

[205] *Re Kaupthing Singer & Friedlander* [2010] EWHC 316 (Ch.) at (10); *Re SSSL Realisations (2002) Ltd* [2006] Ch 610; *Re Maxwell Communications Corp plc (No 2)* [1993] 1 W.L.R. 1402, 1411E-1412C; *Re British & Commonwealth Holdings Plc (No 3)* [1992] 1 W.L.R. 672.

solvent, the assumption is that it has sufficient assets to meet its liabilities to both secured and unsecured creditors.

The facts of *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd*[206] were peculiar given that the flip or subordination clause was a contingent interest. Hence, Neuberger L.J., agreeing with Patten L.J.'s view,[207] noted that,

> "The effect of the "flip" provisions was thus not to divest LBSF of moneys, 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."[208]

Neuberger J.'s statement is arguably plausible given that from the outset of the agreement, the interest of LBSF was contingent on the occurrence or non-occurrence of an event of default. In consequence, LBSF did not actually have a priority of which it was divested of. In fact, based on the occurrence of the event of default, namely insolvency, it never acquired the priority.

It is suggested that an alternative argument in support of the validity of the flip provision in the above case would have been that, in the event that priority had been acquired by LBSF, such interest was merely limited in nature and determinable at

[206] [2010] 3 W.L.R. 87.
[207] Ibid. at 130 (135).
[208] ibid. at 109.

insolvency. This is in contradistinction with an absolute interest which is forfeitable upon insolvency.

In a contingent debt subordination agreement, the junior creditor's dividends will be deferred until the senior creditor has been repaid in full. Where the assets are insufficient after the payment of preferential creditors, the junior creditor will either receive nothing or a reduced share – as opposed to a pro rata share with the senior creditor. This will in turn reduce the assets which would otherwise have been available to the insolvent junior creditor's estate. Against this background, it is suggested that contingent debt subordination agreement will have the effect of contravening the anti-deprivation rule in cases where there are insufficient assets.

The validity or otherwise of a subordination trust, where a junior creditor agrees to hold proceeds of the junior debt on trust for the senior creditor may give rise to diverse considerations. Where a trust has been properly constituted, it is suggested that this ought not to contravene the anti-deprivation given that as a matter of general law, such assets are owned by the beneficiary under the trust.[209] However, it has also been rightly suggested that there will likely be a substantial question regarding registrability.[210] For instance, an extensive clause in a trust which is drafted to cover amounts not owed stands the risk of

[209] Fidelis Oditah, "Assets and the treatment of claims in insolvency" (1992) 108 L.Q.R. 459, 478. See the previous analyse on the trust device above.
[210] ibid.

being re-characterised as a charge which in turn will require registration to be valid.[211]

g. Cessation of Indemnity rights

An indemnity right is an entitlement to an obligation to be paid a sum of money by way of compensation or reparation for a specific loss suffered. It is a contractual obligation to make the injured party or indemnitee whole again in the event of the occurrence of a contractually specified event or sets of events.[212] Can a contractual clause for the termination of an indemnity right upon the indemnitee's insolvency amount to a withdrawal of an asset from the indemnitee's insolvent estate?

The above question was in issue in the case of *Mayhew v King*[213] where a clause for the cessation of an indemnity right on the insolvency of the indemnitee was challenged on the ground that it was in breach of the anti-deprivation rule. Affirming the decision of the lower court, the Court of Appeal[214] ruled that the forfeiture provision was an attempt to extinguish the indemnitee's right on insolvency and this had the effect of withdrawing assets which would otherwise be available to the general body of creditors from the insolvent estate.[215]

[211] *Associated Alloy v ACN* [2006] 202 C.L.R. 588.
[212] *Whittington v Seale-Hayne* (1900) 82 L.T. 49.
[213] [2011] B.C.C. 675.
[214] *Folgate London Market Ltd v. Chaucer Insurance Plc* [2011] B.C.C. 675.
[215] ibid. at 682 per Rimmer L.J.

Significantly, the court rejected the argument that the indemnity right was a chose in action which was subject to a precondition, thus making it a flawed asset. Rimmer J stated thus,

> "If the condition resulting in the non-availability of an asset to creditors in the event of the subsequent insolvency of the asset holder is unrelated to such insolvency, it may well be that the anti-deprivation principle has no role to play. In this case, however, the relevant condition was Milbank's (the indemnitee's) insolvency."[216]

Two points are worth noting from the above pronouncement of Rimmer J. First, contrary to the assertion of his Lordship, insolvency can actually be used as a condition to delineate or limit the interest of a debtor in an asset. A detailed analysis of this issue is carried out in 1.4.1. Secondly, the rejection of the pre-conditions or so called *flawed asset* argument in this case shows that there is some scope for looking at the substance of agreements and not just the form or terms of contracts in the application of the anti-deprivation rule by English courts.

In the light of the forgoing evaluation of contracts and contractual clauses, it is submitted that under English insolvency law, the questions as to what constitutes an asset, ownership of asset and deprivation, can only be ascertained by reference to the applicable non-insolvency law alongside the terms of the parties' contracts – to ascertain the rights and obligations which they have imposed on themselves.

[216] ibid. at 682.

In consequence and in contrast to the Bankruptcy Code's anti-ipso facto rule, the anti-deprivation rule regime follows the general contract law's characterisation of pre-petition contractual interests e.g. as proprietary, security, quasi-security and personal – and does not prescribe its own rules. It is however incumbent on courts to re-categorise contracts which were improperly characterised (pre-petition) by parties. However, such re-categorisation will be with reference to the standard under the general insolvency law.

1.2.3. Time of the divestiture

The anti-deprivation rule will only be applicable if the transfer of the debtor's assets is triggered by the commencement of formal insolvency proceedings.[217] A transfer that is initiated and completed before the commencement of the formal insolvency procedure will not offend the anti-deprivation rule.[218] Patten L.J. noted this principle in *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd*[219] thus,

> "If the provisions in question can be and are operated on other grounds prior to the commencement of any bankruptcy proceedings, it is difficult to see why the

[217] *Lehman Brothers Special Financing Inc. v Carlton Communications Ltd* [2012] 1 C.L.C. 713, 749 (93); *Butters and ors v BBC Worldwide Ltd* (fn. 194) 117 (88), 118 (92); *Perpetual Trustees Co. Ltd v BNY Corporate Trustee Services* (fn. 194) 111-112; *In re Detmold* (1888) L.R. 40 Ch.D. 585, 587-588.
[218] *Lehman Brothers Special Financing Inc. v Carlton Communications Ltd* (fn 217) (39); *Butters and ors v BBC Worldwide Ltd* (fn. 194) 118 (92). Prescott QC's ruling in *Fraser v Oystertec & Ors* [2004] B.C.C. 233 that insolvency was not a necessary condition precedent to the application of the anti-deprivation rule has been overruled by the Court of Appeal in *Perpetual Trustees Co. Ltd v BNY Corporate Trustee Services* [2010] 3 W.L.R. 87.113 (74), 127 (124).
[219] [2010] 3 W.L.R. 87.

> anti-deprivation rule should apply. The property has been removed pursuant to a valid contractual provision on grounds other than the insolvency of the counterparty and cannot, on any view, form part of the insolvent estate." [220]

The previously evaluated plants and equipment vesting clauses in construction contracts,[221] which provide for such materials to become the property of the employer as soon as they are bought on the site also illustrates this principle.[222]

This same principle applies to the Code's anti-ipso facto provisions.[223] The preamble of s. 365(e)(1) limits the effect of the provision to "any time after the commencement of the case."[224] An executory contract requires a performance to be due from both contracting parties;[225] hence, once terminated, the executory element evaporates.[226] Hence *in Comp III Inc. v Computerland Corp*,[227] Brozman J. noted that,

> "Where an executory contract has been terminated in accordance with its terms prior to bankruptcy, s. 365(e)(1) does not authorise the bankruptcy Court to reach beyond the veil of the petition to reinstate the contract."[228]

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[220] ibid. at 138-9. 103-4; *In re Garrud* (1880-1) 16 Ch. D. 522.
[221] See 1.2.1.d.
[222] *Re Cosslett Ltd* [1998] 2 W.L.R. 131; [1998] Ch. 495, 504, 505, 507-508, 511.
[223] *In re C & S Grain Co*. 47 F.3d 233, 237 (7th Cir. 1995); *Thomas American Stone & Building v White Enterprises* 142 B.R. 449, 453 (DO D Utah 1992); *Allied Technology Inc. v Brunemann* 25 B.R. 484, 495 (Bankr. SD Ohio 1982); *In the Matter of Benrus Watch Co*. 13 B.R. 331, 334 (Bankr. SD N.Y. 1981); *In re Bronx-Westchester Mack Corp*. 4 B.R. 730, 733 (Bankr. S.D.N.Y. 1980).
[224] *Yates Development Inc. v Old Kings* Interchange 256 F.3d 1285, 1287-1288, 1289 (11th Cir. 2001); *Spieker Properties LP v Southern Pacific Funding Corp*. (n 18) 717; *In re C.A.F. Bindery Inc. 199* B.R. 828, 830 – 831, 832, 833 (Bankr. S.D.N.Y. 1996); *Nemko Inc. v Motorola Inc*. 163 B.R. 927, 938 (Bankr. E.D.N.Y. 1994).
[225] Vern Countryman, "Executory contracts in bankruptcy" (1973) 57(1) M.L.R. 439, 460.
[226] *In re Oklahoma Trash Control Inc*. 258 B.R. 461, 464 (Bankr. N.D.Okla. 2001); *T.G. Motors Inc. v C.M. Turtur Investment* 93 B.R. 526, 534 (Bankr.S.D.Tex.1988); *In the Matter of Mimi's of Atlanta Inc*. 5 B.R. 623, 628 (Bankr. N.D.Ga.1980).
[227] 136 B.R. 636, 639 (Bankr S.D.N.Y 1991).
[228] ibid. at 639

This equally applies to s. 541(a) and (c), which are only applicable if the debtor has a legal or equitable interest in the asset when the case is commenced. [229] Thus contracts only constitute property of the bankruptcy estate to the extent that they have not been terminated pre-petition.[230] As a corollary, the trustee cannot assume a contract that is no longer in existence as at the time a bankruptcy petition is filed, as it has been extinguished.[231] In practical terms, this means that the anti-ipso facto provisions cannot be used to revive pre-petition terminated contracts with the aim of assuming them.[232]

Significantly, in the recent cases of *In re Charter Communications Ltd*[233] and *Lehman Brothers Special Financing Inc. v BNY Corporate Trustee Services Limited,*[234] Peck J. noted that "a case" as used in ss. 365(e)(1) and 541(c)(1)(B) of the Code is not restricted to the debtor's case, but included the bankruptcy of any other closely related entity. In practical terms, Peck J.'s proposition is that the commencement of formal insolvency proceedings for

[229] *In re Forth Worth Osteopathic Hospital Inc*. 387 B.R. 706, 714 (Bkrtcy N.D. Tex. 2008); *In re Irwin Schweitzer* 19 B.R. 860, 867 (Bankr. E.D.N.Y. 1982).
[230] *In re Thompson* 186 B.R. 301, 308 (Bankr. N.D. Ga 1995); *In re Seven Sisters Restaurant Inc*. 122 B.R. 213, 281 (Bankr. SD N.Y. 1990); *In re Tudor Motor Lodge* 102 B.R. 936, 948 (Bankr. D.N.J. 1989); *Moody & Amoco Oil Company* 734 F.2d 1200, 1212 (7th Cir. 1984); *In re Varisco* 16 B.R. 634, 637 (Bankr. MD Fla. 1981); *In re Butchman* 4 B.R. 379, 381 (Bankr. S.D.N.Y. 1980).
[231] *Counties Contracting and Construction Co. v Constitution Life Insurance Co*. 855 F.2d 1054, 1061 (3d Cir. 1988); *Seacoast Products Inc. v Spring Valley Farms* 34 B.R. 379, 381 (M.D.N.C. 1983); *Executive Square Office Building v O'Connor* 19 B.R. 143, 146 (Bankr. N.D. Fla. 1981).
[232] *In re James Beck* 5 B.R. 169, 170–171 (Bankr.D.Haw.1980). In *LJP v Royal Crown Cola Co*. 22 B.R. 556, 558 (Bankr. S.D. Fla. 1982) it was held that "there is no provision of the Code which permits assumption or the curing of defaults in contracts terminated before bankruptcy."
[233] 449 B.R. 14 (S.D.N.Y. 2011).
[234] 422 B.R. 407 (Bankr. S.D.N.Y. 2010).

one counterparty in a contractual arrangement will trigger off the anti-ipso facto rules in relation to the ipso facto clauses of other solvent counterparties who are closely related to it.

The accuracy of this proposition is doubtful. Contrary to Peck J.'s view, the phrase "after the commencement of the case" in s. 365(e)(1) is intended to limit the application of the language in s. 365(e)(1)(B). The limiting language thus prevents the application of s. 365(e)(1) to *any* ipso facto clause that is effective prior to the commencement of the bankruptcy case.

Furthermore, the legislative history of s. 365(e)(1) explains the essence of the provision as being to prevent the enforcement of insolvency-triggered termination clauses, which frequently hamper rehabilitation efforts, and to enable the trustee assume or assign such contracts.[235] The focus is on the insolvent entity and its rehabilitation and not on any other related entity.

Peck J.'s proposition also raises the question of what constitutes a "sufficient relationship" between counterparties so as to make the insolvency of one trigger the anti-ipso facto rule for another. Put differently, what are the criteria for determining the proximity of parties such as to make the insolvency of one trigger off the anti-ipso facto rule for another?

[235] Senate report No. 95-989.

Significantly, Peck J.'s proposition runs counter to earlier precedents.

Peck J.'s position also runs counter to the prevailing and settled position in the UK. As noted by Lord Patten in *Perpetual Trustees v BNY Corporate Trustee Services Ltd*, [236] compliance with the Insolvency Act constitutes the foundation for the common law anti-deprivation rule whose aim is to prohibit the enforcement of contracts which offend the letter and spirit of the Act. [237] Accordingly the anti-deprivation rule ought to be applied within the confines and limits of the insolvency legislation.

There are effective anti-avoidance provisions in both the Insolvency Act and the Bankruptcy Code that invalidate provisions depriving an insolvent company of its assets before the commencement of formal insolvency.[238] Extending the anti-deprivation and anti-ipso facto rule to retroactively invalidate pre-insolvency deprivations or contract terminations will conflict with these established statutory rules.

It is arguable that certain post-petition terminations may not be objectionable under the two rules. A contract modification or termination which occurs at insolvency or immediately thereafter based

[236] [2010] 3 W.L.R. 87, 127 (123); See also *Lomas v JFB Firth Rixson* [2010] EWHC 3372 (Ch.) (96); *Perpetual Trustees Company Ltd v BNY Corporate Trustee Services* (fn. 194) 108, 109; *Butters and Others v BBC Worldwide Ltd and ors* [2010] 3 W.L.R. 87, 118 (92).
[237] *Lomas v JFB Firth Rixson* (fn. 236) (96); *Perpetual Trustees Company Ltd v BNY Corporate Trustee Services* (fn. 224) 108, 109; *Butters and Ors v BBC Worldwide Ltd and ors* (fn. 236) 118 (92).
[238] One of the anti-avoidance rules is evaluated in chapter 4.

on a pre-petition notice of termination ought not be caught by the anti-divestiture rules. A good example of this scenario would be cases where termination is by service of notice. There seems to be no reason why the automatic termination of the contract at or after the commencement of proceedings should contravene the rules.

First, such termination cannot be said to have been conditioned upon or triggered by insolvency. Here, the decision to terminate the contract was taken when the notice of termination was issued i.e. prior to the commencement of the insolvency procedure.[239] As earlier argued, it is also suggested that terminations of this nature which are colourable are within the purview of the anti-avoidance rules of the regimes – given that actual termination of contract, and if any, asset withdrawal, has occurred before the commencement of insolvency.

Secondly, it can be argued that contract terminations of the above nature do not actually amount to a withdrawal of any assets from the insolvent estate in the two jurisdictions. Under the Bankruptcy Code, by virtue of s. 541(a), all the executory contracts of the debtor are automatically transferred to the bankruptcy estate at the commencement of the case. It is suggested that s. 541(a) will have only a temporary effect on contracts

[239] *In re Tudor Motor Lodge Associates Ltd* 102 B.R. 936, 948-949 (Bkrtcy.D.N.J. 1989).

of the present nature given that the contractual right transferred to the insolvent estate will be limited to the right that subsists before the expiration of the notice. [240] Consequently, the contract will automatically terminate at the expiration of the notice of termination and cease to be part of the bankruptcy estate.

A cardinal rule of English insolvency law is that a liquidator inherits no greater rights than the debtor.[241] Accordingly, when contracts that are subject to limitations, such as the passing of time, are transferred to the insolvent estate, they are transferred with and subject to such limitations, which will also be equally binding on the liquidator.

The above positions in both jurisdictions are plausible. Although a primary objective of the anti-divestiture rules is to maximise realisations for the insolvent estate, insolvency law ought not to be used as a tool for expanding the debtor's rights against others more than they exist at the commencement of formal proceedings. This point was well emphasised by Gambardella J. in *In re Tudor Motor Lodge Associates Ltd*[242] when she observed that,

> "Section 541 of the bankruptcy Code defines property of the estate and specifies what property becomes property of the estate. The commencement of a bankruptcy case creates an estate comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case." Although the language of s. 541 is broad, Congress clearly did not intend to "expand

[240] *Moody v Amoco Oil Co*. 734 F.2d 1200, 1213 (7th Cir. 1984).
[241] *In re Scheibler* (1874) L.R. 9 Ch. 722, 727.
[242] 102 B.R. 936, 948-949 (Bkrtcy.D.N.J. 1989).

> the debtor's rights against others more than they exist at the commencement of the case." [243]

1.2.4. Divestiture conditioned on insolvency

A divestiture that is triggered by an event other than the commencement of formal insolvency will not violate the anti-deprivation rule. This will be the case even if the deprivation coincides with insolvency. For instance in *Ex parte Jay*,[244] Brett J. noted that if forfeiture had taken place on the builder's breach (as the provision envisaged) rather than at bankruptcy, then it would have been valid.[245] Similarly, although the contract in *Ex parte Barter*[246] provided for other events outside bankruptcy in which the property could be forfeited, it was held to violate the rule as it was established that bankruptcy was the basis of the powers of control exercised by the buyers.[247]

The foregoing can be contrasted with *Re Detmold*[248] where the provision was held valid as it was triggered by an event that occurred before the commencement of insolvency i.e. alienation by way of the appointment of a judgement creditor as a receiver by way of equitable execution.[249] In *In re*

[243] ibid. at 948.
[244] (1879) 14 Ch. D. 19.
[245] ibid. at 26.
[246] (1873) L.R. 8 Ch. App. 643.
[247] ibid. at 519.
[248] (1889) 40 Ch. D. 585.
[249] ibid. at 588.

Garrud[250] the forfeiture provision which operated on breach and not on bankruptcy was held to be valid.[251] Here, the bankrupt builder had broken 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.[252]

Prima facie the above principle is also applicable to the anti-ipso facto rules where a termination or modification of a contract is premised on conditions outside the ipso facto events listed under s. 365(e)(1)(A), (B) and (C) of the Code.[253] An example of a case where a post-petition termination will not breach the anti-ipso facto rules will be where a contract has a specified termination date. The contract will automatically terminate on the stated date.

A divestiture that is conditioned upon an event that is unrelated to formal insolvency will not contravene the anti-ipso facto rule.[254] This point is well illustrated in *Nemko Inc. v Motorola Inc.,*[255] where a contract for supplies was cancelled on April 4, 1990, two weeks after the debtor's insolvency petition was filed, due to the failure of the debtor to make

[250] (1880-1) 16 Ch. D. 522.
[251] *BNY Corporate Trustee Services Ltd v Belmont Park Investments Pty Ltd* [2011] B.C.C. 734, 751.
[252] The forfeiture took place after bankruptcy, but it is not clear when the breach occurred in this case – this in a way makes the authority controversial.
[253] *In re New England Marine Services* 174 B.R. 391, 396-397 (Bankr. E.D.N.Y. 1994); *Gloria Manufacturing Corporation v International Ladies' Garments Workers Union* 734 F.2d 1020, 1022 (4th Cir. 1984); *In re Gaslight Village Inc.* (n 22) 875.
[254] *In re Lee West Enterprises* 179 B.R. 204, 209 (Bankr. C.D. Calif. 1995)*; I.T.T Small Business Finance Corp v Frederique* 82 B.R. 4, 6 (E.D.N.Y. 1987).
[255] 163 B.R. 927 (Bankr. E.D.N.Y. 1994).

deliveries that were due on March 12, 1990.[256] Regardless of the ipso facto clause in the contract, the court held that s. 365(e)(1) did not apply where a debtor had materially breached an executory contract pre-petition, made no attempt to assume, reject or cure the defaults and the counterparty, in a timely fashion, terminated the contract post-petition based on the pre-petition default.

An argument against the foregoing approach is the fact that it could create an avenue for creditors to evade the rules. For instance, creditors may strategically purport to employ a non-ipso factor term in an agreement to modify or terminate the rights of a debtor while in fact effecting such termination or modification due to insolvency. This notwithstanding, it is argued that this approach does not conflict with the earlier evaluated policy objectives of the rules.[257] Moreover, it also supports the point previously made that the insolvent estate ought not to acquire any greater contractual interest than that which was held by the debtor prior to insolvency by reason of the rules.

A termination, which is timed to coincide with insolvency, although premised on another ground, may give rise to a number of considerations. It is arguable that such a clause is more likely than not to be invalidated under the US regime. In deed the facts

[256] Ibid. at 938.
[257] Laurence Cherkis, "Recommendations of the National Bankruptcy Review Commission: Partnership as Debtor, Partner as Debtor" (1997) 5 AM Bankr. Inst. L. Rev 381, 395.

of *Garnas v American Family Mutual Insurance*[258] clearly illustrate the extent to which US courts can go in preventing the termination or modification of executory contracts after the filing of the petition.

In *Garnas v American Family Mutual Insurance* the insurance firm was prevented from refusing to renew the insurance cover of a bankrupt which was meant to renew automatically. Although the insurance firm neither stated insolvency as the ground for refusal or for its decision not to renew, the court concluded that it was an attempt to circumvent the purpose of s. 365(1)(e).[259]

In addition, there have cases where creditors who had *termination-at-will* clauses have been prevented from enforcing them, given that their exercise coincided with the commencement of the insolvency case. In *In re Siegel Company*[260] the court ruled that the exercise would "for all practical purposes, nullify the remedial policy of s. 365(e).[261] This position was echoed in *In re National Hydro-Vac Industrial Services*.[262]

The approach of the courts may be defended on the ground that the actions of the creditors were viewed as veiled attempts to circumvent the anti-ipso facto rules. Hence, in the above cases, the bankruptcy

[258] 38 B.R. 221 (Bankr. D.N.D.1984).
[259] ibid. at 223.
[260] 51 B.R. 159 (Bankr. E.D. Mich. 1985)
[261] ibid. at 264.
[262] *262* B.R. 781, 787 (Bankr. E.D. Ark. 2001).

courts looked beyond the face of the agreements in a bid to unearth the true nature of such termination clauses. For instance in *Yates Development Inc. v Old Kings Interchange Inc*. Proctor J. noted that,[263]

> "s. 365(e)(1) also expressly applies to...provisions which do not mention bankruptcy but have the same effect as a clause triggered by a bankruptcy filing."[264]

It is indeed doubtful if any contractual terminations or modifications which coincide with insolvency will survive the anti-ipso facto rule if the above statement is to be taken literally. Furthermore, it is difficult to see how this does not constitute a subtle expansion of the contractual rights of the insolvent estate beyond that which the debtor had pre-petition. For instance, if a solvent party has a right to terminate a contract or modify same on the occurrence of a non-insolvency event, stripping the party of such right merely because it coincides with insolvency is akin to redrafting the agreement and expanding the rights of the debtor post-insolvency.

In contrast, under the English insolvency law regime, terminations which coincide with insolvency but are conditioned on grounds other than insolvency will more likely be enforceable. For instance in *In Re Apex Supply Company Ltd*[265] where a hirer in a hire-purchase agreement was to pay compensation for acts of default one of which was liquidation, Gibson J. upheld the provision on the ground that since the claim could arise in a multitude of circumstances, one

[263] 241 B.R. 247.
[264] ibid. at 253.
[265] [1942] Ch. 108.

only of which is the possible liquidation of the company, it would be extravagant to suggest that the clause was aimed at defeating the bankruptcy laws or at providing for a distribution differing from that which the bankruptcy laws permit.[266]

The disadvantage of this approach is the tendency for an erosion of the anti-deprivation rule through the veiled conditioning of insolvency-triggered terminations on other related grounds. Nevertheless, it is arguable that this approach aligns with the touchstone for determining deprivations in the English regime, namely that courts ought to look at the contractual terms of parties with a view to ascertaining their rights and obligations alongside reference to the applicable non-insolvency law. The next paragraphs will consider two more examples to illustrate this point, as well as how parties can structure the termination of their contracts to coincide with insolvency without being in breach of the rule under English insolvency law.

a. Termination for anticipatory breach

An anticipatory breach occurs when, before performance is due, a party either renounces the contract or disables himself from performing.[267] This

[266] ibid at 113-4.
[267] *Golden Strait Corp. v Nippon Yusen Kubishika Kaisha* [2007] 2 W.L.R. 691, 695; *Universal Cargo Carriers Corp. v Citati* [1957] 2 Q.B. 401, 438. See a criticism of the phrase 'anticipatory breach" in *Maredelanto Compania Naviera*

entitles the innocent party to terminate performance of the contract immediately, if he so wishes, and sue for damages.[268] The rationale for permitting the innocent party to treat the contract as repudiated is that there has been a breach of a right to have the contract kept open as a subsisting and effective contract.[269] Before examining the validity of termination for anticipatory breach vis-a-vis the anti-deprivation rule, it is pertinent to examine the preliminary issue of whether insolvency constitutes an anticipatory breach.

Prima facie, insolvency in itself will not amount to an anticipatory breach, entitling the innocent party to terminate the contract.[270] The insolvency must show or lead to an inference of an intention not to perform or an inability to perform. Accordingly, it must be shown that the insolvent party has either *renounced* the contract or has *disabled* himself from performing it.[271] *Renunciation* will require a "clear" and "absolute" refusal to perform.[272]

S.A. v Bergbau-Handel [1971] 1 Q.B. 164, 196 per Lord Denning and *Bradley v Newsom* [1919] A.C. 16, 53-54 per Lord Wrenbury.

[268] *Afovos Shipping Co. S.A. v Romano Pagnan and Pietro Pagnan* [1983] 1 W.L.R. 195, 203. Lord Diplock asserts that it relates only to a fundamental breach; *Re Asphaltic Wood Pavement Co., Lee & Chapman's case* (1885) 30 Ch.D 216*; Hochster v De La Tour* (1853) 2 E & B 678; Ewan Mckendrick, Contract law, Palgrave Macmillan 2011, 331; Fidelis Oditah, "Assets and the treatment of claims in insolvency" (1992) 108 L.Q.R. 459, 494-5.

[269] *Frost v Knight* (1872) L.R. 7 Exch. 11 per Cockburn C.J.

[270] *Jennings Trustee v King* [1952] 2 All ER 608, *Mess v Duffus* [1901] 6 Comm Cas 165, *Ex p Chalmers* (1873) 8 Ch. App. 289, Morgan v Bain (1874) L.R. 10 C.P. 15, 25-26: Now, whatever may have been thought at one time on this subject, it appears to be the law that mere insolvency does not per se put an end to the contract." per Brett J.; Micheal Bridge, *The Sale of Goods*, 3rd edn, OUP 2014, 585. See *Baker v Lloyd's Bank Ltd* [1920] 2 K.B. 322, 326 for view that a declaration by a firm that it was insolvent amounted to a repudiation of its ability to perform its contracts.

[271] *Universal Cargo Carriers v Citati* [1957] 2 Q.B. 401, 438; Edwin Peel, The Law of Contract, 12th edn, 2007, London Sweet & Maxwell 2007, 845.

[272] This need not be express but can take the form of conduct indicating that the party is unwilling, even though he may be able, to perform. *Stocznia Gdanska v Latvian Shipping Co* [2002] 2 Lloyds Rep 436 at (96); *Laughton and Hawley v BAPP* [1986] 1 C.R. 245

Disablement[273] involves a "deliberate" act that makes performance impossible.[274]

Disability:

Oditah views disability as being more difficult to establish, noting that a party who elects to treat disability as an anticipatory breach may be running a serious risk.[275] His view is rightly premised on the ground that insolvency, which creates disability, can hardly be described as deliberate, although in some cases the insolvent party may be at fault.[276]

Accordingly, in the absence of establishing that a company is in fact unable to perform a specific contract in issue, a solvent party cannot rely on mere insolvency proceedings to establish disability. For instance in *Re Agra Bank,*[277] a bank opened an irrevocable credit but became insolvent and stopped payment before the presentation of the documents. The customer, who had instructed the bank to open the credit, arranged for alternative credit facilities and sought to prove for damages based on the extra expense so incurred. The court upheld the liquidator's rejection of the proof. The bank's insolvency did not constitute an anticipatory breach of the contract

[273] Oditah coins this "incapacity" - Fidelis Oditah, "Assets and the treatment of claims in insolvency," (1992) 108 L.Q.R. 459, 495.
[274] *Universal Cargo Cariers v Citati* [1957] 2 Q.B. 401, 438
[275] Oditah (fn. 273) 495.
[276] ibid.
[277] (1867) L.R. 5 Eq. 160.

because the mere fact of stoppage of payment was no proof that the bank will not accept the bills.[278]

Renunciation:

Insolvency on its own cannot be taken as conclusive evidence of renunciation of a contract.[279] This position is plausible given that the commencement of insolvency only amounts to an admission of the fact of insolvency and not necessarily the incapacity to perform specific or even all contracts of the insolvent company. Hence, even where insolvency will incapacitate the company from fulfilling certain contracts, it is difficult to ascertain which ones it will choose not to perform.[280]

However, it is suggested that there are circumstances where commencement of insolvency proceeding will amount to renunciation. First, in cases where the contract forms the insolvent company's only outstanding liability. Here, the effect of a notice of insolvency without more would indicate the insolvent party's inability to perform the contract.[281] Secondly if the declaration is made in such circumstances as to show that the insolvent company either cannot, or does not intend to carry out the contract, it is open to the solvent contractor to take the

[278] ibid, at 165. See also *Re Barber & Co* (1870) L.R. 9 Eq. 725.
[279] *Mess v Duffus* [1901] 6 Com.Cas. 165; *Morgan v Bain* (1874) L.R. 10 C.P. 15; *Re Edwards* (1873) L.R. 8 Ch. App. 289.
[280] See discussion on disclaimer or rejection of executory contracts in chapter 3.
[281] *Morgan v Bain* (1874) L.R. 10 C.P. 15 at 25-26 (Brett J.).

contract as having been repudiated.[282] Against this background, it is suggested that whether insolvency constitutes a renunciation or not will depend on the facts of each case and the nature of the insolvency proceeding.

Renunciation appears to be an easier form of establishing repudiation. However, the problem is that often the solvent party will be leaving his fate in the hands of the liquidator who may need time to ascertain whether it is profitable to perform or disclaim a contract. Hence a solvent party may have to adopt what Oditah describes as a "wait and see" approach.[283]

Anticipatory breach has been rationalized as a breach of an *implied term* of the contract that neither party will, without just cause, repudiate his obligations under the contract before the time fixed for performance. Accordingly, a termination may not necessarily contravene the anti-deprivation rule, as the implied condition is not an independent forfeiting condition, but a contractual limitation of the insolvent's interest in the contract.[284] Given that a

[282] *Mess v Duffus* (fn. 279) 167.
[283] Oditah also suggests that renunciation necessarily entails a "wait and see" approach as the solvent party has to wait and see whether the liquidator will find the contract profitable to perform. *Morgan v Bain* (1874) L.R. 10 C.P. 15, 26
[284] Considering that these are mere ordinary executory contracts with unperformed obligations, Oditah submits that this is not underpinned by the determinable/defeasible interest distinction but that acceleration and rescission clauses are built-in limitations on each party's entitlement to the other's unperformed obligations.

liquidator takes subject to equities, he must be bound by the contractual terms that qualify the contract.[285]

b. Insolvency as a condition subsequent

As an alternative to anticipatory breach and as a means of avoiding the complexities associated with establishing *disability* and the wait-and-see dilemma in *renunciation*, a contract may be terminated upon insolvency for breach of condition – without necessarily violating the anti-deprivation rule. A breach of condition in a contract is a breach of an obligation and is one which goes to the root of the contract, entitling the injured party to elect to terminate the agreement and claim damages for any breaches which occurred prior to termination and the loss of opportunity to receive performance of the promisor's outstanding obligations.[286]

In *Lombard North Plc. v Butterworth*,[287] Mustill L.J. noted that it was possible by express provision in a contract to make a term a condition, notwithstanding that it would not be so in the absence of the provision. Hence from the perspective of termination, a condition is a label which the law attaches to a contractual term, on the basis of the agreement of contracting parties and the breach of

[285] *Shipton, Anderson & Co. (1927) Ltd.* v. *Micks, Lambert & Co* [1936] 2 All ER 1032.
[286] *BNP Paribas v Wockhardt EU Operations (Swiss) AG* [2009] EWHC 3116 (33); *Lombard North Plc. v Butterworth* [1987] Q.B. 527, 535 per Mustill L.J., and per Nicholls L.J. at 546.
[287] [1987] Q.B. 527.

which effectively confers a right to terminate on the innocent party.[288]

Against this background, parties can include the insolvency of a party as a condition subsequent under the contract, alongside other conditions in the contract. The practical implication of this is that the debtor will commit a breach of condition once it becomes insolvent, entitling the solvent party to accept the breach as repudiation, terminate the contract and prove for damages in the insolvency procedure.

It is argued that this may not necessarily breach the anti-deprivation rule, given that termination is based on breach of condition which goes to the root of the agreement. The foregoing is clearly a veiled breach of the anti-deprivation rule, however, it also illustrates how solicitous English insolvency is towards giving effect to arm's length contract terms.

1.2.5. The role of good faith and intention

The good faith of the contracting parties in inserting an ipso facto clause in their agreement is totally irrelevant under the Bankruptcy Code. The anti-ipso facto rules are absolute in nature and focus on the *effect* of the termination clauses in the contracts.

[288] *Photo Production Ltd v Securicor Transport Ltd* [1980] A.C. 827, 849-850.

The rule disregards security interests and treats secured and unsecured creditors alike, so far as the termination or modification of those contracts or the rights therein are conditioned upon insolvency.

The advantage of this one-cap-fits-all approach is that the rule has been able to achieve a high level of coherence and uniformity in its application. Notwithstanding that secured claims are interfered with, it is arguable that this approach is capable of ensuring that very few executory contracts, viewed as contingent assets, are lost by the insolvent estate, bearing in mind that the aim is to utilise these contingent assets to maximise realisations and boost rehabilitations.

Numerous (and sometimes conflicting) judicial pronouncements have been made regarding the role of good faith in the application of the anti-deprivation rule. In *Money Markets International v London Stock Exchange*,[289] while reviewing the principles in the application of the anti-deprivation rule, Lord Neuberger had observed that,

> "It may be that at one time, the fact that there was no intention to interfere with, or to override the pari passu rules on bankruptcy would have been a reason for holding a deprivation provision valid. However, in the light of the observations of Lord Cross in British Eagle, I consider that that contention is no longer maintainable: he said that it was "irrelevant" that the parties to the arrangements in that case "had good business reasons for entering into them and did not direct their minds to the question how the arrangements might be affected (on) insolvency." To my mind, he was indicating that one must look at the effect of the deprivation provision, and whether, it applies in the context of an insolvency, it is

[289] [2002] 1 W.L.R. 1150.

> contrary to public policy in the light of the bankruptcy laws."[290]

Lord Neuberger thus treated the anti-deprivation rule as if it was the same as the pari passu rule, hence his reference to the observation of Lord Cross in *British Eagle*,[291] wherein the latter was clearly dealing with the role of intention in the application of the pari passu rule.[292] It is however worth noting that *Money Markets International* was decided prior to the *Belmont case* i.e. at a time when no clear distinction was made between the pari passu principle and the anti-deprivation rule.

Lord Neuberger was actually right in his assertion that some previous authorities may have taken the intentions of parties into consideration. This point was highlighted in *Belmont Park Investments Pty Ltd* v *BNY Corporate Trustee Services Ltd*[293] where Lord Collins reviewed a long line of previous decisions[294] and concluded that,

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[290] ibid. at 1177.
[291] [1975] 1 W.L.R. 758, 780.
[292] *Belmont Park Investments Pty Ltd* v *BNY Corporate Trustee Services Ltd* [2011] B.C.C. 734, 752 per Lord Collins: "by contrast, in the leading pari passu principle case, *British Eagle*, it was held by the majority that it did not matter that the clearing transaction was a sensible commercial arrangement not intended to circumvent the pari passu principle."
[293] [2011] B.C.C. 734.
[294] ibid, at 752. Lord Collins observed that the early decisions in *Higinbotham v Holme* and *Whitmore v Mason* showed that the anti-deprivation rule were premised on the presence of "fraud on" the bankruptcy policy or an intention to defraud creditors. He observed that in *Ex parte Mackay* (1873) LR 8 Ch. App. 643, 647 the divestiture clause constituted an ineffective charge, as it was "a clear attempt to evade the operation of the bankruptcy laws." In *Ex parte William* (1877-1878) L.R. 7 Ch.D. 138, 143-4 evidence that the parties "clearly intended" to deprive the debtor of its assets at insolvency led the court to conclude that a deprivation had occurred. In *Worrell v Johns* [1928] Ch. 737, 748 the anti-deprivation principle was breached as there was a "deliberate device" by the parties to secure the transfer of money from the debtor to a third party in the event of bankruptcy. In contrast, the anti-deprivation rule was not infringed in *Bombay Official Assignee v Shroff* [1932] 48 T.L.R. 443, 446 as the rules relating to the forfeiture of membership of the Bombay Broker's Hall were "entirely innocent of any design to evade the law of insolvency." In *Borland's Trustees v Steel Brothers* [1901] 1 Ch. 279, 290, 291, the court concluded that the anti-

> "The overall effect of the authorities is that, where the anti-deprivation rule has applied, it has been an almost invariably expressed element that the party seeking to take advantage of the deprivation was intending to evade the bankruptcy rules; but that where it has not applied, the good faith or the commercial sense of the transaction has been a substantial factor."[295]

Lord Collins concluded his analysis by stating that a subjective intention was not required but that in borderline cases a commercially sensible transaction entered into in good faith should not be held to infringe the anti-deprivation rule.[296]

Lord Mance's view on the role of the state of mind does not accord with that of Lord Collins. His Lordship submitted that the court had to make an objective assessment of the purpose and effect of the relevant transaction or provision in bankruptcy, when considering whether it amounts to an illegitimate evasion of the bankruptcy law or has a legitimate commercial basis in other considerations.[297]

Accordingly, while Lord Collin noted that it was obvious from the wide range of non-insolvency

deprivation rule was not breached as the provision in issue was inserted bona fide and therefore did not constitute a fraud on the insolvency law policy. In *In re Appex Supply Company Ltd* [1942] Ch. 108, 113-4 the hire-purchase agreement stipulated various grounds for the repossession of the property, including insolvency. The Court declined to invalidate the repossession in the absence of clear evidence indicating intention to defeat the bankruptcy laws.

[295] [2011] B.C.C. 734, 752.

[296] ibid. at 752.

[297] [2011] B.C.C. 734, 772. His lordship observed that in other cases the anti-deprivation rule was stated in terms of focusing on the character of the transaction or provision, identified objectively. For instance in *Wilson v Greenwood* (1818) 1 Swans. 471, Mr. Swanston stated that "the 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". This was subsequently quoted by Lord Hatherley L.C. in argument in *Whitmore v Mason,* 209–210 and by Fry L.J. in *Ex p. Barter* (1884) L.R. 26 Ch. D. 510, 519–520. He however admitted that in some cases such as *Higinbotham v Holme* 19 Ves 88, *Ex p. Mackay* (1873) LR 8 Ch. App. 643 and *Re Johns* [1928] Ch. 737, a conclusion that the anti-deprivation principle applied was expressed in terms referring to an express or deliberate object of evading the bankruptcy law.

circumstances capable of constituting an event of default under the swap agreement that the provisions were not deliberately intended to evade insolvency law,[298] Lord Mance stated that what mattered was whether the deprivation was triggered by bankruptcy, and that, if it is, it is irrelevant that there were also events other than bankruptcy, which if they had occurred would have triggered deprivation, but which did not in fact occur.[299]

It is suggested that Lord Mance's view is the more persuasive of the two positions. As a background to applying this objective approach, it is pertinent to re-emphasise that the determination of what constitutes an asset of a company and a deprivation must be made with reference to the pre-insolvency contractual intentions of the parties as evidenced in the terms of their agreement and the applicable non-insolvency law. For example, in a conditional sale transaction reference must be made to the fact that the parties intended to contract on the basis that title in the goods would remain in the seller despite the passing of possession to the insolvent buyer. Hence, reference ought to be made to the applicable law, the Sale of Goods Act to determine ownership of assets.

The result of the application of this objective test would be that once there is a determination, with reference to the non-insolvency law, that assets which

[298] [2011] B.C.C. 734, 761.
[299] ibid. at 773.

ought to fall into the bankruptcy estate have been clawed back, such arrangement will be invalidated, notwithstanding that the transaction makes commercial sense or was entered into in good faith with no intention to evade the bankruptcy scheme.

It is suggested that this approach aligns with the policy objective of the anti-deprivation rule which is the maximisation of realisations by preventing withdrawal of assets from the insolvent estate. Recognising the good faith of the parties or commercial sense of the transactions does not contribute anything to the upholding of this objective. On the contrary, it creates loopholes and avenues for asset dissipation in contravention of the policy objective.

It may be argued that certain pre-petition contracts that have the effect of divesting the insolvent estate of assets at insolvency may have been commercially sensible to the contracting parties at the time they were entered into. Accordingly, such contracts may have been entered into in good faith and for the benefit of the company – given that at the time of contracting, the deprivation clause may have been viewed as a reasonable price that the insolvent entity has to agree to for the agreement to be reached in the first place. The response to the above argument is this; first, if the reasoning is followed, it will eviscerate the anti-deprivation rule and consequently defeat its core objective of asset maximisation. It will

make the application of the rule to be dependent on either the ability of lawyers to draft agreements in a manner which good faith and commercial sense can be inferred or to simply prove the absence of intention to evade the bankruptcy scheme.

Secondly, it is difficult to define what constitutes a *commercially sensible* contract. Put differently, what amounts to a commercially sensible contract to one party may not make sense to another. Accordingly, while deprivation clauses will be commercially sensible to a benefiting creditor, it may not make commercial sense to other creditors – not just because they were not privy to the contract, but also because the deprivation will be detrimental to their interests. Unfortunately in the *Belmont case,* Lord Collins failed to expatiate on this point or specifically state from whose perspective the transaction is to be judged from. It is suggested that it would be incorrect to do so from the perspective of a single benefiting creditor, as this would run counter to the collective nature of insolvency law proceedings.

Insolvency-triggered deprivation clauses in contracts are aimed at insulating solvent counterparties from formal insolvency. Hence, the main objective of such clauses is to claw back assets which otherwise would have fallen into the insolvent estate. The clauses effectively deprive the general body of creditors of valuable assets. From this perspective, it begs the question as to the

circumstances which insolvency-triggered deprivation clauses will be held to have been entered into in good faith and without intention to evade the bankruptcy rules.[300]

It is suggested that creditors who do not wish to be lumped together with unsecured creditors in the event of formal insolvency, ought to protect themselves by taking security or retaining title in their assets. As previously noted, in such cases, English courts will give effect to such security and proprietary interests – given that such assets will not fall into the insolvent estate at insolvency.

It is worth noting that discountenancing good faith and the common sense of transactions in the application of the anti-deprivation rule will not necessarily achieve coherence in the application of the anti-deprivation rule. This is primarily because the rule is usually applied with reference to the pre-petition contractual terms of parties as well as diverse non-insolvency laws – depending on the type of contract in issue. However, it is argued that the elimination of *good faith* and *commercial sense* will ensure coherence in the application of the rule to very similar types of contracts.

[300] See texts accompanying fn. 294-297.

1.3. Exceptions to the anti-ipso facto rules

1.3.1. Validation by applicable non-insolvency law

A creditor cannot be compelled to continue with an executory contract by virtue of s. 365(e) if the applicable non-insolvency law excuses the creditor from accepting or rendering performance to the trustee or an assignee.[301] In the case of *In re Cutler*,[302] "applicable non-bankruptcy law" was defined as the statute that governed the contract of the parties prior to the commencement of insolvency.[303] This exception is reinforced by s. 365(c)(1) of the Code which prohibits an officeholder from "assuming or assigning" executory contracts if applicable non-insolvency law excuses the creditor from accepting or rendering performance to an entity other than the debtor or debtor-in-possession. It is suggested that this latter provision is designed to protect the creditor from being compelled to render or accept performance from an entity other than the trustee or debtor with which it originally contracted. [304] Significantly, the bankruptcy Code permits a creditor

[301] s. 365(e)(2)(A); *In re ANC Rental Corporation* 277 B.R. 226, 237 (Bankr.D. Del. 2002); *In re Pennsylvania Peer Review Organisation* 50 B.R. 640, 645 (Bankr MD Pa. 1985).
[302] 165 B.R. 275, 280 (Bankr.D.Ariz.1994).
[303] ibid at 280.
[304] *In re TechDyn Systems Corp*. 235 B.R. 857, 861-862 (Bankr. E.D. Va. 1999); *Dean v Postle Enterprises Inc*. 48 B.R. 721, 724 (Bankr. D. Ariz. 1985). The operative clause in the preamble of s. 365(c)(1) provides that "the trustee may not assume or assign any executory contract or unexpired lease."

to waive this exception by consenting to the assignment.[305]

The phrase "assume or assign" under s. 365(c)(1) has given rise to a division in judicial opinion over the nature of non-assumable contracts under this heading. Some courts have adopted the so-called *hypothetical* approach wherein a literal language of the provision is followed to a conclusion that the bankruptcy estate loses the rights of the pre-bankruptcy debtor to assume contracts that are not assignable under pre-insolvency law – even if the officeholder does not contemplate an assignment.[306]

On the other hand, other courts have applied the so-called *actual* test wherein the assumption of contracts which are non-assignable outside bankruptcy are only prohibited where there is a finding that under particular circumstances, the assumption would amount to a forbidden assignment under the applicable non-insolvency law.[307]

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[305] *In re Allentown Ambassadors Inc*. 361 B.R. 422, 445 (E.D. Pa. 2007); *In re Pioneer Ford Sales Inc*. 729 F.2d 27, 28 (1st Cir. 1984).

[306] *Perlman v. Catapult Entertainment Inc*. 165 F.3d 747 (9th Cir.) (applying the "hypothetical test" to bar assumption of nonexclusive patent licenses); *In re West Electonics Inc*., 852 F.2d 79, 83-84 (3rd Cir. 1988) (barring assumption of government contract); *Breedon v. Catron* 158 B.R. 629 (E.D. Va. 1993) (barring assumption of partnership agreement).

[307] *In re GP Express Airlines, Inc*. 200 B.R. 222, 231-32 (Bankr. D. Neb. 1996) (applying the actual test and finding that applicable law barring the assignment of certain airline contracts did not prevent the debtor in possession from assuming such contracts); *In re American Ship Building Co. Inc*. 164 B.R. 358, 362-63 (Bankr. M.D. Fla. 1994); *In re Hartec Enter, Inc*. 117 B.R. 865, 872-74 (Bankr. W.D. Tex. 1990) (adopting the "actual test" and allowing the debtor in possession to assume a nonassignable government contract); *In re Cardinal Indus. Inc*. 116 B.R. 964, 977 (Bankr. S.D. Ohio 1990); *Institute Pasteur v. Cambridge Biotech Corp*. 104 F.3d 489, 493-94 (1st Cir.) (debtor in possession may assume patent licenses even though reorganization plan provides for transfer of debtor's stock to third party); *Summit Inv. and Dev. Corp. v. Leroux* 69 F.3d 608, 612-14 (1st Cir. 1995) (rejecting "hypothetical test"); *Texaco, Inc. v. Louisiana Land and Exploration Co*. 136 B.R. 658, 668-71 (M.D. La. 1992) (Statute which required the consent of a state board to assign a state mineral lease was not "applicable law" blocking the assumption of a lease by the debtor in possession).

It is suggested that the hypothetical test runs counter with the general policy of the anti-ipso facto regime earlier analysed – notwithstanding that it accords with a literal construction of s. 365(c)(1). Under the test, valuable contingent assets of the debtor are legally forfeited merely because of the bankruptcy filing. This is regardless of the fact that there is no plan of actually assigning the contracts after assumption. It would thus appear that the actual test, although inconsistent with the literal interpretation of s. 365(c)(1) yields correct results from the perspective of the policy of the anti-ipso fact rule.

There is no corresponding exception under common law anti-deprivation regime. However, it is suggested that UK courts will give effect to a non-insolvency statutory provision that precludes the application of the anti-deprivation rule from specific types of contracts. In addition to the respect for parliamentary sovereignty, such exemptions would certainly be based on a well thought-out policy that outweighs the application of the anti-deprivation rule in the circumstance.[308]

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[308] *MMI Stockbrokers Ltd v LSE Ltd* [2002] 1 W.L.R. 1150, 1190 (139) (Neuberger J): "While there will no doubt be exceptions, it seems to me that it will be a rare case where the Convention and the common law conflict. Bearing in mind the basis of the common law, the way in which it has developed over the centuries, and the continuing ability of the courts to adapt it with the passage of time, it would be surprising if it were otherwise."

An example of a provision of an English non-insolvency law that precludes the application of insolvency law in a commercial transaction is the real remedies conferred by the Sales of Goods Act on an unpaid seller. This exception is evaluated in paragraph 1.4.5. Another example of the intervention of Convention in English law and by extension the anti-deprivation rule is Article 7 of the European Union Financial Collateral Directive, [309] which mandates member-states to recognise and enforce close-out netting provisions in financial collateral agreements in the event of the commencement or continuation of formal insolvency proceeding.[310]

1.3.2. Loans and financial accommodation contracts

Ipso facto clauses relating to loan transactions and other financial accommodation contracts are enforceable. [311] The Bankruptcy Code expressly excludes transactions of this nature from the anti-ipso

[309] 2002/47 (2002) OJ L168/43.

[310] Enacted in England as the Financial Collateral Arrangements (No.2) Regulations 2003.

[311] The legislative history of s. 365 describes this exception as a "characterisation of contracts to make loan or to extend other debt financing or financial accommodations" and it is "limited to the extension of cash or a line of credit and is not intended to embrace ordinary leases or contracts to provide goods or services with payments to be made overtime." 124 Congress' Record H1108 (daily ed. September 28, 1978); *Government National Mortgage Corp v Adana Mortgage Bankers* 12 B.R. 977, 986 (Bankr. N.D. Ga. 1980); See also *In re Best Products Co* 210 B.R. 714, 716 (Bankr. E.D. Va. 1997). *In re Ernie Haire Ford Inc.* 403 B.R. 750, 755 (M.D. Fla. 2009); *In re Neuhoff Farms Inc*. 258 B.R. 343, 347–348 (Bankr. E.D.N.C. 2000); *Gill v Easebe Inc*. 900 F.2d 1417, 1420 (9th Cir.1990); *Airline Reporting Corp*. *v Charringhton Worldwide* 110 B.R. 973 (M.D.Fla.1990); *Airlines Reporting Corp*. *v Wills Travel Service Inc*. 72 B.R. 380, 383 (Bankr. M.D. Fla. 1987).

facto policy.[312] Hence a trustee cannot assume or assign such contracts and a lender cannot be compelled to make further loans to the debtor, even if there is a subsisting pre-petition agreement to that effect.[313]

This exception protects a creditor who has made an unperformed lending commitment to the debtor from being compelled to continue with the obligation post-petition.[314] This is expressed in the legislative history of s. 365(c)(2) which explains the purpose of the exception as being,

> "To make it clear that a party to a transaction which is based upon the financial strength of a debtor should not be required to extend new credit to the debtor whether in the form of loans, lease financing or the purchase of discount notes."[315]

Significantly, the financial accommodation exception leaves no room for consent by the creditor; hence the creditor cannot waive it.[316] The plain statutory

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[312] s. 365(e)(2)(b) and (c)(2) of he Code; *Mims v Fidelity Funding Inc*. 307 B.R. 849, 858 (N. D. Tex. 2002); *Broyhill v Deluca* 194 B.R. 65, 75 (Bankr. E.D. Va. 1996); *The Huntington National Bank Co. v Alix* 146 B.R. 720, 731 (Bankr. S.D. Ohio 1992); *In re New Town Mall* 17 B.R. 326, 327 (Bankr. D.S.D. 1982); Louis Levit, "Use and Disposition of Property under Chapter 11 of the Bankruptcy Code: Some Practical concerns" (1979) 53 AM Bankr. L.J. 275, 276.

[313] *Continental Experts Enterprises Inc. v Stowers* 26 B.R. 308, 309 Bankr. S.D. Fla. 1982); *Peninsula International Corp. v Citizens & Southern International Bank* 19 B.R. 762, 764 (Bankr. S.D. Fla. 1982).

[314] *In re TS Industries* 117 B.R. 682, 686 (Bankr. D. Utah 1990); *Airline Reporting Corp. v Charringhton Worldwide Enterprises* (n 156) 975; *Whinnery v Bank of Onalaska* 106 B.R. 983, 990 (Bkrtcy.W.D.Wis.1989); *In re Travel Shoppe Inc*. 88 B.R. 466, 470 (Bankr. N.D. Ga. 1988).

[315] Senate Report No. 95-989 at 58-59 (95th Cong. 2d Sess. 1978). Andrea Coles-Bjerre, "Ipso Facto: The Pattern Of Assumable Contracts In Bankruptcy" (fn. 31) 96.

[316] *Government National Mortgage Corp. v Adana Mortgage Bankers* 12 B.R. 977, 986 (Bankr. N.D. Ga. 1980). In *In re Prime Inc*. 15 B.R. 216, 218, 219 (Bankr. W.D. Mo. 1981), the parties had agreed to continue an accounts receivables financing contract after the filing of a bankruptcy petition. The court acknowledged that, literally, s. 365(c)(2) prohibits assumption whether the creditor consents or not. However, the court concluded that Congress had intended for the business of the debtor to proceed in as normal a fashion as possible. Thus concluding that the statutory pattern of the Code permitted the inference in the language of s. 365(c)(2) that a trustee may assume a contract for debt financing if the creditor consents. The Court of Appeals in *In re Sun Runner Marine* 945 F.2d 1089, 1093 (9th Cir. 1991) rejected the decision in *In re Prime Inc*., describing the reasoning as "unconvincing." It insisted that the court's

language of the exception suggests that the consent of the creditor is irrelevant. This can be contrasted with the previous exception under s. 365(e)(2)(A) where a consent proviso is included.

At first blush, the foregoing approach may appear to run counter to the policy objective of the anti-ipso facto rule which is to encourage corporate rehabilitation. In addition, one may venture to wonder why the protection accorded to this category of creditors is not extended to dealers in commodities. No doubt, the financial condition of a debtor is a fundamental consideration in any credit contract and is assessed prior to entering the financing contract. The commencement of a bankruptcy case dramatically alters assumptions under which the contract was arranged[317] – but this is also the case for contracts for the supply of commodities. Hence, if a lender is given the privilege of reassessing the desirability and terms for offering credit to the debtor in the light of the changed circumstances, why should a supplier of commodities be denied the same opportunity?

It is arguable that the strict stance against waivers of financial accommodation contracts is partially due to the fact that the Code has a well-structured post-petition financing provision - s. 364 of

inference should not have overridden the plain language of s. 365(c)(2) which prohibits assumption of such contracts regardless of a creditor's consent.

[317] Raymond Nimmer, "Executory Contracts in Bankruptcy: Protecting the fundamental Terms of the Bargain" (1983) 54 Univ. Colo. L. Rev. 507, 533-534.

the Bankruptcy Code.[318] The post-petition financing provision clearly outlines the procedures for post-petition financing agreements as well as incentives and adequate protection for post-petition lenders and existing creditors. Accordingly, precluding such pre-petition financing arrangements is a way of avoiding any conflicts with this post-petition financing regime.

In addition, the above position is in tandem with the collective nature of corporate insolvency proceedings given that such pre-petition financing arrangement may not necessarily be in the interest of the general body of creditors. Put differently, the prohibition against financial accommodation contracts is not only for the protection of a creditor who is involved in the contract in issue but for the benefit of all creditors.[319]

There is no rule precluding the application of the common law anti-deprivation rule to financing contracts under UK insolvency law. Given that most financing agreements are executory in nature – consisting of unperformed obligations, it is suggested that a termination at insolvency, will not necessarily

[318] Andrea Coles-Bjerre, "Ipso Facto: The Pattern Of Assumable Contracts In Bankruptcy" (fn 31) suggests that the question of assumability of financing contracts with consent or waiver of the creditor is purely academic, considering that court approval would be necessary whether it is conceptualized as a waiver plus assumption under s. 365(a) or as the incurring of unsecured financing outside the ordinary course of business under s. 364(b).

[319] *In re Placid Oil* 72 B.R. 135, 139 (Bankr. N.D. Tex. 1987). In *re TS Industries* 117 B.R. 682, 687 (Bankr. D. Utah 1990) the court upheld a waiver of a financing contract holding that it was a pre-petition workout by the parties in anticipation of insolvency. The court noted that the creditor knew that the financing agreement would be incorporated into the reorganisation and that it would be financing a reorganised debtor-in-possession. With respect, the Court seemed to have ignored the adverse effect that the waiver would have on other creditors in the bankruptcy estate.

breach the anti-deprivation rule based on the earlier analysis.[320] As a matter of general principle in English insolvency law, where a contract provides for the future performance of reciprocal obligations, the performance of each of which is the quid pro quo of the other, a termination-at-insolvency clause is unobjectionable.[321]

Acceleration clauses

Under English commercial law, it is common practice for parties in loan agreements to set out circumstances that constitute *events of default*. One of these events is usually the borrower's insolvency. At the occurrence of any of the events, the facility agreement empowers the lender to declare the loan and accrued interest immediately due and payable, thereby accelerating the loan.[322] Accordingly, English courts will often give effect to these arrangements and acceleration clauses.

It is suggested that an acceleration as described above upon the debtor's insolvency will not be in breach of the anti-deprivation rule. Loan contracts with acceleration clauses are *contingent* or *conditioned* on the non-occurrence of the contractually specified events of default. Accordingly,

[320] *BNY Corporate Trustee Services v Belmont Investment Pty Ltd* [2011] B.C.C. 734, 780.
[321] ibid. at 780.
[322] Note that an acceleration provision that purports to recover future interest that would have been payable over the remainder of the term of the facility agreement may constitute a penalty and be unenforceable. *Oresundsvarvet AB v Lemos* [1988] 1 Lloyd's Rep. 122, 125.

a default (including insolvency) effectively brings such a contract to an end. Again, this accords with the touchstone for the determination of deprivations – given that the courts will have to refer to the contractual terms of the parties in the loan agreement to ascertain their contractual rights and obligations.

As previously noted, the Bankruptcy Code's anti-ipso facto rules will not apply to financial accommodation contracts. Moreover, where a lender has partially or wholly performed his obligations, the contract cannot be rightly described as executory. It is therefore settled that acceleration clauses in loan facilities will not engage the Code's ipso facto rules. In the recent case of *EETC v AMR Corp*.,[323] where the lender had made an advance, the court ruled that anti-ipso facto policy was not applicable because the agreement was an executed contract, as opposed to being executory.

Similarly, in *In re General Growth Property Inc*.[324] the debtor had argued that the failure by the lenders to accelerate the defaulted loan obligations pre-petition rendered the automatic acceleration clause contained in the credit agreement ineffective upon the debtor's bankruptcy. In rejecting this argument, Gropper J. held that the anti-ipso facto rule was not applicable given that the credit agreement was an executed contract – hence the loan was

[323] 2013 WL 4840574 (2d Cir. Sept. 12, 2013).
[324] 409 B.R. 43 (Bankr. S.D.N.Y. 2011).

accelerated automatically on date of the filing of the bankruptcy.[325]

1.3.3. Complex market and financial contracts

The Bankruptcy Code exempts certain market and financial contracts from the ambit of the anti-ipso facto rules. In contracts that are protected by these safe harbours, the solvent counterparties retain their right to terminate, liquidate or accelerate the contracts at the insolvency of a party.[326] Section 555 of the Code precludes the application of the anti-ipso facto rules to the right of a solvent party in a securities contract to liquidate, terminate or accelerate the contract on the insolvency of a counterparty. Section 556 permits commodity brokers, forward contracts merchants and other financial participants in commodities contracts or forward contracts to close out such contracts in the event of the insolvency of a counterparty.[327]

Section 560 exempts contracts for the liquidation, termination and acceleration of swap agreements from the anti-ipso facto rules. Accordingly, participants in swap arrangements are

[325] ibid. at 330.
[326] Case No. 08-13555 (JMP) (Bankr. SDNY 15 Sept 2009)
[327] s. 761(4) of the Code contains a list of ten different kinds of contracts that can constitute commodities contract. *In the Matter of Cordora Int'l* 77 B.R. 441, 448 (Bankr D.N.J. 1987).

free to offset or net-out any termination values or payment amounts arising in relation to the termination, acceleration or liquidation of such transactions regardless of the commencement of insolvency proceedings by or against a counterparty.

Section 559 of the Code exempts the liquidation, termination or acceleration of repurchase agreements from the ambit of s. 365(e)(1). Participants can exercise this contractual right notwithstanding the commencement of a party's insolvency proceedings. Finally, s. 561 of the Code precludes the application of the anti-ipso facto rules to contractual clauses that seek to terminate, liquidate, or accelerate diverse types of contracts under a master netting agreement and across contracts.[328]

These safe harbours are justifiable as being in recognition of the sensitive and sophisticated nature of these contracts. Financial market contracts are fluid and the insolvency of a party may have catastrophic effects on other participants, related transactions and the market if solvent participants are unable to promptly closeout the transaction.[329] With these safe harbours, immediate steps can easily be taken to limit exposure caused by the insolvency of a participant. Furthermore, the potential systemic risk in the market

[328] The contracts are securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements or master netting agreements.
[329] *In the Matter of Cordova Int'l* (fn 327); Franklin Feldman, Judah Sommer, "The Special Commodity Provisions of the New Bankruptcy Code" (1981-1982) 37 Bus Law 1487.

due to the domino effect of the insolvency is effectively curbed.

A point worth noting is that the protection by the Code's safe harbours is not foolproof. For an ipso facto clause to be protected by the safe harbours, it must specifically be for the liquidation, termination or acceleration of the contract. Accordingly, in *Lehman Brothers Financing Inc. v BNY Corporate Trustee Services Ltd,*[330] the non-defaulting party was unable to rely on s. 2(a)(iii) of the ISDA Master Agreement to suspend payments to the insolvent party as the safe harbour provisions of s. 560 and s. 561 that protect a non-defaulting party's contractual rights were limited to the *liquidation*, *termination* or *acceleration* of the swap agreement and netting termination values. The court held that the safe harbour did not provide a basis to withhold performance under a swap if it was not terminated.[331]

There are no similar statutory safe harbours for financial market contracts in English insolvency law. Financial market arrangements may therefore be subjected to the general anti-deprivation rule, with each contract decided on its merit. An illustration of this can be seen in the recent decisions in *Belmont Investment Park Co. v BNY Corporate Trustee Service,*[332] *Lomas and ors v JFB Firth Rixson Inc.*[333] and *Lehman Brothers Special Financing Inc. v*

[330] 422 B.R. 407 (Bankr. S.D.N.Y. 2011).
[331] ibid. at 421.
[332] [2011] B.C.C. 734.
[333] [2012] 1 C.L.C. 713.

Carlton Communications Ltd,[334] which all involved complex financial market transactions.

The effect of the anti-deprivation rule in relation to s. 2(a)(iii) of the 1992 form of ISDA Master Agreement was in issue in the last two cases.[335] The relevant provision made the payment obligations of four corporate counterparties under the ISDA Master Agreement to be subject to a condition precedent that there was no continuing event of default or potential default on the part of Lehman Brothers International Europe. Hence the payment obligations of the non-insolvent parties were to be suspended if there was an event of default, one of which was insolvency.

In holding that the provision did not offend the anti-deprivation rule, the Court of Appeal held that s. 2(a)(iii) of the Master Agreement was commercially justifiable and there was no intention to evade the insolvency law.[336] The provision suspended the non-defaulting party's obligations with the aim of protecting it from the credit risk of performing its own obligations to a party that may be unable to reciprocate.

In reaching this conclusion, the court relied heavily on the decision in *Belmont case* where the Supreme Court regarded the "commercial sense" of

[334] ibid.
[335] Which is substantially similar to the current 2002 form of ISDA Master Agreement.
[336] [2012] 1 C.L.C. 713, 746 (87).

the contract and absence of intention to evade insolvency laws as highly relevant factors.[337] Longmore L.J. copiously cited and relied on Lord Collin's ruling that the modern tendency was for commercially justifiable contractual stipulations to be upheld even if they contravene the anti-deprivation rule.

His Lordship noted that this approach will prevent the application of the rule 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."[338] Based on this touchstone, the court of appeal concluded that 2(a)(iii) of the Master Agreement did not offend the anti-deprivation principle.[339]

As has been previously explained, giving effect to the good faith of parties or the commercial sense of a transaction in applying the rules will result to an evisceration of the rules. It would seem that in the instant cases, their Lordships were well aware of the adverse and unsettling effect that an invalidation of the ISDA provision would have had on the industry and other similar existing transactions. Hence in their rulings, there was emphasis on the need for courts to

[337] ibid. at 744-746. Cf. [2011] B.C.C. 734, 760-761.
[338] [2012] 1 C.L.C. 713, 744-746.
[339] ibid. at 748.

endeavour as much as possible to give effect to the terms of such complex transactions.[340]

The foregoing can be contrasted with the US case of *Lehman Brothers Special Financing Inc. v Metavante Corp.*,[341] where the court reached a contrary conclusion as regards the effect of the anti-ipso facto rule on s. 2(a)(iii) of the 1992 form of ISDA Master Agreement. Peck J. ruled that s. 365(e) prohibited a non-insolvent party from relying on such a condition precedent in order to withhold payments indefinitely.

1.4. Exceptions to the anti-deprivation rule

1.4.1. Limited and determinable interests

The anti-deprivation rule will not be engaged where the debtor is divested of an interest in a property and such interest was not absolute but limited and determinable by insolvency.[342] English insolvency law draws a distinction between the grant of an interest which is limited to a specified period of time and which is effective on its own terms (*a*

[340] *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* (fn. 332) 760: "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; *Lomas & Ors v JFB Firth Rixson Inc. & Ors* (fn. 333) 745 "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 Longmore L.J.

[341] No. 08-13555 (JMP) (Bankr. SDNY Sept. 15 2009).

[342] Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet and Maxwell 2011) 220-221.

determinable interest) and the grant of an absolute interest (or limited interest not expressed to be so determinable) with a proviso for forfeiture on alienation at insolvency (*a defeasible interest*).[343] While a determinable interest is valid and enforceable at insolvency, a defeasible interest is unenforceable.[344]

A determinable interest does not offend the anti-deprivation rule because the interest granted to the insolvent company is limited and automatically terminates at insolvency. Given that the quantum of the debtor's interest in the property or his period of entitlement is delineated by the event of insolvency, such determinable interest ceases to be an asset of the debtor upon insolvency and there is no deprivation as such.[345]

In the case of a defeasible interest, there is an absolute transfer of an asset to the debtor, who becomes owner of the asset until insolvency. It thus involves an absolute transfer with a condition-subsequent for a re-transfer at insolvency. The consequence of a forfeiture or retransfer at insolvency is that the asset that would otherwise be available to the debtor's general body of creditors will be withdrawn from the insolvent estate. This breaches the anti-deprivation rule.

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[343] *Belmont Park Investments Pty Ltd and ors v BNY Corporate Trustee Services Ltd* [2011] 3 W.L.R. 521, 547-548 (87); *In re Scientific Investment Pension Plan Trust* [1999] Ch. 53, 59; *Brandon v Robinson* (1811) 18 Ves. 429, 433-434; Roy Goode, "Perpetual Trustee and the Flip Clauses in Swap transactions" (fn. 57) 3.
[344] *Belmont Park Investments Pty Ltd* (fn. 343) 547, 555.
[345] *In re Scientific Investment Pension Plan Trust* (n 182) 59; *Re Sharp Settlement Trusts* [1973] Ch. 331, 340.

The distinction between a determinable interest and a defeasible interest generally tends to be more formalistic than realistic, as it places emphasis on form over substance. It is arguable that treating a transfer of asset as determinable or defeasible, to a large extent, is dependent on the manner which the contract is drafted. It is thus argued that, with skilful drafting, the defeasible interest trap can be gotten around while still achieving the same desired result.[346]

Against this background, Calnan has described it as a distinction without difference as it amounts to simply playing with words.[347] Porter M.R. in *King's Trust*[348] had described it as being "a little short of disgraceful to English jurisprudence when applied to a rule professedly founded on considerations of public policy."[349] The above notwithstanding, the distinction has recently been endorsed by the Supreme Court in the *Belmont case,* where Lord Collins described it as being "too well established to be dislodged otherwise than by legislation."[350]

Notwithstanding the criticisms regarding the emphasis on form over substance, it would seem that in appropriate cases, English courts may discountenance the wording used in contracts and

[346] Richard Calnan, *Proprietary rights and insolvency* (OUP, Oxford 2010) 8.
[347] ibid. at 8.
[348] (1892) 29 L.R. 401.
[349] ibid. at 410. This assertion was endorsed by Pennycuick V-C. in *Re Sharp's Settlement Trusts* [1973] Ch. 331, 340G.
[350] [2011] B.C.C. 734, 757.

give effect to the substance of agreements. In *Belmont*, Lord Mance observed that,

> "There is some scope for looking at the substance, rather than the form when an agreement confers limited or determinable interest or amounts to a condition subsequent depriving the bankrupt of property on bankruptcy."

Accordingly, in *Mayhew v King*[351] where T agreed by a settlement agreement to indemnify M against their liability to a third party (constituting an effective acceptance of a pre-existing exposure to M in negligence), a clause limiting or terminating that agreement upon M's bankruptcy was held to be in breach of the anti-deprivation rule. The forfeiture clause was viewed as having no commercial or other object, except to prevent M from continuing to have the benefit of the indemnity in the event of the commencement of a formal insolvency proceeding.

In contrast, the Bankruptcy Code does not recognise any distinction between a determinable and forfeitable interests. Any interest in an asset, granted with a proviso for its forfeiture at insolvency will offend the anti-ipso facto provisions. Consequently such clauses will be unenforceable at insolvency irrespective of how they are couched.

This position eliminates the confusion that shrouds the distinction under the English insolvency law regime.[352] It is suggested that this approach is also

[351] [2010] EWHC 1121. *Folgate London Market Ltd v Chaucer Insurance Plc* [2011] EWCA Civ 328, [2011] B.C.C. 675.
[352] Roy Goode, *Principles of Corporate Insolvency Law* (fn. 342) 222. Professor Goode describes the Bankruptcy Code's approach as "a sound rule and one which English law could sensibly follow."

in tandem with the general policy objective of the anti-ipso facto regime, which curbs attempts to withdraw existing and contingent assets from the insolvent estate. Perhaps it is incumbent on a creditor who intends to retain an interest in an asset to take a form of recognised security under Article 9 of the Uniform Commercial Code (UCC).

a. Lease of land and licences

In English insolvency law, it is trite that provisos for termination of leases on land and licences at insolvency will not contravene the anti-deprivation rule.[353] This position is underpinned by the distinction between determinable and defeasible interests explained above. Accordingly, in *Whitmore v Mason*,[354] the court noted that the underlying principle can be expressed in the maxim "*cujus est dare ejus est disponere"* meaning "he who gives anything can also direct how the gift is to be used." [355]

In the case of *Butters and ors v BBC Worldwide Ltd*[356] Lord Neuberger explained the present exception to the anti-deprivation rule thus,

> "The fundamental reason why the clause does not infringe the rule is that its invocation does not involve what has been the property of the insolvent party becoming vested in a third party. It merely involves a limited interest being brought to an end, in accordance

[353] s. 146(9) Law of Property Act; *Butters and Ors v BBC Worldwide Ltd* (fn. 236) 114 (81); *MMI Stockbrokers Ltd v LSE Ltd* [2001] 1 W.L.R. 1150, 1164, 1174; *Whitmore v Mason* (fn. 33) 212-213; Adrian Walters, "Lehman Brothers and The British Eagle Principle" (2010) Company Lawyer 65.
[354] (1861) 2 J & H 204.
[355] Ibid. at 212-213.
[356] [2010] 3 W.L.R. 87, 114 (81).

> with its terms by the third party who had granted it to the party who has become insolvent."[357]

Hence the lessor or licensor retains a reversionary interest in the lease or licence and there is no absolute transfer of interest to the lessee or licensee.[358] The interest of the lessee and licensee is limited to the period stated in the contracts i.e. upon insolvency. Insolvency automatically terminates the limited or determinable interest of the lessee or licensor. The debtor has no interest in the lease or licence and thus there can be no deprivation.[359] This distinction has legislative backing under s. 146 (9) of the Law of Property Act.

As previously noted, the Bankruptcy Code's anti-ipso facto regime does not recognise the distinction between determinable and defeasible which underpins the treatment of determinable land leases. Indeed s. 365(e)(1) and s. 541(c)(1) expressly invalidates contractual provisions for the termination or modification of unexpired leases invalid and unenforceable. An exception to this rule will be cases where the applicable non-insolvency law excuses the lessor from rendering or accepting performance at insolvency.[360]

[357] ibid 114 (81), 115 (83), 132 (143).
[358] *Belmont Park Investments Pty Ltd v BNY Corporate Trustees* (fn 343) 547.
[359] [2010] 3 W.L.R. 87, 132 (143).
[360] s. 365(e)(2)(A) and (c)(1) of the Code.

b. Chattel Lease agreements (Operating and Finance leases)

An operating lease is an agreement of hire of a machinery or plant, where the lessee rents the equipment for a time period that is less than the equipment's useful life, and makes payments the total of which is less than the purchase price of the equipment. The lessee has only possession and use of the chattel and property in the chattel remains in the lessor.

In contrast, finance leases are lease agreements where the period of rentals are designed to enable the lessor to recover the cost of purchasing the equipment as well as other financing costs, while also earning returns on the investment in the lease. The period of the lease is usually the equivalent of the estimated useful life of the equipment. Substantially all financial risks and rewards associated with ownership are transferred to the lessee, although property remains in the lessor.

Given that property in the chattel remains in the lessor in both operating and finance leases as described above,[361] insolvency-termination clauses in these transactions will be valid and enforceable. The

[361] Interestingly, in *Bristol Airport Plc*. v. *Powdrill* [1990] Ch. 744, the Court of Appeal held that for the purposes of s. 11(3)(c) of the Insolvency Act 1986, the interest of a lessee under an operating lease was "property" within the definition in s. 436 of the Act. Sir Nicolas Browne-Wilkinson V-C said, "although a chattel lease is a contract, it does not follow that no proprietary interest is created *in* the chattel. The basic equitable principle is that if, under a contract, A has certain rights *over* property as against the legal owner, which rights are specifically enforceable in equity, A has an equitable interest *in* such property."

underpinning principle is the same as that discussed under hire-purchase agreements. At insolvency, the insolvent estate cannot be deemed to have been deprived of any asset which ought to have fallen into it, given that the seller retained proprietary interest in the asset. This position is also hinged on the distinction between a limited or determinable interest and an absolute forfeitable interest. The general rule being that the former does not amount to a withdrawal of asset from the lessee/debtor but a delineation of the lessee's interest in the lease. Hence, given that the fact of insolvency qualifies the debtor's interest in an asset, what is available for distribution is not the asset free of the qualification, but the asset so qualified.[362]

The above position may be harsh to a buyer in a finance lease considering some of the distinctive features of finance leases. First, in a finance lease, the lessee will amortise the full value of the chattel over the term of the lease by the rental payments. Secondly, the lessee bears the risks and enjoys the rewards associated with ownership. Thirdly, the lease is expected to run throughout the life period of the chattel. In consequence, at the time the agreement is entered into, there is a reasonable expectation by the lessee and lessor that the chattel will not be returned to the lessor. To mitigate the harshness of termination at insolvency, a lessee may seek equitable relief from forfeiture. This is evaluated below.

[362] Fidelis Oditah, "Assets and the treatment of claims in insolvency" (1992) 108 L.Q.R. 459, 473.

c. Equitable relief

The general rule is that jurisdiction exists only where the contract involves the transfer of a proprietary or possessory right.[363] Generally, lessees in chattel leases have possessory rights. By virtue of the decision in *On Demand Information Plc. v Michael Gerson Plc*.[364] it is now settled that courts have jurisdiction to grant equitable relief against forfeitures of finance leases.[365] On the other hand, notwithstanding the possessory rights of lessees in operating leases,[366] *Celestial Aviation Trading 71 Ltd v Paramount Airways Pte Ltd*[367] tends to suggest that courts may not necessarily have jurisdiction to grant equitable relief against forfeitures.

In the *Celestial Aviation Trading case*, equitable relief was sought against the forfeiture of three aircraft (with an economic life of at least 20 years each) in an eight-year specific operating lease agreement. Hamblen J. ruled that equitable relief was only available where possessory rights were *indefinite*, noting that,

"For the relief jurisdiction to apply to contracts

[363] *Celestial Aviation Trading 71 Ltd v Paramount Airways Pte Ltd* [2010] 1 C.L.C. 165, 179; *On Demand Information plc v Michael Gerson (Finance) plc* [2003] 1 A.C. 368*; Transag Haulage Ltd v Leyland DAF Finance plc* [1994] 2 B.C.L.C. 88*; Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana* [1983] 2 A.C. 694, 702C where the House of Lords confirmed that jurisdiction did not arise in a contract of services such as a time charter.
[364] [2003] 1 A.C. 368.
[365] ibid. at 379 (29).
[366] *On Demand Information Plc v Michael Gerson (Finance) Plc*. (fn. 364) 379 (per Lord Millett); *Shiloh Spinners Ltd v Harding* [1973] A.C. 691.
[367] [2010] 1 C.L.C. 165.

> transferring a bare possessory right for only a proportion of the economic life of the chattel would represent a major extension of existing authority."[368]

An analogy can be drawn between Hamblen J.'s reasoning and the facts in *On Demand v Michael Gerson*[369] that also involved an indefinite possession of chattels. The rent was payable for a primary period of 36 months at a rate that was designed to recoup the cost of the chattels for the lessor by the end of the primary period alongside other costs and profit. The lessee was thereafter entitled to indefinite possession for a nominal annual rent. The consequence of this arrangement was that the lessor's continuing interest in the chattel was in substance an economic one -- its interest was in payment of the rent rather than the return of the chattel.

In contrast, under the leases in *Celestial Aviation Trading*, the lessor retained real interest in the aircraft and most of the risks and rewards, including their maintenance, the extent of their use, their condition, and their rental and resale value. In addition, possession of the aircraft was to revert to the lessor at a time when the bulk of their economic life was still to run, and there were detailed terms addressing the return of the aircraft and their required redelivery condition.

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[368] ibid. at 181-182. The appeal was disallowed in *Celestial Aviation Trading 71 Ltd v Paramount Airways (Private) Ltd* [2010] EWCA Civ. 340 but not on the merits of the case.
[369] [2003] 1 A.C. 368.

1.4.2. Compensation with fair value/fair terms

Where there has been either a replacement of assets withdrawn from the debtor or any other form of adequate compensation, the anti-divestiture rules ought not to be engaged.[370] It is suggested that the asset that is used as a replacement or the monetary compensation must constitute a fair value in relation to the divested asset. This will ensure that the insolvent estate does not lose any value. In this case, there will arguably be no divestiture as any previous deprivation is matched with a subsequent compensation or asset replacement. Accordingly there will be no reduction in the balance sheet of the insolvent company.

The case of *Borland Trustees v Steel Brothers Company*[371] illustrates the forgoing points. In that case Farwell J. upheld the enforceability of a provision in a company's articles of association which stipulated for the sale of the shares of a bankrupt member on the ground that such a party was fairly compensated. His Lordship noted that there was no attempt to defraud the bankruptcy law considering that the price at which the shares were to be sold was fixed for all members and was not shown to be less than the fair price.[372]

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[370] *Butters and ors v BBC Worldwide Ltd and ors* (fn. 236) (83).
[371] [1901] 1 Ch. 279.
[372] ibid. at 291. Note also the comments of Farewell J at p.292 where he distinguished the case before him with that of *Whitmore v Mason* (fn. 33) 216 where an article in a deed provided for the forfeiture of an entire lease by an insolvent counterpart without any compensation.

Accordingly, what constitutes fair value is a question of facts to be determined on a case-by-case basis.[373] In ascertaining whether the compensation is the fair value, courts will take into consideration factors that are peculiar (internal) to the contract and other external factors. The former will include factors such as the terms of the contract and the manner in which other parties in similar circumstance were treated or would be treated.

In *Borland Trustees case*[374] it was impossible to determine the market value of the shares in issue due to the restriction clauses in the articles of association.[375] The fairness of the price was therefore determined on factors that were internal to the company. The court considered that the price of the company's shares under its Articles was fixed for both bankrupt and non-bankrupt shareholders, and reasoned that any price differential would have been repugnant to insolvency law policy.[376] The court also took into account the fact that two other bankrupt shareholders had earlier been compelled to sell their shares on the same terms without any objection.[377] The insolvent party did not therefore receive less than what he would otherwise receive in any other circumstance. Hence there was no deprivation.

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[373] *MMI Stockbrokers Ltd v LSE Ltd* [2002] 1 W.L.R. 1150, 1183 (119).
[374] [1901] 1 Ch. 279.
[375] With respect, the dicta of Neuberger J. in *Butters and Ors v BBC Worldwide Ltd* (fn. 236) 115 (83) to the effect that the sale in *Borland Trustees* was at "market value" is incorrect as the market value of the shares in that case was incapable of being determined due to the restrictive clause as noted by Farewell J. in p.291.
[376] ibid. at 191.
[377] ibid. at 291-292.

The present exception does not run counter to the anti-ipso facto rule regime's objectives of corporate rehabilitation and maximization of realisations. However, it will not be upheld under the regime due to the nature of the rules. The ipso facto rules are codified and admit of only two exceptions that are equally codified. In addition, the rules are automatically triggered off once there is a divestment which is conditioned on insolvency. In consequence, there is no room for judicial discretion. Accordingly, what happens subsequently by way of compensation or restitution from the creditor to the debtor is inconsequential.

1.4.3. Valueless assets and pre-emption rights

In the case of *Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd*[378] Neuberger J. described "valueless assets" as being,

> "Those where the right or property subject to the deprivation provision has no value, or (in many cases) if it is incapable of assignment, or depends on the character or status of the owner."[379]

According to his lordship, an asset is valueless if its withdrawal from the debtor will not be detrimental to the debtor's creditors or the insolvent estate.[380] An example of this is the withdrawal of rights attached to

[378] [2002] 1 W.L.R. 1150; *Belmont Park Investments v BNY Corporate Trustee Services Ltd* (fn. 344) 547, 555.
[379] *Money Markets Int'l Stockbrokers Ltd v LSE Ltd* [2002] 1 W.L.R. 1150, 1180.
[380] ibid.

a membership of an association, if such rights are incapable of uncontrolled transfer.

This was indeed the issue in *MMI v LSE*.[381] Under LSE's articles of association, only members could hold category B shares. Members were bound to transfer their shares to LSE on their cessation of membership of the Exchange for no consideration. MMI ceased to be a member of the Exchange due to its failure to honour its obligations and was put into voluntary liquidation in March 1999.

MMI's shares in the exchange were rescinded by LSE in February 2000. MMI sued LSE seeking reinstatement as a member or compensation for the loss of B share on the ground of the deprivation provision. Neuberger J. ruled that since the share in LSE was incapable of uncontrolled transfer given that it was contingent on one's membership of the Exchange (which had been validly terminated), there was no deprivation. [382]

An important point that is worth noting is that on February 14 when MMI's B share was rescinded, the share carried only voting rights and no monetary value. The LSE demutualised on March 15, with each B share valued at £2.8m. This was indeed taken into consideration by the court.[383] Hence, besides the fact that the share of LSE was ancillary to being a member

[381] [2002] 1 W.L.R. 1150; *Belmont Park Investments v BNY Corporate Trustee Services Ltd* (fn. 344) 547, 555.
[382] *MMI Stockbrokers Ltd v LSE Ltd* (fn. 381) 1183-1184.
[383] ibid.

of the Exchange, the share had no monetary value as at the time MMI filed for voluntary liquidation and at the time it was rescinded by LSE.

It is suggested that if the forfeiture had been effected after March 15, it would have been difficult to justify the rescission as not constituting a withdrawal of a valuable asset from the insolvent estate – in the absence of adequate compensation with fair value. This is regardless of the fact that the share was incapable of being transferred without the consent of the directors.

Hence in *Borland Trustees v Steel Brothers Company,*[384] the decision of Farwell J. to uphold the enforceability of a provision in a company's articles of association which stipulated for the sale of the shares of a bankrupt member was premised on the ground that the party was fairly compensated. His Lordship noted that there was no attempt to defraud the bankruptcy law considering that the price at which the shares were to be sold was fixed for all members and was not shown to be less than the fair price.[385]

The US Bankruptcy Code's anti-ipso facto rules will be engaged once there is a modification or termination of executory contracts or contractual rights, subject to the two exceptions previously

[384] [1901] 1 Ch. 279.
[385] ibid. at 291. Note also the comments of Farewell J at p. 292 where he distinguished the case before him with that of *Whitmore v Mason* (at p. 216) where an article in a deed provided for the forfeiture of an entire lease by an insolvent counterpart without any compensation.

evaluated. Accordingly, any divestiture will be invalidated irrespective of whether the assets are valueless. It is however doubtful how useful the invalidation of ipso facto clauses in such valueless assets will be towards promoting the objective of maximisation of realisations and rehabilitation. It may well be that the officeholder will have no choice but to *reject* them in the course of the insolvency procedure.

1.4.4. Close-out netting in Financial Collateral agreements

The EU Financial Collateral directive [386] mandates European Union member-states to recognise and enforce close-out netting provisions in financial collateral agreements in the event of the commencement or continuation of a formal insolvency proceeding.[387] Accordingly, the provisions of the directive have been enacted in England and Wales.[388] Under this statutory instrument, financial collateral arrangements are exempted from the orbit of the anti-deprivation rule.[389] Consequently, subject to exceptions relating to good faith,[390] a financial collateral arrangement and its close-out netting provision will be capable of enforcement in accordance with their terms, notwithstanding the commencement of insolvency.

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[386] Article 7, 2002/47 (2002)
[387] Financial Collateral Directive (2002) OJ L168/43
[388] Financial Collateral Arrangements (No.2) Regulations 2003.
[389] ibid rules 12 and 13.
[390] i.e. knowledge of the insolvency proceedings.

The rationale for the EU directive is to remove obstacles that may impair the use of collateral in cross-border transactions. In effect, a simple, clear and effective cross-border financial collateral contracts regime within the EU is set up, propped up by legal certainty. The exemption from the anti-deprivation rule averts the negative domino effect that the unwinding of such multilateral netting arrangements would have on other participants and the financial system generally. This exemption applies only to financial collateral arrangements and will not apply to ordinary multi-party netting agreements like that in the *British Eagle* case.

1.4.5. Unpaid seller's real remedies

The Sale of Goods Act grants an unpaid seller a number of security and property rights, notwithstanding that property in the goods has passed to a buyer.[391] A significant feature of the rights that is relevant to this discourse is that they are made to override the effects of insolvency, hence insulating the seller from the buyer's insolvency. This section will examine two of these real remedies namely the unpaid seller's lien and the right of stoppage of goods in transit, in relation to the anti-deprivation rule in the event of buyer's insolvency.

[391] s. 39 Sale of Goods Act 1979.

a. Unpaid seller's lien

The unpaid seller has a lien on the goods or a right to retain the goods for the price while he is in possession of the goods.[392] This right is conferred on the seller notwithstanding that property in the goods has passed to the buyer. For the exercise of this right to be possible, a seller must be in possession of the goods.[393] In addition, a seller who is in possession as agent, a bailee or a custodian for the buyer can also exercise the lien.[394] Significantly, the unpaid seller's lien is not affected by the insolvency of the buyer – the consequence, being that his claim cannot be reduced to mere dividends in the insolvency proceedings.

b. Unpaid seller's right of stoppage in transit

The unpaid seller is also granted the right prevent delivery of goods to the buyer and resume possession. The seller can stop goods in transit[395] after he has parted with possession of the goods notwithstanding that property in the goods has passed to the buyer.[396] Significantly, the right of stoppage in

[392] s. 39(1)(a) SGA.
[393] By virtue of s. 43(1) SGA the unpaid seller can lose his lien in three ways, namely, when he delivers the goods to a carrier or other bailee or custodier for the purpose of transmission to the buyer without reserving the right of disposal of the goods, when the buyer or his agent lawfully obtains possession of the goods and by waiver of the lien or right of retention.
[394] s. 41(2) SGA.
[395] s. 45(1) SGA provides that goods are deemed to be in course of transit from the time when they are delivered to a carrier or other bailee or custodier for the purpose of transmission to the buyer, until the buyer or his agent in that behalf takes delivery of them from the carrier or other bailee or custodier.
[396] s. 39(1)(b) SGA; s. 44 SGA.

transit can only be exercised where the buyer is insolvent.[397] The unpaid seller's right of stoppage exists only when the goods are in the possession of a third party or the carrier. The right will cease to exist once the buyer has possession of the goods.[398]

c. The unpaid seller's real remedies in insolvency proceedings

A significant feature of the unpaid seller's real remedies is that they only apply where the property in the goods has passed to the buyer. This approach may be premised on the ground that if property has not passed, it would be more convenient for an unpaid seller to rely on his proprietary rights (i.e. ownership of the goods) on the buyer's failure to pay on insolvency.[399] The conferment of the rights on unpaid sellers has a number of implications.

First, the unpaid seller is effectively conferred with the status of a secured creditor in the event of insolvency. This blurs the distinction between personal and proprietary interests, which is paramount in English insolvency law. Accordingly, considering that the sellers have proprietary interest in the goods, repossessing such goods upon the insolvency of the buyers will not constitute a clawing back of assets

[397] ibid.
[398] This can give rise to certain legal issues where the carrier is an agent of either the debtor or the creditor. For instance by virtue of s. 45(2), if the buyer or his agent in that behalf obtains delivery of the goods before their arrival at the appointed destination, the transit is at an end. However s. 45(5) stipulates that in cases where goods are delivered to a ship chartered by the buyer it is a question depending on the circumstances of the particular case whether they are in the possession of the ship-owner as a carrier or as agent to the buyer.
[399] *Bolton v Lancashire and Yorkshire Railway Co*. (1866) L.R. 1 C.P. 431.

from the insolvent estate. They will merely take back what has remained their property by operation of law.

The real remedies of the unpaid seller represent a significant incursion into the realm of insolvency law by a non-insolvency law. What should make this incursion even more worrisome to the insolvent estate is the fact that in *Bethell v Clark*,[400] Esher M.R. emphasised that these rights are always construed favourably to unpaid sellers. A number of arguments have been put forward as justifications for giving an unpaid seller a security in cases of stoppage of goods in transit. In *Bohtlingk v Inglis*[401] and *Berntson v Strang*,[402] the rule was explained as being for the benefit of trade. In practical terms, this means that sellers are encouraged to surrender goods to the carrier when they know that the goods can be stopped on the buyer's insolvency.

In *Bloxam v Sanders*[403] the policy objective for the stoppage rule was given as being that the buyer's right to possession of goods, the property in which has passed to him is defeasible on his insolvency. This reason is to a large extent unconvincing to the extent that no explanation was given as to why the buyer's property and possession is defeasible in transit cases. In *D'Aquila v Lambert*,[404] it was simply stated as being that the seller's goods should not be

[400] (1888) 20 Q.B.D. 615, 617).
[401] (1803) 3 East 381.
[402] (1867) LR 4 Esq 481, 490.
[403] (1825) 4 B&C 941.
[404] (1761) 1 Amb 399. Approved in *Booth Steamship Co Ltd v Cargo Fleet Inn Co Ltd* [1916] 2 K.B. 579, 580.

applied to the payment of the insolvent buyer's debts. This reason seems to be counterintuitive. In view of the fact that since property in the goods has passed to the seller, it is faulty to describe them as the seller's goods.

The necessity of conferring these security interests on a select group of creditors is arguably questionable. It is suggested that the decision as to whether to obtain security for one's transactions should be left to individual creditors and not imposed by law, to the detriment of other prospective creditors. These transactions are consensual hence a seller has the choice of insisting on payment at the time of the transaction, retaining title in the goods or retaining the right of disposal until payment is made and stipulating for payment under a documentary letter of credit. There is also an option of taking security on the goods.

The fact that creditors are perhaps better positioned to protect themselves is illustrated by the seeming lack of continued relevance of the seller's right of stoppage in transit. In international sales, there is now a widespread use of bankers' confirmed commercial credits with reduced prospects of non-payments. Accordingly, sellers are guaranteed continuing property in the goods by reserving the right of disposal after shipment and surrendering this right on documentary exchange only against payments under a banker's credit.

Conclusion

The Insolvency Act's anti-deprivation rule and the Bankruptcy Code's anti-ipso facto rules are aimed at ensuring that assets which are vested in the debtor and which ought to be available to the general body of creditors at insolvency are not withdrawn from the insolvent estate upon the commencement of formal insolvency proceedings. A primary distinction between the anti-deprivation rule and the anti-ipso facto rules is that the former is limited to deprivation of assets and does not extend to the termination of ordinary executory contracts upon insolvency.

The approach in the UK is underpinned by the principle of freedom of contract and autonomy of parties. However, it has been suggested in this chapter that executory contracts can be viewed as *contingent assets* which the debtor can perform or assign to realise the benefits thereof. Against this background, where the insolvent estate is able and willing to perform, permitting the termination of executory contracts simply on the basis of an insolvency filing may be viewed as being unnecessarily harsh to the insolvent estate and general body of creditors. In addition, depriving the estate of the opportunity of performing and realising the benefits of such contracts runs counter to the value-maximisation objective of the anti-deprivation rule.

If the UK is to adopt a regime where ipso facto clauses are unenforceable when the insolvent estate is able and willing to perform its obligations, it would be proper for affected creditors to be adequately protected, as is the case under the Bankruptcy Code. As would be seen later in chapter three, the Code's pre-condition of *adequate protection* for creditors prior to *assumption* of executory contracts ensures that creditors who are prevented from terminating such executory contracts and whose contracts are assumed, receive benefits which they would have been entitled to outside insolvency and in the absence of the debtor's default. This ensures that such creditors are not forced into gratuitous contracts with insolvent entities, which may from the onset have no intention or ability to perform their obligations therein.

The US anti-ipso facto regime has achieved a high level of coherence while the application of the anti-deprivation rule has been plagued with incoherence and lack of a uniformed approach. The coherence in the application of the anti-ipso facto rules is because the standard for judging the validity or otherwise of insolvency-triggered contractual termination clauses is clearly prescribed under s. 365(e) and s. 541(c) of the Bankruptcy Code. Accordingly, reference is made to the provisions, rather than any applicable non-insolvency law or the contractual intentions of the parties, to determine the

validity of divestiture clauses in prepetition contracts. Although this approach entails a some-what arbitrary invalidation of ipso facto clauses and may often result incursion into the security and proprietary rights of parties, it enhances the maximisation of realisations for the insolvent estate.

In contrast, the anti-deprivation rule follows the characterisation of the non-insolvency law in the treatment of interests of creditors as secured, proprietary or personal. In applying the rule, questions regarding what constitutes an asset, ownership of assets and deprivation are addressed with reference to contractual intention of the parties as evidenced in the terms of their pre-petition contracts as well as the applicable non-insolvency law. Given that reference is made to diverse types of pre-petition contracts alongside different applicable rules outside the insolvency forum, it would be virtually impossible to achieve coherence in the application of the rule.

The incoherence notwithstanding, adopting the principled and uniform touchstone highlighted throughout this chapter is capable of ensuring that there is coherence in the application of the rules in similar types of contracts. In contrast to the anti-ipso factor rules, the anti-deprivation rule gives effect to contractual arrangements that confer security or proprietary interests on solvent parties. To a great extent, this approach promotes certainty of contracts given that the anti-deprivation rule is applied with reference to the pre-petition contract terms of parties

as well as the applicable non-insolvency law. Again, this ensures that insolvency law does not engage in the pursuit of redistribution simply for the sake of equality – which could in turn encourage opportunistic behaviours on the part of unsecured creditors.

CHAPTER TWO
AUTOMATIC STAY/MORATORIUM

2.0. Introduction

A significant consequence of the commencement of a formal insolvency proceeding is the automatic activation of a statutory prohibition against enforcement actions and claims against the insolvent company. The *moratorium* in UK insolvency law and *automatic stay* in US bankruptcy law are self-executing and restrain a wide range of claims and actions to enforce contractual remedies during the period of the formal procedures. It is instructive to note from the outset that the statutory moratorium[1] does not extinguish the substantive law rights of creditors. The mechanism is procedural in nature and merely suspends such rights during the duration of the procedure.[2]

As a matter of general principle, creditors with property rights are not subject to insolvency law's mandatory administration or distribution process. This is because assets of third parties neither fall into the insolvent estate nor are they available to the general body of creditors. However, the statutory moratorium strikes at the heart of security and property rights.

[1] The term "statutory moratorium" is used when referring to both the UK moratorium and the US automatic stay throughout the chapter.
[2] Jack William, "Application of the Cash Collateral Paradigm to the Preservation of the Right to set off in Bankruptcy" (1990) 7 Bankr Dev. J. 27, 30.

Accordingly, in addition to the avoidance of antecedent transactions and the treatment of floating charges, the statutory moratorium is one of the rare occasions where security and property rights of creditors are interfered with in the insolvency process.

This chapter comparatively evaluates the impact of the statutory moratorium in the UK and US insolvency regimes on corporate contracts. It analyses the scope and policy objectives of the statutory moratorium in the jurisdictions and evaluates the efficacy of the rules against this background. Given the inevitable clash in the policy expectations of contract law and those of insolvency law in the application of the moratorium, this chapter also evaluates the relief procedure in the two jurisdictions as well as the treatment of property rights.

2.1. Policy objectives of the statutory moratorium

2.1.1. Debtor protection and asset preservation

There are two major policy objectives for the Bankruptcy Code's automatic stay and the Insolvency Act's moratorium. As a primary objective, the statutory moratorium preserves the assets in the insolvent estate from piecemeal dismemberment by creditors who are often understandably anxious to enforce their contractual remedies against the debtor at insolvency. The mechanism therefore preserves the

assets of the debtor and those in its possession from enforcement claims and repossession actions by creditors and their assignees. Hence in the UK case of *AES Barry Ltd v. TXU Europe Energy Trading*[3] Patten J. noted that,

> "The moratorium … is primarily concerned to avoid the assets of the Company from being removed by creditors whilst the administrators continue to attempt to achieve the statutory purposes for which the administration order was made."[4]

Similarly, the accompanying legislative statement of the US Bankruptcy Code describes the automatic stay provision as "one of the fundamental debtor protections provided by the bankruptcy laws."[5] In the US case of *Small Business Admin. v. Rinehart*,[6] Larson J. noted that,

> "A primary purpose of the automatic stay provision is to afford debtors in Chapter 11 reorganizations an opportunity to continue their businesses with their available assets."[7]

The temporary restraint on enforcement and collection activities gives the officeholder a breathing spell to plan and perform his statutory responsibilities without interference from creditors and their assignees.[8] Accordingly, the officeholder is offered ample time and opportunity to utilize the debtor's assets and other assets in its possessions to achieve

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[3] *AES Barry Ltd v TXU Europe Energy Trading* [2005] 2 B.C.L.C. 22, 25.
[4] ibid.
[5] S. Rep. No. 95–989, p. 54 (1978); H.R.Rep. No. 95–595, p. 340 (1977), U.S. Code Cong. & Admin.News 1978, pp. 5787, 5840, 5963, 6296. *In re Soares* 107 F.3d 969, 975-76 (1st Cir. 1997); *Midlantic Nat'l Bank v. New Jersey Dept of Envtl. Protection*, 474 U.S. 494, 503, 106 S.Ct. 755, 760, 88 L.Ed.2d 859 (1986); *In re Smith Corset Shops, Inc.*, 696 F.2d 971, 977 (1st Cir.1982).
[6] 887 F.2d 165 C.A.8 (S.D. 1989).
[7] ibid. at 168.
[8] Ian Fletcher, John Higham, *Corporate Administrations and Rescue Procedures* (2nd edn, Tottel Publishing 2004) 50; Jack William, "Application of the Cash Collateral Paradigm To the Preservation of the Right to set off in Bankruptcy" (fn. 2).

the purpose of the insolvency procedure.[9] The statutory moratorium thus relieves the insolvent estate of the financial pressures which drove the debtor into insolvency in the first place.[10]

2.1.2. Creditor protection and collective procedure

By restraining unilateral and disorderly realisations by some creditors, the statutory moratorium protects other creditors from the adverse effects of such individual enforcement efforts.[11] In consequence, it promotes insolvency law policy's cardinal objective of collectivity among creditors in the administration and distribution of assets.[12] Hence, in addition to the primary objective, the Code's legislative statement asserts that the automatic stay,

> "Provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors..."[13]

Similarly, in the US bankruptcy case of *In re*

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[9] *Small Business Administration v Harold Rinehart* (fn. 6) 167-168; *In re Archer* 34 B.R. 28, 29-30 (Bankr.N.D.Tex.1983).

[10] *In re Stephen Jamo* 283 F.3D 392, 398 (1st Cir. 2002); *Pertuso v Form Motor Credit* 233 F.3d 417, 423 (6th Cir. 2000); *Soares v Brockton Credit Union* (fn 5) 975; *In re Atlantic Business and Community Corp*. 901 F.2d 325, 327 (3rd Cir. 1990); *Olson v McFarland Clinic* 38 B.R. 515, 516 (Bankr. N.D. Iowa 1984); *Avellino & Bienes v Frenville* 744 F.2d 332, 334 (3d Cir. 1984); *Johnson v First National Bank of Montevideo* 719 F.2d 270, 276 (8th Cir.1983); *In re Smith Corset Shops Inc*. 696 F.2d 971, 977 (1st Cir.1982); *In re Related Asbestos Cases* 23 B.R. 523, 527 (D. Ct. ND. Cal. 1982).

[11] *S.E.C. v Environmental Resources* 230 F.3d 65, 70 (2d Cir. 2000); *Civic Centre square Inc. v Ford* 12 F.3d 875, 878 (9th Cir.1993); *Penn Terra Ltd v Dept. of Environmental Resources* 733 F.2d 267, 271 (3d Cir 1984).

[12] *In re BNT Terminals* 125 B.R. 963, 971(Bankr.N.D.Ill.1991); *In re AP Industries Inc*. 117 B.R. 789, 799 (Bankr. S.D.N.Y. 1990); Scott Silverman, "Administrative Freeze and the Automatic Stay: A New Perspective" (1994) 72 Wash. U. L. Q. 441, 443.

[13] S. Rep. No. 95–989, p. 54 (1978); H.R.Rep. No. 95–595, p. 340 (1977), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5840, 5963, 6296; *In re Atlantic Business and Community Corp*. (fn. 10).

Germansen Decorating Inc.[14] Ginsbegr J. noted that,

> "The automatic stay is meant to prevent one creditor from securing an advantage over its peers after a petition is filed by or against a debtor. It makes no difference whether that creditor gets that advantage as a result of a voluntary or involuntary transfer."[15]

The statutory moratorium therefore curbs the race of diligence by creditors. It deters them from jockeying for advantage to the detriment of others.[16] The moratorium safeguards the insolvent estate and general body of creditors from a multiplicity of actions and claims by different creditors in the same or different courts, which is capable of setting in motion a free-for-all and a piecemeal dismemberment of the debtor's assets outside the formal insolvency procedure.[17]

Lastly, the statutory moratorium also assures equality in asset administration and distribution among similarly situated creditors. Here it must be noted that this objective has no bearing on holders of secured claims or proprietary interests, given that such creditors are normally not subject to insolvency law's pari passu distribution scheme. Nevertheless, to unsecured creditors, the moratorium ensures that creditors do not improve their pre-insolvency positions through converting an unsecured pre-petition claim to a secured claim, obtaining actual possession of property in the insolvent estate and

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[14] 149 B.R. 517 (Bankr. N.D. Ill. 1992).
[15] ibid. at 521.
[16] *Mann v Chase Manhattan Mortgage Corp*. 316 F.3d 1, 3 (1st Cir. 2003*); University Medical Centre v Louis Sullivan* 973 F.2d 1065, 1074 (*3d Cir*.1992); *In re Szechuan City Inc*. 55 B.R. 8, 40 (Bankr. D.D.C.1985); *USA v Nicolet Inc*. (n 3) 207; *Grady v A.H. Robins Co*. 839 F.2d 198, 200 (4th Cir. 1988).
[17] *Soares v Brockton Credit Union* (fn 5) 975; *Sunshine Dev. Inc. v FDIC* 33 F.3d 106, 114 (1st Cir.1994).

commencing or continuing legal processes that may effect unequal allocation of the debtor's assets.

2.1.3. Acts in breach of the moratorium

Judicial opinion is divided as to the effect of a violation of the Code's moratorium. While the prevailing view is that actions in violation of the stay are void,[18] some bankruptcy courts have held such acts to be voidable.[19] This semantic distinction has at least two significant practical consequences. First, characterising such acts as void or voidable influences the burden of going forward.[20] If the violation of the moratorium is deemed to be voidable, the burden of proceeding in challenging the action is placed on the debtor. In contrast, if the violation of the moratorium is treated as being void, the burden would be shifted to the offending creditor.

Secondly, the prefatory part of s. 362(d) vests bankruptcy courts with the discretion to inter alia annul the moratorium. "Annulment" presupposes a retroactive relief and entails retrospectively validating

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[18] *In re Ernie Haire Ford Inc*. 403 B.R. 750, 760 (M.D. Fla. 2009); *Bronson v United States* 46 F.3d 1573, 1579 (Fed. Cir. 1995); *In re Sambo's Restaurants Inc*. 754 F.2d 811, 816 (9th Cir.1985); *Borg-Warner Acceptance Corp v Hall* 685 F.2d 1306, 1308 (11th Cir.1982); *In re Advent Corporation* 24 B.R 612, 614 (B.A.P. 1st Cir. 1982); *In re Miller* 10 B.R. 778, 779 (Bankr.Md.1981); *Meyer v Rowen* 181 F.2d 715, 716 (10th Cir. 1950); *Kalb v Feuerstein* 308 US 433, 438 (1940).

[19] *Raymark Industries Inc. v Lai* 973 F.2d 1125, 1132 (3rd Cir. 1992); *In re Schwartz* 954 F.2d 569, 574 (9th Cir. 1991); *In re Calder* 907 F.2d 953, 956 (10th Cir.1990); *In re Sapp* 91 B.R. 520, 522 (Bankr. ED Mo. 1988); *In re 48th Steakhouse Inc*. 835 F.2d 427, 431 (2d Cir. 1987); *Matthews v Rosene* 739 F.2d 249, 251 (7th Cir. 1984); *In re Smith Corset Shop Inc*. (fn. 10) 976; *In re Potts* 142 F.2d 883, 888, 890 (6th Cir.1944).

[20] *Soares v Brockton Credit Union* (fn. 5) 976.

acts of a creditor that constituted a violation of the moratorium prior to the grant of relief.[21] As a matter of general principle, void acts cannot be validated or cured. Hence, if acts that violate the moratorium are void, the power to annul the stay will be extraneous.[22]

In resolving this conflict, it has been held that a retroactive relief under s. 362(d) means that there has been no violation of the moratorium. [23] The implication of this is that it is immaterial to determine whether the effect of the violation is void or voidable in such cases. This approach is a logical one. First, it ensures that the insolvent estate is not burdened with the task of expending the same valuable assets which the moratorium is aimed at preserving in pursuing the judicial invalidation of acts that are in breach of the moratorium. Secondly, it ensures that s. 362(d) which grants courts powers to retroactively grant reliefs from the moratorium is not made otiose.

Under the UK regime, there have been conflicting decisions as regards the retrospective application for relief. Virtually all the decisions have been on the commencement of proceedings or legal processes, hence, it is arguable that these decisions are not relevant to other forms of violation of the moratorium. In *Wilson v Banner Scaffolding Ltd*[24] Milmo J. held that proceedings commenced against a company in compulsory liquidation without prior

[21] *In re Albany Partners* 749 F.2d 670, 675 (11th Cir.1984).
[22] *Easley v Pettibone Michigan Corporation* 990 F.2d 905, 910 (6th Cir. 1993).
[23] *In re Schwartz* 954 F.2d 569, 573 (9th Cir. 1991).
[24] The Times, 22 June 1982.

permission were a nullity and could not be retrospectively validated. Rattee J. echoed this position in *In re National Employers Mutual General Insurance Association Ltd*.[25] where an action was commenced without leave against a company in compulsory liquidation, contrary to s. 130(2) of the Insolvency Act.

The contrary view was reached by Lindsay J. in *In re Saunders*,[26] to the effect that legal proceedings commenced against a bankrupt or a company in compulsory liquidation were not a nullity as the court had jurisdiction to give retrospective permission for their commencement.[27] The *Saunders* case was followed in *Godfrey v Torpy*[28] and *Bank of Scotland Plc. v. Breytenbach*.[29] In *Gaardsoe v. Optimal Wealth Management Ltd*,[30] deputy judge John Martin QC ruled that the moratorium on administration embodied in para. 43(6) did not render void any legal proceedings initiated in breach and such proceedings could be retrospectively validated.

Similarly in *Bank of Ireland and anor v. Colliers International UK plc*.[31] Richards J. ruled that the purpose of the provisions in par. 43(6) of Sch. B1 was not so much the protection of creditors as the

[25] [1995] B.C.C. 774, 777.
[26] [1997] Ch. 60. See also *Bristol & West Building Society v Trustee of Back*. [1997] B.P.I.R. 358; *Re Linkrealm Ltd* [1998] B.C.C. 478.
[27] A contrary position was adopted by Judge Kershaw QC in *In re Taylor (A Bankrupt)* [2007] Ch. 150.
[28] [2007] Bus. L.R. 1203.
[29] [2012] B.P.I.R. 1.
[30] Unreported February 28, 2012.
[31] [2013] 2 W.L.R. 895.

need to ensure that when such an order had been made all proceedings having any bearing upon the administration should remain under the supervision and control of the court which had made the order. Given that purpose, proceedings brought without the permission required under the relevant provision were not a nullity and retrospective permission could be given.[32]

As previously noted from the outset, the foregoing decisions specifically focused on the moratorium provision in respect of commencement of legal proceedings under para. 43(6) of the Act. It is suggested that they do not serve as authority for the consequence of a breach of other provisions of the moratorium relating to repossession of goods, enforcement of security and peaceable re-entry.

Nevertheless, the reasoning of Vinelott J. in *Re AGB Research Plc*[33] (relating to forfeiture of a lease) suggests that a violation of the moratorium is voidable. In that case Vinelott J. ruled that the grant of the new lease was an unequivocal assertion by the lessor of its right to re-enter. Notwithstanding that it was in breach of a moratorium, Vinelott J. held that the lease had been forfeited.[34] By implication, this suggests that the violation of the moratorium was merely voidable. The demerit of this position has been previously noted; it places the burden of setting aside

[32] ibid. at 898.
[33] [1995] B.C.C. 1091.
[34] ibid. at 1094.

such breaches on the insolvent estate. This will require the dissipation of the estate's resources, which is at odds with the asset-preservation policy objective of the moratorium.

2.2. Scope of the moratorium

The Bankruptcy Code's automatic stay suspends post-petition commencement, continuation and enforcement actions relating to pre-petition contractual claims against the debtor.[35] As the name suggests, the stay is automatic in nature and comes into effect immediately an insolvency petition is filed.[36] The debtor does not need to take any steps to effectuate it.[37] The Insolvency Act's moratorium operates in a similar manner to the Code's automatic stay. It temporarily restrains the enforcement of contractual remedies and property rights at the commencement of a formal insolvency proceeding. This restraint preserves the assets of the debtor and gives the officeholder ample opportunity to perform his statutory duties.[38] It is procedural and does not extinguish or modify the substantive property law

[35] House Report No 595, 95th Congress, 1st session 340 (1977); *In re Schwartz* (fn. 19) 571; *Szechuan City Inc. v North American Motor Inns Inc.* 96 B.R. 37, 40 (Bankr.E.D.Pa.1989); *USA v Nicolet Inc.* (fn. 16) 207; *H & H Beverage Distributors v Dept. of Revenue of Commonwealth of Pennsylvania* 850 F.2d 165, 166 (3d Cir. 1988); *Grady v A.H. Robins Co.* (fn. 16) 200.

[36] *In re Weiner Merchant* 958 F.2d 738, 741 (6th Cir. 1992); *In re Stephen Jamo* (fn. 10) 398.

[37] *Eskanos & Adler P.C. v Leetien* 309 F.3d 1210, 1214 (9th Cir. 2002); *Soares v Brockton Credit Union* (fn. 5) 975; *Sunshine Derv Inc. v FDIC* 33 F.3d 106, 133 (1st Cir. 1994); *Rexnord Holdings Inc. v Bidermann* 21 F.3d 522, 527 (2d Cir. 1994); *Shimer v Fugazy* 982 F.2d 769, 776 (2d Cir. 1992).

[38] *Re Atlantic Computer Systems* [1992] 1 All ER 476, 489.

rights of creditors.[39] In contrast to the Code's automatic stay, the Insolvency Act has separate provisions for moratorium in administration on one hand, and a less extensive moratorium in winding up on the other.[40]

Actions that are stayed by the Bankruptcy Code on the filing of a petition are listed under s. 362(a) of the Code. Its scope has been devised to be as broad as possible in order to capture diverse forms of formal and informal actions against the corporate debtor and its estate.[41] Subject to some exceptions, the automatic stay provision does not affect assets which do not belong to the debtor or which have ceased to be its assets before the bankruptcy filing.[42] This position is plausible given that in accordance with its earlier evaluated policy objective, the moratorium in both jurisdictions ought to apply to only the assets of the debtor or assets in the insolvent estate.[43] As a corollary, it is suggested that the automatic stay cannot also be used to revive lost interests in assets. The contrary position, it is argued, will result in the use of the moratorium to expand the contractual right of the debtor.

There are two types of administration

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[39] *Barclays Mercantile Business Finance Ltd v Sibec* [1992] 1 W.L.R. 1253, 1257; Ian Fletcher, John Higham, *Corporate Administrations and Rescue Procedures* (2nd edn, Tottel Publishing 2004) 50.

[40] They are examined in detail in chapter 6 under post-insolvency and post commencement contracts.

[41] James Sack, "Adequate Protection" (1985) 2 Bankr Dev. J. 21, 27.

[42] *In re Mann* 907 F.2d 923, 927 (9th Cir.1990); *In re Gull Air Inc*. 890 F.2d 1255, 1259 (1st Cir. 1989)*; In re Air Illinois* 53 B.R. 1, 2-3 (Bankr.S.D.Ill.1985);

[43] s. 362(a)(3); s 541(a) of the Code; *Erickson v Polk* 921 F.2d 200 (8th Cir. 1990); *In re Cole* 88 B.R. 763, 767 (Bankr. E.D.Va.1988).

moratorium, namely, a moratorium for the period during which the company is in administration[44] and an interim moratorium pending either the disposal of an application for an administration order or the coming into effect of an out-of-court appointment of an administrator.[45] Similar procedural restrictions on the enforcement of rights apply to the two moratoria. The only significant distinction between the two is their duration and the mode for seeking relief. As the name implies, the interim moratorium is imposed prior to the commencement of the administration and the duration is shorter. Relief from the interim moratorium can only be sought from the court as no administrator is usually in office at the relevant time. This chapter will focus on the moratorium during administration.

There is also a moratorium at the commencement of winding up proceedings under UK law. After the making of a winding up order, any disposition of the company's property, transfer of its shares and alteration of the status of its members are void unless validated by the court.[46] This restraint also applies to any attachment, sequestration, distress or execution against the estate or effects of the insolvent company.[47] This provision complements s. 130(2), which restrains the commencement or continuation of

[44] Sch. B1, Paras 42 and 43 of Insolvency Act. These provisions are similar to their corresponding sections under the previous s. 11(3) of the 1986 Insolvency Act; hence the old cases decided under s. 11(3) are still relevant.
[45] Sch. B1, Para 44 of Insolvency Act.
[46] s. 127 Insolvency Act. Ian Fletcher, *Law of Insolvency* (4t edn, Sweet Maxwell 2009) 700.
[47] s. 128(1) Insolvency Act.

any action against the company or its property after a winding up order has been made unless the court permits. The winding-up moratorium is primarily concerned with the protection of the debtor's assets from depletion by the activities of company directors and other insiders, [48] while the administration moratorium focuses on the activities of creditors and outsiders.

In contrast to the administration moratorium, the winding up moratorium does not affect security interests and property rights.[49] Holders of secured claims can proceed to enforce their clams or repossess their goods.[50] Considering that the primary purpose of liquidation is an orderly and equitable distribution of the company's assets to unsecured creditors, it would be unfair to utilise the assets of secured creditors for this purpose. The Bankruptcy Code's automatic stay restrains the enforcement of liens in Chapter 7 liquidation procedures. However, bankruptcy courts will often grant relief from the stay as a matter of course once the creditor makes an application, showing that the debtor-company has no equity in the property.

The comparative analysis in this chapter will focus on the UK administration moratorium and the Code's Chapter 11 reorganisation automatic stay.

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[48] *David Milman, "Administration orders: the moratorium feature"* (1992) 5(9) Insolv. Int. 73-75.
[49] *Re Aro Co* [1980] Ch. 196, 204.
[50] *In re Wanzer Ltd* (1891) 1 Ch. 305, 310-311; *Re David Lloyd* (1877) 6 Ch. D. 339, 343-344.

The application and effect of the moratorium is most notable in these procedures in view of their purposes. The next paragraphs will specifically evaluate four areas and contract-related claims which statutory moratorium provisions restrain in the two jurisdictions namely enforcement of security, repossession of goods, forfeiture of leases and set-off claims.

2.2.1. Enforcement of security

The moratorium imposes a total, albeit temporary, suspension on the rights of creditors to *enforce* their security at the commencement of administration under UK insolvency law. Steps can only be taken to enforce security with the consent of the administrator or leave of court.[51] This prohibition is pre-emptive as it transcends the mere enforcement of security, and includes preparatory acts to enforce security.[52] The Bankruptcy Code restrains all acts to *create*, *perfect* or *enforce* liens against the bankruptcy estate after the filing of the bankruptcy petition.[53] As is the case under the Act, the Code restrains preparatory steps taken to enforce a lien. Under the Code, "lien" is a generic term for various forms of

[51] Schedule B1, Paras 42 and 43 of Insolvency Act.
[52] "Security" is defined under s. 248(b)(1) of the Act to include any mortgage, charge, lien or other security. "Other security" will encompass forms of consensual and non-consensual security.
[53] s. 362(a)(4) and (5) of the Code. *In re Edgins* 36 B.R. 480, 482 (9th. Cir. BAP 1984).

security interests similar to those mentioned in the Insolvency Act.[54]

A significant difference between the prohibition under the Insolvency Act and the Bankruptcy Code is that the Act does not stay steps taken to *create* or *perfect* security. Woolf L.J. emphasized this point in *Bristol Airport Plc. v Powdrill and Ors*[55] when he stated that,

> "It is not the creation of the security without the consent of the administrator or the leave of the court which is prohibited by section 11(3)(c) (now paragraph 42 and 43 of Schedule B1) but the *taking of steps* to enforce that security. "[56]

Accordingly, in addition to restraining all acts to enforce security,[57] the Code also restrains acts to create and perfect security. This means that a creditor under the UK regime may subsequently take steps to perfect his security during the pendency of an administration procedure without violating the moratorium, thus becoming secured.[58] At first blush this gives the impression that the scope of the Code's prohibition is wider than the Act's. It is suggested that this may not necessarily be the case given that the automatic stay also accommodates an exception relating to the perfection of certain liens. This is examined in 2.4.1.

Again, in respect of the different approaches

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[54] Article 9 of the United States Uniform Commercial Code, which deals with secured transactions, adopts a universal concept of security interest as against the different terminologies and ways of securing a claim under English law.
[55] (1990) 2 W.L.R. 1362 [1990] Ch. 744.
[56] ibid. at 768.
[57] *Bristol Airport Plc. v Powdrill & ors* [1990] 2 All ER 499, 508.
[58] *London Flight Centre (Stansted) Ltd v Osprey Aviation Ltd* [2002] W.L. 1310827.

of the regimes towards the *creation* of security, it is suggested that the exemption of creation of security from the ambit of the statutory moratorium does not run counter to the objectives of the moratorium. For acts or steps to be at cross-purposes with the earlier evaluated objectives of the moratorium, such acts must interfere with or impede the administrator in the fulfillment of his statutory duties in relation to the insolvent estate. Alternatively, such acts must have the effect of depleting or interfering with the assets of the debtor or in possession of the debtor. The creation of security, absent any steps to enforce such security, will not have any of these effects.

Significantly, the US court of appeals in *In re John Morton*[59] has ruled that s. 362(a)(4) of the Code does not prohibit acts to *extend, continue* or *renew* otherwise valid statutory liens. The issue for determination in that case was whether a judgment lien, normally valid under New York law for a period of ten years, remained enforceable after expiration of the ten-year period when during that period the property subject to the lien becomes part of a bankrupt estate protected by the automatic stay imposed. The court reasoned that the extension, continuation or renewal of the lien under the State law was incapable of enlarging the lien or threatening property of the estate which would otherwise be available to general creditors. To the contrary, the extension simply allowed the holder of a valid lien to

[59] 866 F.2d 561, 564 (2d Cir.1989)

maintain the status quo.[60] It is suggested that the position of the court of appeal is plausible based on the specific provisions of the State law that was in issue.

2.2.2. Acts of Repossession

The Insolvency Act restrains preparatory steps taken to repossess goods in the debtor's possession under a hire purchase agreement except where the consent of the administrator or leave of court is obtained.[61] "Hire purchase agreement" under this provision embraces transactions such as chattel leasing, retention of title agreements, conditional sale and other quasi-security transactions.[62] By virtue of this provision, suppliers who retain some form of interest or title in the goods in the possession of the insolvent buyer to avoid an absolute transfer of such property, will be temporarily restrained from exercising their proprietary or security rights to repossess the goods during the administration.[63]

Section 362(a)(3), which is at the heart of the Code's automatic stay regime, restrains creditors from engaging in acts to obtain possession of property of or from the bankruptcy estate. It also restrains attempts to exercise control over any property of the

[60] ibid. at 564.
[61] Sch. B1, Para 43(3) of the Insolvency Act.
[62] Par 111, Sch. B1, Insolvency Act; s. 436 of the Insolvency Act, which makes reference to the definition under s. 189(1) of Consumer Credit Act 1974.
[63] *Re Atlantic Computer Systems Plc*. (fn. 38) 492.

bankruptcy estate. Most acts prohibited under this provision will have elements of harassment. This therefore begs the question in both jurisdictions whether voluntary handover of assets by the debtor or officeholder will violate the automatic moratorium.

Considering that administrators have the power to consent to relief from the moratorium, it is suggested that the above issue will only arise in an interim moratorium. Accordingly, Goode has argued that in an interim moratorium, repossession is intended to be limited to enforcement measures. He however posits that where the company is under interim management, courts will likely look carefully at the reality of the company's "consent" and will disregard it where it was obtained by threat. Goode's argument is underpinned by the notion that the interim moratorium is aimed at preserving the company's assets.[64]

Goode's position can be disputed on the ground that he ignores the fact that the interim moratorium is also aimed at protecting creditors against the enforcement and collection activities of other creditors which could result in the conferment of unfair preferences. Furthermore, the language of the provision does not entirely support his position, given that in contrast to the restriction on security, the restriction on repossession is not expressed to be

[64] Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) 440.

confined to *enforcement*.

The foregoing issue was considered in the US (where only bankruptcy courts can grant relief from the stay) in the case of *In re Germansen Decorating Inc*.[65] The parties had worked out a payment plan to pay off the past due account balance. Pursuant to the payment plan, the debtor delivered post-dated checks to the creditor. While the creditor contended it took no action post-petition to collect from the debtor, the trustee disputed this fact and contended that the creditor exerted pressure on the debtor to pay its prepetition debt post-petition. The court ruled that the payment violated the automatic say notwithstanding that it was voluntary. The court based its decision on the ground that the stay was also a creditor-protection mechanism, hence cannot be waived by the debtor. [66]

The above decision is plausible on at least three grounds. First, as noted by the court and as previously analysed in this chapter,[67] a subsidiary policy objective of the statutory moratorium is the protection of creditors from the activities of other creditors which may result to gaining an unfair preference.[68] Hence an agreement between a debtor and a single creditor that has the effect of waiving the moratorium may be detrimental to other creditors and thus runs counter to this policy objective. This point was noted by Ginsberg J. in *In re Germansen*

[65] 149 B.R. 517, 521 (Bankr. N.D. Ill. 1992).
[66] *In re Germansen Decorating Inc*. 149 B.R. 517, 521 (Bankr. N.D. Ill. 1992).
[67] See 2.1.2.
[68] ibid. at 521.

Decorating Inc.[69] where he stated thus,

> "This court will not sit idle and permit debtors to waive willy-nilly the automatic stay so that certain creditors may be preferred with impunity and the estate dismembered without reference to the Code … The automatic stay is meant to prevent one creditor from securing an advantage over its peers after a petition is filed by or against a debtor. It makes no difference whether that creditor gets that advantage as a result of a voluntary or involuntary transfer"[70]

Secondly, where a debtor has just a few assets or a single vitally valuable asset, it is arguable that such voluntary release of assets or waiver of the statutory moratorium may have the effect of frustrating the asset-preservation objective of the statutory moratorium.[71] However, one may argue that this concern is exaggerated, given that under the UK regime, administrators have been given the power to grant relief from the moratorium.

Thirdly, the language of s. 362(a) does not distinguish between voluntary and involuntary repossessions. It operates to stay "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." Moreover, s. 362(a)(6) provides that s. 362 operates as a stay of "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title."

It is argued that the provisions restraining acts or steps relating to the repossession of goods of the

[69] 149 B.R. 517, 521 (Bankr. N.D. Ill. 1992).
[70] ibid. at 521-522.
[71] *In re McBride Estates Ltd* 154 B.R. 339, 342 (Bankr. N.D. Fla. 1993); *In re Excelsior Henderson Motorcycle Manufacturing Co. Inc*. 273 B.R. 920, 924 (Bankr. S.D. Fla. 2002).

debtor in the jurisdictions practically have the same effect on contracts notwithstanding that they are couched differently. First, the prohibitions do not extinguish the substantive law rights of creditors as their rights to repossess their goods are merely suspended during the procedure. Secondly, the moratorium in the jurisdictions restrain *preparatory* steps or acts taken by creditors with the aim of repossessing or taking control of goods. Thus while the Insolvency Act prohibits any step taken to repossess goods, the Code restrains acts to obtain possession.

Thirdly, it is settled under the UK insolvency law regime that the moratorium on repossession of goods equally applies to the property of the debtor in the physical possession of a third party. In *Re Atlantic Computer Systems Plc.*,[72] the Court of Appeal ruled that computer equipment which had been sub-let (and which was still in the physical possession of the sub-lessees) were in possession of the lessee for the purpose of the moratorium.[73] Nicholls L.J. reasoned that repossession from the sub-lessee amounted to repossession from the lessee/debtor and that the provision was concerned with relations between the lessor and the lessee/debtor. Consequently, the latter had possession of the goods regardless of whether it was on its premises or not, entrusted by the company to others for repairs or sublet by the company.[74]

[72] (1992) Ch. 505.
[73] ibid. at 532. See also *Fashoff (UK) Ltd v Linton* [2008] B.C.C. 542.
[74] ibid.

In the same vein, it is also settled that property which does not belong to the debtor but is otherwise in its possession by reason of a hire-purchase or lease agreement is subject to the moratorium. In *Bristol Airport Plc. v. Powdrill and ors*[75] where the debtor airline held aircraft under the terms of leases, it was held that the aircraft were "property" of the debtor airline within the meaning of s. 436 of the Insolvency Act 1986 and for the purpose of the moratorium. In fact in *Re David Meek Plant Ltd*[76] Judge Weeks QC ruled that the moratorium will also be extended to such goods, whether or not the agreement had been terminated before the presentation of the petition for an administration order or on that event, provided the goods remained in the company's possession.[77]

It is suggested that the above principle will also be applicable under the US regime notwithstanding the absence of a judicial view in this regard. This assertion is supported by the language of the provision in the Code which expressly prohibits acts to obtain possession of property “of” and “from” the bankruptcy estate.[78] While acts to obtain possession of property *of* the bankruptcy estate refers to the property of the debtor in its possession or in the possession of third parties, property *from* the bankruptcy estate presupposes the property of third parties in the possession of the debtor. Accordingly in

[75] [1990] Ch. 744, 759, 760, 761, 762 - 763- 764, 767.
[76] [1993] B.C.C. 175.
[77] ibid. at 180.
[78] s. 362(a)(3) of Bankruptcy Code.

In re Plastech Engineered Products,[79] Shefferly J. held that the possessory interest that the debtor-supplier in the case had in equipment was sufficient to trigger the protection of automatic stay and to prevent the manufacturer, without first obtaining relief from the stay, from taking possession of equipment.

Finally a potential difficulty with the present restraint is determining with certainty which actions will constitute steps or acts to repossess goods. The provisions of both statutes are unhelpful, as they offer no guidance in this regard. It has been suggested that the prohibition under the Act will only restrain acts that interfere with the debtor's enjoyment of its property or the property in its possession or inhibit the administrator's use of such property in the conduct of the business.[80]

This proposition is a useful touchstone given that it would be impossible to draw an exhaustive list of factual scenarios that will constitute steps or acts to repossess. The proposition aligns with the underlying purpose of the moratorium which is to preserve assets available to the debtor by precluding the taking of steps which might impair the administrator's ability to use the assets or manage the business for the purpose of the procedure. Hence, it is incumbent on courts to exercise their discretion judiciously in dealing with applications on a case-by-case basis.

[79] 382 B.R. 90, 106 (Bankr. E.D. Mich. 2008).
[80] Roy Goode, *Principles of Corporate Insolvency* (fn. 64) 429, 430 e.g. service of a demand on a company for payment or a notice terminating a contract or making time of performance of essence.

2.2.3. Forfeiture of lease by peaceable re-entry

At the commencement of administration, a landlord's right to forfeiture by peaceable re-entry in respect of premises let to a debtor is suspended under the Insolvency Act. This right can only be exercised with the administrator's consent or leave of court.[81] The contention that formerly existed as to whether or not forfeiture of leases by peaceable re-entry constituted an *enforcement of security* is now a settled issue by virtue of the present provision.[82]

There is no specific corresponding provision of this nature in the Bankruptcy Code. However, all property of the debtor automatically becomes part of the bankruptcy estate once a bankruptcy case is commenced.[83] Property includes "all legal and equitable interests of the debtor in property as at the commencement of the case." It is suggested that this definition is broad enough to encompass rights over premises let to or occupied by the debtor. This position is supported by the assertion of Tabb in his seminal work that,

> "Whether the debtor holds a fee simple, a joint interest, a leasehold, a naked possessory right, legal title only; whatever the debtor has comes into the estate."[84]

In the light of this, it is argued that s. 362(a)(3) will restrain attempts to forfeit or obtain possession of

[81] Schedule B1, Para 43(4) of the Insolvency Act.
[82] *In re Lomax Leisure Ltd* [2000] Ch. 502, 512, *Redleaf Investment Ltd v Talbot* [1995] B.C.C. 1091; *Exchange Travel Agency v Triton Property Trust Plc*. [1991] B.C.L.C. 396, 400-401. This provision was not available in the previous legislation, giving rise to divisions in judicial opinions as to whether forfeiture of leases by peaceable re-entry constituted an enforcement of security.
[83] s. 541(a)(1) of Bankruptcy Code.
[84] Charles Tabb, *The Law of Bankruptcy* (2nd edn, Foundation Press 2009) 399.

premises or exercise control over it.

Goode has argued that where a lease stipulates for forfeiture by notice on stated grounds or events, the landlord will not be precluded under this provision from exercising such a right.[85] This position is plausible, given that in this circumstance, the landlord will not be required to take physical possession of the property, an act which the moratorium restrains. The issuance of a notice will simply have the effect of terminating the lease. Nevertheless, it is suggested that if the premises in issue is still under the occupation of the debtor/lessee, leave of court may still be required.

In addition, it is instructive to note that although the UK moratorium restrains the commencement and continuation of legal proceedings against the debtor and its property after the commencement of administration,[86] the prohibition is limited to any legal or quasi-legal processes or other proceedings which require the assistance of courts.[87] Accordingly, self-help measures such as notices of termination that do not require the assistance of courts do not come under the ambit of this restrain.[88] In deed the wording of the present provision has put to rest

[85] Roy Goode, *Principles of Corporate Insolvency* (fn 64) 435.
[86] Schedule B1, Para 43(6) of Insolvency Act. Legal processes include legal proceedings, execution, distress and diligence.
[87] *Carr v British International Helicopters Ltd* [1994] 22 B.C.L.C. 474, 475, 482.
[88] Gavin Lightman, Gabriel Moss, et. al *The Law of Administrators and Receivers of Companies* (5th edn, Sweet & Maxwell 2013) 589. Self-help effort which do not require the assistance of the courts include service on the company of a contractual termination notice, service of a notice of making time of essence for the purposes of a contract, set-off etc.

the controversy associated with the equivalent provision in the legislation that preceded it as to whether non-legal proceedings can constitute 'other proceedings' as was used therein.[89] Hence In *Re Olympia & York Canary Wharf Ltd*[90] Millet J. ruled that the service upon a company in administration of a contractual notice purporting to make time of the essence or to terminate the contract did not require the consent of the joint administrators of the company or the leave of the court.[91]

In contrast to the foregoing, a forfeiture of a lease by notice on stated grounds or events will likely be in breach of the Code's automatic stay provision. The automatic stay restrains almost all forms of *self-help* mechanisms that can be employed by creditors to recover or collect their debts, outside judicial, arbitral or administrative means.[92] For instance in *Olson v. McFarland Clinic*,[93] a creditor's letter informing debtors that the creditor, would no longer be able to provide services to the debtor based on failure to pay for services already provided was held to constitute an act to collect a pre-petition claim against debtors in breach of s. 362(a)(6).

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[89] *Bristol Airport Plc. v Powdrill & ors* (fn. 57) 506 illustrates this point. Here it was held that the detention of aircraft did not constitute legal or other proceedings under the old regime. The court reasoned that reference to the "commencement" and "continuation" of proceedings indicates that what Parliament had in mind was legal proceedings.
[90] [1993] B.C.C. 154.
[91] ibid. at 157-8.
[92] s. 362(a)(6) of the Code. *In re Henry* 266 B.R. 457, 470 (Bankr. C.D. Cal. 2001); *In re Haffner* 25 B.R. 882, 886 (Bankr.N.D.Ind.1982); *In re Green* 15 B.R. 75, 78 (Bankr. S.D. Ohio 1981); *In re Lanford* 10 B.R. 132, 134 (Bankr.D.Minn.1981); *In re Heath* 3 B.R. 351 (Bankr. N.D. Ill. 1980).
[93] 38 B.R. 515, 518 (Bankr. N.D. Iowa 1984).

In *Sechuan City Inc. v. North American Motor Inns Inc*.[94] the conduct of lessor and his associates in posting various signs throughout a hotel lobby that restaurant lessee had filed for bankruptcy and was not paying its bills, coupled with lessor hotel's decision not to allow alcoholic drinks to be served in debtor lessee restaurant, was held to violate the automatic stay. Lastly in *In re Promower Inc*.,[95] a lessor was held to have violated the automatic stay by "engaging in self-help" against the debtor/tenant through, inter alia, barricading debtor's business premises.

Indeed the US regime illustrates a manifest Congressional intention to close every possible loophole with which creditors may exploit to interfere with assets in the insolvent estate. This notwithstanding, it is argued here that the automatic stay can still be evaded via self-help. It is suggested that self-help measures that are adopted without express reference to the debtor's insolvency may not be in breach of the automatic stay. This position has judicial support in the earlier cited *Olson v McFarland Clinic*,[96] where the court agreed with the defendant's assertion that if the defendant had simply refused service without any mention of the debtors' bankruptcy filing in their letter, s. 362(a)(6) would not have come into play.[97]

[94] 96 B.R. 37, 40 (Bkrtcy.E.D.Pa. 1989).
[95] 56 B.R. 619, 621 (Bankr.D.Md.1986).
[96] 38 B.R. 515 (Bankr. N.D. Iowa 1984).
[97] ibid at 518.

2.2.4. Set-off

Insolvency set-off rights are recognised under the Insolvency Act and Bankruptcy Code.[98] However, the jurisdictions differ as to the effect of the statutory moratorium on set-off rights. The Insolvency Act's set-off rights are self-executing and are consequently not suspended or interfered with by the moratorium.[99] Hence it constitutes one of the so-called true exceptions to the pari passu principle. Accordingly, the factual effect of a set-off claim is that it confers a preference on the creditor who holds the right. Prima facie this runs counter to the two policy objectives of the statutory moratorium earlier evaluated namely, asset-preservation and ensuring a collective procedure.

The Bankruptcy Code's automatic stay suspends the exercise of set-off rights at the commencement of insolvency.[100] In the light of the preferential effect of set-off rights, this position accords with the earlier evaluated policy objectives of the automatic stay. Restraining such rights potentially has the effect of avoiding the preferential treatment of certain pre-petition creditors. More importantly, the estate is preserved from erosion and the officeholder is given the breathing spell to carry out his responsibilities without interference from holders of

[98] s. 553 of the Code; Rules 2.85 and 4.90 of the Insolvency Rules 1986.
[99] Ian Fletcher, John Higham, *Corporate Administrations and Rescue Procedures* (fn. 8) 57.
[100] s. 362(a)(7) of the Code; *Bank of America Nat'l Trust and Savings Ass. v Edgins* (fn. 53) 482.

set-off rights.

Significantly, the Code draws a distinction between *set-off rights* and common law *recoupment rights*. While a set-off is a claim arising out of a completely independent and unrelated transaction,[101] in recoupment, the debt must arise from the same transaction. Here is a hypothetical illustration of this distinction: If S sues B for $1,000 for goods that S supplied, and B seeks to reduce the judgment by $500 representing S's (unrelated) unpaid rental of B's warehouse, B is seeking a *setoff*. On the other hand, if S sues B for $1,000 for goods that S supplied, and B seeks to reduce the judgment by $500 representing B's expenditure to repair some of the goods which turned out to be defective or the cost of replacing them, B is seeking a *recoupment*. In this regard in *In re Delicruz,*[102] Shefferly J. noted that

> "Only apples can be recouped against apples, not apples against oranges. Apples may be set-off against oranges, but this takes the matter out of the nature of recoupment."[103]

Recoupment is therefore an affirmative defence that may be asserted by a defendant whose claim is based on the same transaction that is the subject of the claimant's suit.[104] This distinction is alien to English insolvency law**.** In contrast to set-off rights, recoupment claims are not affected by the

[101] s. 553 of the Code; *Atlantic City Hospital v Finkle* 110 N.J. Super. 435, 439 (Cty. Ct. 1970).
[102] 300 B.R. 669 (Bankr. E.D. Mich. 2003),
[103] ibid at 683.
[104] *Beneficial Finance Co. v Swaggerty* 86 N.J. 602, 609, (432 A.2d 512 1981).

moratorium. [105] Factually, a recoupment claim constitutes an exception to insolvency law's policy of equal treatment of unsecured creditors. Accordingly, regardless of the justifications that are often given as underpinning the recognition of recoupment rights (evaluated in 2.3.2), it factually runs counter to the policy objectives of the moratorium, namely asset-preservation and collectivity.

Applying the statutory moratorium to the Code's set-off rules often results in what is termed the "banker's dilemma." This occurs where, prior to bankruptcy filing, a bank lends funds to a debtor who also has a cheque account with the bank. On insolvency, the bank will have a right to set-off. As a matter of general principle, set-off rights only subsist as long as there is mutuality of debts. Once the element of mutuality is lost, the set-off right is extinguished. A strict adherence to s. 362(a)(7) and (a)(6)) will require a creditor to hand over the asset to the debtor, the consequence of which will be a permanent loss of the set-off right. In deed, there is an authority to the effect that a bank that fails to preserve its setoff rights by freezing a debtor's account is not entitled to any compensation if post-petition clearing of cheques depletes the account.[106] Accordingly in *First Union National Bank of Florida v. Abbey Financial Corp*.[107] a bank which failed to protect its

[105] *In re Slater Health Centre* 398 F.3d 98 (1stb Cir. 2005); *In re Holford* 896 F.2d 176(5th Cir 1990); *B & L Oil* 782 F.2d 155(10th Cir 1986).
[106] *In re Kleather* 208 B.R. 406 (Bankr. S.D. Ohio 1997).
[107] 193 B.R. 89 (Bankr. D. Mass. 1996). The same decision would be reached where a creditor turns over the property to the trustee in the absence of

contingent right of setoff by placing an administrative freeze on the debtor-customer's account was held not to be entitled to a refund of monies it had wire-transferred to the customer's debtor-in-possession account.

In order to preserve their set-off rights, bankers and creditors have devised the "administrative freeze," which is a temporary hold on an account wherein the account is not debited. The debtor is temporarily prevented from having access to the account and making withdrawals while awaiting a judicial decision regarding the validity of the set-off right.[108] However, it is suggested that this does not provide a foolproof solution to the against the background of a number of provisions in the Code which are seemingly difficult to reconcile with s. 362(a)(7).

For instance s. 363(c)(2)(A) and (B) of the Code prohibit debtors from using cash collateral without the consent of the creditor or authorisation of the court. Cash collateral is defined as cash or cash equivalents in which the bankruptcy estate and an entity other than the estate have an interest.[109] Monies that are subject to set-off rights or an administrative freeze qualify as cash collateral. Furthermore, s. 542(a) of the Code, which mandates a creditor to

compulsion. *In re Gehrke* 158 B.R. 465 (Bankr. N.D. Iowa 1993), *distinguishing In re Archer* 34 B.R. 28 (Bankr. N.D. Tex. 1983) as a case in which turnover was involuntary" because of the creditor's fear of contempt.

[108] James Wynn, "Freeze and Recoupment: Methods for circumventing the automatic stay" (1988) 5 Bankr Dev. J. 85 fn.1.

[109] s. 363(a) of the Code.

deliver to the trustee any debt or property owed to the debtor, expressly exempts creditors with set-off rights from turning over an asset to the trustee.[110] The foregoing provisions clearly support the use of the administrative freeze mechanism.

On the other hand, the administrative freeze is not without its shortcomings. It is arguable that it amounts to an act "to exercise control over property of the estate" in violation of the moratorium.[111] The debtor is denied the immediate use of the funds in the creditor's possession at a time that could be highly critical in its reorganisation.[112] The freeze also violates the moratorium provisions that prohibit the creation, enforcement and perfection of pre-petition liens and any acts to collect, assess or recover pre-petition claims against the debtor respectively.[113] Accordingly, the administrative freeze amounts to a unilateral extra-judicial determination by the creditor of the validity of its setoff- right.[114] Prima facie it constitutes a resort to self-help which (as previously noted) the Bankruptcy regime discourages.

Notwithstanding the above, the fact remains that handing over an asset which is subject to a set-off right to a debtor while hoping to get it back through a

[110] s. 542(b) and (c) of the Code.
[111] s. 362(a)(3) of the Code.
[112] *In re Fred Patterson* 967 F.2d 505, 510 (11th Cir.1992); James Wynn (fn. 108) 92.
[113] s. 362 (a)(4) and (a)(6) Code. *In re Fred Patterson* (fn 112) 511; *In re Homan* 116 B.R. 595, 602 (Bankr. S.D. Ohio 1990); *In re First Conn Small Business Investment Co*. 118 B.R. 179, 181 (Bankr. D. Conn. 1990).
[114] *In re Homan* (fn 113) 603; *In re Wildcat construction* 57 B.R. 981, 986 (Bankr. D.Vt.1986); *Kenney's Franchise Corp v Central Fidelity Bank* 12 B.R. 390, 391 (Bankr. W.D. Va. 1981).

court order, may not be a very sensible option. In deed it may amount to merely locking the barn door after the horse has bolted.[115] There is also a risk of the dissipation of the asset in the hands of the debtor. The Supreme Court has attempted to put this contentious issue to rest with its decision in *Citizen's Bank of Maryland v. Strumpf*.[116] In that case the Supreme Court held that administrative freezes do not constitute the exercise of set-off rights as there is often no intention to permanently reduce the debtor's account balance by the amount of the defaulted loan.

The Supreme Court identified three steps that must be taken to effect a set-off, namely, a decision to effectuate the set-off, some action accomplishing the set-off and a recording of the set-off.[117] The court however emphasized the need for a prompt application for relief while the administrative freeze is pending.[118] Accordingly, an unnecessarily prolonged administrative freeze without a timely application for relief may be construed as constituting the exercise of a set-off right in violation of the stay.[119] For instance in *Town of Hempstead Employees Federal Credit*

[115] *Bank of America Nat'l Trust and Savings Ass v Edgins* (fn. 53) 484.
[116] 516 US 16 (1995).
[117] 516 US 16, 19(1995); *Normand Josef Enterprises Inc. v Connecticut National Bank* 230 Conn. 486, 504-505 (A.2d 1289 1994); *In re Crispell* 73 Bankr 375, 377 (Bankr. E.D. Mo. 1987); *In re Carpenter* 14 B.R. 405, 407 (Bankr. M.D. Tenn. 1981); *Baker v National City Bank of Cleveland* 511 F.2D 1016, 1018 (6th Cir. 1975); Paul Groschadl, "Freezing the Debtor's Bank Account: A violation of the Automatic Stay?" (1983) 57 Am Bankr. L.J. 75, 76.
[118] See also *Air Atlanta v National Bank of Georgia* 81 B.R. 724, 725 (N.D. Ga. 1987); *In re Hoffman* 51 B.R. 42, 46 (Bankr. W.D. Ark. 1985); *Stann v Mid Am. Credit Union* 39 B.R. 246, 248 (D. Kan. 1984); *Kenney's Franchise Corp v Central Fidelity Bank* 22 B.R. 747, 748-749 (W.D. Va. 1982); *In re Carpenter* 14 B.R. 405, 407 (Bankr. M.D. Tenn. 1981).
[119] *In re Crispell* 73 Bankr 375, 379 (Bankr. E.D. Mo. 1987).

Union v. Wicks[120] a four-month administrative freeze by a creditor that never sought relief from the stay was held to constitute a violation of the automatic stay.

It is suggested here that the Supreme Court's approach in *Strumpf* plainly offends the moratorium provision and its policy objectives. The Code expressly suspends the exercise of set-off rights and this construction is an emasculation of that prohibition.[121] In addition, the legislative statement accompanying the set-off provision expressly mentions the automatic stay as being one of the two exceptions to the set-off rule.[122] Furthermore, an account that is described as being *open* but in respect of which the debtor cannot make use of the funds is of no practical use to the debtor. Nevertheless, given that a strict literal construction and application of s. 362(a)(7) will result in a permanent loss of a set-off right, it may be argued that the equitable approach in *Strumpf* is in order subject to the condition that a timely application for relief must be made to court. This pragmatic approach effectively balances the competing interests of the parties. While the holder of the set-off right retains his right, the matter is also timely resolved by the courts to prevent any delays that may hamper the insolvency procedure.[123]

Perhaps a step towards completely resolving

[120] **215** B.R. 316 (E.D.N.Y. 1997).
[121] s. 362(a)(7) of the Code.
[122] House Report No 595, 95th Congress, 1st session 340 (1977).
[123] i.e. ss. 362(a)(7), 553 and 506(a)(1) of the Code.

this issue would be the codification of administrative freeze and comprehensively defining what would constitute a freeze as opposed to a set-off. A possible alternative to the contentious administrative freeze would be for the creditor to file an ex parte motion pursuant to s. 362(f) and 363(e).[124] While s. 362(f) provides that,

> "Upon request of a party in interest, the court, with or without a hearing, shall grant such relief from the stay provided under subsection (a) of this section as is necessary to prevent irreparable damage to the interest of an entity in property, if such interest will suffer such damage before there is an opportunity for notice and a hearing under subsection (d) or (e) of this section."

Section 363(e) provides that,

> "Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest. This subsection also applies to property that is subject to any unexpired lease of personal property (to the exclusion of such property being subject to an order to grant relief from the stay under s. 362)."

The motion would be accompanied with the funds from the debtor's account to be paid into the registry of the court pending the determination of the motion. This procedure will have the merits of ensuring that the interests of all parties are protected. While there is no risk of the creditor losing his set-off rights, the matter will also be decided speedily so as not to starve the insolvent estate of funds which it may be entitled to.

[124] *Air Atlanta v National Bank of Georgia* 81 B.R. 724, 725 (N.D. Ga. 1987).

2.3. Exceptions to the statutory moratorium

The Bankruptcy Code's automatic stay provisions do not apply in every case and do not stop all forms of enforcement and collection actions. US lawmakers have decided that certain debts are very significant and deserve to be granted priority over the policy objectives of the automatic stay. Accordingly, the Code has set out a number of exceptions to the automatic stay.[125] Conversely, the Insolvency Act does not expressly list exceptions to the moratorium. Most of the exceptions under the Code relate to personal bankruptcy, albeit, the next paragraphs will evaluate the exceptions which are relevant to this thesis. It will also examine the likely attitude of UK courts to these exceptions.

2.3.1. Retroactive perfection of interests

The Code's automatic stay does not suspend the right of creditors to perfect or continue to perfect an interest in property of the bankruptcy estate to the extent that the trustee's rights and powers are subject to perfection under s. 546(b) of the Code.[126] The companion provision, s. 546(b), limits the debtor's powers to avoid statutory liens by providing that they "are subject to any generally applicable law that permits perfection of an interest in property to be

[125] s. 362(b) of the Code.
[126] s. 362(b)(3) of the Code; *In re New England Carpet Co*. 26 B.R. 934 (Bankr. D. Vt. 1983).

effective against an entity that acquires rights in such property before the date of perfection."[127]

Hence s. 546(b) of the Code deals with statutes that provide for the perfection of liens during periods of grace. For example a lien that arises pre-petition but is not perfected before the filing of the bankruptcy petition, can be perfected if the applicable non-insolvency law permits a later perfection against any party who has acquired an interest in the property.[128] The doctrine of relation back operates to give the perfection a retroactive effect thereby pre-dating the insolvency.[129]

Thus s. 362(b)(3) and s. 546(b)(1)(A) read together, plot the boundaries of the exception to the automatic stay which is at issue here.[130] A good example of a case where the present exception will be applicable is a purchase money security interest (PMSI), where Article 9 of the Uniform Commercial Code gives the secured creditor a grace period within which to perfect the PMSI and still maintain priority over intervening lien creditors.[131] Hence if the debtor files for bankruptcy during the grace period, s. 362(b)(3) permits the secured party to go ahead and perfect its PMSI, and that perfection is given retroactive effect under s. 546(b).

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[127] s. 546(b)(1)(A).
[128] The perfection can only be performed if the period of grace for perfection under the applicable non-insolvency law has not expired before the intervening insolvency.
[129] s. 546(b) of the Code.
[130] *In re 229 Main Street Ltd. Partnership* 262 F.3d 1, 4 (1st Cir. 2001).
[131] UCC 9-317(e).

A further illustration of the foregoing can be seen in *In re 229 Main Street Ltd*.[132] In that case C notified the owner of a property of its intention to file a lien against the property under Massachusetts Oil and Hazardous Materials Prevention Act. The owner sought administrative hearing under the Act, and before obtaining ruling, filed for Chapter 11 bankruptcy. The Court of Appeals held that C's simultaneous creation and perfection of lien constituted *perfection* under the Code, hence fell within the present exception to the automatic stay.

Similarly, in *In re Cohen*,[133] CA sought relief from automatic stay to foreclose on its lien, Gerling C.J., ruled that CA was not entitled to relief from stay in order to foreclose on lien that it had not yet perfected by filing notice thereof.[134] Nevertheless, the court ruled that CA could file its notice post-petition under the present exception given that the general applicable law, s. 339a of the New York Real Property Law, permitted a perfection of such interest with a retroactive effect.

This exception is not necessary under UK insolvency law regime considering that the Insolvency Act's moratorium only restrains steps taken to *enforce* security and does not restrain steps taken to *create* or *perfect* security.[135] However, the ability of a creditor under the Code to perfect his

[132] 262 F.3d 1 (1st Cir. 2001).
[133] 279 B.R. 626 (Bankr. N.D.N.Y. 2002).
[134] ibid at 636,
[135] Para 43(2) of Insolvency Act.

security during the statutory injunction is limited compared to a creditor under the Act. This is because perfection under the Code is only possible if such is permitted by the applicable non-insolvency law, by way of a grace period, as stipulated under s. 546 (b) of the Code.

It is suggested that the exclusion of perfection of security from the statutory moratorium can be justified on at least two grounds. First, If the broad stay of s. 362(a)(4) and (5) is left unqualified, it would operate to make certain creditors worse off than they would have been outside of bankruptcy. Such would run counter to the purposes of the stay which is meant only to preserve the status quo and the assets available to the insolvent estate. Secondly, perfection (as opposed to enforcement) of security interests during the pendency of the statutory moratorium will not necessarily be at cross-purposes with the policy objectives of the moratorium. Perfection of security will not interfere with the assets in the insolvent estate, the officeholder's work or grant the creditor an unfair preference. Accordingly, there is no strong policy argument against perfection of liens by creditors who desire to make their security effective in the insolvency and against third parties. The statutory moratorium ought not to be used as a mechanism for extinguishing security interests and permanent confiscation of assets of third parties.

2.3.2. Complex market contracts

Series of complex market-related contracts are exempted from the ambit of the Code's automatic stay.[136] Some examples of these include enforcement of contractual rights by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency in such transactions.[137] In the same vein, the UK administration moratorium will not interfere with enforcement of market charges.[138] This exception is to ensure that financial market operations are safeguarded against the insolvency of participants.[139] The exemptions are plausible considering the domino effect that the disruption of a single market transaction by the insolvency of a participant can have on the entire market. Against this background, priority is granted to these complex market transactions over the policy objectives of the statutory moratorium.

2.3.3. Recoupment and set-off

Whilst set-off rights are suspended,[140] recoupment rights are exempted from the operation of Bankruptcy Code's automatic stay.[141] As previously

[136] s. 362(b)(6) of the Code.
[137] s. 362(b)(6), 555 and 556 of the Code.
[138] The statutory moratorium does not prohibit the enforcement of market charges as defined by s. 173(1) of CA 1989.
[139] Part VII of Companies Act 1989; Ian Fletcher, John Higham, *Corporate Administrations and Rescue Procedures* (2nd edn, Tottel Publishing 2004) 57.
[140] *Bank of America Nat'l Trust and Savings Ass. v Edgins* (fn. 53) 482.
[141] s. 362(a)(7) of the Code stays only set-off rights; *Holford v Powers* (fn. 105) 179.

noted, the Bankruptcy Code differentiates recoupment rights from setoff rights.[142] There are two primary distinctions between these two doctrines. First, recoupment allows a creditor to reduce the amount of a debtor's claim by asserting a claim against the debtor which arose out of the same transaction to arrive at a just and proper liability on debtor's claim.[143] In contrast, setoff involves a claim of a creditor against a debtor which arises out of a transaction which is different from that on which debtor's claim is based.[144] A hypothetical illustration of this distinction can be seen in 2.2.4.

A second distinction between the two doctrines is that while pre-petition debts can be recouped from the debtor's post-petition assets,[145] pre-petition debts can only be set-off from the debtor's pre-petition revenues or assets.[146] Hence in *Rakozy v. Reiman Construction Inc*.[147] the court observed that "a claim of recoupment should be allowed regardless of whether the plaintiff's claim is considered a pre-

[142] See 2.2.4.

[143] *Rakozy v. Reiman Construction* 42 B.R. 627, 628 (Bankr. D. Idaho 1984).

[144] *In re Slater Health Center Inc*. (fn. 105) 103; *In re Holyoke Nursing Home Inc*. 372 F.3d 1, 3 (1st Cir.2004); *United Structures of America Inc. v G.R.G Engineering* 9 F.3d 996, 998 (1st Cir.1993); *Holford v Powers* (fn 105) 178.

[145] *American Central Airlines, Inc., v Dept. of Transportation* 60 B.R. 587, 589 (Bankr. N.D. Iowa 1986); *United States v Midwest Service Co. Inc*. 44 B.R. 262 (Bankr. D.C. Utah 1983); *Sapir v Blue Cross/Blue Shield of Greater New York* 34 B.R. 385 (Bankr. S.D. N.Y. 1983); *Waldschmidt v CBS, Inc*. 14 B.R. 309 (M.D. Tenn. 1981).

[146] *In re Springfield Casket Co. Inc*. 21 B.R. 223, 228 (Bankr. S.D. Ohio 1982) (Anderson, J.). "(I)n the context of bankruptcy, post-petition debts may not provide the basis for setoff because mutuality ceases upon the filing of the bankruptcy estate, i.e. a claim owing to a creditor by a debtor may not be offset by a debt owing by the creditor to that debtor's estate, since the parties are not identical and mutuality has ceased." *In re* Kleather, 208 B.R. 406, 413 (Bankr. S.D. Ohio 1997).

[147] 42 B.R. 627 (Bankr. D. Idaho 1984).

petition or post-petition claim."[148] The leading case of *Ashland Petroleum Co. v Appel*[149] illustrates this point. In that case. B&L and Ashland entered into an oil division contract that gave Ashland the right to purchase unspecified amounts of crude oil produced by B&L. In August 1982, Ashland overpaid B&L on two occasions. In September 1982, B&L filed for bankruptcy. Ashland withheld payments for subsequent post-petition deliveries in order to recover its pre-petition overpayments. The US Court of Appeals held that Ashland had properly recouped pre-petition overpayments made to B&L by withholding money for deliveries made after B&L had filed for bankruptcy.[150] The court thus refused to limit recoupment in the same way as set-off claims.

The above decision turned on the ground that it was inequitable for the debtor to benefit from post-petition sales to the creditor under the contract without the burden of repaying pre-petition overpayments made by the creditor under the same contract.[151] In other words, the court reasoned that since both debts arose out of a single integrated transaction, it would have been "inequitable for the debtor to enjoy the benefits of that transaction without also meeting its obligations."[152] This indeed has been the main justification for the scope of the doctrine of recoupment and for exempting it from the ambit of

[148] *Rakozy v. Reiman Construction* (fn. 143) 628.
[149] 782 F. 2d 155 (10th Cir. 1986).
[150] ibid. at 158-159.
[151] ibid. at 159.
[152] *In re University Medical Center* 973 F.2d. 1065, 1081 (3rd Cir. 1992).

the automatic stay.[153]

Accordingly, a recoupment right is deemed to be essentially a defense to the debtor's claim against the creditor rather than a mutual obligation. [154] Furthermore, in *United Structures of America Inc. v. G.R.G. Engineering, S.E.*,[155] Breyer C.J. noted that allowing the creditor to recoup damages simply allows the debtor precisely what it is due when viewing the transaction "as a whole."[156] In practical terms, there is but one recovery due on a contract[157] and the creditor does not interpose an independent, countervailing claim, but merely counterclaims to limit the debtor's recovery to what is due.

Notwithstanding the foregoing, recoupment rights prima facie run counter to the asset-preservation and collectivity objectives of the statutory moratorium. Recoupment claims are capable of disrupting the debtor's cash flow and the officeholder's task just as much as set-off claims and other enforcement and collection activities restrained by the automatic stay. If creditors with proprietary and security claims against the debtor are temporarily restrained from enforcements and repossessions for the benefit of the procedure generally, why should a creditor who has neither reserved title in goods nor

[153] *In re Women's Technical Institute, Inc.* 200 B.R. 77, 80 (Bankr.D.Mass.1996); *In re Slater Health Centre* (fn. 105).
[154] *In the Lee v. Schweiker* 739 F.2d 870, 875 (3rd Cir.1984).
[155] 9 F.3d 996, 999 (1st Cir. 1993).
[156] ibid. at 999.
[157] *In re Maine* 32 B.R. 452, 455 (Bankr.W.D.N.Y.1983); *In re Women's Technical Institute, Inc.* (fn. 153) 80.

taken security be allowed to walk away with his claim by virtue of an "accidental" security which he never bargained for?

Although there may be merits in recouping the debtor's claims with pre-petition claims against it, using a debtor's post-petition assets to satisfy pre-petition recoupment claims without any court approval seems to be contrary to sound bankruptcy policy. It runs counter to the philosophy of US bankruptcy law which generally tends to suggest that the bankruptcy petition date effects a cleavage between the sins of the past and the promise of the future. Hence the debtor's post-petition assets and revenues ought to be used for its rehabilitation generally and not channelled towards pre-petition claims of a creditor.

For instance s. 549 permits the trustee to avoid post-petition transfers not otherwise authorized under the Code or by the court. Section 552 makes property acquired post-petition not to be subject to any pre-petition liens (such as an after-acquired property clause). Also s. 553(a) retains a creditor's right of setoff for mutual debts "that arose before the commencement of the case." It is perhaps in recognition of the foregoing that US bankruptcy courts have time and time again counselled for a narrow construction and application of the

recoupment doctrine.[158]

Under the US bankruptcy law regime, a set-off right is based on the principle that justice and equity require that the demands of parties mutually indebted be set-off against each other and only the balance recovered.[159] A set-off right in US bankruptcy law regime is thus rooted in equity.[160] However, the rationale for the suspension of set-off rights under the automatic stay regime has been stated as being that they undermine the principle of equality among unsecured creditors, by granting a preference to a creditor through the full satisfaction of his claim.[161] This accords with the policy objectives of the statutory moratorium namely, preservation of the assets in the insolvent estate and ensuring a collective procedure. It may however not be entirely correct to posit that this position promotes the principle of equality, given that the restraint is temporary and does not extinguish the set-off holder's "security."

The doctrine of recoupment is alien to UK insolvency law. Pre-petition mutual credits, debts or other mutual dealings between the debtor and any of its creditors proving or claiming to prove for a debt in the procedure can only result to insolvency set-off

[158] *In re McMahon* 129 F.3d 93, 97 (2d Cir.1997); *In Re Public Serv. Co. of N.H.* 107 B.R. 441, 444 (Bankr.D.N.H.1989).
[159] *United States v. Norton* 717 F.2d 767, 773 (3d. Cir. 1983).
[160] *In re Braniff Airways* 42 B.R. 443, 448 (Bankr. N.D. Tex. 1984)
[161] *In re Slater Health Centre* (fn. 105); *In re Women's Technical Institute Inc.* (fn. 153) 80; *Matter of Bevill, Bresler & Schulman Asset Corp.* 896 F.2d 54 (C.A.3 1990).

claims. [162] Insolvency set-off rights in English insolvency law are self-executing, mandatory[163] and are not subject to the moratorium.[164] In *Forster v. Wilson,* [165] it was stated that the objective of insolvency set-off is to do substantial justice between contracting parties. Similarly in *Re Kaupthing Singer and Friedlander Ltd*[166] Etherton L.J. noted that,

> "The provisions for insolvency set-off are intended to promote speedy and efficient administration of the assets so as to enable a distribution to be made to creditors as soon as possible and in a manner which achieves substantial justice between the parties to the set-off and, so far as practicable, equality in the treatment of creditors. The purpose of insolvency set-off has nothing to do with the release of liabilities owed to the company save to the extent necessary to achieve those objectives."[167]

Accordingly, insolvency set-off rule may be rightly viewed as a rule of convenience given that it promotes speedy and efficient administration of the debtor's assets. Insolvency set-off also promotes substantial justice between parties to transactions which the set-off rule is applied. However, it is arguable that such justice is only limited to the contracting parties and not other creditors in line with the collective nature of insolvency law.[168]

Furthermore, the assertion that insolvency set-off rule promotes equality in treatment of parties is doubtful. In the context of the statutory moratorium

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[162] r. 4.90 IR; *M.S. Fashions Ltd. and Ors v Bank of Credit and Commerce International S.A.* [1993] Ch. 425, 446.
[163] *Halesowen Presswork & Assemblies Ltd v. Nat'l Westminster Bank Ltd* [1972] A.C. 785
[164] Ian Fletcher, John Higham, *Corporate Administrations and Rescue Procedures* (fn. 8) 57.
[165] (1843) 12 M&W 191, 204.
[166] [2011] B.C.C. 555.
[167] ibid. at 565.
[168] See Lord Hoffman's observation in *Stein v Blake* [1996] A.C. 243, 250 that the justice of the set-off rule is by no means universal i.e. not accepted by all.

and within the wider context of insolvency law's collective process, set-off rights are arguably unfair. The rights result in certain creditors being given preferential treatments 'accidentally" or in circumstances where they never bargained for. Just as is the case with recoupment claims, set-off rights are capable of disrupting the cash flow in the insolvent estate, thus interfering with the task of the officeholder and the asset-preservation objective of the moratorium.

2.3.4. Action by a Government unit

The Bankruptcy Code exempts government agencies from the ambit of the statutory moratorium when the agencies are carrying out their regulatory functions. [169] This exception is confined to enforcement actions or claims arising from the performance of regulatory duties.[170] For instance in *In re Catalano* [171] the debtor moved for issuance of temporary restraining order to prevent a city authority from demolishing rental unit allegedly necessary for a successful reorganization. Mahoney C.J. held that the condemnation proceeding brought by the city

[169] s. 362(b)(4) and (5) Code.
[170] *USA v Nicolet Inc*. (fn. 16) 207. David Epstein, Steve Nickles, *Bankruptcy* (West Group 1993) 121. The two tests which are often applied in this regard are the "pecuniary test" – see *In re Universal Life Church* 128 F.2d 1294, 1297 (9th Cir. 1997); *Thomassen v DMQA* 15 B.R. 907, 909 (9th Cir. BAP 1981); *Yellow Cab Cooperative v Metro Taxi Inc*. 132 F.3d 591, 597 (10th Cir. 1997) and the "public policy test" – see *Continental Hagen* 932 F.2d 828, 833 (9th Cir.1991); *NLRB v Edward Cooper Painting Inc*. 804 F.2d 934, 942 (6th Cir. 1986); *In re Corporacion de Servicios Midicos Hospitalarios de Fajardo* 805 F.2d 440, 445 (1st Cir. 1986).
[171] 155 B.R. 219 (Bankr. D. Neb. 1993).

authority for the removal of a structure determined to be unsafe was exempted from the reach of the automatic stay on the ground that it was an "exercise of police or regulatory power by a governmental unit."[172]

The present exception will not apply where a government agency is seeking to enforce a contract. The accompanying legislative statement expressly excludes the application of the exception in a manner which will protect the government's pecuniary interest in property of a debtor or estate. [173] Accordingly, where a government department wears two hats as a creditor and a regulator, bankruptcy courts have to determine which capacity the government department is actually acting in connection to the contract.[174] In *In re Kansas Personal Communication Services* [175] a Chapter 11 debtor-licensee/winning bidder at a pre-petition government auction of radio spectrum licenses listed the licenses on its schedule of assets and identified them as property subject to a lien securing a creditor. The

[172] ibid. at 221.
[173] The American Bankruptcy Institute has noted that the absence of a specific exception permitting governmental agencies, acting in their police or regulatory capacities, to "exercise control" over property of the estate hinders the ability of government agencies to carry out their important licensing and regulating functions that protect the safety and welfare of others. It has thus recommended the inclusion of this exception in the carve-out: *http://www.abiworld.org/AM/Template.cfm?Section=Working_Group_Proposals&Template=/CM/ContentDisplay.cfm&ContentID=36559* (accessed on 28 January 2013). Note that although some courts have often adopted a flexible approach and concluded that s. 362(b)(4) permits government agencies to exercise control over property of the estate to enforce police or regulatory powers without seeking bankruptcy court's permission e.g. *In re Universal Life Church Inc*. (n 125) 442, *others have adhered to the traditional construction of the automatic stay e.g. Hillis Motors Inc. v Hawaii Automobile Dealers* 997 F.2d 581, 590 (9th Cir. 1993).
[174] *In re Kansas Personal Communication Services* (fn. 175) 191.
[175] 252 B.R. 179, 191 (Bankr. D. Kan. 2000).

regulator initiated an action for removal of the licenses from the schedule. Robinson J. ruled that the cancellation of the licenses was not a regulatory act excepted from the automatic stay.[176]

The accompanying legislative statement of s. 362(b)(4) explains the rationale for the present exception as being to permit governmental units to exercise police and regulatory powers in pursuing actions to protect public health and safety.[177] The current exception appears to embody US lawmakers' recognition that enforcement of certain public and environmental protection laws merits a higher priority than the debtor's rights to a "cease fire" or the creditors' rights to an orderly administration of the estate.

From another perspective, it can be argued that the present exception protects the integrity of the statutory moratorium by preventing the mechanism from becoming a sanctuary of public and environmental wrongdoers. Accordingly the exception has the potential of preventing the abuse of the moratorium by debtors who may be improperly seeking refuge under the stay with the aim of frustrating necessary governmental functions. For instance in *USA v. Nicolet Inc*.[178] the automatic stay was held not to apply to Government's action to recover response clean-up costs under an

[176] See also *In re Corporacion de Servicios Midicos Hospitalarios de Fajardo* (fn. 170) 445.
[177] Senate Rep. No. 989, 95th Cong., 2d Sess. 51-52 (1978).
[178] 857 F.2d 202 (C.A.3 (Pa.) 1988).

environmental law from the debtor for clean-up of the debtor's hazardous waste site, even though the action sought money judgment for pre-petition derelictions.

There is no similar exception under the UK insolvency law regime. Accordingly, the regime does not draw a distinction between cases when a government department acts in a regulatory capacity on one hand and when it is engaged in a contract with pecuniary interest on the other. In consequence, the moratorium will apply to government agencies regardless of the capacity in which they are dealing with a debtor. Government agencies whose regulatory responsibilities are impeded by the moratorium may promptly seek for relief from the moratorium from the court.

2.3.5. Running of time and extension of time in contracts

The Code's automatic stay will neither suspend the running of time in a contract nor stop an automatic transfer of property following the expiration of an agreed or statutory period of redemption. [179] Accordingly, contracts that are

[179] In addition, s.108(c) of the Code provides for extension of time for the enforcement of claims or rights against the debtor as agreed by the debtor and its creditor if such a time period has not expired before the filing of the bankruptcy petition. Here the creditor's redemption period will be the latter of either the end of such period, including any suspension of such period occurring on or after the commencement of insolvency; or 30 days after notice of the termination or expiration of the stay. s. 108(c)(1) and (2). In the light of this, an interpretation of s. 362(a) as an indefinite stay of the statutory period of redemption will make s. 108(c) meaningless. *In re Hoffinger Industries* Inc. 329 F.3d 948, 953 (8th Cir. 2003); *In re Morton 866* F.2d 561, 565-566 (2d Cir.1989); *In The Matter of Construction Leasing and Investment Corp*. 20 B.R. 546, 547 (Bankr. MD Fla. 1982); *Bank of Commonwealth v Bevan* 13 B.R. 989, 994 (Bankr. E.D. Mich.

scheduled to automatically terminate on a specified date without the requirement of any action by the parties will be terminated on the agreed date, regardless of the commencement of insolvency.[180] The foregoing is illustrated in the case of *Hazen First State Bank v. Phillip Speight* [181] where the expiration date under the terms of agreement was expressly stated, the Court of Appeal ruled that no act on the part of the parties was required in order for the contract to expire on the contractually-specified date and that the expiration was not within the purview of the s. 362(a) stay.[182] Similarly in *Moody v Amoco Oil Co*.[183] the court ruled that the fact that termination was not effective for ninety days did not make the termination different from that effected immediately.

This present exception can be justified on the ground that suspending the running of time of contracts will amount to enlarging the contractual right of the debtor. At insolvency, an insolvent estate consisting of "all legal or equitable interests of the debtor in property as of the commencement of a case"

1981); *In re Ecklund & Swedlund Development Corp*. 17 B.R. 451, 455, 456 (Bkrtcy.D.Minn.1981). See the contrary view in *Johnson v First National Bank of Montevideo* 719 F.2d 270, 275 (8th Cir. 1983); *In re Jenkins* 19 B.R. 105, 110 (D.Colo.1982); *In re Johnson* 8 B.R. 371, 374 (Bkrtcy.D.Minn.1981). The purpose of s. 108(c) is to prevent a debtor from taking advantage of the bankruptcy scheme by filing for bankruptcy and then waiting for the statute of limitation to run on the creditor's claim. *Hazen First State Bank v Phillip Speigh*t 888 F.2d 574, 577 (8th Cir. 1989).

[180] *In re Beverages Int'l Ltd* 61 B.R. 966, 972 (Bankr.D.Mass.1986*); In re Heaven Sent* Ltd 37 B.R. 597, 597-598 (Bankr. E.D.Pa.1984); *Moody v Amoco Oil Co*. 734 F.2d 1200, 1213 (7th Cir. 1984); *Johnson v First National Bank of Montevideo* (fn. 10) 276.

[181] 888 F.2d 574, 576 (8th Cir. 1989).

[182] ibid. at 576.

[183] 734 F.2d 1200, 1213 (7th Cir. 1984),

is formed by virtue of s. 541(a).[184] Thus, whatever rights a debtor has in property at the commencement of the case continue in bankruptcy—no more, no less.[185] Once a termination notice is given and time starts running, the debtor's contractual interest is limited to the period before the expiration of the notice. This limited interest is what falls into the bankruptcy estate. Accordingly, time and time again bankruptcy courts have noted that the filing of a bankruptcy petition does not expand the contractual right of a debtor by suspending the running of time.[186]

It is submitted that the above reasoning is consistent with the settled principle of bankruptcy law that an executory contract or lease validly terminated prior to the institution of bankruptcy proceedings cannot be revived by the filing of a bankruptcy petition. [187] In *In re Butchman* [188] Schwartsberg J. had rightly observed that,

> "When a debtor's legal and equitable interests in property are terminated prior to the filing of the petition with the Bankruptcy Court that was intended to preserve the debtor's interest in such property, the Bankruptcy court cannot then cultivate rights where none can grow."[189]

Hence, as a matter of general principle, the trustee

[184] H.R.Rep. No. 595, 95th Cong., 1st Sess., reprinted in 1978 U.S.Code Cong. & Ad.News 5787.
[185] *Moody v Amoco Oil Co*. (fn. 131) 1213; *Schokbeton Industries Inc. v. Schokbeton Products Corp*. 466 F.2d 171, 176–177 (5th Cir.1972).
[186] *Moody v Amoco Oil Co*. 734 F.2d 1200, 1213 (7th Cir. 1984); *New Media Irjax v. D.C. Comics* 19 B.R. 199 (Bkrtcy.M.D.Fla.1982); *In re Benrus Watch Co*. 13 B.R. 331 (Bkrtcy.S.D.N.Y.1981); *In re Beck* 5 B.R. 169 (Bkrtcy. D. Haw.1980)
[187] *In re Commodity Merchants, Inc*. 538 F.2d 1260, 1263 (7th Cir. 1976); *In re GSVC Restaurant Corp*. 10 B.R. 300, 302 (D.C.S.D.N.Y.1980); *In re Youngs* 7 B.R. 69, 71 (Bkrtcy., D.Mass.1980); *In re Mimi's of Atlanta, Inc.,* 5 B.R. 623, 627-29 (Bkrtcy., N. D. Ga. 1980); *In re Bronx-Westchester Mack Corp*., 4 B.R. 730, 731 (Bkrtcy. S.D.N.Y. 1980); D. Fogel, "Executory Contracts and Unexpired Leases in the Bankruptcy Code" (1980) 64 Minn. L. Rev. 341, 346.
[188] 4 B.R. 379, 381 (Bkrtcy. S.D.N.Y. 1980),
[189] ibid. at 381.

succeeds only to the rights the bankrupt possessed.[190]

In the UK, just as is the case under the US regime, it is suggested that the moratorium will not affect the running of time in a contract. As a matter of general principle in English insolvency law, the officeholder takes, with a few exceptions,[191] subject to equities. Accordingly, he takes the assets of the debtor in substantially the state in which he finds them.[192] Against this background, the officeholder will be bound by the contractual terms which qualify the contract i.e. the running of time. The contractual interest which is passed to the insolvent estate is therefore limited to the period before the expiration of the contract.

Judicial support for the above reasoning can be found in the case of *Re Maxwell Fleet & Facilities Management Ltd*.[193] The issue for consideration in that case was whether limitation periods ceased to run during the period of an administration. After a careful examination of the position in compulsory liquidation, where limitation periods cease to run, Judge Sher QC concluded that,

> "The moratorium on proceedings, strong though it is, is not nearly enough to enable a court to read into a comprehensive modern statute like the Insolvency Act 1986 an implied disapplication of the limitation periods during the tenure of the administrator."[194]

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[190] *In re Beverages Int'l Ltd*. 61 B.R. 966, 972 (Bankr.D.Mass.1986); *In re Triangle Laboratories, Inc*. 663 F.2d 463, 467–68 (3d Cir.1981); *Bank of Marin v. England*, 385 U.S. 99, 101, 87 S. Ct. 274, 276, 17 L.Ed.2d 197 (1966).
[191] e.g. the avoidance of preferences and transactions at an undervalue.
[192] *In re Scheibler* (1874) L.R. 9 Ch. App. 722, 726
[193] [2001] 1 W.L.R. 323.
[194] ibid. at 328.

2.4. Relief from the statutory moratorium

The effect of the moratorium is procedural and creditors' rights ought to be suspended and not extinguished. In some cases, creditors may face the risk of incurring substantial losses if they opt to wait till the termination of the moratorium by operation of law or at the end of the procedure. The value of the assets may depreciate and creditors may lose the benefits that they would have derived from putting such assets into immediate use. In other instances, the asset may not be relevant or required in the insolvency procedure. Against this background, creditors in the two jurisdictions are afforded the opportunity to safeguard their security and proprietary interests in assets by applying for relief from the statutory moratorium.[195]

Under the UK insolvency law regime, the administrators and courts have the power to grant relief from the moratorium. This is in contrast with the US regime where only bankruptcy courts can grant relief from the automatic stay. Although no rationale has been proffered for this approach, it is arguable that Congress has deliberately opted to restrict the grant of relief to courts with the aim of avoiding inevitable conflict of interests that will arise if the power is extended to officeholders. Under Code's debtor-in-possession regime, pre-petition

[195] s. 362(d) of the Code; Sch. B1 para 43 of the Insolvency Act.

company managers will also be saddled with the responsibility of granting or refusing relief from the stay.

There are no statutory guidelines for the grant of relief from the moratorium under the Insolvency Act. However, a non-exhaustive set of guidelines to assist administrators and courts in determining applications for relief was laid down by Nicholls J. in *Re Atlantic Company Systems Plc*.[196] On the other hand, a creditor seeking for relief under the Code must show *cause* as to why the relief should be granted.[197] The Bankruptcy Code has listed two circumstances that constitute cause, namely lack of *adequate protection* by the debtor for the creditor's interest in property and the dual conditions under s. 362(d)(2), to wit, the debtor's lack of equity in the property and that the property is not necessary for an effective reorganization.[198]

A number of authorities however suggest that *cause* for stay of relief is not limited to the above.[199] This is because the operative word which introduces the causes under s. 362(d) is "includes," suggesting that the list is not exhaustive. Given that the Code does not define what constitutes cause, bankruptcy

[196] [1992] 1 All ER 476, 501-502.
[197] *In re M.J & K Co Inc*. 161 B.R. 586, 590 (Bankr. S.D.N.Y. 1993); *Sonnax Industry v Tri Component Products* 907 F.2d 1280, 1285 (2d Cir.1990); *In re Leibowitz* 147 B.R. 341, 343 (Bankr. S.D.N.Y. 1992); *In Drexel Burnham lambert group* 113 B.R. 830,837-38 (Bankr. SD. N.Y. 1990).
[198] *In re Plastech Engineered Products* 382 B.R. 90, 109 (Bankr. E.D. Mich. 2008); *In re CBJ Development Inc. 202* B.R. 467, 473 (9th Cir. BAP. 1996).
[199] *In re Internal Revenue Service v. Bacha* 166 B.R. 611, 612 (Bankr..D. Md. 1993); *In re Robbins* 964 F.2d 342, 345 C.A.4 (N.C. 1992).

courts have often exercised their discretion in the grant or denial or reliefs based on the circumstances of each case.[200] This approach has been confirmed in the leading case of *In re Robbins*[201] where it was noted that

> "According to s. 362(d), the bankruptcy court may lift the stay "for cause." Because the Code provides no definition of what constitutes "cause," courts must determine when discretionary relief is appropriate on a case-by-case basis."[202]

In a similar vein, in the *Atlantic Computer case* in the UK, Nicholls J. reiterated the point that the factors he enumerated where merely guidelines, hence the list is not exhaustive.[203] Patten J. echoed this point in *A.E.S. Barry Ltd. v. TXU Europe Energy Trading*[204] when he noted that,

> "The court of appeal (in Atlantic Computer) was careful to emphasize that these are simply principles for the guidance of the court and are not intended in some way to override the general discretion vested in the Court under the provisions of the statute. Nonetheless they are a useful guide as to the matters which one ought to consider when coming to exercise the discretion."[205]

In consequence, the factors to be considered in granting relief in both jurisdictions have been left open, giving courts wide powers to exercise their discretion on a case-by-case basis. The next paragraphs will evaluate four specific factors that are capable of influencing the exercise of discretion by

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[200] *In re Shady Grove Tech Centre Association Limited Partnership* 216 B.R. 386 (Bkrtcy D. Md. 1998). (389)
[201] 964 F.2d 342 C.A.4 (N.C.), 1992.
[202] ibid. at 345; *In re Mac Donald,* 755 F.2d 715, 717 (9th Cir.1985); *In re Boomgarden,* 780 F.2d 657, 660 (7th Cir.1985). *In re Holtkamp* 669 F.2d 505, 507 (7th Cir.1982).
[203] *In Re Atlantic Computer Systems Plc*. [1992] 2 W.L.R. 367, [1992] Ch. 505, 543.
[204] [2004] EWHC 1757 (Ch.).
[205] ibid. at (15); *Metro Nominees (Wandsworth) (No.1) Ltd v Rayment* [2008] B.C.C. 40, 45-6 – "It is emphasised by the Court of Appeal that this passage contains guidelines which must be treated as such and must not be regarded as a straitjacket, fettering the exercise of a general discretion."

courts in the two jurisdictions, namely the effect of the relief on the procedure, the balance of equities, treatment of secured claims and the conduct of the parties. The paragraphs will also examine the extent to which these factors align with the policy objectives of the statutory moratorium.

2.4.1. Effect of relief on procedure

The paramount consideration in granting relief from the statutory moratorium in both jurisdictions is whether such relief will derail the insolvency procedure or hinder the officeholder from performing his duties. This consideration aligns with the principal policy objective of the statutory moratorium in both jurisdictions previously evaluated in 2.1.1.

Under the Bankruptcy Code, relief will be granted if no bankruptcy policy necessitates interfering with the secured creditor's right to repossess his assets or enforce his security.[206] As noted in the prefatory section of 2.4, this will include, but not limited to, where the debtor has no equity in the property in issue and the property is not necessary to an effective reorganisation.[207] Accordingly, in Chapter 7 liquidation cases, the latter requirement is not necessary. This part of the thesis will focus on the second or latter limb of the requirement, while the

[206] *In re Jack Gindi* 642 F.3d 865, 875 (10th Cir. 2011); Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 299.
[207] s. 362(d)(2) of the Code.

requirement for the debtor's equity in the property is evaluated in 2.4.2.

To show that a property is "necessary for an effective reorganisation," it must be shown that the property is essential for an effective procedure, and that there is a reasonable possibility of a successful reorganisation within a reasonable time. In *In re Plastech Engineered Products* [208] the creditor successfully established that the debtor, an automobile parts supplier, had no equity in the property in issue (a tooling equipment), given that full payment had been made. This notwithstanding, the bankruptcy court denied relief on the ground that the debtor had shown that the equipment was necessary to an effective reorganisation reasonably in prospect.

Establishing that property is necessary to an effective reorganisation is a question of fact and the burden of proof is on the debtor.[209] It is suggested that showing that an asset is necessary for the effective reorganization may be easier to establish in cases where an asset constitutes the only asset or revenue-generating asset of the debtor. For instance in *In re San Clemente Estates* [210] this requirement was established because the asset was the only asset available for the debtor to build a reorganisation plan around.[211]

[208] 382 B.R. 90, 109 (Bankr. E.D. Mich. 2008).
[209] s. 362(g)(2) of the Code.
[210] 5 B.R. 605, 610 (Bankr. SD Cal. 1980).
[211] ibid at 610.

Furthermore, it is now settled that what is required is not merely a showing that if there is conceivably to be an effective reorganization, the property will be needed for it; but that the property is essential for an effective reorganization *that is in prospect*. This means that there must be "a reasonable possibility of a successful reorganization within a reasonable time."[212] It can thus be argued that even where a property is undoubtedly useful to the debtor, the regime will not permit the property to be retained if there is only a remote prospect of a successful reorganisation. It would seem that the only reasonable means of establishing this against an application for relief which is brought at an early stage of the procedure would probably be through a feasible reorganisation plan.

Under UK insolvency law regime, as a general rule, relief will be granted where it is equitable to do so. A secured creditor will not be deprived of the fruits of his security if enforcement will neither impair the officeholder from performing his duties nor adversely affect insolvency procedure. In the leading case of *Re Atlantic Computer Systems Plc*[213] Nicholls L.J. stated this point when he observed that,

> "The prohibition in s 11(3)*(c)* and *(d)* is intended to assist the company, under the management of the administrator, to achieve the purpose for which the administration order was made. If granting leave to a lessor of land or the hirer of goods (a 'lessor') to exercise his proprietary rights and repossess his land or goods is

[212] *United Sav. Association of Texas v. Timbers of Inwood Forest Associates, Ltd* 484 U.S. 365, 375-6 108 S.Ct. 626 U.S.Tex.,1988*; In re Timbers of Inwood Forest Associates Ltd.*808 F.2d 363, 370-371 (C.A.5 (Tex.),1987).
[213] [1992] Ch. 505.

> unlikely to impede the achievement of that purpose, leave should normally be given."[214]

This point was echoed in *Metro Nominees (Wandsworth) (No.1) Ltd v. Rayment*[215] where it was stated that,

> "The general rule in the normal case is that if a creditor seeks to exercise a proprietary right that is unlikely to impede the achievement of the purpose for which the administration is being pursued, then leave should normally be given."[216]

As previously noted while evaluating the US regime, this approach aligns with the underlying policy objective of the moratorium. The moratorium is primarily aimed at preserving the assets available to the officeholder at insolvency. It therefore enables the administrator to collect and manage those assets without being impaired by enforcement actions or other legal processes. Against this background, where the grant of relief from the stay will not impede the officeholder from achieving his tasks or the purpose of the administration, it is only logical that relief be granted. This would often be the case where the asset is not actually useful to the company or where the objective of the procedure has already been achieved or substantially achieved.

Hence in the recent case of *Lazari GP Ltd v Jervis*[217] the landlords applied for relief to exercise their rights to forfeit a lease of the premises of a company in administration which was occupied by a buyer under a pre-pack sale. In granting the relief,

[214] ibid. at 542.
[215] [2008] B.C.C. 40.
[216] ibid. at 45-6.
[217] [2012] EWHC 1466 (Ch). [2013] B.C.C. 294.

Briggs J. held that the purpose of the administration had been substantially achieved by the business sale agreement and would in no way be interfered with by a grant of relief to the landlords to pursue their proprietary rights.[218] A significant factor which the court took into cognizance was the fact that under the pre-pack, the third party buyer had agreed to take full risk of the exercise of those rights, hence a forfeiture had no potential adverse consequence for the achievement of the purpose of the administration.[219]

In *Magical Marketing Ltd v Phillips*[220] relief from stay was granted after Norris J. reached the conclusion that allowing the creditor to pursue its claim would not significantly impede the objective of the administration.[221] An important factor that led to this conclusion was the finding that the administration achieved its objective on the first day by selling its entire undertaking and assets to an associated company which was to collect the debts. Accordingly, the only task left for the administrators was the distribution of funds which they had in their hands.

The *Magical Marketing Ltd case* is similar to the facts of *Metro Nominees (Wandsworth) (No.1) Ltd v Rayment*[222] where relief was granted on the ground that the object of the administration namely, a better realisation of the assets than would have been

[218] ibid. at 298.
[219] ibid. at 299.
[220] [2008] F.S.R. 36.
[221] ibid. at 979.
[222] [2008] B.C.C. 40.

achieved in an immediate liquidation, had been achieved by an earlier sale agreement between the administrators and a third party.[223]

In contrast, in *Re David Meek Plant Ltd*[224] Judge Weeks QC denied relief from the moratorium after concluding that a repossession of the goods in issue would bring the administration to an abrupt end.[225] Hence where it is clear that insisting on an original bargain will be detrimental to the success of the procedure, property rights may be suspended or altered, but not extinguished. The case of *Innovate Logistics Ltd v. Sunberry Properties Ltd*[226] illustrates this point. In that case the granting of a licence for premises to a purchaser by an administrator in breach of the original licence agreement and without leave of court, was not sufficient to persuade the court to grant relief to the landlord. The court reasoned that in some circumstances, an administrator may be compelled to breach existing company contracts in pursuit of the achievement of the objective of the administration.[227] In this case, it was established that the landlord would not be substantially prejudiced by a refusal to grant leave because the administrators had agreed that the fee for the licence would be paid to the landlord.

[223] ibid. at 46.
[224] [1993] B.C.C. 175
[225] ibid. at 192.
[226] [2009] B.C.C. 164.
[227] ibid. at 179.

2.4.2. Balance of equities

Where there is likelihood that the grant of relief may impede the officeholder or derail the procedure,[228] courts in both jurisdictions ought to make a decision based on the weighing of the interests of the applicant-creditor against those of the debtor and its other creditors.[229] This weighing exercise manifests in diverse ways. The next paragraphs will evaluate some of the ways in which courts weigh the interests of parties to determine the grant of relief. The approaches will be evaluated against the background of the policy objectives of the moratorium. As previously noted, a creditor seeking for relief under the Code must show cause as to why the relief should be granted.[230] Accordingly, all relevant factors including the three factors listed as causes under s. 362(d), namely adequate protection, debtor's equity in the property in issue and the necessity of the property for an effective reorganisation will be taken into consideration in the balancing exercise.

An important factor that is capable of influencing the manner in which the court's discretion is exercised is the availability of *adequate protection*

[228] In *Lazari GP Ltd v Jervis* [2013] B.C.C. 294, 298 Briggs J. observed that the need for a balancing act did not arise if it was established that relief would not impede the procedure.
[229] *Metro Nominees (Wandsworth) (No.1) Ltd v Rayment* (fn. 205) 45-6; *Re Divine Solutions UK Ltd* [2004] 1 B.C.L.C. 373, 376.
[230] *In re M.J & K Co Inc*. 161 B.R. 586, 590 (Bankr. S.D.N.Y. 1993); *Sonnax Industry v Tri Component Products* 907 F.2d 1280, 1285 (2d Cir.1990); *In re Leibowitz* 147 B.R. 341, 343 (Bankr. S.D.N.Y. 1992); *In Drexel Burnham Lambert Group* 113 B.R. 830,837-38 (Bankr. SD. N.Y. 1990).

under s. 362(d)(1) to holders of secured claims. While its absence will constitute cause for grant of relief,[231] its presence may persuade the court to decline granting relief subject to the balancing of other factors. For instance in *Matter of Holt County Grain Storage Inc*.[232] a holder of first mortgage was denied relief from the stay notwithstanding that the debtor had no equity in the asset. The bankruptcy court took cognizance of the fact that the creditor had been adequately protected and that the asset represented all of the debtor's property, hence was necessary for the reorganisation.[233]

Lack of adequate protection is indeed the most common basis for the grant of relief under the Code.[234] Adequate protection requires that the value of the secured creditor's collateral position should not be allowed to decline because of the stay.[235] By virtue of s. 361, adequate protection includes cash payments, additional or replacement liens that are commensurate with the decrease in the value of the creditor's security interest or any relief that will enable the creditor to realise the *indubitable equivalent* of his interest in the property.[236]

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[231] *In re Mid-Atlantic Handling Systems* 304 B.R. 111, 130 (Bankr. D.N.J. 2003); David Epstein, Steve Nickles, *Bankruptcy* (fn. 170) 62; Daniel Warren, "Relief From Automatic Stay: Section 362(d)(1)" (1986) 3 Bankr Dev. J. 199.
[232] 25 B.R. 271 (Bankr. D. Neb. 1982).
[233] ibid. at 273. *Batucci v O'Neil* 64 Fed. Appx 344 (3d Cir. 2003).
[234] *In re Mid-Atlantic Handling Systems* (fn. 231) 130; *In re Telegraph Inc*. 237 B.R. 87, 91; *In re Mariner American Industries* 734 F.2d 426 (9th Cir.1984).
[235] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 299.
[236] s. 361 of the Code; *In re Mellor* 734 F.2d 1396, 1400 (9th Cir. 1984). Daniel Warren, "Relief From Automatic Stay: Section 362(d)(1)" (n 164) 200. A large equity cushion on collateral will constitute adequate protection of the creditor. *In re Idolia Avila* 311 B.R. 81, 83, 84 (Bankr. N.D. Cal. 2004); *United Finance C.y v Cote* 27 B.R. 510, 512 (Bankr.D.Or.1983); *In re Curtis* 9 B.R. 110, 112 (B.Ct .E.D. Penn. 1981); *In re San Clemente Estates* 5 B.R. 605, 610 (Bankr. SD. Cal.

Although not specifically mentioned in s. 361, the existence of *equity cushion* (evaluated in 2.4.3) on its own has been held to constitute adequate protection.[237] For instance in *In re Curtis*[238] King Jr. J. held that the existence of equity cushion of approximately $40,000 in property which was the subject of a mortgage was adequate protection for the creditor who held first mortgage in amount of $35,000 and had obtained default judgment in foreclosure action in amount of $38,222.32. The court thus held that the creditor was not entitled to relief.[239] This is plainly correct. Generally, it is incumbent on bankruptcy courts to weigh the contending interests of parties i.e. the harm which would be incurred in the event of a grant or denial of relief to either of the parities. For instance, in *In re Idolia Avila*[240] relief from stay was denied after it was established that the creditor was adequately protected by a large equity cushion and that the debtor would suffer a substantial loss in the event of foreclosure, with no economic harm to the creditor.

Under the UK regime, relief from the moratorium will be granted where it is equitable to do so.[241] Hence, courts must carry out a balancing exercise by weighing the potential prejudice which

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1980); *In re Tucker* 5 B.R. 180, 182 (B.Ct. S.D.N.Y.1980). An equity cushion is the difference between the value of the outstanding debt and the value of collateral, the latter being greater than the former. *In re Curtis,* 9 B.R. 110, 111–112 (B.Ct.E.D.Penn.1981).

[237] *In re Mellor* 734 F.2d 1396, 1400 (9th Cir. 1984); *In re San Clemente Estates* (fn 236) 610; *In re Tucker* (fn. 236) 182.

[238] 9 B.R. 110 (B.Ct .E.D.Penn.1981)

[239] ibid. at 112.

[240] *In re Idolia Avila* (fn. 236) 84.

[241] *Re Atlantic Company Systems Plc*. [1991] B.C.L.C. 606, 632.

the relief will cause to the debtor's insolvency procedure against the hardship which the relief may inflict on applicant-creditor if it is denied.[242] Prospective significant loss to the applicant-creditor will be a factor in his favour. However, such loss, irrespective of how significant, may be discountenanced if other creditors will incur substantially greater losses.[243] The instructive point to note in the balancing exercise is that it involves the exercise of judicial discretion and facts that courts ought to take into consideration in weighing the interests of parties are virtually limitless. Hence in *Re Atlantic Computer Systems Plc*.[244] Nicholls L.J. emphasized that,

> "Parliament has left at large the discretion given to the court, and it is not for us to cut down that discretion or, as it was put in argument, to confine it within a straitjacket … s. 11(3)(c) and (d) (nor paragraph 43 of Schedule B1) applies to a very wide range of steps and proceedings, and the circumstances in which leave is sought will vary almost infinitely."[245]

In the *Atlantic Computer Systems* case, Nicholls laid down guidelines that courts may follow in the balancing act. In the case itself, the court conducted its balancing exercise by examining the effect on the administration if leave were given,[246] the effect of a grant or denial on the parties, the prospects of a successful procedure if leave was refused – especially the fact that the administration was a prelude to

[242] *Innovate Logistics Ltd v Sunberry Properties Ltd* [2009] B.C.C. 164, 174; *In re Indian River Estates Inc*. 293 B.R. 429, 433 (Bankr. N.D. Ohio 2003); *In re LDN Corporation* 191 B.R. 320, 324 (Bankr. E.D. Va. 1996); *In re Robbins* 964 F.2d 342, 345 (4th. Cir. 1992).
[243] [1992] Ch. 505, 543.
[244] [1992] Ch. 505.
[245] ibid. at 541.
[246] ibid. at 538.

winding up the company[247] and the conduct of the parties.[248]

Another illustration of the balancing act can be seen in *Lazari GP Ltd v. Jervis*.[249] In granting relief from the moratorium, Briggs J. took into consideration evidence that demonstrated a real prospect that the applicant/landlords would suffer financial loss by any delay caused by being unable to enforce their rights, as well as the probable adverse effect of inability to grant a new lease new lease of the premises. On the part of the debtor, his Lordship observed that the relief would not impede the procedure, given that its purpose had been substantially achieved via a pre-pack sale.[250]

In *Bristol Airport Plc. v Powdrill & ors*[251] Sir Nicolas Browne-Wilkinson V-C endorsed the balancing act of the lower court which had taken into consideration factors such as the fact that the applicants were unsecured creditors, the detriment to similarly ranked creditors, the impediment of a relief to the achievement of the purpose of the procedure and the conduct of the parities.[252] Lastly in *Re David Meek Access Ltd*.[253] Judge Weeks QC's decision to deny relief from the moratorium was premised on the ground that the applicant finance companies had not

[247] ibid. at 538-9.
[248] ibid. at 539.
[249] [2013] B.C.C. 294.
[250] ibid. at 299.
[251] [1990] 2 W.L.R. 1362, [1990] Ch. 744.
[252] ibid. at 766.
[253] [1993] B.C.C. 175.

proved that they would suffer a significant loss compared with the position they would have been in if they had been allowed to repossess their goods when the administration order was made.[254]

In the light of the foregoing, the balancing of interests to determine whether relief from the statutory moratorium should be granted is an exercise of judicial discretion. This discretion ought to be exercised in a manner that gives effect to the objectives of the statutory moratorium. Furthermore, in the exercise of the discretion, regard ought to be given to the diverse interests of contending parties, especially the proprietary rights of creditors.

2.4.3. Treatment of secured claims

In weighing the interests of the creditor and debtor to determine whether to grant relief from the moratorium, the courts in both jurisdictions aim to protect property rights of creditors. This approach is underpinned by the principle that, save in exceptional cases, an administration or a reorganisation for the benefit of unsecured creditors ought not to be conducted at the expense of creditors with security interests or proprietary rights.[255] This also aligns with

[254] ibid. at 192. *Magical Marking Ltd v Phillips* [2008] EWHC 1640 (Pat) [2008] F.S.R. 36, 979.

[255] *In Re Atlantic Computer Systems Plc*. [1992] Ch. 505, 541*; Bristol Airport Plc. v. Powdrill* [1990] Ch. 744, 767. The Bankruptcy Code bestows the fundamental right of *adequate protection* on all secured creditors by virtue of s. 361. See also *United States v Whitting Pools Inc*. 462 US 198, 207 (1983);

the wider insolvency law policy that only assets of the debtor ought to be available to the general body of creditors. Accordingly and as discussed in 2.4.2., the Code places significant importance on the provision of adequate protection for secured creditors, the absence of which can constitute cause for relief.

An alternative ground for relief from the Code's automatic stay under s. 362(d)(2) is showing that the debtor does not have an equity in the property in issue. This must however be accompanied by the showing that the property is not necessary for an effective reorganisation, a point evaluated in 2.4.1. [256] Accordingly, bankruptcy courts have developed the *equity cushion test* for determining whether a debtor has equity in the property. It is suggested that ascertaining whether a debtor has equity in property is plausible given that if the trustee is to sell the property in which the debtor has equity, there would be something left over for the estate after paying the creditor his due. This will not harm the secured creditor who will be paid in full. A sale by the trustee would therefore enhance the likelihood of maximising realization for unsecured creditors. In contrast, if the sale is done by the secured creditor, there is a likelihood that the creditor may have no incentive to attempt to obtain a sale price over and above his own debt.

Wright v Union Central Life Ins Co. 311 U.S. 273 (1940); *Louisville Joint Stock Land Bank v Radford* 295 U.S. 555 (1935).

[256] *In re Plastech Engineered Products* 382 B.R. 90, 109 (Bankr. E.D. Mich. 2008); *In re CBJ Development Inc*. *202* B.R. 467, 473 (9th Cir. B.A.P. 1996).

In carrying out the equity cushion test, some courts have insisted on consideration of all liens regardless of whether or not other lien holders have also requested for relief,[257] while other courts have often considered the value of the lien of the applicant alone.[258] Here is a hypothetical illustration: Debtor has property valued at $10,000. Creditor C1 has a senior lien against the property securing a debt of $8,000. Creditor C2 has a junior lien against the property securing a debt of $3,000. Creditor C1 moves for relief from stay. Under the first approach, Creditor C1 will satisfy the equity cushion test given that the two secured debts of $8,000 and $3,000 together total $11,000 and thus greater than the $10,000 value of the property. In contrast, under the second approach, only Creditor C1's $8,000 will be considered, this will be less than the $10,000 value of the property, and Debtor will have equity in the property.

The first view is premised on the literal construction of the relevant provision. First, the statute refers to the debtor's "equity" which has been defined as "the amount or value of a property above the *total* liens or charges."[259] In addition, the statute does not refer to the debtor's equity as against the only

[257] *Viper Mining Co. v Diversified Energy Venture* 311 B.R. 712, 717 (Bankr. W.D. Pa. 2004); *Nantucket Investors II v California Federal Bank* 61 F.3d 197, 206-207 (3d Cir. 1995); *In re Mikole Developers Inc.* 14 B.R. 524, 525 (Bankr. E.D. Pa. 1981); *In re Dallasta 7* B.R. 883 (Bkrtcy., E.D.Pa.1980); *In re Gardner* 14 B.R. 455, 456 (Bankr. E.D. Pa. 1981); *Stewart v Gurley* 745 F.2d 1194, 1195 (9th Cir.1984); *In re Trina-Dee Inc.* 26 B.R. 152, 154 (Bankr.E.D.Pa.1983);
[258] *In re Spring Garden River Foliage Inc.* 15 B.R. 140, 143 (Bankr. M.D. Fla.1981); *In re Palmer River Reality* 26 B.R. 138, 140 (Bankr. D.R.I. 1983); *In re Certified Mortgage Corp.* 25 B.R. 662, 663 (Bankr. M.D. Fla. 1982); *In re Wolford Enterprises, Inc.* 11 B.R.571. (Bkrtcy. W.Va., 1981).
[259] *In re Faires* 34 B.R. 549, 552.

plaintiff-lienholder seeking to lift the stay or persons holding liens senior to that of the plaintiff-lienholder. This view undoubtedly favours a creditor seeking relief.

The second and opposing view which favours a debtor is based on the need to protect the interests junior lienholders as opposed to the interests of the debtor or senior lienholder. It is suggested that a more persuasive argument for the second approach would be that it is more supportive of the asset-preservation objective of the statutory moratorium.[260] Here, the comparison of the equity in the property will be between the debtor's and that of the applicant/lien-holder. Accordingly, an equity cushion test which ignores any outstanding junior encumbrance against the subject property so long as the debtor has a substantial and meaningful equity cushion over and above the senior encumbrance, will shore-up this objective. This will undoubtedly give the debtor a greater chance of proving that it has equity in the property.

However, it is suggested that the first approach is the appropriate approach based on the reasons proffered by the courts above. A number of courts have defined "equity" as used in s. 362(d)(2)(A) as the value above all secured claims against the property that can be realised from the sale

[260] Baird describes this as 'a defensible interpretation of the language of the Bankruptcy Code." Douglas Baird, Elements of Bankruptcy, 5th edn., Foundation Press 2010, 200; Charles Tabb, Law of Bankruptcy (2nd edn., Foundation Press 2009) 319.

of the property for the benefit of unsecured creditors and equity security holders.[261] Against this background, the focus is solely on the debtor's equity in the property and not the debtor's equity compared to that of the applicant/senior lien-holder. Hence the fact that the debtor's equity is slightly greater than that of the applicant is immaterial so far as the former is less than the total outstanding lien. This position is the same even in cases where some junior lienholders are in support of the reorganisation.[262] The general rule being that equity is computed from the perspective of the debtor and not the creditor who is seeking for relief.[263]

UK courts also pay significant attention to the proprietary rights of creditors.[264] As a matter of general rule, insolvency ought not to be conducted for the benefit of unsecured creditors at the expense of holders of secured or proprietary interests.[265] Accordingly, it is incumbent on courts to ensure that holders of proprietary rights are not left worse off than they would have been in an insolvent liquidation. Even where assets which are owned by third parties or

[261] *In re Plastech Engineered Products* (fn 256) 109; *Stephens Industries Inc. v McClung* 789 F.2d 386, 392 (6th Cir.1986); *In re Roane,* 8 B.R. 997, 1000 (B.Ct.E.D.Pa.1981), affirmed in 14 B.R. 542 (D.C.E.D.Pa.1981).
[262] A contrary decision was reached in *In re Spring Garden River Foliage Inc.* 15 B.R. 140, 143 (Bankr.M.D.Fla.1981); *In re Palmer River Reality* 26 B.R. 138, 140 (Bankr.D.R.I.1983) where in calculating the total equities, the Courts excluded the equities of lien holders who were in support of the debtor's reorganisation plan. In *In re Spring Garden Foliage, Inc.* 15 B.R. 140, 143 (Bkrtcy. M.D. Fla. 1981), Paskay J. described this approach as having "no support by logic or by the legislative history of § 362."
[263] *Nantucket Investors II v. California Fed. Bank* (fn. 257); *Stewart v. Gurley* 745 F.2d 1194 (9th Cir 1984); Charles Tabb, *Law of Bankruptcy* (fn. 84)319.
[264] *Re Atlantic Computer Systems Plc.* (fn. 38): "Great importance or weight should be given to proprietary interests of a lessor and where an administration order is made in lieu of liquidation."
[265] *Metro Nominees (Wandsworth) (No.1) Ltd v Rayment* (fn. 205) 45-6.

subject to security interests are used in the course of the administration procedure,[266] the general position is that the affected secured creditor must be adequately compensated by being given the equivalent value of his security.[267] An unavoidable case could be where there is a great prospect of success of an insolvency procedure and the court also considers that the secured creditor will not incur any substantial loss by a further delay in granting relief.[268] This approach places a secured creditor in the UK regime on the same footing with his US counterpart.

It is argued that the foregoing is sound insolvency law practice. First, insolvency law ought not to be a forum for confiscating the assets of other parties or expanding the contractual rights of debtors. Only assets of the debtor ought to be used for the procedure or available for the general body of creditors. However the insolvency policy in both jurisdictions has recognised that in some cases the officeholder may have a greater incentive to maximize the value of assets in the possession of the company, notwithstanding that such assets are owned by third parties or subject to security interests. As previously noted, by comparison, creditors may not necessarily have the incentive to realize any value above that owed by the company.

In the light of the foregoing, the following

[266] *Re Atlantic Computer Systems Plc*. (fn. 38) 501-502*; Innovate Logistics Ltd* (fn. 157) 174.
[267] [1992] 1 All ER 476.
[268] Sch. B1, Paras 70, 71 and 72 of the Act.

conclusions can be reached as regards the treatment of secured claim holders in the two jurisdictions with regards to the statutory moratorium. First, both jurisdictions duly respect the proprietary rights of creditors. Secondly, the procedure will not be carried out for the benefit of unsecured creditors at the expense of creditors with proprietary interests. Thirdly and notwithstanding the foregoing, assets that are subject to proprietary claims will only be used in the procedure where they are necessary for the reorganisation and there is a reasonable prospect of a successful reorganisation. Finally, assets that are subject to proprietary claims will only be used if the affected creditor is adequately protected.

2.4.4. Conduct of the parties

As previously noted, grant of relief from the statutory moratorium is discretionary. Accordingly, courts in the two jurisdictions are mandated to take all relevant factors into consideration in the exercise of their discretion.[269] The courts have a wide discretion in relation to factors to be considered in determining the grant of relief.[270] One of such relevant factors capable of influencing the exercise of the court's discretion is the conduct of the parties.

Under UK insolvency law, it has been held that it is incumbent on the applicant-creditor to make

[269] *Bristol Airport v Powdrill & ors* [1990] 2 W.L.R. 1362, [1990] Ch. 744.
[270] *Fashoff (UK) Ltd v Linton* (fn. 73) 367.

a good case for himself by making his position clear from the outset and promptly filing his application for leave.[271] A delay in an application for relief or conduct which suggests that a creditor is in support of an officeholder's reorganisation plan is likely to have an adverse effect on a subsequent application for relief. In refusing to grant relief in *Bristol Airport v Powdrill*[272] the court took into account the fact that during the administration, the applicants had stood by and benefited from the business under the supervision of the administrator and also received sums exceeding what they would have received in liquidation.[273] Other objectionable conducts such as flouting the prohibition prior to an application may be detrimental to an application for relief.[274] This can be contrasted with the attitude of the applicant in *Re Atlantic Computer Systems Plc*.[275] who from the outset of the administration sought the administrator's consent to the realisation of its security.[276]

Under the Bankruptcy Code, a debtor's bad faith can constitute sufficient cause for lifting the statutory moratorium.[277] What will constitute bad faith will depend on the facts of each case. It is incumbent on courts to consider the actions of the debtor to

[271] *Re Atlantic Computer Systems Plc*. (fn. 38) 498*; Fashoff (UK) Ltd v Linton* (fn. 73) 378 (98)-(99), 379 (109)-(110).
[272] [1990] 2 W.L.R. 1362, [1990] Ch. 744
[273] ibid. at 767.
[274] (fn. 272) 767, 771.
[275] (1992) Ch. 505.
[276] ibid. at 539.
[277] s. 362(d)(1) of the Code; *In re Club Tower* 138 B.R. 307, 310 (Bankr. N.D. Ga. 1991); *In re Citadel Properties Inc*. 86 B.R. 275, 277 (Bankr. M.D. Fla. 1988). James Sack, "Adequate Protection" (1985) 2 Bankr Dev. J. 21, 34.

determine if it is colourable in any way.[278] In the case of *In re RAD Properties*[279] the debtor filed its bankruptcy petition on the eve of foreclosure. Proctor J. granted the creditor's application to modify automatic stay in order to permit continuance of foreclosure proceedings on the ground that the bankruptcy filing was done in bad faith. Similarly in *In re Citadel Properties Inc*.[280] a bankruptcy petition was filed less than one hour prior to a scheduled foreclosure sale of a one-asset enterprise with no employees and no source of income. Again Proctor J. granted relief to the creditor on the ground of bad faith on the part of the debtor.[281]

Indeed, time and time again bankruptcy courts have held that bad faith filing of a bankruptcy petition on its own constitutes *cause* for lifting of the statutory moratorium.[282] This position is plainly correct. First, once bad faith is established in the filing, the whole bankruptcy petition is tainted and there is no need to examine the merits or otherwise of the moratorium. Accordingly, Epstein has noted that in cases relating to a finding of bad faith, the concern is much broader than the threat to the creditor's collateral; it amounts to an abuse of the bankruptcy process against the

[278] *In re Phoenix-Piccadilly Ltd* 84 B.R. 843 (Bankr.M.D.Fla.1988); *In re RAD Properties* 84 B.R. 827 (Bankr.M.D.Fla.1988).
[279] 84 B.R. 827 (Bankr.M.D.Fla.1988).
[280] 86 B.R. 275.
[281] Ibid. at 276.
[282] ibid at 829; *In re Bell Partners, Ltd*. 82 B.R. 593 (Bkrptcy.M.D.Fla.1988); *In re Phoenix–Piccadilly, Ltd*. (fn. 278); *In re Sar–Manco, Inc*., 70 B.R. 132 (Bankr.M.D.Fla.1986); *In re Little Creek Development Co*. 779 F.2d 1068 (5th Cir.1986); *In re Albany Partners, Ltd*. 749 F.2d 670 (11th Cir.1984); *In re Victory Const. Co. Inc*. 9 B.R. 549 (Bkrtcy..Cal. 1981).

intentions of the bankruptcy law.[283] Secondly, the moratorium ought to serve as a shield for the debtor in line with the earlier evaluated objectives and not as a sword. Hence, an efficient relief procedure ought to safeguard against the offensive use of the statutory moratorium solely as a means of preventing creditors from enforcing contractual remedies or as a bargaining tool to extract concessions from secured creditors.[284]

UK courts have not had the opportunity to exercise their discretion in granting or refusing relief where the filing of the insolvency petition was done in bad faith. In the recent case of *Somerfield Stores Ltd and Spring Ltd* [285] Judge Purle QC stated that administrators cannot and should not hide behind the moratorium to delay proceedings brought under the Landlord and Tenant Act 1954 – as it was improper for administrators to use the power to give or withhold consent as a bargaining tool.

In the earlier case of *Re Dianoor Jewels Ltd*,[286] the principal contention was that the petition for the administration order was an abuse of process, given that the company was the alter ego of a husband and

[283] It has however been posited that in cases relating to a finding of bad faith, the concern is much broader than the threat to the creditor's collateral; It amounts to an abuse of the bankruptcy process against the intentions of the law. David Epstein, Steve Nickles, *Bankruptcy* (fn. 170) 149.
[284] *In re Cooper* 116 B.R. 469, 472 (Bkrtcy..E.D.Va. 1990); *In re A.H. Robins Co*. 828 F.2d 1023, 1026 (4th Cir.1987); *Drubner v Gaslight Village* 8 B.R. 866, 870 (Bankr.D.Conn.1981). However see *Pettibone Corp v Baker* 110 B.R. 848, 855 (Bankr.N.D.Ill.1990) where it was held that the debtor's alleged offensive use of the stay "is precisely what the law allows a debtor to do."
[285] [2010] EWHC 2084 (Ch.).
[286] [2001] 1 B.C.L.C. 450.

the latter had simply influenced the directors into commencing the insolvency proceedings with the aim of thwarting the enforcement of a subsisting judgment. In rejecting this argument, Blackburne J., stated that regardless of whether the administration petition was an abuse of process, the statutory requirements for commencing the procedure had been sufficiently demonstrated, namely, that the company is or is likely to become unable to pay its debts and the court considers that the making of an administration order would be likely to achieve one or more of the statutory purposes. According to his Lordship,

> "The fact that the making of an administration order may thwart the genuine claims of a third party is not a reason for not making it ... It frequently happens that a purpose of the making of an administration order is to stop the prosecution of legal proceedings against the company's property. It is none the worse for that."[287]

Although this position may not be emotionally appealing, it is plainly correct. If the petition fulfills the statutory requirements, the motive is immaterial.

Significantly, in *Innovate Logistics Ltd v Sunberry Properties Ltd*[288] the granting of a licence for premises to a purchaser by an administrator in breach of the original licence agreement and without leave of court was not sufficient to persuade the court to grant relief to the landlord. Notwithstanding the objectionable behaviour of the administrator,[289] the

[287] ibid. at 458.
[288] [2009] B.C.C. 164.
[289] Goode describes the decision as "certainly an unusual one" in Roy Goode, *Principles of Corporate Law* (at p. 425). The decision has also been criticised by Counsel for the landlord in Gabriel Moss, "Court of Appeal Confiscates Landlord's Bargaining Position" (2009) Ins. Int. 1.

court of appeal proceeded with the balancing of interests and subsequently refused leave. The court reached the conclusion that in some circumstances, an administrator may be compelled to breach existing company contracts in pursuit of the achievement of the objective of the administration.[290]

The approach of the court in *Innovate Logistics* can be justified on the ground that regardless of the initial wrongful act of the administrator, his action ensured that large sums, by way of book debts, which would pay off secured creditors and provide dividends to the unsecured creditors, were collected by reason of the fulfillment of the debtor's outstanding contracts.[291] Furthermore, the landlord stood to benefit from the purchaser's occupation of the property since the debtor did not have funds to pay the rent and the purchaser had agreed to pay a monthly amount that was equal to the rent under the lease. In addition the rent payable under the lease was higher than the market rent and it would have been impossible for the landlord to re-let at such a rate.[292] Granting leave to the landlord solely because of the breach of the leasehold covenant by of the administrator would have amounted to converting the relief procedure into a punitive mechanism.

[290] ibid. at 179.
[291] [2009] B.C.C. 164, 179 (51), 176. Furthermore, the interference with the landlord's proprietary rights was temporary and was to last for the period of the unlawful licence when the purchaser was to occupy the premises to carry out the business and realise book debts.
[292] Ibid. at 181 (67).

Conclusion

It is impossible for all creditors of an insolvent company to receive the fruits of their pre-insolvency contractual bargains.[293] The fact that a company is undergoing an insolvency procedure clearly points to its inability to fulfil those pre-insolvency contractual obligations to the letter. Hence, permitting creditors to enforce their claims and effect repossession against the debtor once the insolvency procedure commences will effectively jeopardise the objectives of the procedure.

The Bankruptcy Code's automatic stay and the Insolvency Act's moratorium operate in a similar manner and substantially have the same effect on contracts. They constitute another occasion where insolvency law interferes with pre-petition contracts and the enforcement of contractual remedies. They also constitute one of the few instances where proprietary and security interests are interfered with during formal insolvency procedures.

Once in place, the statutory moratorium constitutes a near impenetrable barrier to certain unilateral creditor actions and claims against the insolvent company. These suspensions of rights preserve the assets available to the officeholder, gives the officeholder a breathing spell to perform his responsibilities and enhances a collective procedure as

[293] Daniel Keating, 'Offensive Use of the Bankruptcy Stay' (1992) 45 Vand. L. Rev. 71, 122.

opposed to a premature piece-meal dismemberment of the debtor's assets.

Against this background, the statutory moratorium undoubtedly promotes sound insolvency law policy objectives. Accordingly its transient interference with legitimate contractual rights is arguably justifiable. The mechanism for relief from the statutory moratorium creates an avenue for the protection of the interests of creditors, especially holders of proprietary claims. Hence, while the restraint by the statutory moratorium may impose temporary inconvenience on individual creditors, it enhances efficiency in the administration of the insolvent estate as well as the maximisation of realisations for the general body of creditors.

CHAPTER THREE
DISCLAIMER/REJECTION OF CONTRACTS

3.0. Introduction

Companies usually engage in diverse contractual arrangements and relationships in the course of their operations. At the commencement of formal insolvency proceedings, some of these contracts may be essential to the success of the insolvency procedure. Conversely, others may be burdensome to the company, imposing enormous obligations without reciprocal benefits, such that the performance of those contractual obligations may result in the dissipation of the company's limited resources.

The commencement of formal insolvency does not automatically terminate pre-petition executory contracts unless otherwise stipulated in the contract.[1] Contracts that are not terminated prior to the commencement of insolvency will survive the insolvency filing. Although executory contracts are not automatically terminated, they are not also enforceable per se against the debtor or the bankruptcy estate. Certain officeholders in under the Insolvency Act and the Bankruptcy Code are

[1] Such termination-at-insolvency clauses are ipso facto clauses which are unenforceable at insolvency under s. 365 of the Code subject to the exceptions analysed in chapter one. UK law upholds termination at insolvency clauses so long as they do not effect a transfer of the debtor's asset.

empowered to *disclaim* or *reject* such contracts respectively in appropriate cases. [2] Conversely, officeholders are also empowered to look into the debtor's inventory of executory contracts and cherry-pick beneficial contracts with the aim of maximising realisations for the general creditors.

This chapter analyses the policy objectives of the power to disclaim executory contracts under the UK Insolvency Act and the corresponding power to reject or assume pre-insolvency executory contracts under the Bankruptcy Code. The chapter evaluates the statutory rules and their efficacy at achieving the policy objectives. It also attempts to develop a sound understanding of and distinction between the concepts of disclaimer and rejection of executory contracts in the two jurisdictions.

3.1. The policy rationale

3.1.1 Asset-preservation/maximisation of realisations

One of the cardinal objectives of corporate insolvency law is the maximization of realisations for the benefit of the general body of creditors. The disclaimer/rejection and assumption provisions are some of the mechanisms through which this insolvency law objective is achieved. The power of officeholders to disclaim/reject or assume executory

[2] s. 178 0f the Act and s. 365(a) of the Code. The UK Insolvency Act does not explicitly empower administrators to disclaim contracts.

contracts and unexpired leases enables them to renege on any unbeneficial pre-petition executory contract in the debtor's inventory. In consequence, contracts which will require the dissipation of the limited assets of the company in performance, without commensurate benefits to the insolvency estate can be reneged.

This power enables the debtor or bankruptcy estate to have a clean break from the pre-petition contractual liabilities of the debtor. This obviates the need to expend the limited resources of the corporate debtor in performing the obligations under such unbeneficial contracts.[3] It also prevents the depletion of the debtor's assets, considering that the performance of such onerous contracts after the commencement of insolvency will give rise to liabilities ranking as expenses of the liquidation or reorganisation.[4] The debtor is therefore relieved of burdensome contractual obligations that may have contributed to its insolvency.[5]

Secondly, the power to assume pre-petition executory contracts under the Code, provides the officeholder with the opportunity to cherry-pick beneficial executory contracts.[6] This power enables the officeholder to preserve useful pre-insolvency

[3] *In re Park Air Services plc*. [2000] 2 AC 172, 184; Report of the Review Committee, *Insolvency Law and Practice,* Cmnd 8558 (1982), para.1185.
[4] *Re Nottingham General Cemetery* [1995] Ch. 683.
[5] *In re Perry Elton Register* 95 B.R. 73, 74; *Chattanooga Memorial Park v. Still* 574 F.2d 349, 350–51 (6th Cir.1978); Robert Jordan, William Warren, et. al. *Bankruptcy* (5th edn, Foundation Press 1999) 335.
[6] Michael Andrew, "Executory Contracts In Bankruptcy: Understanding 'Rejection'" (1988) 59 U. Colo. L. Rev. 845, 895.

executory contracts for the benefit of the general creditors. This ensures that valuable contracts and assets of the debtor are not lost in course of the insolvency, but channelled towards maximising returns to creditors.[7] The assumption provision thus facilitates the swelling of assets in the estate in furtherance of insolvency law's cardinal objective of maximisation of realisations.[8]

The foregoing policy objectives of the rejection and assumption provisions were stated by Klobucher J. in *In re Norquist*[9] when he noted that,

> "The purpose for allowing the trustee or debtor-in-possession to assume or reject an executory contract is to enable a trustee or troubled debtor to take advantage of a contract that will benefit the estate by assuming it or alternatively, to relieve the estate of a burdensome contract by rejecting it. Rejection of an executory contract … relieves the debtor of burdensome future obligations while he is trying to recover financially."[10]

It is instructive to note that, in contrast to the Bankruptcy Code, the Insolvency Act does not provide for an express *assumption* of contracts. Indeed in the recent case of *Mackay v Kaupthing Singer & Friedlander Ltd*[11] it was held that using the term *adoption* in sale contracts is "a trifle misleading," given that the Insolvency Act only employs the expression in relation to contracts of

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[7] *In re Jeffrey Lavigne* 114 F.3d 379, 386 (2nd Cir 1997); *Leasing Service Corp v First Tennessee Bank National Association* 826 F.2d 434, 436 (6th Cir. 1987).
[8] *SSSL Realisations* (2006) Ch 619; Edward Bailey, Hugo Groves, *Corporate Insolvency Law And Practice* (3rd edn, LexisNexis Butterworth 2007)900; Roy Goode, *Principles of Corporate Insolvency* (4th edn, Sweet & Maxwell 2011) 200.
[9] 43 B.R. 224 (Bankr.E.D.Wash.1984).
[10] ibid. at 225-6; *In re Chateaugay Corp*. 10 F.3d 944, 955 (2d Cir.1993); *Burger King Corp. v. Rovine* 6 B.R. 661, 666 (Bankr.W.D.Tenn.1980); *In re Jolly*,574 F.2d 349, 350 (6th Cir.1978).
[11] [2013] B.C.C. 752, 760.

employment.[12] The implication of an express power to assume contracts is evaluated in detail in 3.3. For now, it suffices to bear in mind that under the UK regime, an election by the liquidator not to disclaim a contract (i.e. to perform) has the same practical effect as an assumption by a trustee or debtor-in-possession under the Bankruptcy Code.

3.1.2 Equality?

In his seminal work, Baird has emphasised the role of rejection in furthering collectivity by asserting that the mechanism gives the trustee the ability to breach contracts, which ensures *equal treatment* among those who are similarly situated.[13] He states that by virtue of the rejection provision, those with actions for damages against the trustee are treated the same way and that at the end of the day, they all have a claim against the debtor and they all share pro rata in the bankruptcy estate.[14]

With respect, Baird's proposition of the role of rejection in promoting equality is overstated in terms of practice. In reality, rejection plays a very limited role in this regard. The primary focus of an officeholder when disclaiming or rejecting pre-petition executory contracts is to relieve the debtor or bankruptcy estate from being shackled with

[12] Sch. B1, par. 99(5) of the Act.
[13] Douglas Baird, *Elements of Bankruptcy* (5th edn, Foundation Press 2010) 117.
[14] ibid.

unbeneficial contracts. The aim is to avoid asset depletion through the performance of such contractual obligations. The effect of the pre-insolvency executory contract on individual creditors is not a primary consideration, what is paramount is the effect of the transaction on the debtor's net asset base.

An illustration of this point is where the debtor's inventory has multiplicity of executory contracts for the same purpose. The logical action for an officeholder in this circumstance will be to perform or assume one or two of the contracts based on the needs of the debtor or the bankruptcy estate and disclaim or reject the rest so as not to dissipate limited resources on unprofitable contracts. The officeholder will be acting in line with the policy objectives of the disclaimer or rejection mechanisms notwithstanding that this will result in an unequal treatment of similarly ranked creditors.

3.2. Power to disclaim or reject contracts

3.2.1. The scope of power of disclaimer/rejection

Upon insolvency under the UK regime, the liquidator is statutorily empowered to repudiate onerous pre-insolvency executory contracts of the debtor.[15] A disclaimer is a unilateral repudiation of the contract by the debtor. It releases the debtor from all

[15] s. 178 Insolvency Act 1986.

future obligations under the contract.[16] Consequently, the contract is determined from the date of the disclaimer, together with the rights and liabilities of the debtor in the disclaimed contract or property.

Under the Bankruptcy Code, the trustee can elect to either assume or reject executory contracts and unexpired leases in the debtor's inventory.[17] Although the mechanism for the rejection of contracts is aimed at achieving a similar objective as the disclaimer under UK insolvency law, the two are conceptually different. Under the Bankruptcy Code, the debtor is regarded as a distinct entity from the bankruptcy estate created at the filing of the bankruptcy petition. This is premised on s. 541 of the Code which stipulates that "the commencement of a case under s. 301, 302, or 303 of this title creates an estate."[18] Sections 301, 302 and 303 deal with voluntary, joint and involuntary insolvency procedures. The bankruptcy estate is therefore not regarded as a party to pre-petition contracts of the debtor and is not bound by them.

The consequence of this is that "rejection" is not just the opposite of assumption. It is not a mere refusal to perform pre-petition executory contracts. It is a decision by the trustee on behalf of the bankruptcy estate *not to assume* the executory

[16] Roy Goode, *Principles of Corporate Insolvency* (fn. 8) 200.
[17] s. 365(a) of the Code; Charles Tabb, *The Law of Bankruptcy* (2nd edn, Foundation Press 2009) 815, 845.
[18] s. 541(a) Bankruptcy Code.

contract of the debtor.[19] In a bid to eliminate the confusion to which the foregoing often gives rise to, the National Bankruptcy Review Commission had in the past recommended that the concept of "rejection" in the Code should be replaced with "election to breach" while "assumption" should be replaced with "election to perform." [20] A rejection is therefore a choice by the bankruptcy estate not to become a party to a pre-insolvency contract of the debtor company and its counterparties.[21] Conversely, in assuming an executory contract, the bankruptcy estate accepts the contract and place of the debtor in the pre-petition contract.

A disclaimer or rejection does not have the effect of a rescission. There is no retrospective termination of accrued rights and liabilities; only prospective obligations under the contract are terminated. [22] In consequence, only executory contracts can be disclaimed or rejected. Executed contracts that have been fully or substantially performed cannot be disclaimed or rejected.[23] Such contracts cannot be considered as being onerous or burdensome, as there are no outstanding or

[19] *Thompson v Lil Joe Records Inc*. 476 F.3d 1294 (11th Cir. 2007; *In re Austin Development* 19 F.3d 1077 (5th Cir. 1994); Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 818.
[20] David Epstein, Steve Nickles, "The National Bankruptcy Review Commission's Section 365 Recommendations and the 'Larger Conceptual Issues'" (1997-1998) 102 Dick. L. Rev. 679, 680.
[21] Michael Andrew, "Executory Contracts In Bankruptcy: Understanding 'Rejection'" (fn. 6) 931: "The election to 'assume or reject' is the election to assume or not to assume; 'rejection' is the name for the latter alternative."
[22] S. 178(4)(a) of the Act; *Re No. 1 London Ltd* [1991] B.C.C. 118, 119.
[23] *Capital Prime Plc. v Worthgate Ltd* [2000] 1 B.C.L.C. 647.

prospective obligations to be performed.[24]

Under the UK regime, the power to disclaim contracts is conferred only on liquidators. Although a limited form of disclaimer has been given to administrative receivers in relation to employment contracts, [25] an administrator is not statutorily empowered to renege on the pre-insolvency contracts of the debtor.[26] The justification for this position is yet to be properly explained. In *Astor Chemicals v Synthetic Technology Ltd*,[27] Vinelott J. was reluctant to relieve a company in administration of its pre-petition contractual obligations by way of a disclaimer. His lordship noted that,

> "There is in this respect no analogy between the position of a receiver and an administrator. The administrator is appointed to manage the affairs of the company and not to realise them for the benefit of one of the creditors."[28]

The decision in *Astor Chemicals* was cited with approval by Scott J. in *P & C and R & T (Stockport) Ltd* [29] where the court concluded that "an administration order does not constitute an authority for the administrators to break the company's contracts."[30] It has been suggested that it would be inappropriate for a company in administration which

[24] A contract for the sale of land cannot be disclaimed by the liquidator as this would deprive the buyer of his equitable title. *Capital Prime Properties Plc. v Worthgate Ltd* (fn. 23) 534; *Re Bastable* [1901] 2 K.B. 518, 527-8; See also the receivership cases of *Telemetrix Plc. v Modern Engineers of Bristol Plc.* [1985] B.C.L.C. 213, 217; *Freevale Ltd v Metrostore Ltd* [1984] B.C.L.C. 72, 81-82.
[25] s. 37(2) Insolvency Act.
[26] *Joint Administrators of Rangers Football Club Plc.* [2012] S.L.T. 599, 606; *Re P & C v R & T (Stockport) Ltd* [1991] B.C.C. 98, 104; *Astor Chemical Ltd v Synthetic Technology Ltd* [1990] B.C.C. 97; Roy Goode, *Principles of Corporate Insolvency* (fn. 8) 767; Edward Bailey, Hugo Groves, *Corporate Insolvency Law And Practice* (fn. 8) 900.
[27] [1990] BCLC 1.
[28] ibid. at 12.
[29] [1991] B.C.C. 98.
[30] ibid. at 104.

might yet resume trading to be able to disclaim onerous contracts and property.[31] With respect, this reason is far from convincing.

The primary objective of a disclaimer is to exempt the company from performing contractual obligations which may be detrimental to the insolvent estate. There will be occasions where disclaiming onerous contracts will enhance the prospects of achieving the purpose of administration.[32] For instance, the administration procedure's objective of achieving a better result for creditors as a whole than would be achieved in a winding up[33] equates to objectives pursued in liquidation, hence an express disclaimer power may be required. Judicial support for this argument can be found in the observation of Norris J. in *BLV Reality Organisation Ltd v Batten*[34] where he noted that,

> "The obligation of the administrators is to perform their functions in the interests of "the creditors as a whole" … It may be in the interests of the creditors as a whole that one particular contract with one particular creditor is terminated (even wrongfully): for example if the administrators thought that a particular service could be provided more cheaply or to a higher standard than was currently being done by a creditor with a continuing contract for a service necessary to the on-going trading, with a beneficial result to the creditors as such."[35]

Against this background, it would have therefore been expedient to expressly grant the administrator the power to disclaim in appropriate cases. This would reduce the likelihood of an administrator being

[31] Edward Bailey, Hugo Groves, *Corporate Insolvency Law And Practice* (fn 8) 900.
[32] Sch. B1, Para 3(1)(a), (b) and (c) Insolvency Act.
[33] Sch. B1, Para 3(1)(b) Insolvency Act.
[34] [2009] EWHC 2994 (Ch) (20).
[35] ibid. at (20).

exposed to tortious liabilities for interfering with contracts for the purpose of the administration.[36]

It is suggested that an administrator can choose not to perform a pre-petition executory contract in the exercise of his power to achieve the purpose of the administration.[37] In addition, the Act confers an administrator with the power to "do anything necessary or expedient for the management of the affairs, business and property of the company."[38] It is suggested that this provision is broad enough to encompass powers of the administrator to repudiate executory contracts which may impair the administration. UK courts will often ratify the repudiation of executory contracts involving personal rights by an administrator when it is done in furtherance of the purpose of the administration.[39]

In *Joint Administrators of Rangers Football Club Plc*.,[40] it was held that an administrator may have to decline to perform a contractual obligation of the company in pursuit of the statutory objective or objectives in his proposals if that is in the interest of the company's creditors as a whole.[41] In addition the court ruled that should the administrator opt not to perform a contract, the court would not, absent

[36] This issue is explored further below.
[37] Para. 3(1). See the submission of Counsel for administrator in *Lictor Anstalt v Mir Steel UK Ltd* [2012] Bus. L.R. D84, D86.
[38] Para. 59(1) and 1(1).
[39] *Innovate Logistics Limited v Sunberry Properties Limited* [2009] B.C.C. 164.
[39] Roy Goode, *Principles of Corporate Insolvency* (fn. 8) 453; *Hachette UK v Borders* [2009] EWHC 3487.
[40] [2012] S.L.T. 599 – a decision of Scotland's Outer House, Court of Session.
[41] ibid. at 608.

exceptional circumstances, force the company to perform those contractual obligations to the detriment of the creditors as a whole.[42] Hence, as matter of general principle, courts will leave commercial decisions to the discretion of administrators who are usually in a better position to make such decisions.[43] Commercial decisions will include the decision as to whether to renege or perform pre-petition contracts.[44]

3.2.2. The timing of the decision

Executory contracts generally remain in effect pending assumption or disclaimer/rejection by the officeholder.[45] The timing of the officeholder's decision is therefore crucial. There are usually two competing interests. The officeholder will desire as much time as possible to decide which pre-petition contracts will be beneficial to the general creditors depending on the objective(s) of the insolvency procedure. Conversely, a solvent party will be in favour of having an early decision by the officeholder rather than being left in limbo. During the *limbo period*,[46] the solvent party may be hesitant to expend

[42] ibid. at 609.
[43] *BLV Reality Organisation Ltd v Batten* (fn. 34) (20): "What the administrators decide to do about it, is a matter of commercial judgement. They have decided to terminate the relationship." See also *MTI Trading Systems Ltd v Winter* [1998] B.C.C. 591, 594; *Re NS Distribution Ltd* [1990] B.C.L.C. 169.
[44] Edward Bailey, Hugo Groves, *Corporate Insolvency Law And Practice* (fn. 8) 399.
[45] *In re Pub. Serv. Co. of N.H.* 884 F.2d 11, 14 (1st Cir.1989); *In re Boston Post Rd. Ltd. P'ship* 21 F.3d 477, 484 (2d Cir.1994); *Matter of Whitcomb & Keller Mortgage Co.*, 715 F.2d 375, 378–79 (7th Cir.1983); *In re Cochise College Park, Inc.* 703 F.2d 1339, 1352 (9th Cir.1983).
[46] The period between the commencement of insolvency and when an officeholder makes a decision whether to disclaim or reject an executory contract.

resources towards making substitute contracts, given that the pre-insolvency executory contract may later be performed or assumed. Again, he may not be able to make reliable future business plans as the contract may be disclaimed or rejected by the officeholder.[47]

Tabb has described the Bankruptcy Code's approach as being "markedly pro-debtor and remarkably unsympathetic to the concerns of the non-debtor party to the contract."[48] This observation is premised on the ground that only the bankruptcy estate can enforce an executory contract prior to the debtor-in-possession or trustee's decision to reject or assume the contract.[49] The contract cannot be enforced against the insolvent estate, notwithstanding that the estate has received post-petition benefits under it.[50]

It is suggested that this position is underpinned by two principles. First, assumption or rejection of contracts determines whether a contract is to be categorised as an administrative expense under s. 503(b) of the Code or a pre-petition claim under s.

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[47] Note also that a unilateral termination of a contract by the solvent party based on insolvency will be invalid under the anti-ipso facto rule of s. 365(e) Code.
[48] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 872.
[49] *In re Monarch Capital Corp* 163 B.R. 899, 907 (Bankr. D. Mass. 1994); *In re Gunter Hotel Assocs*. 96 B.R. 696, 700 (Bankr.W.D.Tex.1988); *In re T.H.W. Enterprises, Inc*. 89 B.R. 351, 354 (Bankr.S.D.N.Y.1988); *In re Metro Transp. Co*. 87 B.R. 338, 339 (Bankr.E.D.Pa.1988); *In re Feyline Presents, Inc*. 81 B.R. 623, 626 (Bankr.D.Colo.1988); *In re O.P.M. Leasing Services, Inc*. 79 B.R. 161, 164 (S.D.N.Y.1987); *In re Wilson* 69 B.R. 960, 965 (Bankr.N.D.Tex.1987).
[50] *In re FBI Distribution Corp*. 330 F.3d 36, 43 (1st Cir.2003); *In re Monarch Capital Corp*. (fn. 49) 907; *United States ex rel. Postal Serv. v. Dewey Freight Sys., Inc*. 31 F.3d 620, 624 (8th Cir.1994); *In re Gunter Hotel Assocs*. (fn. 49) 699–700; *Wilson v. TXO Prod. Corp*. 69 B.R. 960, 965–66 (Bankr.N.D.Tex.1987); *N.L.R.B. v. Bildisco and Bildisco* 465 U.S. 513, 532, 104 S.Ct. 1188 U.S., 1984.

365(g) of the Code.[51] Secondly, the Code requires assumption or rejection of contracts to be approved by a bankruptcy court.[52] In addition, assumption or rejection must be express, and not by implication or conduct.[53] Hence in *In re El Paso Refinery*[54] Clark J. noted that "until the court has affirmatively authorized *rejection*, the non-debtor party is not free to ignore the terms of the contract, and must continue to perform."[55] Worse still, there is authority for the proposition that the trustee can enter into a new contract that supersedes the old one.[56]

It is however argued that the foregoing concerns may be somewhat exaggerated. Time and time again, bankruptcy courts have reached a conclusion that performance by a non-debtor during the limbo period will constitute an administrative expense.[57] For instance in *FBI Distribution*[58] where the debtor-in-possession induced a non-debtor to render performance under an un-assumed pre-petition executory contract, pending its decision to assume or

[51] *In re National Steel Corp*. 316 B.R. 287, 303=305 (Bankr. N.D. Ill. 2004); *In re Airlift International, Inc*., 761 F.2d 1503 (11th Cir.1985).
[52] s. 365(a). *In re Whitcomb & Keller Mortgage Co*. (fn. 45).
[53] *S.N.A. Nut Co. v. Haagen–Dazs Co*. 191 B.R. 117, 121 (Bankr.N.D.Ill.1996); *In re Providence Television Limited Partnership* 113 B.R. 446, 452–53 (Bankr.N.D.Ill.1990); *In re Metro Transportation Co*., 87 B.R. 338, 342 (Bankr.E.D.Pa.1988); *In re Gunter Hotel Assocs*. (fn. 49) 696, 700; *In re A.H. Robins Co. Inc* 68 B.R. 705, 709 (Bankr.E.D.Va.1986); *In re Memorial Hospital of Iowa County, Inc*. 82 B.R. 478, 483–484 (W.D.Wis.1988); *In re Marrero* 7 B.R. 586, 588 (D.Puerto Rico 1980).
[54] 196 B.R. 58, 72 (Bankr.W.D.Tex.1996).
[55] ibid. at 72.
[56] *In re F.H. Lawson Co*., 97 B.R. 895, 897 (Bankr.S.D.Ohio 1989).
[57] *In re Section 20 Land Group, Ltd*., 261 B.R. 711, 716 (Bankr.M.D.Fla.2000); *In re Res. Tech. Corp*., 254 B.R. 215, 221 (Bankr.N.D.Ill.2000); *Goldin v. Putnam Lovell, Inc*. 163 B.R. 899, 907 (Bankr.D.Mass.1994); *In re Chateaugay Corp*., 10 F.3d 944, 955 (2d Cir.1993); Douglas Bordewieck, "The Post-petition, Pre-Rejection, Pre-Assumption status of an executory contract" (1985) 59 Am. Bankr. L.J. 197, 219.
[58] 330 F.3d 36, 42–44 (1st Cir. 2003).

reject, it was held that the non-debtor was entitled to administrative expense priority to the extent that the consideration supporting the claim was supplied to the debtor-in-possession post-petition and was beneficial to the estate. Similarly, In *In re Florida West Gateway Inc*,[59] the court held that the non-debtor who had continued to sell jet fuel to a Chapter 11 trustee operating a debtor airline was entitled to payment of an administrative expense claim – notwithstanding that the trustee had not yet elected whether to reject or assume the contract.

Under UK insolvency law regime, a liquidator's decision to disclaim a pre-petition executory contract does not require the approval of a court. This is a departure from the preceding UK regime wherein leave of court was required under the corporate insolvency code (and re-enacted in s. 617(1) of the Companies Act 1985).[60] Further more, any value that a debtor receives during the gap period between the commencement of the formal insolvency procedure and the making of a decision to disclaim an executory contract by the liquidator will rank in priority as an expense of the liquidation.[61] This is plainly fair and equitable.

A Chapter 7 liquidation trustee has 60 days from the time of the commencement of the case to

[59] 180 B.R. 299 (Bankr. S.D. Fla.1995). *SSSL*
[60] *SSSL Realisations* (fn. 8) 630.
[61] Rule 4.218(1) Insolvency Rules.

assume a pre-petition contract,[62] and the contract will be deemed to be rejected if not assumed within this period. In Chapter 11 reorganisation cases, a decision must be made before the confirmation of the plan.[63] A debtor has 120 days after the commencement of the case to file a plan.[64] It is arguable that the difference in the length of periods given to officeholders in Chapter 7 and Chapter 11 cases reflects the fact that a Chapter 11 officeholder will often require more time to make decisions, given of the nature of the procedure. Accordingly, In *In re American National Trust,*[65] the court held that a trustee in a reorganization proceeding "is entitled to a reasonable time to make a careful and informed evaluation as to possible burdens and benefits of an executory contract"[66] In order to mitigate the inconvenience that a lengthy limbo period may cause solvent parties, at the instance of a solvent party, a Court may order a trustee to make a decision within a specified period.[67]

Under the UK regime, a liquidator can exercise the power of disclaimer at any time.[68] Again, to avoid creditors waiting indefinitely in limbo, the Act empowers the solvent party to require the

[62] s. 365(d)(1) Code.
[63] s. 365(d)(2) Code; *NLRB v Bildisco & Bildisco* (fn. 50) 529; *Skeen v. Denver Coca–Cola Bottling Co*. 81 B.R. 623, 626 (Bankr.D.Colo.1988).
[64] s. 1121(b) Code.
[65] 426 F.2d 1059 (7 Cir.1970).
[66] ibid. at 1064.
[67] s. 365(d)(2) Code; *In re Heward Brothers* 210 B.R. 475, 476 (Bankr.D.Idaho 1997); *In the Matter of Whitcomb & Keller Mortgage Co*. (fn. 45) 378; *In re Anderson 36* BR 120 (Bankr. D. Haw. 1983) (debtor-in-possession was given 120 days to make a decision); *In re Merchants Plaza Inc*. 35 B.R. 888 (*Bankr*. E.D. Tenn. 1983) (court gave 15 days within which to assume or reject); *In re Will* 33 B.R. 843 (*Bankr*. MD Fla. 1983) (30 days was given).
[68] The 12-month period under the preceding regime by virtue of s.618 (3) of the Companies Act 1968 has been removed.

liquidator to elect whether to disclaim the contract or not. Once a notice to this effect is served, the liquidator must exercise his power to disclaim or not perform within 28 days of the notice or lose the power to disclaim.[69] A liquidator who loses his power to disclaim is not under any duty to perform or procure the corporate debtor to perform a contract; only his right to disclaim under the statute is lost.

In the light of the foregoing, a significant difference between the two jurisdictions is the consequence of failure of an officeholder to make an election to perform or assume the contract within the required time. While the Code deems the absence of a decision as a rejection, the Act merely strips the liquidator of its power to disclaim – the consequence being that the contract is deemed to subsist. It is arguable that the Code's approach is due to the distinction that the regime draws between the pre-petition debtor and the post-petition bankruptcy estate. The two are deemed to be two distinct entities, accordingly the pre-petition contracts of the debtor does not automatically fall into the post-petition estate, except it is assumed for this purpose. It is argued that this, to a large extent, supports the policy objective of rejection. Principally, it ensures that only carefully considered contracts of the debtor are assumed. In other words, no unbeneficial executory contract can fall into the bankruptcy estate by default. The possible demerits of this approach in evaluated in

[69] r. 4.191 Insolvency Rules.

3.3.

The default rule in the UK regime can be explained on the basis of what would be obtainable in the absence of the power to disclaim. As a matter of general principle, insolvency in itself does not terminate contracts except otherwise stipulated. The pre-petition contracts of the debtor fall into the bankruptcy estate, given that the liquidator stands exactly in the same position as the debtor itself stands in.[70] It is arguable that this default rule may not necessarily be detrimental to the policy objectives of the disclaimer mechanism, given that the liquidator may nevertheless opt not to perform. In this case the solvent party will prove for damages in the insolvency as an unsecured creditor, just as would be the case if the contract was disclaimed. However, where the contractual obligations of the solvent party are continuing in nature, the latter can carry on with performance and prove for payments as they fall due.[71] This will certainly erode assets in the insolvent estate. From this perspective, it may be argued that this is not actually a demerit of the disclaimer mechanism, but the adverse consequence of the liquidator's failure to take advantage of the mechanism.

[70] *In re Scheibler* (1874) L.R. 9 Ch. 722, 727.
[71] Roy Goode, *Principles of Corporate Insolvency* (fn. 8) 204-205.

3.2.3. Standard for disclaiming/rejecting executory contracts

The power to disclaim under UK insolvency law can only be exercised over a debtor's *onerous property*. Onerous property is defined under the Act as any unprofitable contract and any other property of the company that is unsaleable, not readily saleable or is such that it may give rise to a liability to pay money or perform any other onerous act.[72] A significant distinction between the current law and its predecessor is that there is no additional requirement of showing that the worthless asset also binds the possessor/counterparty to the performance of an onerous act in all cases.[73] The previous position of the law is illustrated in *Re Potters Oils Ltd (No. 1)*[74] where the liquidator sought to disclaim a chlorinated waste oil stored in tanks on the property of another, which had no commercial value and would have cost £14,500 to dispose of. Refusing leave, Harman J. ruled that the oil was not unsaleable "by reason of its binding the possessor thereof to the performance of any onerous act."[75]

In *SSSL Realisations*[76] the UK court of appeal accepted the following guidelines for determining when a contract will be unprofitable for the purpose of a disclaimer:

i. A contract is unprofitable if it imposes on the

[72] s. 178(3)(a) and (b) of the Insolvency Act; *Re Celtic Extraction Ltd* (2001) Ch. 475.
[73] Ian Fletcher, *The Law of Insolvency* (4th edn., Sweet & Maxwell 2009) 768.
[74] *Re Potters Oils Ltd (No. 1)* [1985] 1 B.C.C. 99384.
[75] ibid. at 99388.
[76] [2006] Ch. 610, 628-629 (per Chadwick L.J.).

company continuing financial obligations that may be regarded as detrimental to the creditors, which presumably means that the contract confers no sufficient reciprocal benefit.

ii. The contract may be unprofitable if it must give rise to prospective liabilities.

iii. Contracts which will delay the winding up of the company's affairs because they are to be performed over a substantial period of time and will involve expenditure that may not be recovered are unprofitable.

iv. No case has decided that a contract is unprofitable merely because it is financially disadvantageous. The cases focus upon the nature and cause of the disadvantage.

v. A contract is not unprofitable merely because the company could have made or could make a better bargain."[77]

It is suggested that guidelines (i), (ii) and (iii) attempt to cover a broad range of factual scenarios where the performance of an executory contract will demand the insolvent estate to either dissipate its assets in performing or incur losses with no reciprocal benefits. This accords with the earlier evaluated asset-preservation and value-maximisation objective of the disclaimer.

It is argued that guidelines (iv) and (v) aim to

[77] *SSSL Realisations (2002) Ltd* (fn. 76) 628-629 (Chadwick L.J.) citing the lower Court which had adopted the position of the Supreme Court of Austral in *Transmetor Corporation Ltd v Real Investment Property* [1999] 17 A.C.L.C. 1314, 1321 (per Chesterman J.)

draw limits to the liquidator's power to disclaim. First, it notes that a contract is not merely unprofitable because it is financially disadvantageous – as the focus is on the nature and cause of the disadvantage. In addition, the fact that the liquidator could make a better bargain, in comparison to the pre-petition contract, is not material. A hypothetical illustration of these two guidelines is as follows,

> Debtor (D) enters into a contract to sell a specified quantity of jet fuel to creditor (C) for £350,000. A formal insolvency proceeding is commenced for D before both payment and delivery is made. On assumption of office, D's liquidator discovers that the market price for jet fuel has skyrocketed such that a sale at the prevalent market price would fetch the insolvent estate approximately £700,000.

According to guidelines (iv) and (v), this will not constitute an unprofitable contract to which a disclaimer is applicable. Prima facie this runs counter to insolvency law's cardinal objective of maximisation of realisations for the general creditors. This is because an alternative sale of the jet fuel in the market and at the prevalent market price would generate double of the revenue compared to a sale to C. This point is further highlighted if the roles of the parties in the hypothetical transaction are reversed,

> Creditor (C) enters into a contract to sell a specified quantity of jet fuel to debtor (D) for £700,000. A formal insolvency proceeding is commenced for D before both payment and delivery is made. On assumption of office, D's liquidator discovers that the market price for jet fuel has slumped such that a purchase at the prevalent market price would approximately be £350,000.

Again, if guidelines (iv) and (v) are strictly complied with, this will not constitute an "unprofitable contract" to which a disclaimer is applicable. This clearly runs counter to one of the core objectives of insolvency law – maximisation of realisations. Here, the insolvent estate would save

$350,000 for the general body of creditors if the liquidator disclaims the contract and buys the fuel at the prevalent market rate. Note that guideline (i) may not be relevant to this type of one-off transaction, except the transaction can be categorised as one which imposes "continuing financial obligations" on the company. Accordingly it is arguable that the propositions in *SSSL Realisations* [78] are mere guidelines and do not represent an exhaustive list.

A possible argument in favour of the narrow construction of the disclaimer power in *SSSL Realisations* is that the disclaimer provision is not an arbitrary contract-breaching device. Accordingly, the core objective of the power to disclaim is asset-preservation through the repudiation of onerous contracts as narrowly defined in *SSSL Realisations*. An extension of this power beyond these parameters will amount to an abuse of the power. Again, notwithstanding that a disclaimer has the effect of a breach of contract, a breach of contract procured via a disclaimer is narrower, given that it is specifically conferred by the Insolvency Act and ought to be premised on the narrow and specific grounds laid down.

Accordingly, liquidators who wish to substitute more financially advantageous contracts or better bargains for existing executory contracts can procure the company to breach those contracts

[78] [2006] Ch. 610 628-629 (per Chadwick L.J.).

through other forms of disablement or renunciation, but not with the use of the disclaimer. The consequence of such a repudiatory breach will be the same as a disclaimer. The solvent counterparty will prove for damages in the insolvency as an unsecured creditor. An example of this is the earlier noted failure of the liquidator to make an election whether to disclaim or not within a required period. Here, except where the contract is one of a continuing nature, where payments will have to be made as they fall due – and which in any case, guideline (i) will apply, the liquidator will only lose his disclaimer power, but can not be compelled to perform the contract.

The Bankruptcy Code is silent on the standard upon which trustees must rely in deciding whether to assume or reject executory contracts.[79] A significant difference between the rejection under the Code and the Insolvency Act's disclaimer provision is that there is no express requirement for the rejected property to be onerous or burdensome. Accordingly s. 365(a) provides that,

> "Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."

It is suggested that, apart from the court's approval, the trustee's power to reject executory contracts is not subject to any limitation. Bankruptcy courts have developed two broad standards for

[79] The exception to this is a collective bargaining agreement which s. 1113(c)(3) of the Code stipulates the standard as being that the balance of equities must clearly favour rejection.

determining whether to approve rejection of executory contracts. While very few courts have adopted the *burdensome test*,[80] majority of courts have favoured the prevailing test - the *business judgment test*.[81]

Although the business judgment test was applied in *The Matter of Minges*,[82] the court gave the rationale behind the burdensome test as being that the power to reject derives from the long-held doctrine that the bankrupt estate may abandon burdensome property.[83] Under the burdensome test, a pre-petition executory contract will be rejected if assumption and performance will give rise to losses.[84] The trustee must be able to demonstrate that the income generated through the performance of the contract will not cover the operating expenses incurred in its performance. Hence, emphasis is on preventing net loss and the trustee will not be expected to decline assumption merely because an alternative investment would yield

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[80] *In re Lafayette Radio Electronics* 8 B.R. 528, 533 (Bnktcy E.D.N.Y. 1981); *In re Vidicom Systems, Inc*. 2 B.C.D. 2 (Bankr.S.D.N.Y.1975); *American Brake Shoe & Foundry Co. v. New York Rys. Co*. 278 F. 842 (S.D.N.Y.1922); *In re Chicago Rapid Transit Co*. 129 F.2d 1 (7th Cir.1942).

[81] *In re Stable Mews Association* 41 B.R. 594, 595 (Bankr. S.D.N.Y.1984); *National Labor Relations Board v. Bildisco & Bildisco* (fn 50) 104, 1195. *In re Roman Crest Fruit, Inc*., 35 B.R. 939, 948–49 (Bkrtcy.S.D.N.Y.1983); *In re O.P.M. Leasing Services, Inc*., 23 B.R. 104 (Bkrtcy.S.D.N.Y.1982); *In re Nat'l Sugar Refining Co*. 21 B.R. 196 (Bkrtcy.S.D.N.Y.1982); *In re Sombrero Reef Club, Inc*. 18 B.R. 612, 8 B.C.D. 1277, 6 C.B.C.2d 506 (Bkrtcy.S.D.Fla.1982); *In re Int'l Coins & Currency* 18 B.R. 335, 6 C.B.C.2d 309 (Bkrtcy.D.Vt.1982); *In re Summit Land Co*. 13 B.R. 310, 314, 7 B.C.D. 1361 (Bkrtcy.Utah 1981); *In re Hurricane Elkhorn Coal Corp. II*, 15 B.R. 987, 989 (Bkrtcy.W.D.Ky.1981); *In re J.H. Land & Cattle Co., Inc*., 8 B.R. 237, 238, 7 B.C.D. 228, 3 C.B.C.2d 695 (Bkrtcy.W.D.Okl.1981); *In re Lafayette Radio Electronics Corp*. (fn. 80) 533; *In re Marina Enterprises, Inc*. 14 B.R. 327, 8 B.C.D. 59, 5 C.B.C.2d 434 (Bkrtcy.S.D.Fla.1981).

[82] 602 F.2d 38 (2d Cir. 1979).

[83] ibid. at 42; 42 A Silverstein, Rejection of Executory Contracts, 31 U.Chi.L.Rev. 467, 468-72 (1964).

[84] *In re Vidicom Systems Inc*. (fn. 80); *In re D. H. Overmyer Co. Inc*. 1 CBC 516 (S.D.N.Y. 1974).

a more favourable result.[85]

An analogy can be drawn between the burdensome test and the previously evaluated standard for measuring for unprofitable contracts under the UK Insolvency law. As previously noted, guidelines (iv) and (v) narrow the disclaimer power of the liquidator in such a way that the availability of a better bargain of a more financially advantageous transaction will not justify a disclaimer.[86] This eliminates the consideration of the maximization of profit as a primary motivation for the disclaimer or assumption of pre-petition contracts.

Prima facie the burdensome test does not align with the language of the Code's rejection provision. As earlier noted, the Code does not impose any limitation to a trustee's power to reject contracts, except that it is subject to the approval of the court. In addition, just like the narrow approach under *SSSL Realisations,* the burdensome test does not fully support insolvency law's cardinal principle of maximization of realisations. The approach deprives the insolvent estate of the opportunity of entering into alternative contracts which can potentially yield greater returns for the benefit of the general creditors. Against this background, the standard has been rightly described as being "rigid" considering that a decision not to assume is only permitted on proof of net loss to

[85] Michael Andrew, "Executory Contracts In Bankruptcy: Understanding 'Rejection'" (fn. 6) 897.
[86] *SSSL Realisations (2002) Ltd* (fn. 76) 628-629.

the bankruptcy estate.[87] From a perspective, the effect of this test is that a single counterparty will be allowed to reap substantial benefits under the assumed contract, while the debtor's other creditors are forced to make substantial compromises to their claims.

Under the Code, rejection is not the revocation or repudiation or cancellation of a contract or lease, nor does it affect contract or lease liabilities. It is simply a bankruptcy estate's decision not to assume because the contract or lease does not represent a favorable or appropriate investment of the estate's resources.[88] This position is underpinned by the principle that the pre-petition and post-petition entities are separate legal entities. Hence, not being privy to the pre-petition executory contract, the post-petition entity is not bound by it. Rejection therefore indicates an election by the bankruptcy estate not to become party to the contract. Placing a restriction or condition on the insolvent estate and on the power of the trustee to reject an executory contract by way of the burdensome test, will run counter to this settled position.

The business judgment test lays emphasis on the potential profit which would accrue to the bankruptcy estate if a pre-insolvency executory contract is assumed or rejected.[89] Thus if greater profit

[87] *In the Matter of Minges* 602 F.2d 38, 43 (2d Cir. 1979).
[88] Douglas Baird, *Elements of Bankruptcy* (fn. 13) 848-9; Michael Andrew, "Executory Contracts in Bankruptcy: Understanding Rejection." (fn. 6).
[89] *In re Orion Pictures Corp*. 4 F.3d 1095, 1099 (2d Cir. 1993); *In re Minges* (n 53) 43; *Local Joint Exec. Bd. AFL-CIO v Hotel Circle Inc*. 419 F. Supp. 778 (S.D.Calif.1976) affirmed 613 F.2d 210 (9th Cir. 1977); *In re New York Investors Mutual Group* 143 F. Supp. 51 (S.D.N.Y.1956).

will accrue to unsecured creditors by a rejection, the trustee is entitled to decline assuming the contract.[90] This will be the position notwithstanding that the bankruptcy estate would not have incurred any loss if the contract had been assumed. Under this test, "burden" is equated with "not beneficial" rather than "net loss."[91] This test is relatively more flexible and commercially sensible from the perspective of the bankruptcy estate.

The business judgment test relatively accords with the language of the rejection provision under the Code. As the name suggest, the trustee or debtor-in-possession is expected to use his good judgments in ensuring that the estate obtains the best of contractual bargains, subject to the approval of the court. Given that the trustee or debtor-in-possession is given the autonomy and discretion of weighing the benefits of the pre-insolvency contracts with other available alternatives,[92] the standard has the potential of maximising realisations for the general body of creditors.

The best way to appreciate the advantage of the business judgment test over the burdensome test under the US regime as well as the distinction between the US regime and UK regime is to view *rejection* as the bankruptcy estate's determination not

[90] *In re Stable Mews Association* (fn. 81) 596; *In Re Florence Chi-Feng Huang* 23 B.R. 798, 801 (Bankr. 9th Cir. 1982).
[91] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 815–816.
[92] *In the Matter of Minges* (fn. 87) 43.

to assume, as opposed to a special "power to breach" contracts. From this perspective, it would be appreciated that a decision to reject has nothing to do with repudiating or revoking a contractual obligation. It merely constitutes a decision to invest the estate's funds in a contract or a lease asset included in the debtor's property.[93]

Lastly it is pertinent to note that although the business judgment test focuses on whether rejection would benefit general unsecured creditors, bankruptcy courts may intervene and decline approval of a rejection where the solvent party would be damaged disproportionately to any benefit to be derived by the general creditors.[94] Accordingly in *In Re Gamma Fishing Co*.[95] Hargrove J. rightly noted that the

> "Requirement of Court approval furthers the Bankruptcy Code's policy of maximizing the value of the estate for the benefit of all creditors, while preserving certain rights of parties to contract with the debtor."[96]

3.3. Effects of performing or assuming contracts

3.3.1. Assumption and performance

"Assumption" of contracts is peculiar to the Bankruptcy Code.[97] The UK Insolvency Act does not mandate a liquidator to "assume" a contract as an alternative to a disclaimer. The liquidator may simply

[93] Michael Andrew, "Executory Contracts in Bankruptcy: Understanding Rejection." (fn. 6).
[94] *In Re Florence Chi-Feng Huang* (fn 89) 801; *Matter of Minges* (fn. 87) 44.
[95] 70 B.R. 949 (Bankr. S.D. Cal.1987).
[96] ibid. at 952.
[97] s. 365(b) of the Code.

choose to perform the contract as opposed to disclaiming it. Assumption or rejection/disclaimer of an executory contract determines the status of the contracting creditor's claim, namely whether it is merely a pre-petition obligation of the debtor or is entitled to priority as an expense of administration or the liquidation of the estate.[98] The legal effects of performing or assuming an executory contract in the two jurisdictions are substantially similar. An assumption of a pre-petition executory contract constitutes an assumption of both the prospective rights and obligations or liabilities under the contract.[99] The post-insolvency performance by the solvent party under the contract ranks in priority as a liquidation or administration expense.[100]

An election to assume or perform a pre-petition contract does not guarantee performance from the solvent party. It merely ensures the continuation of the contract on its pre-petition terms. Hence in *In re Lucre Inc*.[101] Hughes J. noted that,

> "Assumption itself does not guarantee performance by the other party. It simply means that the other party no longer can excuse its refusal to perform based upon the debtor's pre-petition breach."[102]

Consequently, the solvent party can no longer

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[98] *In re Airlift International, Inc*. (fn. 51)*; In re Univ. Med. Ctr*. 973 F.2d 1065, 1078 (3d Cir.1992) *(quoting Leasing Serv. Corp. v. First Tenn. Bank Nat'l Ass*. 826 F.2d 434, 437 (6th Cir.1987).

[99] *In re University Medical Centre* 973 F.2d 1065, 1078 (3d Cir. 1992); *Leasing Services Corp v First Tenn. Bank National Ass*. (fn. 98) 437; *In re Airlift International, Inc*. (fn. 51) 1509.

[100] r. 4.218(1) Insolvency Rules; s. 503(b)(1)(A) Bankruptcy Code; *In re Nat'l Steel Corp*. (fn. 51) 304; *In re Columbia Gas System Inc*. 50 F.3d 233, 238-39 (3d Cir.1995).
In re Airlift International, Inc. (fn. 51) 1509.

[101] 339 B.R. 648 (Bankr. W.D. Mich. 2006),

[102] ibid. at 657; *In re National Steel Corp*. (fn. 51) 304; *In re Univ. Med. Ctr*. 973 F.2d 1065, 1078 (3d Cir.1992); *Leasing Serv. Corp. v. First Tenn. Bank Nat'l Association*. (fn. 98) 437.

rely on the debtor's breach as a ground for non-performance. [103] The solvent party can decline performance if he so wishes. In such an event, the debtor will be entitled to damages. Courts will only compel solvent parties whose contracts have been assumed to perform their contractual obligations if such are of a nature that an order of specific performance can be made, for example when the award of damages will not be adequate.[104]

3.3.2. Statutory preconditions for assumption

The Bankruptcy Code has placed some preconditions to the assumption of pre-petition executory contracts by a trustee or debtor-in-possession.[105] As was seen in chapter one, subject to exceptions, the Code generally invalidates termination clauses conditioned upon insolvency. This invalidation renders unenforceable the rights of solvent parties to terminate such contracts or enforce other contractually agreed remedies at insolvency or for other insolvency-related breaches. In the light of this, it is suggested that the preconditions to assumption are aimed at ensuring that the contractual interests of affected solvent parties are adequately protected post-petition.

Accordingly, before assuming an executory

[103] *In re Lucre Inc*. 339 B.R. 648, 657 (Bankr. W.D. Mich. 2006).
[104] *Telemetrix Plc v Modern Engineers of Bristol Plc*. (fn. 24) 217; *Freevale Ltd v Metrostore Ltd* (fn. 24) 81-82.
[105] *In re BankVest* 360 F.3d 291, 296 (1st Cir. 2004).

contract or unexpired lease under s. 365(a), the insolvent estate must (i) cure all defaults,[106] (ii) compensate the solvent party for any pecuniary losses arising from such default,[107] and (iii) provide adequate assurance of future performance under the agreement.[108] The implication of the foregoing is that even pre-petition debts in the contract must be cured. This effectively carves out another exception to the rule for the equal treatment of similarly situated creditors. In *In re Superior Toy & Mfg. Co.*,[109] Escbach C.J. stated the effect of the above provision thus,

> "The language of s. 365(b)(1) is unequivocal. A party to an executory contract must be paid all amounts due to him under the contract before the contract may be assumed. In drafting § 365(b)(1), Congress went further than requiring that the trustee guarantee payment for future performance under the contract. It required that the trustee guarantee payment of all amounts owed prior to assumption."[110]

The accompanying legislative statement of the provision justifies this requirement of giving a creditor the full benefit of his bargain on the grounds of "fairness."[111] In other words, the debtor must cure all defaults, assure future performance, and make the other contracting party whole before it may be permitted to assume the agreement. Tabb suggests that the preconditions reflect the intention of the bankruptcy policy to protect the legitimate interests of

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[106] s. 365(b)(1)(A).
[107] s. 365(b)(1)(B).
[108] s. 365 (b)(1)(C); *In re Dehon Inc*. 352 B.R. 546, 559 (Bankr. D. Mass. 2006); *In re Airlift Int'l Inc* (fn. 51) 1508.
[109] 78 F.3d 1169 (7th Cir.1996)
[110] ibid. at 1174.
[111] H.R.Rep. No. 95-595, at 348 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6304-05; *Kimmelman v. The Port Auth. of N.Y. & N.J.* 344 F.3d 311, 318 (3d Cir.2003).

counterparties whose contracts are being assumed.[112] It can also be argued that this protection is necessary considering that the Code's invalidation of ipso facto clauses and other contractual remedies which are conditioned on or triggered by insolvency.

There are no preconditions to performance under UK insolvency law. Although the UK regime ensures that a liquidator who elects to perform a pre-petition executory contract cures post-insolvency defaults, it does not expressly make curing or compensation for such defaults a precondition. In addition, the Insolvency Act does not require a liquidator to cure pre-petition defaults on a contract before performing post-petition. In the last paragraph, the Bankruptcy Code's approach has been attributed to its treatment of ipso facto clauses – extensively dealt with in Chapter one. This is in contrast with the Act which does not interfere with insolvency-related or triggered contractual remedies of parties. As previously noted, [113] any post-insolvency benefit derived by the debtor as a result of a post-insolvency performance by a creditor during the limbo period will rank in priority as an expense of the liquidation.[114]

3.3.3. Non-assumable contracts

[112] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 850.
[113] See text for fn. 42.
[114] r. 4.218 Insolvency Rules.

a. Terminated and executed agreements

A liquidator or trustee cannot disclaim or reject (or assume) contracts that have been terminated and leases whose terms have expired before the commencement of a formal insolvency procedure. Once a contract has been terminated prior to insolvency, there is no outstanding contractual right or obligation that can be enforced. Hence, the relevant provisions cannot be used to revive contracts that have been terminated pre-insolvency.

Similarly, only executory contracts and unexpired leases can be disclaimed or rejected. Executed contracts cannot be disclaimed or rejected.[115] The insolvency policies in the two jurisdictions recognise and respect accrued rights of creditors. Officeholders cannot use the disclaimer or rejection provisions as a means of interfering with such settled rights. Contracts are "executed" (as opposed to being *executory*) where there has been substantial performance from both or either of the parties. Having benefitted from the performance therein, a debtor cannot turn around to repudiate the executed contract via a disclaimer or rejection. Conversely, where the debtor has performed its obligations under the contract, there will be no outstanding contractual obligations that can be described as onerous or burdensome, necessitating a disclaimer or rejection.

[115] *Capital Prime Plc v Worthgate* (fn. 23).

b. Debt financing and loan contracts

The Bankruptcy Code prohibits the assumption of a contract to lend or extend financial accommodation or debt financing.[116] This has been previously evaluated in detail in 1.3.2. in the context of an exception to the Code's anti-ipso facto rule. The present prohibition is therefore in line with the general policy of the Code towards contracts of this nature. As earlier noted in Chapter one, the Code is very strict on this prohibition such that a pre-petition agreement to continue with a financing contract after the commencement of formal insolvency will be invalid and unenforceable.

A significant implication of the present prohibition is that, even where there is no ipso facto clause in a loan or financial accommodation agreement, a trustee or debtor-in-possession is effectively disentitled from assuming such contracts. The position will be unchanged where there is a subsisting pre-petition agreement to that effect.[117] As explained in chapter one, this prohibition is aimed at ensuring that a creditor who has made an unperformed lending commitment to the debtor from being compelled to continue with the obligation post-

[116] s. 365(c)(2) of the Code.
[117] *Government Nat'l Mortgage Corp. v Adana Mortgage Bankers* 12 B.R. 977, 986 (Bankr. N.D. Ga. 1980). In *In re Prime Inc*. 15 B.R. 216, 218, 219 (Bankr. W.D. Mo. 1981).

petition.[118] Furthermore, the Code has a well-structured post-petition financing provision under s. 364.[119] The post-petition financing provision outlines the procedures for post-petition financing agreements as well as incentives and adequate protection for post-petition lenders and existing creditors.[120] Accordingly, precluding such pre-petition financing arrangements is a way of avoiding any conflicts with this post-petition financing regime.

In contrast, the UK Insolvency Act does not prohibit the continuation of pre-insolvency lending contracts or debt financing agreements. Liquidators can therefore continue performing the contractual obligations of the debtor. However, such contracts may often contain ipso facto clauses or acceleration clauses, which are plainly valid and enforceable under UK insolvency law. In the absence of such clauses, it is still doubtful if UK courts would compel an unwilling pre-petition lender to continue lending to a financially distressed company which is the subject of a winding up proceeding. This would in effect amount to compelling the lender to fund the winding-up procedure of the debtor, considering that the funds

[118] Senate Report No. 95-989 at 58-59 (95th Cong. 2d Sess. 1978); *In re TS Industries* 117 B.R. 682, 686 (Bankr. D. Utah 1990); *Airline Reporting Corp. v Charringhton Worldwide Ent.* 110 B.R. 973, 975 (M.D.Fla.1990); *Whinnery v Bank of Onalaska* 106 B.R. 983, 990 (Bkrtcy.W.D.Wis.1989); *In re Travel Shoppe Inc.* 88 B.R. 466, 470 (Bankr. N.D. Ga. 1988); *In re Ernie Haire Ford Inc.* 403 B.R. 750, 757 (M.D. Fla. 2009); Andrea Coles-Bjerre, "Ipso Facto: The Pattern Of Assumable Contracts In Bankruptcy" (2010) 40 N.M. L. Rev. 77, 96.

[119] Andrea Coles-Bjerre, (fn 118) suggests that the question of assumability of financing contracts with consent or waiver of the creditor is purely academic, considering that court approval would be necessary whether it is conceptualized as a waiver plus assumption under s. 365(a) or as the incurring of unsecured financing outside the ordinary course of business under s. 364(b).

[120] s. 364 of the Code; *Continental Experts Ent. Inc. v Stowers* 26 B.R. 308, 309 Bankr. S.D. Fla. 1982); *Peninsula Int'l Corp. v Citizens & Southern Int'l Bank* 19 B.R. 762, 764 (Bankr. S.D. Fla. 1982).

will presumably be passed on to other unsecured creditors. It is possible that a pre-petition agreement for the provision of funds to an insolvent company during insolvency may be enforceable if the latter has furnished consideration or the contract is by deed.

c. Prohibition of assumption or assignment by non-bankruptcy law

The Bankruptcy Code prohibits the assumption of pre-petition contracts where the applicable non-bankruptcy law prohibits assumption or assignment to a third party unless the creditor consents.[121] This exception had been previously evaluated in detail under 1.3.1. in the context of an exception to the anti-deprivation rule. *Applicable non-bankruptcy law* as defined in *In re Cutler*[122] is the statute that governed the contract of the parties prior to the commencement of insolvency.[123]

Again, as noted in 1.3.2, there is a split in judicial opinion regarding the construction of the phrase "assume or assign" under s. 365(c)(1) regarding the nature of non-assumable contracts. Some courts have adopted the so-called *hypothetical* approach wherein the literal language of the provision

[121] s. 365(c) of the Code. *In re ANC Rental Corporation* 277 B.R. 226, 237 (Bankr.D.Del.2002); *In re Allentown Ambassadors Inc*. 361 B.R. 422, 445 (E.D. Pa. 2007); *In re Pennsylvania Peer Review Organisation* 50 B.R. 640, 645 (Bankr MD Pa. 1985); *In re Pioneer Ford Sales Inc*. 729 F.2d 27, 28 (1st Cir. 1984).
[122] 165 B.R. 275, 280 (Bankr.D.Ariz.1994).
[123] ibid. at 280.

is followed to a conclusion that the bankruptcy estate loses the rights of the pre-bankruptcy debtor to assume contracts that are not assignable under pre-insolvency law – even if the officeholder does not contemplate an assignment.[124] Other courts have applied the so-called *actual* test wherein the assumption of contracts which are non-assignable outside bankruptcy are only prohibited where there is a finding that there is actually a plan to assign or that the assumption would amount to a forbidden assignment under the applicable non-insolvency law.[125]

In 1.3.2. it was argued that the hypothetical test runs counter to the general policy of the anti-ipso facto regime notwithstanding that it accords with a literal construction of s. 365(c)(1). Similarly, it is also suggested here that the construction is at cross-purposes with the asset-preservation objective of the rejection/assumption mechanism. The consequence of applying the test is that valuable *contingent assets* of

[124] *Perlman v. Catapult Entertainment Inc*. 165 F.3d 747 (9th Cir.) (applying the "hypothetical test" to bar assumption of nonexclusive patent licenses); *In re West Electonics Inc*., 852 F.2d 79, 83-84 (3rd Cir. 1988) (barring assumption of government contract); *Breedon v. Catron* 158 B.R. 629 (E.D. Va. 1993) (barring assumption of partnership agreement).

[125] *In re GP Express Airlines, Inc*. 200 B.R. 222, 231-32 (Bankr. D. Neb. 1996) (applying the actual test and finding that applicable law barring the assignment of certain airline contracts did not prevent the debtor in possession from assuming such contracts); *In re American Ship Building Co. Inc*. 164 B.R. 358, 362-63 (Bankr. M.D. Fla. 1994); *In re Hartec Enter, Inc*. 117 B.R. 865, 872-74 (Bankr. W.D. Tex. 1990) (adopting the "actual test" and allowing the debtor in possession to assume a non-assignable government contract); *In re Cardinal Indus. Inc*. 116 B.R. 964, 977 (Bankr. S.D. Ohio 1990); *Institute Pasteur v. Cambridge Biotech Corp*. 104 F.3d 489, 493-94 (1st Cir.) (debtor in possession may assume patent licenses even though reorganization plan provides for transfer of debtor's stock to third party); *Summit Inv. and Dev. Corp. v. Leroux* 69 F.3d 608, 612-14 (1st Cir. 1995) (rejecting "hypothetical test");*Texaco, Inc. v. Louisiana Land and Exploration Co*. 136 B.R. 658, 668-71 (M.D. La. 1992) (Statute which required the consent of a state board to assign a state mineral lease was not "applicable law" blocking the assumption of a lease by the debtor in possession).

the debtor will be forfeited merely due to a bankruptcy filing. This is regardless of the fact that there is no plan of assigning the contracts after assumption. It is suggested that if non-insolvency law is not applicable because there is no plan to assign, it arguably makes little sense to give effect to such anti-assignment law in insolvency when the debtor is not seeking to assign the contract. Furthermore, given that assumption is a prerequisite to assignment, the application of the hypothetical test will arguably render the word "assignment" as used in s. 365(c)(1) a mere suplusage.

By comparison, notwithstanding that the plain language of s. 365(c)(1) cannot provide the basis for the actual test given that it transforms the phrase "assume or assign" to "assume and assign," it has been previously argued in Chapter one that the test will yield results which accord with the objective of the rejection/assumption regime. [126] Accordingly in *Texaco Inc. v La. Land & Exploration Co.,* Parker J. noted that,[127]

> "The proposition tends to defeat the basic bankruptcy purpose of enhancement of the bankruptcy estate for benefit of rehabilitation and the general creditors upon a highly technical 'hypothetical' test which furthers no bankruptcy purpose at all. It would allow one disgruntled creditor to frustrate payment of claims to other creditors or rehabilitation, contrary to the whole purpose of bankruptcy."[128]

The actual test is thus more in tune with the asset-preservation and value-maximisation goals of

[126] *In re TechDyn Sys. Corp.* 235 B.R. 857, 864 (Bankr. E.D. Va. 1999); *In re Cardinal Indus. Inc.* 116 B.R. B.R. 964, 981 (Bankr. S.D. Ohio 1990)
[127] 136 BR. 658 (M.D. La. 1992).
[128] ibid. at 671.

the rejection regime and the bankruptcy estate.

There is no equivalent provision of this nature in UK insolvency law. However, a specific provision of a statute, which excludes the application of the Insolvency Act, or some specific provisions (including the disclaimer regime) on good policy grounds will be enforceable by UK courts. For instance, a liquidator cannot disclaim market contracts or a contract effected by the exchange or clearing house for the purpose of realising property provided as margin in relation to market contracts;[129] a transfer order or a contract for the purpose of realising security under settlement finality regulations;[130] where a collateral provider or a collateral taker within the financial collateral regulations is being wound up, any financial collateral arrangement within those regulations.[131]

3.4. Effects of disclaiming or rejecting contracts

3.4.1. Effect on parties to the contract

A rejection or disclaimer of a contract in both jurisdictions is deemed as a breach which relates back to the date immediately preceding the commencement of the insolvency.[132] The solvent parties are therefore

[129] s. 164(1) Companies Act 1989.
[130] Financial Markets and Insolvency Regulations 1999 (SI 1999/2979).
[131] Financial Collateral Arrangements (No.2) Regulations 2003 (SI 2003/3226).
[132] s. 178(4) Act; s. 365(g)(1) Code. *In re Jeffrey Lavigne* (n 6) 387; *In re The Drexel Burnham Lambert* 138 B.R. 687, 707 (Bankr. S.D.N.Y. 1992); *In re*

treated as unsecured creditors in the insolvency procedure. [133] Whereas this breach constitutes a unilateral termination of the contract under UK insolvency law, the contract remains in force under the US regime.[134] This is because, under the Code, rejection by the trustee or debtor-in-possession on behalf of the bankruptcy estate is merely a decision to decline taking the place of the pre-petition debtor as a party in the pre-petition contract.[135] Accordingly, In *In re The Drexel Burnham Group,*[136] the court noted that "rejection merely frees the estate from the obligation to perform."[137]

As has been previously noted, the bankruptcy estate is a distinct entity from the pre-petition debtor for this purpose, and therefore is not regarded as a party to the pre-petition contract.[138] The bankruptcy estate therefore lacks legal capacity to "terminate" the contract. It can only decline assuming and performing the contractual obligations. Nevertheless, the legal effect of a rejection and disclaimer on a solvent party in the jurisdictions are substantially similar. The solvent party will be incapable of proceeding with the executory contract and is entitled to claim for

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Modern Textile Inc. 900 F.2d 1184, 1191 (8th Cir. 1990); *NLRB v Bildisco & Bildisco* (n 37) 530.

[133] s. 502(g) of the Code.

[134] *Thompkins v Lil' Joe Records Inc*. 476 F.3d 1294, 1306 (11th Cir. 2007); *In re Jeffrey Lavigne* (n 16) 387; Michael Andrew, "Executory Contracts In Bankruptcy: Understanding 'Rejection'" (n 5) 916.

[135] *In 6177 Reality Associates Inc*. 142 B.R. 1017, 1018 (Bankr. S.D.Fla.1992); *In re Austin Dev. Co*., 19 F.3d 1077, 1082-83 (5th Cir.1994); *In re Tri-Glied, Ltd*.,179 B.R. 1014, 1017-18 (Bkrtcy.E.D.N.Y.1995); *In re Continental Airlines,* 981 F.2d 1450, 1459-61 (5th Cir.1993); *In re Elm Inn Inc*. 942 F.2d 630, 633 (9th Cir. 1991); *In re Modern Textile* 900 (fn. 132) 1191-92.

[136] 138 B.R. 687, 703 (Bkrtcy.S.D.N.Y.1992).

[137] ibid. at 703.

[138] *In re Tri-Glied Ltd* (fn. 135) 1018.

damages as an unsecured creditor in the insolvency process.[139]

Significantly, neither the Bankruptcy Code nor case law proffers any explanation as to what becomes of the breached contract after rejection. Based on the above analysis, the solvent counterparty cannot continue performing its obligations when the contract is rejected, as there will be no party to contract with. The only option available to the counterparty will be a claim for damages in the insolvency procedure as an unsecured creditor. Furthermore, the pre-petition contract cannot be said to have been "terminated." For instance, Andrew has rightly noted that,

> "Rejection is not the power to *release, revoke, repudiate, void, avoid, cancel or terminate, or even to breach*, contract obligations. Rather, rejection is a bankruptcy estate's election to decline a contract or lease asset."[140]

In addition, theoretically, the trustee cannot be deemed to have terminated the contract considering that the bankruptcy estate was never a party to the contract. Similarly, termination cannot be attributed to the pre-petition corporate debtor who neither terminated the contract prior to the commencement of insolvency nor during the insolvency procedure. It is suggested here that a logical explanation would be that there has been a material breach by the corporate debtor, which excuses the solvent counterparty from performance and also entitles him to damages.

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[139] s. 502(g) of the Code; *In re Jeffrey Lavigne* (fn. 16) 387; *In re The Drexel Burnham Lambert* (n 132) 707; *In re Modern Textile Inc*. (fn. 88) 1191; *NLRB v Bildisco & Bildisco* (fn. 50) 530.

[140] Michael Andrew, "Executory Contracts In Bankruptcy: Understanding 'Rejection'" (fn. 6) 931, cited with approval in *In re Jeffrey Lavigne* (fn. 7) 387.

Considering that the breach relates back to a date immediately preceding the commencement of the insolvency, this will rank as an unsecured claim.

The US regime's "ride-through" option, developed by bankruptcy courts as a middle ground approach, supports the above reasoning.[141] As the provision for assumption and rejection of executory contracts are permissive, there is a "no-action" option for the officeholder in reorganisation procedures.[142] This doctrine will come into operation where the trustee has neither affirmatively accepted nor rejected an executory contract throughout the reorganisation procedure.[143] In addition, the solvent counterparty must also opt to seek redress for defaults in the contract outside the bankruptcy proceeding.[144] An exercise of the ride-through option ensures that an executory contract remains in force until rejected and unless rejected it passes through with the other property of debtor to the reorganised corporation.[145] The disadvantage of this option is that a corporate debtor may unwittingly burden itself post-insolvency with onerous contracts.

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[141] *Boston Post Road v FDIC* 21 F.3d 477, 484 (2d Cir. 1994).
[142] *In re JZ L.L.C.* 371 B.R. 412, 422 (9th Cir. B.A.P. 2007); *In re National Gypsum Co.* 208 F.3d 498, 504 n.(5th Cir. 2000). This is not possible in Chapter 7 cases or cases involving leases of non-residential real property as failure to act by the trustee in these cases within the specified time periods, will make the contracts to be deemed rejected – s. 365(d)(1),(4).
[143] *In re Hernandez* 287 B.R. 795, 799 (Bankr. D. Ariz. 2002); *Federal's Inc. v. Edmonton Inv. Co.* 555 F.2d 577, 579 (6th Cir.1977).
[144] *In re Dehon Inc.* 352 B.R. 546, 560-561 (Bankr. D. Mass. 2006); *In re Day* 208 BR 358, 368 (Bankr.E.D.Pa.1997); *In re Polysat Inc.* 152 B.R. 886, 890 (Bankr. E.D. Pa. 1993).
[145] *Consolidated Gas Electric Light and Power Co v United Railways and Electric Co.* 85 F.2d 799, 805 (4th Cir. 1936).

3.4.2. Effect of rejection/disclaimer on third parties

Although a disclaimer constitutes a unilateral repudiation, the Insolvency Act expressly excludes a disclaimer from affecting the rights and liabilities of third parties such as guarantors, issuers of letters of credit, sub-lessees, sub-tenants etc.[146] The contractual rights and liabilities of these parties will remain intact and will only be affected by a disclaimer if it is necessary to ensure that the debtor is released from liability under the contract.[147] The rationale for this position is that the disclaimer is aimed at obviating only the debtor of its burdensome contractual obligations and not other solvent counterparties. Consequently the rights and obligations of the debtor company will be severed from the contract while the contractual rights and obligations of the other third parties will subsist.

There is no equivalent provision under the Bankruptcy Code. It is arguable that this may be due to the reasoning that the bankruptcy estate is not a party to the pre-petition contracts of the debtor. What then happens to third parties with subsisting rights and obligations under a rejected pre-petition contract? Again there appears to be no judicial authority for

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[146] s. 178(4)(b) of the Act; *In re Thompson and Cottrell's Contract* (1943) Ch. 97, 99; *Arthur Hill v The East and West India Dock Company* (1883-84) L.R. 9 App. Cas. 448, 455, 461.

[147] *Shaw v Doleman* (2009) B.C.C. 730, 736, 737; *Scottish Widows Plc. & Anor v Tripipatkul* (2004) B.C.C. 200, 204; *Basch v Stee*l (2001) L & T.R. 1, 9; *Capital Prime Properties Plc. v Worthgate Ltd* (2000) B.C.C. 525; *Hindcastle Ltd v Barbara Attenborough* (1997) A.C. 70, 86-87; *W H Smith v Wyndham Investments* (1994) B.C.C. 699, 700; *Wamford Investments Ltd v Duckworth* (1978) 2 All ER 517; *Hill v East and West India Dock Co.* (1884) 9 App. Cas. 448; *In re Levy* (1881) L.R. 17 Ch. D. 746, 754.

this. However, it is suggested that, since a rejection constitutes a breach but not a termination, the pre-petition contractual rights and obligations of other counterparties will subsist and survive the rejection. This of course will be the case where the contract can be continued without the debtor. For instance, a guarantor of the obligations of the debtor will not be relieved of his obligation under the guarantee agreement notwithstanding a rejection of the underlying contract. In the light of this, the position will be largely be similar to that in the UK regime.

3.4.3. Effect of rejection in special cases: Leases, licenses

There are special cases where the Bankruptcy Code has provided special rules in relation to the rejection of contracts. The operative principle in these special rules is that a lessee/solvent party or licensee who is in possession of property under an unexpired lease or licence will be allowed to remain in possession of the property notwithstanding the rejection of the agreement by the trustee.[148] For instance, a lessee/solvent counterparty whose unexpired lease or licence term has been rejected has the option of retaining his interest in the lease or licence.[149] In this case the lessee will remain in possession of the property for the remainder of the

[148] s. 365(h), (i) and (j) Code.
[149] s. 365(h)(1)(A)(ii).

term of the licence or lease.[150] He will also be entitled to enforce any option for renewal or extension.[151] Alternatively, the lessee can treat the rejection as a termination in accordance with the applicable non-bankruptcy law[152] and proceed to claim for damages in the insolvency as an unsecured creditor.

At first blush, it is arguable that forfeiting the lease upon rejection would be more favourable to the insolvent estate and would promote the asset-preservation and value-maximisation objectives of the rejection provision, compared to permitting the lessee/solvent party to retain possession. This is because there is a possibility that the trustee may be able to lease out the property on more profitable terms. However, permitting a forfeiture of the lease would amount to treating the debtor/lessor's rejection as a *rescission* or *termination*. This will run counter to the previously evaluated Bankruptcy Code's notion of rejection. It is suggested that the prevailing approach accords with Bankruptcy Code's notion of "rejection" under the Bankruptcy Code. As previously noted, a rejection under the Code does not constitute rescission or termination.[153]

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[150] s. 365(h) of the Code; *In re Carlton Restaurant Inc*. 151 B.R. 353, 356 (Bankr. ED Pa. 1993).

[151] Under this option, the counterparty must keep paying rents and performing his obligations therein. However, the trustee is not obliged to perform his obligations under the lease, as rejection relieves him from any subsisting contractual obligations of the corporate debtor. The lessee/solvent counterparty may offset rent against the damages due from lessor's non-performance. s. 365(h)(1)(A)(ii).

[152] s. 365(h)(1)(A)(i) Code.

[153] *In re Austin Dev. Co*., 19 F.3d 1077, 1082-83 (5th Cir.1994); *In re Tri-Glied, Ltd*. (fn. 135) 1017-18; *In re Continental Airlines* (fn 135) 1459-61; *In re Elm Inn Inc*. (fn. 135) 633; *In re Modern Textile* (fn 132) 1191-92.

Tabb, in his seminal work has attributed the enactment of the present special rules for leases and licences to "the failure of some courts to ascribe the appropriate limited effect to rejection" – so as to "protect the legitimate interests of non-debtor parties to contracts or leases in the event of rejection." Tabb therefore argues that "if all courts understood rejection, the special rules of s. 365 … would not be necessary."[154] Tabb's assertion is plausible. It is suggested that even in the absence of the special rules, the prevailing approach would be the outcome of such rejection of leases (in the light of the Code's notion of rejection).

Conversely, a rejection of an unexpired lease by a lessee/debtor will have the effect of terminating the lease.[155] The reason for this can be found in the statutory language of s. 365(d)(4) of the Bankruptcy Code which provides that,

> "An unexpired lease of non-residential real property under which the debtor is the lessee shall be deemed rejected, and the trustee shall immediately surrender that non-residential real property to the lessor, if the trustee does not assume or reject the unexpired lease…"

Hence, in the absence of assumption within the specified time, the lease is deemed rejected. Consequently, the Code mandates the trustee to "immediately surrender" the lease to the lessor/creditor.[156] Although the word "terminated" is not used under the provision, it is suggested that the

[154] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 831.
[155] *In re Tri-Glied Ltd* (fn 135) 1019; *In re Elm Inn Inc*. (fn. 135) 633; *In re BSL Operating Corp* 57 B.R. 945, 947 (Bankr. S.D.N.Y. 1986); *In re Re-Trac Corp* 59 B.R. 251, 257 (Bankr. D Minn. 1986).
[156] *In 6177 Reality Associates Inc*. (fn. 135) 1019.

surrender of the lease effectively terminates it.[157]

Judicial support for the foregoing can be found in *In re Southwest Aircraft services Inc*.[158] where the debtor-in-possession's argument that his rejection of the lease did not terminate the lease, but rather, the lease was abandoned to the insolvent estate, was rejected. Russell J. noted that such an argument, if correct, would render s. 365(d)(4) an exercise in futility for a lessor. [159] Similarly in *In re Criadores de Yabucoa Inc*.[160] the lessors filed motions requesting immediate surrender of premises leased by Chapter 11 debtor. Lamoutte C.J. held that the debtor-in-possession was required to immediately surrender the leased premises due to its failure to assume unexpired leases within the statutory period after the date of the order for relief. In addition, there is authority for the proposition that where a debtor holds over after rejection of the lease, rent will accrue at the fair use and occupancy rate.[161]

It is suggested that this position is plainly correct. Having rejected the unexpired term of the lease, it is only fair that it should be forfeited. A contrary position would amount to the leased property being occupied for free – given that the lessor will not be entitled to any payment by way of administrative expense priority.

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[157] *In re Giles Association Ltd* 92 B.R. 695, 698 (Bankr.W.D.Tex.1988); *In re Southwest Aircraft services Inc*. 53 B.R. 805, 810 (Bankr. C.D. Cal. 1985).
[158] 53 B.R. 805, 810 (Bankr. C.D. Cal. 1985).
[159] See also *In re Giles Association Ltd* (fn. 157) 698.
[160] 75 Bankr. 96, 97 (Bankr. D.P.R. 1987).
[161] *In re Herr* 61 Bankr. 252 (Bankr. E.D. Pa. 1986).

The leading authority for the present issue under UK law is the House of Lord's decision in *Hindcastle Ltd v Barbara Attenborough Associates*.[162] In that case, Lord Nicholls considered the effect of a disclaimer on different lessee-lessor relationships. First and similar to the approach under the Code, where there is only a debtor/lessee and a lessor, a disclaimer effectively terminates the lease. The lessor's reciprocal covenants are also determined so as to relieve the debtor/lessee of any further obligations. This is clearly in line with UK insolvency law's policy on disclaimer which views a disclaimer as a unilateral determination.[163] Thus the disclaimer operates to determine all the debtor/lessee's obligations under the lessee's covenant and its rights under the lessor's covenants.

In contrast to the position under the Bankruptcy Code, the above effect will also apply where a debtor/lessor disclaims a lease. Unlike under the Bankruptcy Code's approach, where the solvent counterparty/lessee is given the option of retaining the lease or licence for the remainder of the unexpired term, under UK law a disclaimer effectively terminates the lease agreement. There is no question whatsoever of the solvent counterparty/lessee having an option to remain in the leased property for the remainder of the term or to keep possession of the

[162] [1997] AC 70.
[163] ibid. at 87.

licence for the remainder of the term of the agreement. The solvent counterparty/lessee or licensee is entitled to a claim for damages in the winding up. As previously noted, this approach is capable of giving the liquidator the opportunity to lease out the property on more profitable terms which in turn could maximise realisations for the general creditors.

Another scenario envisaged by Lord Nicholls is where there are third parties with subsisting rights such as sub-lessees and sureties. A disclaimer will not affect their rights and obligations under the lease.[164] It is suggested that this position accords with the Insolvency Act's provision in relation to third parties. In *Shaw v Doleman*,[165] a guarantor's contention that her guarantee liability ceased on the disclaimer of a lease by a liquidator was rejected. The Court of Appeal ruled that by virtue of s. 178(4)(b) the disclaimer of the lease did not affect the guarantor's liability to the landlord but the liability remained as though the lease had not come to an end but had continued after the disclaimer. The rights and liabilities of sub-lessees, sureties and other persons deriving interests from the insolvent entity will only be interfered with "so far as is necessary for the purpose of releasing the company from any liability."[166]

[164] ibid. at 87-89. *RVB Investments Limited v Alastair Roderick Bibby* [2013] EWHC 65 (Ch) (15)-(17).
[165] [2009] B.C.C. 730, 738-9.
[166] s. 178(4)(b) Act.

The Bankruptcy Code is silent on this issue. However, as previously noted, a rejection of an unexpired lease by a debtor/lessee under the Code has the effect of terminating the lease, considering that the Code directs a debtor/lessee to surrender the lease to the lessor upon rejection.[167] As a corollary, in view of the requirement for a surrender of the lease, it is suggested that the rejection of an unexpired lease by a debtor/lessee will effectively terminate all interests of other parties within the debtor/lessee's interest. Judicial support for this reasoning can be found in *In 6177 Reality Associates Inc*.[168] In that case, a Chapter 7 debtor/lessee's rejection of a lease was held to have terminated the lease, thereby precluding a sub-lessee from further sub-leasing the property in its Chapter 11 case. Mark J. noted that upon termination of master lease, lessor was entitled to immediate surrender of premises not only by lessee but also by sub-lessee and any other parties claiming interest in premises through lessee. [169] A different conclusion will be reached where the debtor is the lessor. As explained above, a rejection of the lease will constitute a breach and not a termination and the lessee/solvent party will have the option of either terminating the lease or retaining his interest in it. In this case, the fate of the sub-lessees will rest on the decision of the lessee.

[167] s. 365(d)(4) of the Code.
[168] 142 B.R. 1017, 1019 (Bankr. S.D.Fla.1992).
[169] ibid. at 1019.

Conclusion

An insolvent company will often have several pre-petition executory contracts and unexpired leases in its inventory. At insolvency, the company will almost certainly lack the capacity to honour all the contractual obligations in the executory contracts. Indeed the objectives of the insolvency procedure might be jeopardised if all counterparties are allowed to insist on and enforce their pre-petition executory contracts. Accordingly, while some executory contracts might be unbeneficial or burdensome to the debtor, others may maximise realisations for the insolvent estate and hence the success of the procedure may be largely dependent on their continuation.

Against this background, the rejection/disclaimer regime negates the principle of certainty of contracts. Insolvency law's pursuit of maximisation of value trumps the pre-petition contractual entitlements of individual creditors. This notwithstanding, it is arguable that the disclaimer or rejection mechanism does not actually constitute a drastic deviation from what would otherwise be the position outside the insolvency law forum. For instance, outside formal insolvency, a repudiatory breach of a contract will entitle the innocent party to damages. Similarly a disclaimer or rejection constitutes a breach which relates back to the time immediately before the date of the commencement of

the procedure.

Accordingly, just as is the case outside formal insolvency proceedings, the solvent counterparty is entitled to prove for damages in the insolvency as an unsecured creditor. This narrative can indeed serve as a basis for the justification of the disclaimer or rejection mechanism. From this perspective, the disclaimer or rejection regime merely projects in the formal insolvency forum, what would have ordinarily been the position in the absence of a formal insolvency proceeding.

This chapter has highlighted the fact that in contrast to the Bankruptcy Code, the power to disclaim under s. 178 of the UK Insolvency Act is limited to liquidators and is not expressly extended to administrators. Notwithstanding that English courts are often inclined to sanctioning decisions of administrators to renege on pre-petition contracts if such will enhance the achievement of a purpose of the procedure, it is necessary for the powers to be expressly extended to administrators. This will ensure certainty as regards the powers of administrators to disclaim such unbeneficial contracts. Such express provision will also protect administrators from exposure to tortious liability for interference with contracts.

CHAPTER FOUR
CONTRACTS AT AN UNDERVALUE/FRAUDULENT TRANSFERS

4.0. Introduction

Transaction avoidance rules are significant in two respects. First, they represent the only instance where pre-petition transactions can be reopened and retrospectively avoided or adjusted. This can be contrasted with the rules evaluated in the previous chapters which either operate *on* or *after* the commencement of formal insolvency procedure. Secondly, transaction avoidance rules constitute one of the very few instances where insolvency law interferes with proprietary rights of solvent parties. This chapter will specifically focus on provisions against transactions at an undervalue under the Insolvency Act and the corresponding rule against fraudulent transfer under the Bankruptcy Code.

This chapter comparatively analyses the effect of the rules against transactions at an undervalue and fraudulent transfers on pre-insolvency contracts. It evaluates the policy objectives for these contract adjustment and avoidance rules and the efficacy of the rules in achieving the policy goals. This chapter also evaluates the application of the rules to two contracts which are likely to raise transaction at an undervalue or fraudulent transfer concerns, namely leveraged

buyouts and intra-corporate guarantee contracts. In line with the theme of this thesis, the analysis of transactions in this chapter is limited to transactions that constitute or involve the performance of contracts as opposed to gifts and other *non-contract* transactions.

The present transaction avoidance rules present a significant instance where insolvency law interferes with the policy concerns of contract law. Accordingly, the analysis in this chapter examines how the jurisdictions manage the competing interests of parties with the aim of exempting non-colourable transactions from the ambit of the rules.

4.1. The Scope of the rules

4.1.1. Rules against fraudulent transfers

The first limb of the Bankruptcy Code's *fraudulent transfers and obligations* provision enables a trustee to avoid transfers or obligations in contracts incurred by the debtor during the twilight period with *actual intent* to *hinder, delay or defraud* a creditor.[1] This avoidance rule is radically different from the English insolvency rules against transactions at an undervalue because it places primacy on the debtor's intention and also focuses on the protection of

[1] s. 548(a)(1)(A) of the Code; *In re Sherman* 67 F.3d 1348, 1353, 1354 (8th Cir. 1995); *Max Sugarman Funeral Home Inc. v ADB Investors* 926 F.2d 1248, 1254 (1" Cir. 1991). David Epstein, Steve Nickles, *Bankruptcy* (West Group 1993) 368-369.

creditors individually and not collectively. A functional analogy can however be drawn between this rule and the Insolvency Act's provision against transactions at an undervalue with the aim of defrauding creditors.[2] Both of these avoidance provisions deal with attempts to intentionally prejudice the interest of individual creditors through contracts that have the effect of delaying, hindering or defrauding them.[3]

The second limb of the Bankruptcy Code's fraudulent transfers and obligations provision focuses on *constructive fraud*.[4] Subject to certain conditions, it empowers trustees to avoid pre-insolvency transfers made during the twilight period for less than a reasonably equivalent value by the debtor.[5] As would be observed in the evaluation in this chapter, this limb operates in a similar manner as the Insolvency Act's rules against transactions at an undervalue. Both of these avoidance rules enable the officeholder to retroactively avoid or adjust pre-insolvency contracts where the debtor either received no consideration or received consideration that was significantly less in value than what it gave.

In addition to the above, most US States have

[2] s. 423 of the Act; *Pena v Coyne (No.1)* [2004] 2 BCLC 703, 722.
[3] s. 423 has no time limitation in relation to when the voidable transaction was entered into.
[4] Douglas Baird, "Legal approaches to restricting distributions to shareholders: the role of fraudulent transfer law" (2006) E.B.O. L. Rev. 199 (n 1): "In the United Kingdom, fraudulent conveyance law evolved differently. Its legacy can still be seen in such provisions as s. 238 of the Insolvency Act 1986."
[5] s. 548(a)(1)(B)(I), (II) and (III) of the Code; Robert Jordan, William Warren, *Bankruptcy* (3rd edn, Foundation Press 1993) 499.

versions of fraudulent transfer laws under the Uniform Fraudulent Conveyance Act or its successor legislation, the Uniform Fraudulent Transfer Act.[6] These State fraudulent transfer laws are largely modelled after the Bankruptcy Code's. However the State fraudulent transfer laws retrospectively avoid transfers in contracts made within a period of four years prior to formal insolvency in contrast to the two-year twilight period under the Bankruptcy Code. In practice, a trustee can bring a fraudulent conveyance action either under the Bankruptcy Code or State law when transactions involve more than one jurisdiction or State.[7] In the interests of simplicity, this chapter's comparative evaluation will be restricted to the Bankruptcy Code's fraudulent transfers and obligations provisions.

4.1.2. Rules against transactions at an undervalue

As previously noted, the rules against transactions at an undervalue are designed to retrospectively avoid or adjust pre-petition contracts where the corporate debtor had either received no consideration or received consideration that was significantly less in value than what it gave. The Insolvency Act has two rules aimed at frustrating pre-petition transactions that are at an undervalue under s. 238 and s. 423 of the Act.

[6] s. 544 of the Code incorporates state fraudulent transfer laws.
[7] *In re Pajaro Dunes Rental Agency* 174 B.R. 557, 572 (Bankr. N.D. Cal. 1994); David Baird, *Elements of Bankruptcy* (5th edn, Foundation Press 2010) 139.

Section 238 of the Act operates in a similar manner as the second limb of the Bankruptcy Code's fraudulent transfers and obligations provision. It retroactively adjusts or avoids transactions which had been entered into prior to the commencement of the formal proceeding, wherein the debtor has either received no consideration or has received one which is significantly less than what it has given. Another significant similarity between this provision and the second limb of the Code's fraudulent transfer provision is that the vulnerable transactions must have been entered into at a time in the period of two years ending with the onset of insolvency.[8]

Section 423 of the Act operates in a substantially similar manner as s. 238. The overlap between the two provisions has been judicially noted in a number of cases. For instance in *Agricultural Mortgage Corp. Pty Ltd v Woodward*[9] which was on s. 423, the court relied on Millett J.'s comments in *Re MC Bacon Ltd (No. 1)*[10] in relation to the meaning of undervalue under s. 238.[11] Similarly, in *Menzies v National Bank of Kuwait*[12] Balcombe L.J. ruled that "the definition of a 'transaction at an undervalue' in s. 423(1) is in all relevant respects the same as the definition in s. 238(4)"[13] and accordingly applied the ruling of Millet J. in *M C Bacon Ltd (No. 1)*[14] where s. 238 was in

[8] s. 240(1) Insolvency Act; s. 548(a)(1) Bankruptcy Code.
[9] [1994] B.C.C. 688, 695.
[10] [1990] B.C.C. 78.
[11] ibid. at 340.
[12] [1994] B.C.C. 119.
[13] ibid at 128-9.
[14] [1990] B.C.C. 78.

issue.

However, for a transaction to be impugned under s. 423, the purpose of the transaction must be to either put the assets beyond the reach of an existing or prospective creditor[15] or prejudice the interests of a creditor in relation to the claim.[16] Against this background, a functional analogy can be drawn between this rule and the first limb of the Bankruptcy Code's fraudulent transfers and obligations provision. The latter provision enables a trustee to avoid transfers or obligations in contracts incurred by the debtor during the twilight period with actual intent to hinder, delay or defraud a creditor. Both avoidance provisions deal with attempts to intentionally prejudice the interest of individual creditors through contracts that have the effect of delaying, hindering or defrauding them.[17]

In deed both provisions have the same origin. The origins of the provisions can be traced to the English Fraudulent Conveyances Act 1571 otherwise known as the Statute of Elizabeth 1571.[18] The statute provided that a conveyance made "to the end, purpose and intent to delay, hinder or defraud creditors" is voidable. In the US, this law was passed into the common law and was later revised and codified in

[15] s. 423(3)(a) Insolvency Act.
[16] s. 423(3)(b) Insolvency Act.
[17] s. 423 has no time limitation in relation to when the voidable transaction was entered into.
[18] Andrew Keay, Peter Walton, *Insolvency Law, Corporate and personal,* Pearson Longman 2003, 506; *In re Bay Plastics* 187 BR 315, 322 (Bankr. C.D. Cal. 1995) per Samuel L. Bufford J.

1918 when the Uniform Fraudulent Conveyance Act was promulgated. In the UK it was repealed by the Law of Property Act 1925[19] and the successor to the rules are presently in s. 423.

4.2. The policy rationale

4.2.1. Preservation of the debtor's net assets

The central objective of the Bankruptcy Code's rules against constructive fraud and the Insolvency Act's rules against contracts at an undervalue is asset-preservation through the recovery of the debtor's valuable assets that have been unjustifiably transferred for an unreasonably or significantly inadequate consideration.[20] The rules aim to ensure that the debtor's assets that are transferred through vulnerable pre-insolvency transactions are recaptured.[21] Hence in *In re Bay Plastics*[22] Bufford J. noted that,

> "The purpose of fraudulent transfer law is to prevent a debtor from transferring away valuable assets in exchange for less than adequate value, if the transfer leaves insufficient assets to compensate honest creditors."[23]

The rules against contracts at an undervalue

[19] s. 207.
[20] *In re Bay Plastics* 187 BR 315, 322 (Bankr. C.D. Cal. 1995); Robert Jordan, William Warren, *Bankruptcy* (n 5) 499; Review *Committee* on Insolvency Law and Practice (1982) Cmnd 8558 para 1221: The Cork Committee considered provisions relating to transactions at an undervalue in relation to personal insolvency and expressed the principal rationale as being: "To prevent assets from being put in the hands of the debtor's family or associates in order to preserve them from claims of creditors."
[21] *Elliot v. Glushon*, 390 F.2d 514, 516–17 (9th Cir.1967).
[22] 187 BR 315 (Bankr. C.D. Cal. 1995).
[23] ibid. at 322; *Pajaro Dunes Rental Agency v. Spitters (In re Pajaro Dunes Rental Agency)* 174 B.R. 557, 571 (Bankr.N.D.Cal.1994).

focus on the net assets of the company, as opposed to individual rights of creditors. Accordingly, a distinction can be drawn between the present rules and *preference avoidance rules,* given that the latter rules are aimed at ensuring equal treatment of similarly situated creditors. A hypothetical illustration of this distinction can be made with a cake that is to be equally shared between X, Y and Z. While preference avoidance rules ensure that X, Y and Z receive equal portions of the cake, the rules against transactions at an undervalue will ensure that the whole cake is preserved and not reduced before the sharing is done. Reducing the size of the cake will proportionally reduce the size of the portions of cake that X, Y and Z will receive, although it will not result to the unequal treatment of X, Y and Z.

In the light of the foregoing, the often-held view that the pari passu rule is at the heart of insolvency avoidance rules is incorrect.[24] The insolvency pari passu rule is only relevant and applicable among creditors of an insolvent company. The pari passu rule is of no relevance to non-creditors. The present avoidance rules are not restricted to creditors and sureties as is the case with preference avoidance rules. Rules against contracts at an undervalue frustrate vulnerable contracts of both creditors and non-creditors. In essence, the rules are concerned with the size of the cake rather than how it is divided up.

[24] Andrew Keay, "The avoidance of pre-liquidation transactions; An Anglo-Australian comparison" (1998) J.B.L. 515, 519: "The pari passu principle has been widely regarded as constituting the essential rationale for the existence of the avoidance provisions."

The case of *Re MC Bacon (No. 1)*[25] illustrates the foregoing point. In that case a charge which was granted to secure pre-existing indebtedness (in return for the creditor to continue to provide credit) was held not to constitute a transaction at an undervalue as it did not diminish the value of the company's net assets. By charging its assets, the company appropriated them to meet its liabilities due to the secured creditor. This is notwithstanding that it had the potential of adversely affecting individual entitlements of creditors.[26] However, the grant of security for *no* consideration will constitute a transaction at an undervalue.

4.2.2. Protection of creditors

The primary objective of the first limb of the Bankruptcy Code's fraudulent transfer provision is the protection of the individual rights of existing and prospective creditors of the corporate debtor. The rule enables a trustee to avoid contractual transfers made or obligations incurred by the debtor during the twilight period with actual intent to hinder, delay or defraud a creditor.[27] As previously noted, s. 423 of the Insolvency Act, which avoids transactions at an undervalue with the aim of defrauding creditors, also has an individual-creditor-protection objective.[28] This latter avoidance provision primarily targets attempts

[25] [1990] B.C.C. 78.
[26] ibid. at 92.
[27] s. 548(a)(1)(A) of the Code; *In re Sherman* 67 F.3d 1348, 1354 (8th Cir. 1995).
[28] s. 423 of the Act; *Pena v Coyne (No.1)* (fn. 2) 722.

by a debtor to either put assets beyond the reach of a creditor or to intentionally prejudice his interests.[29]

Both the first limb of the Code's fraudulent transfer rules and s. 423 protects individual rights of creditors. For instance in contrast to other avoidance rules under the Act where only an officeholder can institute proceedings, a victim of the fraudulent contract can file an application for an order under s. 423.[30] Furthermore, a s. 423 application can be made outside a formal insolvency procedure. A consequence of this is that neither of these two rules promote insolvency law's cardinal objectives of collectivity or equality among creditors. In consequence, neither of the instant rules promotes collectivity or equality among unsecured creditors. The central objective of this category of avoidance rules is therefore to ensure that individual (as opposed to collective) rights and collection efforts of creditors are not hampered by debtors.

4.2.3. Destination of recoveries

The foregoing analysis of the objectives of the present avoidance rules will be incomplete without an evaluation of the destination of recoveries from the actions. This is in the light of floating charges or liens which are designed to cover all the assets of the company both present and future and will entitle the

[29] s. 423(3) of the Act.
[30] s. 424 of the Act.

charge-holder to payment ahead of unsecured creditors. As most courts have not expressed specific views on the fate of recoveries in transactions at an undervalue or fraudulent transfers, some of the cases below relate to *preferences*. It is however accepted that for this purpose, transactions at an undervalue are analogous to preferences.[31]

Section 550(a) of the Code provides that the trustee may recover transfers avoided under s. 548 "for the benefit of the estate." Similarly, s. 552(a) of the Code sinks a floating lien upon a bankruptcy filing. The section provides that property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case. Accordingly, the provision frees post-petition assets and recoveries from the clutches of pre-petition liens.[32]

However, this provision is subject to s. 552(b) which provides that a pre-petition security interest can attach to the post-petition proceeds, product, offspring, profits or rents of pre-petition collateral.[33] There is judicial consensus that the right to avoid transfers under the trustee's various avoiding powers does not constitute "proceeds, product, offspring as provided in the security agreement and applicable

[31] Andrew Keay, "Another way of skinning a cat: enforcing directors' duties for the benefit of creditors," (2004) Insolv. Int. 1, 7.
[32] Charles Tabb, *The Law of Bankruptcy* (2nd edn, Foundation Press 2009) 739.
[33] s. 552(b) of Code.

non-bankruptcy law" under s. 552(b).[34] First, the potential right to avoid a transfer comes into existence at the time of the property transfer (and is exercised only by the trustee). Secondly, a corollary can be drawn between this position and the long-held principle that a trustee cannot assign or sell the right to avoid pre-petition transfers.[35]

Accordingly, in *In re Integrated Testing Products Corp*.[36] the reasoning of Cowen J. was that since the debtor never possessed the right to institute an avoidance action, the secured creditor could not have "acquired" the right prior to the filing of the petition as required under s. 552, and consequently can have no security interest in the recovery.[37] The court also held that "it makes little sense to allow the appellant (secured creditor) to recover from the trustee what it could not have received from the debtor absent the preference action."[38]

The above reasoning was followed in *In re Sun Island Foods*,[39] where the court placed emphasis on the fact that the avoidance action was a result of the filing of the bankruptcy and that absent the petition in bankruptcy, there would have been no recoveries. The court reasoned that,

> "It is illogical to allow a secured creditor to attach the

[34] *In re Integrated Testing Products Corp*. 69 B.R. 901, 904 (D.C.N.J.1987); *In re Figearo* 79 B.R. 914, 917 (Bankr.Nev.1987).
[35] *United Capital Corp. v. Sapolin Paints Inc*. 11 Bankr. 930, 937 (Bankr. E.D.N.Y. 1981); *Grass v. Osbor* 39 F.2d 461, 461 (9th Cir. 1930).
[36] 69 B.R. 901 (D.C.N.J.1987).
[37] ibid. at 905.
[38] ibid.
[39] 125 B.R. 615 (Bankr. D. Haw. 1991).

> proceeds of recoveries … if the trustee herein had not pursued the preference actions, the secured creditor could not have sued on its own to recover the preferences. Yet, by the trustee having pursued the recoveries, the plaintiff argues that the secured creditor now is in a position to claim the proceeds as covered by their security interest. This is an anomaly, and it results in the use of powers created by the Bankruptcy Code for the benefit of one creditor alone, and is to be avoided." [40]

Against this background, the argument is primarily premised on the ground that since the right of action only arises at insolvency and since only the trustee can sue for such recoveries, the secured creditor is not entitled to the assets recovered as a result of the action. This position supports the asset-preservation and creditor-protection policy objective of the rules against fraudulent transfers. The reasoning ensures that recoveries are not made for the sole benefit of a secured creditor, but for the benefit of the general body of creditors

A principal duty of the officeholder, is to gather the assets of the insolvent estate. Accordingly, the grant of power to recover improper transfers is an important component of the associated duty to maximize the value of the estate. In exercising the avoidance powers, the trustee does not assert a cause of action that at any time belonged to the debtor and devolved upon the officeholder with the insolvency filing. Rather, the officeholder asserts a personal right, exercisable by the officeholder while acting in a representative capacity on behalf of all creditors.

[40] ibid. at 619. In *In re First Capital Mortgage Loan Corp*. 60 B.R. 915, 917 (Bankr.D.Utah 1986).

Conversely, the approach might be criticised on the ground that it has the effect of granting unsecured creditors a windfall. In other words, assets that were subject to security will be unencumbered when recovered. This is notwithstanding that the loss of the asset was through no fault of the secured claim holder. For instance, in *In re Figearo*[41] Thompson J. held that funds received by trustee from a fraudulent transfer action were subject to creditor's security interest and not equivalent to a post-petition acquisition of property by the estate as contemplated by s. 552(a). The court reasoned that,

> "Where the trustee to recover the property from Pacific (the preferred creditor) free of any pre-petition encumbrances, he would recover a greater interest in the property than that held by Pacific or the debtor prior to the transfer."[42]

In contrast to the reasoning in the *Integrated Testing Products Corp.* and *Sun Island Foods* line of cases, the court opined that the transferee merely held voidable title to the transferred property. In consequence, the successful exercise of the trustee's avoiding power caused the transfer to become void. Any property recovered by the trustee which was subject to a security interest pre-petition, continued to be subject to such security interest. Accordingly, it has been argued that a secured creditor who held a pre-petition floating lien should be entitled to claim the benefits flowing from an avoidance action on the ground that this is consistent with the benefits which the creditor would have received in the absence of the

[41] 79 B.R. 914 (Bankr.Nev.1987).
[42] ibid. at 918; *In re Mid–Atlantic Piping of Charlotte* 24 B.R. 314, 321-325 (Bankr. W.D.N.C.1982).

voidable transaction.[43]

The above position may be criticized on the ground that it completely disregards the imperative of the fact that recoveries via avoidance actions are only possible through a right conferred solely on the trustee or debtor-in-possession.[44] It thus overlooks the fact that formal insolvency proceedings alters the dynamics in company operations and produces new sets of relationships and duties. As opposed to being run by directors for the benefit of shareholders, the company is administered by a trustee or debtor-in-possession for the benefit of the general body of creditors. Accordingly, in avoiding such transfers, a trustee or debtor-in-possession acts on behalf of the insolvent estate and for the general body of creditors.

Two other notable US decisions supporting the argument that avoidance recoveries are subject to security interest worth mentioning are the cases of *In re Cambria Clover Mercantile Co.*[45] and *In re Lively*.[46] In ruling on a motion directing the disbursement of funds acquired through an avoidance action in *In re Cambria Clover Mercantile Co.*,[47] King Jr. J. noted that pre-petition security interest could extend to such recoveries depending on the security agreement and the non-bankruptcy law. The court did

[43] Nancy Sanbom, "Avoidance Recoveries in Bankruptcy: For the Benefit of the Estate or the Secured Creditor?" (1990) 90 *Columbia*.Law *Review* 1376, 1399-1400.
[44] As would be seen under UK law, a counter argument may be that this is merely a procedural matter.
[45] 51 B.R. 983, 986 (Bankr.E.D.Penn.1985).
[46] 74 B.R. 238 (S.D.Ga.1987).
[47] 51 B.R. 983, 986 (Bankr.E.D.Penn.1985).

not however expatiate on this point. In addition, no reference was made to the scope of s. 552(a) with regards to preventing the attachment of a pre-petition perfected Article 9 security interest to such recoveries.

In *In re Lively*[48] the district court held that the trustee's recovery from a fraudulent transfer action was subject to pre-petition secured claims of a judgment lien-holder. It is arguable that this decision may have turned on the facts of the case as the court noted that the language of s. 552(a) is implicitly limited to "liens resulting from any security agreement" and is not applicable to judicial liens.[49] It is thus arguable that a contrary result would have been reached had the creditor's lien been consensual. Nevertheless, it is suggested that this approach does not entirely consonant with the language of s. 550(a) that indicates that the trustee's recovery is for the benefit of the estate.

Under UK insolvency regime, recoveries pursuant to actions for preferences (and by analogy, transactions at an undervalue) are not available to satisfy a charge-holder. The leading authority is *Re Yagerphone*[50] where monies repaid by a creditor, who had been improperly preferred, were held to be for the benefit of the creditors and not covered by a debenture charging all present and future assets of a company. Bennett J. held that the money did not

[48] 74 B.R. 238 (S.D. Ga.1987).
[49] ibid. at 239.
[50] [1935] Ch. 392.

become part of the general assets of the company, but was a sum of money received by the liquidators and impressed with a trust in favour of the company's creditors.[51]

On the face of the *Yagerphone Ltd* judgment, the timing of the crystallization of the charge was a compelling factor in Bennett J.'s decision. Bennett J. noted that,

> "I propose to decide ... in favour of the liquidators on this ground--namely, that, at the time when the securities contained in the debenture ... crystallised, the (preferential payment) was not the property of Yagerphone Ltd, the company which issued the debenture."[52]

The reasoning of Bennett J. was that when the floating charge crystallised, its scope did not extend to recoveries from avoidance actions, but was restricted to assets in possession of the company at the time of the crystallization. This ground has been criticised on the ground that a floating charge will also catch assets that come into the company's ownership post-crystallisation.[53] Indeed there is authority to the effect that property acquired by a chargor after crystallisation is still capable of falling under an after-acquired property clause.[54]

Perhaps due to the weakness of the crystallization argument, subsequent cases have relied on the ground that the right of action only arises in

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[51] ibid. at 395.
[52] [1935] 1 Ch. 392, 395.
[53] *Sally Wheeler,* "Swelling the assets for distribution in corporate insolvency" (1993) J.B.L. 256, 261-2.
[54] *NW Robbie & Co Ltd v Witney Warehouse Co Ltd* [1963] 1 W.L.R. 1324; *Holroyd v Marshall* [1962] 10 H.L. Cas. 191.

insolvency, as a basis for excluding recoveries from the scope of floating charges. For instance in *NW Robbie & Co. Ltd v. Witney Warehouse Co. Ltd*,[55] Russell L.J. referred to the *Yagerphone* decision with approval and noted that "a statutory right in and only in the liquidator to make such a (fraudulent preference) claim could never have been property of the company subject to the charge."[56]

Similarly, in *Re MC Bacon (No. 2)*[57] Millet J. observed that an application to set aside a voidable preference can only be made by a liquidator or administrator and in the absence of a liquidation or administration order, cannot be made at all. Accordingly, citing *Re Yagerphone* with approval, Millet J. reasoned that,

> "Any sum recovered from a creditor who has been wrongly preferred enures for the benefit of the general body of creditors, not for the benefit of the company or the holder of a floating charge. It does not become part of the company's assets but is received by the liquidator impressed with a trust in favour of those creditors amongst whom he has to distribute the assets of the company."[58]

This is in tandem with the reasoning of McPherson JA in the Australian case of *Starky v Deputy Commissioner of Tmation*[59] where he noted that if a secured creditor could not initiate for his or

[55] [1963] 1 W.L.R. 1324.
[56] ibid. at 1338. *Re Asiatic Electric Co. Pty Ltd* [1970] 92 WN (NSW) 361, 363-4 per Street J.
[57] (No. 2) [1990] B.C.C. 430. at 434
[58] ibid. at 434. Significantly, Millett J. noted in his judgment that "the actual ratio in that case (*Yagerphone*) was that the payment of a debt due to an unsecured creditor prior to the crystallisation of the floating charge bound the debenture holder." Australian cases also hold that such recoveries are for the benefit of unsecured creditors *Campbell v Michael Mount PPB* (1996) 14 ACLC 218, 226, and on appeal (1996) 14 ACLC 218; *NA Kratzmann Pty Ltd v. Tucker (No 2)* [1968] 123 CLR 295, 300.
[59] [1993] 11 ACLC 558.

her own benefit such avoidance proceedings, it follows logically that the secured creditor should not be able to claim the proceeds of such proceedings.[60]

In *Re Oasis Merchandising Ltd*.[61] Gibson L.J. drew a distinction between assets that are the property of the company at the commencement of liquidation and those recoverable by the liquidator post-petition pursuant to his statutory powers.[62] He reasoned that while a misfeasance action was capable of being caught by a debenture because the right of action arose and was available pre-petition, recovery of a preference or for fraudulent or wrongful trading were not property of the company and so not caught by the debenture.[63] According to Gibson L.J.,

> "Bennett J. held that a debenture charging all present and future assets of a company did not cover money recovered by the liquidators from fraudulently preferred creditors, because it never became part of the general assets of the company, but when received by the liquidators was impressed in their hands with a trust for those creditors among whom they had to distribute the assets of the company."[64]

Significantly, some commentators have argued that the vesting of the entitlement to bring avoidance action in a liquidator is merely a procedural matter.[65] Hence, McCormack has observed that the liquidator or administrator is not acting in their own individual rights but rather by virtue of the office they hold in relation to a particular company. In a broad sense the

[60] ibid. at 566-567.
[61] [1998] Ch. 170.
[62] ibid. at 181.
[63] ibid.
[64] ibid.
[65] *Sally Wheeler*, "Swelling the assets for distribution in corporate insolvency" (1993) J.B.L. 256, 262; Fidelis Oditah, "Wrongful Trading" (1990) L.M.C.Q. 205, 217; Dan Prentice, "Creditor's Interests and Director's Duties" (1990) 10 Oxford J. Legal Stud. 265, 271.

proceedings are brought on behalf of the company in question.[66]

Notably, it would be observed in the earlier quotes from the judgments of Millett J. in *MC Bacon Ltd (No. 2)* and Gibson J in *Re Oasis Merchandising Ltd* above that emphasis was also placed in Bennett J.'s holding that recoveries received by the liquidator were impressed with a trust in favour of unsecured creditors for distribution.[67] Again the trust argument is not free from criticism. An application of the above position has the potential of expropriating property rights and effecting redistribution. This would be the case where there is a grant of two floating charges and a subsequent avoidance of the senior creditor's charge. An application of the above position will have the effect of transferring the liberated assets to unsecured creditors rather than a prior satisfaction of the junior secured creditor's claim.

The reasoning in the *Re Yagerphone Ltd* line of cases substantially accord with the reasoning in the earlier evaluated US cases of *Integrated Testing Products Corp.*[68] and *Sun Island Foods.*[69] As previously noted, this position favours the general body of unsecured creditors by ensuring that recoveries are not encumbered by floating charges or liens but are available for the benefit of the general

[66] Gerard McCormack, "Swelling Corporate Assets: Changing What is on the Menu" (2006) 6(1) JCLS 39-69, 57.
[67] *Re Yagerpbone Ltd* [I935] 1 Ch. 392, 396; *Re Quality Camera Co Pty Ltd* [1965] 83 NSW 226, 229.
[68] 69 B.R. 901 (D.C.N.J.1987).
[69] 125 B.R. 615 (Bankr. D. Haw. 1991).

body of creditors. In consequence, the approach consonants with the asset-preservation and creditor-protection objectives of the rules against fraudulent transfers and transactions at an undervalue.

Notwithstanding its merits, it is germane to note that *Yagerphone Ltd*. was premised on s. 265 of the 1925 Companies Act which incorporates s. 44 of the Bankruptcy Act. Subsequently, it has been argued that the court's powers might have been widened by s. 239(3) of the Insolvency Act 1986, which provides that,

> "The court shall ... make such order as it thinks fit for restoring the position to what it would have been if the company had not given the preference."

It is therefore arguable that the statutory language of s. 293(3) grants courts discretion to order, in appropriate circumstances, that recoveries be applied first to meet the claims of floating charge holders. This can be contrasted with s. 44 of the Bankruptcy Act 1914 which merely provided that a preference was void[70] and did not empower courts to make such orders as it thought fit to restore the position to what it would have been in the absence of the vulnerable transaction.

However, in *Re MC Bacon Ltd (No 2)*[71] Millett J in ruling that the new statutory wording had empowered the court to earmark preference avoidance recoveries for the benefit of floating charge holders,

[70] Subsequently interpreted to mean voidable.
[71] *Re MC Bacon Ltd (No. 2)* [1990] B.C.C. 430.

observed that the restorative powers were not intended to be exercised so as to enable a debenture holder to obtain the benefit of the proceedings brought by the liquidator.[72] However, Oditah and McCormack have rightly argued that s. 239(3) does not specify which parties should benefit from recoveries.[73] McCormack has further observed that Millett J. paid insufficient attention to the precise wording of the provision.[74] Similarly, Parry has persuasively argued that given the broad and clear terms in which the court's discretion is phrased under s. 239(3), if the court, in restoring the position to what it would have been, is required to exclude the floating charge holder, this would have been clearly stated.[75]

Against this background, it is arguable that nothing precludes courts from ordering that such proceeds be applied to meet claims of floating charges in priority to claims of unsecured creditors. It is also arguable that a distribution of proceeds of recoveries to unsecured creditors does not accord with the restorative principle under s. 239(3). Given that a floating charge applied to the asset prior to the vulnerable transaction, applying the recoveries to the floating charge may actually be the true means of restoring the company to the position that it would have been if the transaction had not been entered into.

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[72] ibid. at 434.
[73] Gerard McCormack, "Swelling Corporate Assets: Changing What is on the Menu" (2006) 6(1) JCLS 39-69, 55-6; Fidelis Oditah, *Legal Aspects of Receivables Financing* (Sweet & Maxwell, London 1991) 215.
[74] Gerard McCormack, (fn. 55-56).
[75] Rebecca Parry, "The Destination of Proceeds of Insolvency Litigation" (2002) 23 Company Lawyer 49, 52-53.

It is instructive to note that adopting the above position for the destination of recoveries will have a number of implications. Keay has argued that holding that charge-holders are entitled to any recoveries could cause ailing companies to be dismembered more quickly, as creditors are likely to be even more aggressive in seeking payments, particularly where companies appear to be insolvent and likely to end up in liquidation.[76]

The destination of discoveries is also likely to influence an officeholder's decision on whether to pursue avoidance actions or not. It is arguable that where the proceeds of avoidance actions are subject to floating charges and liens, officeholders may not be inclined to dissipate resources from the insolvent estate in pursuit of such actions for the benefit of a single secured creditor. Conversely, it may be argued that the foregoing may not necessarily be the outcome of a finding that recoveries should be applied to floating charges or liens. There is a possibility that such secured claim holders, with the knowledge of the destination of such recoveries, may be willing to fund the avoidance actions.

[76] Andrew Keay, The Effects of a successful action by a liquidator to avoid a pre-liquidation transaction (1996) 15 (2) Univ. of Tasmania L. Rev. 236, 264; A Keay, 'An Exposition and Assessment of Unfair Preferences' (1994) 19 MULR 545, 570.

4.3. Significant elements of the rules

The basic elements of the first limb of the Code's fraudulent transfers and obligations provision will be comparatively evaluated with s. 423 of the Insolvency Act, while the elements of the second limb of the provision (which deals with transactions at an undervalue) will be comparatively evaluated with the Insolvency Act's rules against transactions at an undervalue. It is instructive to note that the absence of any of these elements will constitute a *safe harbour* or defence for a counterparty in an action for fraudulent conveyance under the Code or transaction at an undervalue under the Act.

4.3.1. Equivalence in the value of consideration

The first limb of the Code's fraudulent conveyance provision makes no reference to the proportionality of the value of consideration given and received by the debtor in a contract.[77] It focuses squarely on the intention of the debtor to hinder, delay or defraud a creditor. In contrast, s. 423 of the Insolvency Act requires a valuation of the consideration which the debtor has given and a weighing of that value against what it has received.[78] This condition must be fulfilled alongside proving that the debtor entered into the transaction with the

[77] s. 548((a)(1)(A) of the Code.
[78] The standard for weighing whether the consideration is one at an undervalue is the same used in determining transactions at an undervalue under s. 238. s. 423(1)(a), (b) and (c).

requisite intention.[79] In spite of the fact that the Code's provision does not expressly stipulate that the value of the consideration is a relevant factor, it is suggested that any evidence that a debtor received value which is significantly less than that which it gave, will be helpful in showing an intention to *hinder* or *defraud* the creditors.

Under the second limb of the Bankruptcy Code's fraudulent transfer provision, the trustee must show that the debtor received less than a "reasonable equivalent value" in exchange, coupled with evidence that the company was financially distressed pursuant to any of the standards for measuring that. This is an alternative means of establishing a fraudulent conveyance which obviates the trustee of the need to prove "actual intent" to defraud under the first limb of the Code's fraudulent conveyance and obligation provision.[80]

The Insolvency Act provides two categories of transactions that will be vulnerable as transactions at an undervalue. These are:

i. gifts or transfers with no corresponding receipt of consideration;[81] and
ii. consideration whose value is significantly less than that which the company has given, in money or money's worth.[82]

[79] s. 423(3) Insolvency Act.
[80] s. 548 (a)(1)(B) Bankruptcy Code. This is often referred to as "constructive fraudulent transfer."
[81] s. 238(4)(a); *Re Barton Manufacturing Co*. [1998] B.C.C. 827, 829.
[82] s. 238(4)(b) of the Act.

Vulnerable contracts are more likely to be in the context of the second category i.e. involving consideration that is not commensurate with the value of that which has been received. This discussion will therefore focus on this category of transactions at an undervalue.

Notwithstanding the differences in their wordings, for a contract to be vulnerable as one at an undervalue, the value of the consideration received by the debtor-company must be measured against that which it has given out. In the UK case of *Re MC Bacon Ltd (No. 1)* Millet J. noted that,

> "It requires a comparison to be made between the value obtained by the company for the transaction and the value of consideration provided by the company. Both values must be measurable in money or money's worth and both must be considered from the company's point of view." [83]

In a similar vein, in the US case of *Barber v Golden Seed Co. Inc.*[84] Bauer J. noted that,

> "To prevail in a fraudulent conveyance action under s. 548, the Trustee must prove that the debtor received less than reasonably equivalent value. The test used to determine reasonably equivalent value in the context of a fraudulent conveyance requires the court to determine the value of what was transferred and to compare it to what was received."[85]

This is plausible given that the avoidance rules are aimed at preventing the diminution of the net assets of the debtor. Accordingly, a contract that facilitates the transfer of assets of the company to a party without bringing equivalent value to the

[83] [1990] 78, 92.
[84] 129 F.3d 382, (7th Cir. 1997).
[85] ibid. at 387; *Matter of Vitreous Steel Products Co.* 911 F.2d 1223, 1234-35 (7th Cir.1990); *In re Bundles,* 856 F.2d 815, 816-17 (7th Cir.1988).

company will be vulnerable.[86]

The process of valuation has the potential to give rise to diverse considerations. For instance, in addition to the express benefits, there could be some indirect or incidental benefits or detriments emanating from contracts. The question has always been whether it is equitable for these to be taken into account (from the perspective of the debtor or the general body of creditors) in valuing consideration. In most cases, a counterparty may not be notified of the incidental detriments of the contract to the debtor at the time of entering into the transaction. This notwithstanding, in some cases, these indirect detriments may even outweigh the value the debtor has expressly given.

An illustration of this is a contract by a debtor-company (a bakery) for the sale of its only good oven. Although the counterparty may pay a price that is reasonably equivalent with the market value of the oven, this may not necessarily be an equivalent value from the perspective of the debtor and the general body of creditors. This may be the case when viewed against the background of the debtors existing debts and the importance of the oven to the debtor's business. The sale of the oven will result to the total grounding of the debtor's business. The detriment to the debtor and the creditors from the sale of the oven will be significantly higher than the value of the

[86] David Baird, *Elements of Bankruptcy* (n 8) 141; Ian Fletcher, John Higham, *Corporate Administrations and Rescue* (2nd edn, Tottel Publishing 2004) 209: The critical question is not the value of what was given by the recipient; it is rather the value of what was received by the company.

counterparty's consideration.

Under UK law, the value of the consideration is examined from the standpoint of the debtor and not the benefitting counterparty.[87] In carrying out the valuation, courts will analyse the debtor's overall financial position prior to and after the performance of the contract to determine whether there has been any negative alteration that has a monetary value.[88] Only incidental benefits and detriments which the parties have acknowledged and have requested or bargained for are taken into consideration. Accordingly Goode has rightly pointed out that,

> "While an asset of the company may be disposed of for full value, the sale may still be a transaction at an undervalue if its effect is to reduce the value of the remaining assets held by the company and this effect was part of the bargain. Thus it includes the bargained-for detriment it suffers to its remaining assets or business." [89]

Hence, a debtor's asset may be disposed of in accordance with the market value but may nevertheless be a transaction at an undervalue if it has the effect of reducing the value of the remaining assets of the debtor and such detriment was not anticipated or acknowledged by the parties.[90]

The Bankruptcy Code adopts a very similar

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[87] *National Westminster Bank v Jones* [2002] 1 B.C.L.C. 55, 61; *Re MC Bacon Ltd (No. 1)* [1990] B.C.C. 78, 92.

[88] In *Stanley v TMK Finance* [2011] Bus. L.R. D93, 95, 96 it was held that the court was entitled to use a sale on a later date to establish by inference the market value at the date the contract was agreed upon on an earlier date. This will however be subject to the conditions that there has not been any change in market conditions between the two dates and that the circumstances of the sale are such that it is reasonable to make the comparison and conclusion.

[89] Roy Goode, *Principles of Corporate Insolvency* (4th edn, Sweet & Maxwell 2011) 542.

[90] *Agricultural Mortgage Corp Plc. v Woodward* [1994] B.C.C. 688. Roy Goode, *Principles of Corporate Insolvency* (fn. 89) 542.

approach. As a general rule, value must be measured from the perspective of *the creditors of the debtor*.[91] The rationale is that constructive fraud is aimed at redressing a wrong against the creditors, namely, the removal of assets from the debtor's estate. This creditors-oriented approach is not materially different from that of the Insolvency Act, considering that the general body of creditors and the officeholders will often have the same interest, which will often be in conflict with that of a counterparty or single creditor.

Under UK insolvency law, the consideration must be capable of being valued in monetary terms as the Act requires a comparison of the considerations in *money or money's worth*.[92] It appears that the requirement of monetary valuation of the consideration is aimed at avoiding difficulties that may arise when no monetary or economic value can be placed on a consideration that has been provided.[93] An example of this is where a company provides goods or services to a counterparty in exchange for payment which is not commensurate with the goods or services provided, in addition to the counterparty's "goodwill." Considering that goodwill is incapable of being monetarily evaluated, it may not constitute

[91] Charles Tabb, *The Law of Bankruptcy* (2nd edn, Foundation Press 2009) 578, 593.
[92] *Re M C Bacon Ltd (No. 1)* [1990] B.C.C. 78, 92. Ian Fletcher, John Higham, *Corporate Administrations and Rescue* (2nd edn, Tottel Publishing 2004) 210.
[93] Ian Fletcher, John Higham, *Corporate Administrations and Rescue* (fn. 92) 210: "The requirement that the consideration should be capable of being valued in money or money's worth is critical. The grant by a company of a charge or debenture as security for its own indebtedness cannot be a transaction at an undervalue, because the loss of the company of the right to apply the assets otherwise than in payment of the secured debt is not capable of valuation in monetary terms."

consideration for the purpose of the instant provision.

There is no equivalent requirement for monetary evaluation under the Bankruptcy Code. It is generally agreed that value must be calculated by reference to an objective market determinant of value.[94] The debtor must therefore receive something with a measurably equivalent economic benefit. In deed, in contrast to the position under UK regime, US bankruptcy courts have held that indirect economic benefits to the debtor such as goodwill and expertise are capable of constituting consideration and value.[95] In *Mutual Life Ins. Co. v. Menin*[96] a debtor's goodwill was held to constitute property asset that may be sold in bankruptcy proceedings. Accordingly, in *Mellon Bank v Metro Communications Inc*.[97] the court held that it is appropriate to take into account intangible assets not carried on the debtor's balance sheet, including good will.[98] It is suggested that the touchstone here is whether the transaction in issue has conferred any realizable commercial value on the debtor which is reasonably equivalent to the realizable commercial value of the assets transferred.

There is no specification under the Insolvency Act as to where the consideration must emanate from; hence, it need not come directly from the counterparty. What is imperative is for the debtor

[94] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 597.
[95] *In re Da-Sota Elevator Co*. 939 F.2d 654, 656 (8th Cir. 1991).
[96] 115 F.2d 975, 977 (2d Cir.1940).
[97] 945 F.2d 635 (3d Cir. 1991).
[98] ibid. at 646-647.

company to receive commensurate consideration under the contract.[99] This is also the position under the Code where the courts have held that the value can come from a third party.[100] This position is commercially expedient in contractual arrangements involving multiple counterparties with cross-obligations e.g. contracts of guarantee, issuance of letters of credit, contracts involving holding or subsidiary companies which belong to the same group.

4.3.2. The state of mind of parties

The state of mind of the solvent parties and the debtor are relevant in varying ways in determining the vulnerability of transactions at an undervalue or fraudulent conveyances. This is plausible given the fact that the rules against fraudulent transfers and transactions at an undervalue are not strict liability rules. Taking cognizance of the motives or intentions of parties ensures that contracts that are prima facie vulnerable but were not entered into with the primary aim of withdrawing assets from the insolvent estate are exempted from the ambit of the rules. It also ensures that counterparties are not deterred from trading with marginally solvent companies due to the fear that such transactions may be reopened in the event of a formal insolvency proceeding. The next paragraphs will highlight the instances where the

[99] *Phillips v Brewin Dolphin Bell Lawrie* [2001] B.C.C. 864, 870.
[100] *Mellon Bank v Metro Communications Inc*. 945 F.2d 635, 647 (3d Cir. 1991).

motives or intentions of parties are relevant in the application of the rules in the two jurisdictions.

a. Intention to hinder, delay, defraud or prejudice

The Code's fraudulent conveyance provision provides that a transfer of value or obligation in a contract will be voidable if the debtor made the transfer or incurred the obligation with the *actual intent* to hinder, delay or defraud creditors.[101] This makes the intention of the debtor the most vital element in this avoidance rule. The practical implication of this is that the debtor is not impliedly barred from engaging in transactions during the twilight period. Such transactions will only be vulnerable if it is proved that the debtor engaged in them with the requisite actual intention to hinder, delay or defraud creditors. this approach is plainly justifiable.

As previously noted, an analogy can be drawn between the Code's actual fraudulent transfer provision and s. 423 of the Insolvency Act which deals with rules against transactions at an undervalue with the purpose of defrauding creditors.[102] Under the latter avoidance rule, in addition to the contractual arrangement being at an undervalue, it must be shown that it was done for the purpose of:

i. Putting the assets beyond the reach of a current

[101] s. 548(a)(1)(A) Bankruptcy Code.
[102] s. 423 Insolvency Act.

or prospective creditor;[103] and/or

ii. Prejudicing the interests of such a person in relation to a possible claim.[104]

Accordingly, as is the case with the Code's fraudulent transfer provision, it has to be shown that the *motive* of the debtor in contracting at an undervalue is to achieve the aims set out above, in other words, to prejudice or defraud the creditor. The foregoing provisions ensure that pre-petition transactions that are entered into in good faith and in the course of business during the twilight period are not reopened just because of the happenstance of insolvency of a party. Again, this is plainly justifiable.

b. Intention to contract at an undervalue

The Code's constructive fraudulent conveyance provision obviates the need for prove of actual intention to defraud, delay or hinder a creditor. However, one of the standards for measuring the state of financial distress of the debtor reintroduces the element of motive into the rule against contracts at an undervalue. Under this limb, in addition to showing that the debtor received less than a reasonable equivalent value in exchange, it must also be proved that the debtor "intended" to incur, or believed that it would incur debts which would be beyond its ability

[103] s. 423(3)(a).
[104] s. 423(3)(b).

to pay when due.[105]

The above makes the state of mind of the debtor at the time of contracting a fundamentally relevant factor under the provision. As previously noted, this safeguards transactions which do not have as their primary purpose, the withdrawal of assets from the debtor without giving commensurate value in exchange. Under the Insolvency Act, the provisions against transactions at an undervalue do not require proof of intention to contract at an undervalue. The intention of the creditor or counterparty is also irrelevant to a large extent in the determination of the vulnerability of the contract. On the contrary, the good faith of the debtor is a relevant factor and this is analysed below.[106]

c. The defence of good faith

In the process of determining the validity or otherwise of a contract which prima facie violates the rules against transactions at an undervalue or fraudulent transfers, the good faith of parties is often a relevant consideration in a number of instances. For instance, under the Bankruptcy Code, an initial transferee who takes for value and in good faith will not be liable to the extent of the value that he has given.[107] This provision grants the initial transferee or

[105] s. 548(a)(1)(B)(ii)(III) Bankruptcy Code.
[106] s. 238(5) Insolvency Act.
[107] s. 548(c) Bankruptcy Code.

obligee a lien over the asset it has received and the right to enforce an obligation incurred to the extent of the value of the consideration which it has furnished in good faith. In the absence of good faith, an initial transferee will forfeit this protection regardless of the fact that he gave value.[108] Again, based on the arguments made in the prefatory part, this is plainly justifiable. In addition, a subsequent transferee who receives from the initial transferee in good faith and for value is completely immune from recovery regardless of the disproportionality of the value of his consideration compared to the benefit received.[109]

In contrast, under UK insolvency law the state of mind of a counterparty is irrelevant in determining whether a contract is one at an undervalue. Only the good faith of the contracting debtor is material.[110] Accordingly, plainly vulnerable contracts will not offend the present rule if the debtor acted in good faith and for the purpose of carrying on the business of the company and there were reasonable grounds for believing that the contract would benefit the debtor.[111] Here, the controlling mind of the company is viewed subjectively to ascertain whether there was absence of good faith. The second limb imports an objective test to determine whether there were reasonable grounds for believing that the contract would benefit the company. Significantly, as is the case under the Code, indirect transferees or recipients of benefits otherwise

[108] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 628.
[109] s.550(b)(1) of the Code.
[110] s. 238(5)(a) Insolvency Act.
[111] s. 238(5)(b).

than from the debtor, who take in good faith and for value are also protected by the Act.[112]

Exempting contracts that are plainly at an undervalue from the avoidance rules on the basis of the good faith of the debtor is aimed at giving effect to contracts which are ordinarily beneficial to the debtor company. Fletcher has used the fire-sale transaction to illustrate this point.[113] In fire-sale contracts, company stock is sold well below the cost price or market value with the aim of generating cash-flow for the company. In transactions of this nature, purchasers will have to be assured that their contracts will not be impeachable in the event of insolvency. Section 238(5) will therefore save such bargains regardless of the fact that the contracts are plainly at an undervalue.

The exemption is also aimed at encouraging and emboldening debtors to take reasonable steps to engage in such beneficial contracts even when a company is marginally solvent without fear of a potential avoidance at insolvency.[114] The legislation therefore strikes a fair balance between encouraging reasonable and potentially profitable trading aimed at ensuring a continuation of business by a financially distressed company on one hand and the policy of the avoidance rules on the other.

In contrast, the Bankruptcy Code does not

[112] s. 241(2) of the Act.
[113] Ian Fletcher, *The Law of Insolvency* (4th edn, Sweet & Maxwell 2009) 831.
[114] Ibid. at 831.

expressly make the good faith of the debtor-company a defence or relevant factor in determining if a contract is one at an undervalue (constructive fraud). However, to establish constructive fraud, in addition to proving that the debtor received less than a reasonable equivalent value, it must also be shown that,

i. the debtor was insolvent on the date of the transfer or became insolvent as a result of it;[115] or
ii. the remaining capital of the debtor, after the contract, was unreasonably small,[116] or
iii. the debtor company intended to incur debts that would be beyond the debtor's ability to pay such debts.[117]

In the absence of these additional conditions, a contract will not be vulnerable notwithstanding that it is plainly at an undervalue. It is suggested that the fact that a debtor contracted at an undervalue, in addition to condition (c) above, demonstrates lack of good faith on the part of the debtor. Conversely, if the UK rule is applied in a case with condition (c), this will negative any assertion that the contract had been entered into in good faith and that there were reasonable grounds for believing that it will be beneficial to the debtor.

[115] s. 548(a)(1)(B)(ii)(I) of the Code.
[116] s. 548(a)(1)(B)(ii)(II).
[117] s. 548(a)(1)(B)(ii)(III).

4.3.3. Solvency of the debtor

For a contract to be vulnerable as one at an undervalue under the Act, it must be shown that the debtor was either unable to pay its debts at the time of the contract or became insolvent as a consequence of it.[118] Although expressed differently, the state of solvency of the debtor is also fundamental in determining the vulnerability of a contract at an undervalue under the Code. In addition to the requirement that the debtor had received less than a reasonably equivalent value in exchange, at least one of the financial distress tests set out by the Code[119] must be fulfilled.

Under the first of these tests,[120] a contract will be vulnerable if the debtor was insolvent at the time of the contract or became insolvent by reason of the contract. The second test makes contracts vulnerable if the debtor engages in a business for which its remaining property is an unreasonably small capital.[121] The third test is the cash flow insolvency test. Contractual transfers and obligations will be vulnerable if, at the time of contracting, the debtor is incapable of paying its debts as they fall due or becomes incapable of doing so as a result of the contract.[122]

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[118] s. 240(2)(a and (b) of the Act.
[119] Listed in paragraph 5.2.2 (c) (i), (ii) and (iii).
[120] s. 548(a)(1)(B)(ii)(I) of the Code.
[121] s. 548(a)(1)(B)(ii)(II) Bankruptcy Code.
[122] s. 548(a)(1)(B)(ii)(III).

In light of the above, in terms of the financial state of the debtor, it is arguable that there will be no significant difference as to when the rules against contracts at an undervalue under the Insolvency Act and the Bankruptcy Code will be applicable. This is because in both jurisdictions, the debtor will be subjected to both the balance sheet and cash flow insolvency tests to establish its state of financial distress or otherwise at the time it entered into the contract.

The state of solvency of the debtor is not material in determining contracts that are vulnerable for actual fraud under the Code. All that is required for contracts to be voidable is for the contract to be executed during the twilight period of two years prior to the commencement of insolvency. The solvency of the debtor is also immaterial in determining the voidability of contracts under s. 423 of the Insolvency Act. Significantly, and in contrast to the corresponding rule in the Code, there is no limitation as to the relevant time wherein a contract will be vulnerable under s. 423.

4.4. Effects of avoidance on contracts

4.4.1. A general overview

The Insolvency Act provides a catalogue of

orders that courts can make for contracts vulnerable as contracts at an undervalue.[123] In contrast, the Bankruptcy Code does not provide any list of possible orders for bankruptcy courts. UK insolvency law mandates courts to restore the position to what it would have been had the debtor not entered into the contract.[124] The objective of the adjustment of contracts at an undervalue is to protect the assets of the debtor from depletion.[125] In contrast, the Bankruptcy Code seems to adopt a narrower approach. On avoidance of fraudulent conveyances under the Bankruptcy Code, the contract is set aside and becomes ineffective. In cases where there has been transfer of assets, the trustee will subsequently take steps to recover such assets, as avoidance under the Code does not automatically result to a retransfer of property or value under a contract.

The Code protects a counterparty that has given value for a benefit it received in a contract in good faith to the extent of the value that he has given in exchange under/pursuant to the contract.[126] To determine whether a recipient acted in good faith, bankruptcy courts look to what the recipient knew or should have known at the time of the transaction.[127] This approach can be contrasted with that of the Insolvency Act where the state of mind of the

[123] s. 241 of the Act.
[124] s. 238(3) and s. 423(2) Insolvency Act.
[125] *Lord v Sinai Securities* [2004] B.C.C. 986, 991: "the Court's primary, and possibly only, concern under s. 238(3) is the restoration of the company's position."
[126] s. 548(c).
[127] *In re Sherman* 67 F.3d 1348, 1354 (8th Cir. 1995). Considering what the counterparty should have known imports negligence.

benefitting counterparty is not relevant. It is arguable that the Code's position is more commercially sensible given that it gives effect to the honest pre-insolvency expectations of counterparties.[128] This is capable of incentivizing counterparties to trade with marginally solvent companies. This notwithstanding, it is arguable that by virtue of its transaction adjusting or avoidance powers under s. 241 of the Act, UK courts can achieve a similar result as the Code's provision. Accordingly, UK courts may order for a retransfer of a part of the value which the debtor has received no consideration for.

UK courts adopt different approaches in applying the Act's restorative provisions to preferences and contracts at an undervalue. In relation to preference avoidance, the focus is usually on the effect of the preference and not necessarily the contract as a whole. Where the severance of the preferential element in the contract will suffice, courts will adjust the contracts (rather than avoid them) with the aim of reversing the effect of the preference. On the other hand, a restoration of a contract at an undervalue to the position of what would have been if the contract had not been entered into, prima facie presupposes an outright nullification of the contract.[129]

However, the "position" envisaged in the

[128] Here, cognisance is taken of the fact that the good faith of the debtor in addition to commercial justification of the transaction will save the transaction. s. 238(5) of the Act.

[129] *Whalley (liquidator of MDA Investment Management Ltd) v* Doney [2005] B.C.C. 783 Park J. construed the section as demanding for a nullification of the whole contract.

provision is the "financial position" of the debtor. Hence contracts need not be out-rightly nullified in all cases. This approach is justified by the fact that the avoidance provision requires a measurement of the value of consideration given and received by the company in money or money's worth.

Furthermore, in some cases, attempting to restore the parties to the status quo ante the voidable transaction may produce absurd results that contradict the underlying policy rationale of the avoidance rule. For instance, in *Whalley v Doney,*[130] the court declined to make an order to restore the position to what it would have been if the transaction had not been entered into on the ground that if the debtor had not entered into the contract it would have closed down its business, and would have been worse off.

A commercially expedient construction of the present avoidance rule will therefore be to restrict "position" to the debtor's financial position. The underlying policy objective of the rule against contracts at an undervalue is to prevent the depletion of the debtor's assets for the benefit of unsecured creditors. If focus is to be placed on substance rather than form, then the aim of the court should be to reverse the harmful effect of the contract and not necessarily the contract itself.

Nullifying the whole contract should be

[130] [2005] B.C.C. 783.

considered only if severance is impossible and the nullification will further the policy of the avoidance regime. The priority of courts should therefore be to place the debtor in the same financial position that it would have been if the vulnerable contract had not been entered into. The s. 241 catalogue of possible court orders supports this position. For instance the catalogue includes the possibility of the counterparty being ordered to make payment to the debtor -- presumably the difference between the value of the property transferred and the consideration the debtor actually received.[131]

Both the Bankruptcy Code and the Insolvency Act make provisions for statutory defences for subsequent transferees or beneficiaries. For a transferee to be covered by this immunity, he must have received the value from a party other than the debtor and must have done so for value and in good faith.[132]

4.4.2. Leveraged buyouts in the twilight period

A leveraged buyout ("LBO") is a mode of acquisition of a company where the "acquirers" purchase (or "buy out") shares from the shareholders of the company (the "target") with (mostly) borrowed money (the "leverage"). The target is then made to

[131] s. 241(1)(d) Insolvency Act.
[132] s. 550(b)(1) of the Code, s. 241(2) of the Act.

guarantee the loan and its assets are used as security for the debt.[133] A typical leveraged buyout will have adverse effects on the target company, although this may be short-term in some cases. Firstly the target receives no direct benefit from the transaction i.e. from guaranteeing the new shareholders' debts and granting security in support of the guarantee.

The target is saddled with substantial secured debt in addition to the interest on such debt.[134] Selling shareholders obtain direct benefit as they are often "cashed out" at a premium. The acquirers gain ownership of the company with money that is not theirs. Conversely, the target's unsecured creditors face the prospect of incurring losses in the event of its insolvency, as the target's unencumbered assets would have been pledged as security for repayment of the debt under the LBO.[135]

In the light of the above, an LBO completed during an insolvency twilight period may be attacked on the ground that it constitutes a transaction at an undervalue under the Insolvency Act or an actual or constructive fraudulent transfer under the Bankruptcy Code. Before comparatively analysing the effects of insolvency avoidance rules on LBOs it is instructive to note that UK company law rules on financial assistance also place certain restrictions on LBOs.

[133] Six different ways in which LBOs can be structured are set out in David Gray Carlson, "Leveraged Buyout In Bankruptcy" (1985) 20 Ga. L. Rev. 73, 80-83.
[134] *Mellon Bank v Metro Communications Inc*. 945 F.2d 635, 645-646 (3d Cir. 1991).
[135] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 610.

This preliminary issue will be briefly examined before the comparative analysis.

The 2006 Companies Act outlaws the giving of financial assistance by public companies or their subsidiaries, directly or indirectly, to acquirers of its shares for the purpose of the acquisition of the shares of the company.[136] The rationale for the prohibition is to prevent the abuses that such transactions are likely to give rise to. This point was noted in the Jenkins Committee on the Reform of Company Law 1962 thus,

> "If people who cannot provide the funds necessary to acquire control of a company from their own resources, or by borrowing on their own credit, gain control of a company with large assets on the understanding that they will use the funds of the company to pay for their shares it seems to us all too likely that in many cases the company will be made to part with its funds either on inadequate security or for an illusory consideration." [137]

The common forms of LBOs involve the guaranteeing by a target of the borrowings of an acquirer of its shares, if the borrowing is for the purpose of acquiring the shares, or the grant of security over the target's assets for the borrowing. These constitute financial assistance.[138] The Act's prohibition on financial assistance applies to public companies only and does not apply to private companies unless they are subsidiaries of public

[136] s. 678 (1) of the Companies Act 2006. This provision will not apply if the principal purpose of the financial assistance is not the acquisition of the shares (s. 678(2)(a)) or if the giving for that purpose is only an incidental part of some larger purpose of the company (s. 678(2)(b)), provided that the assistance is given in good faith and in the interest of the company. The general prohibition on the giving of financial assistance by public companies is required by the EC 2nd Company Law Directive (77/91/EEC).

[137] Report of The Company Law Amendment Committee (Cmnd 1749, 1962) para 173. See also *In re V. G. M. Holdings Ltd*. (1942) Ch. 235, 239.

[138] s. 677(1)(b)(i); *Harlow v Loveday* (2005) 1 B.C.L.C. 41. Eilis Ferran, *Principles Of Corporate Finance Law* (Oxford University Press, 2007) 281.

companies.[139] The prohibition also applies to public companies that that are subsidiaries of a private company.[140]

A contract that violates the law against financial assistance is illegal and unenforceable by either of the parties.[141] Hence obligations by the target/debtor arising from the grant of security, guarantee or other transactions that constitute financial assistance in an LBO are unenforceable.[142] A target/debtor in an LBO commits an offence by participating in the transaction and is liable to a fine.[143] An individual who participates in the transaction commits an offence and is also liable to a jail term of up to two years or a fine or both.[144]

A public company will have to be re-registered as a private company before it can grant financial assistance to an acquirer.[145] The couching of the financial assistance provisions creates an avenue for public companies that are engaged in refinancing contracts and restructuring such as LBOs to re-register as private companies before the financial

[139] s. 678(1) of the Companies Act. Under the predecessor Companies Act 1985, s. 151 prohibited both private and public companies from giving direct or indirect financial assistance for the acquisition of its shares. However the prohibition on private companies was more relaxed and could be circumvented with the cumbersome 'whitewash' procedure under the then ss.155-158. Len Sealy, Sarah Worthington, *Cases and Materials in Company Law* (9th edn, Oxford University Press, 2011) 490.
[140] s. 679 of the Companies Act 2006. Eilis Ferran, *Principles Of Corporate Finance Law* (Oxford University Press, 2007) 287, 288.
[141] *Re Hill and Tyler Ltd* (2005) 1 BCLC 41. Len Sealy, Sarah Worthington, *Cases and Materials in Company Law* (n 76) 501.
[142] *Selangor United Rubber Estates Ltd v Cradock* [1968] 2 All ER 1073, 1154; *Brady v Brady* [1989] AC 755. Eilis Ferran, *Principles Of Corporate Finance Law* (Oxford University Press, 2007) 303.
[143] s. 680 of the Companies Act.
[144] s. 680 (2) of the Companies Act.
[145] Provided that it is not a subsidiary of a public company.

assistance is given.[146]

However, re-registering a public company may not always be an attractive option in view of the regulatory and procedural measures that must be complied with. The comparative advantages of public companies over private limited enterprise also make re-registration unattractive. Significantly the company will be delisted from the Stock Exchange. This may affect its ability to raise funds in future, as publicly traded companies are often able to raise capital through the sale of their securities in the markets. [147]Having dealt with the preliminary issue of the restriction on financial assistance as it relates to LBOs under UK law, it is germane to now consider the substantive issue of the effect of the US avoidance rules on LBOs completed during the twilight period or that result in the insolvency of the target.

Under the UK regime, it has to be shown that the target/debtor either received no consideration or that the value that it received was significantly less than the value it gave in money or money's worth in the LBO. The requirement for monetary evaluation and comparison is capable of posing difficulties in cases where detriments or intangible incidental benefits are involved. It is suggested that the monetary evaluation requirement is aimed at eliminating considerations that would make evaluation more difficult. However,

[146] s. 678(3) of the Companies Act. Eilis Ferran, *Principles Of Corporate Finance Law* (Oxford University Press, 2007) 287.
[147] s. 755-760 UK Companies Act 2006.

even if the debtor received benefits which were significantly less than what it gave, the LBO will not constitute a transaction at an undervalue if it is shown that the contract was done in good faith and for the purpose of carrying out the business of the company and that there were reasonable grounds to believe that it would be beneficial to the company.[148]

Under the US regime, actual fraud requires a proof of an intent to "hinder, delay, or defraud" a creditor.[149] An adverse effect of an LBO is that assets of the target that would have otherwise been available to unsecured creditors are encumbered. In appropriate cases, it can be argued that the elimination of the debtor's equity and the creation of a senior secured debt in its place was done with the intent to hinder or delay creditors.[150] This argument will be plausible in the absence of proof that there were reasonable grounds for the debtor and the LBO lender to believe that the LBO had potential benefits for the debtor or the likelihood of transforming it into a more successful enterprise.[151] Hence, in the absence of any financial benefit, the critical question would be what new value the new equity holders were bringing to the company.

For an LBO to be vulnerable as constructive fraud under the second limb of the Code's fraudulent

[148] s. 238(5) of the Act.
[149] s. 548(a)(1)(A) of the Code.
[150] Charles Tabb, *The Law of Bankruptcy* (2nd edn, Foundation Press 2009) 610.
[151] s. 548(c) of the Code.

transfer provision,[152] first, it has to be shown that the target/debtor did not receive "reasonably equivalent value" in exchange for its consideration. In addition, any of the three conditions which demonstrate the state of financial distress of the target must be established, namely: that the debtor was insolvent at the time of the transfer or as a result of it; that the debtor's capital was unreasonably small in comparison to the nature of the transaction; or that the debtor intended to incur losses which it would be unable to repay.[153]

The requirement that the debtor has not received a "reasonable equivalent value" or that the value it received is "significantly less" than what it has given will often be readily satisfied in LBOs. This is because, while selling shareholders are cashed-out and the acquirers have the benefit of acquiring the debtor with money that is not theirs, the target/debtor literally receives nothing in return for giving the guarantee/granting security in addition to a detriment of its assets being encumbered by the grant of security. It seems if the acquirers make a contribution to the acquisition and such contribution amounts to a substantial part of the purchase price, it may be sufficient to meet the reasonable equivalent value requirement. For instance in *Official Committee of unsecured creditors of Grand Eagle Cos. v. ASEA*

[152] s. 548(a)(1)(B) of the Code.
[153] *Hechinger Investment Co. v Fleet Retail Finance Group* 274 B.R. 71, 82 (D. Del. 2002): "LBOs will not be deemed fraudulent where the parties entering the transaction reasonably believed that the acquired would be solvent when it emerged or that it would have a fair chance to survive financially."

Brown Boverie,[154] a contribution of 47% of the purchase price in the LBO by the acquirer was accepted by the court. This can be contrasted with the case of *US v. Tabor Court Reality*[155] where 8% was viewed as not being sufficient.

Under the US regime, any indirect economic benefit to the target/debtor is capable of constituting consideration and value.[156] In other words, the court can consider intangible benefits that may be incapable of being registered in the debtor's balance sheet. This may include the *expertise* that the new management will bring into the target and the *goodwill* of the acquirer in the market and society.[157] For example in *Mutual Life Insurance Co. v Menin*[158] it was held that the debtor's goodwill is property asset which may be sold in bankruptcy proceedings. Hence, the touchstone is whether the transaction has actually conferred any value that is commercially realisable on the debtor, which is reasonably commensurate with the commercial value it has given.

The difficulty with these indirect economic benefits is that due to their intangible character, their values are incapable of being precisely measured at the time of the transaction in order to carry out the comparison with the values given. In addition, such a

[154] 313 B.R. 219, 230 (N.D. Ohio 2004).
[155] (N.D. Ohio 2004) 803 F.2d 1288 (3d Cir. 1986).
[156] *Mellon Bank v Metro Communications Inc*. 945 F.2d 635, 646-647 (3d Cir. 1991).
[157] ibid. at 647. In *Mutual Life Insurance Co. v Menin* 115 F.2d 975, 977 (2d Cir. 1940) it was held that the debtor's goodwill is property asset which may be sold in bankruptcy proceedings. See also *In re Da-Sota Elevator Co*. (fn. 35) 656.
[158] 115 F.2d 975, 977 (2d Cir. 1940).

transaction may turn out to be a gamble that does not payoff, given that the intangible consideration has to be valued at the time the transaction is entered into rather than following the business's failure.

As previously noted, under UK insolvency law, an LBO will not constitute a transaction at an undervalue if the target/debtor can establish that it was done in good faith and there were reasonable grounds to believe that it would be beneficial to the target/debtor.[159] Similarly, an LBO lender under the Code who acts in good faith will have a good defence against an action for fraudulent transfer, as there will be no intention to prejudice the interest of creditors.[160] However showing "good faith" in a failed LBO that was executed during the insolvency twilight period may be an uphill task considering that LBOs usually involve investing millions and courts will expect lenders to carry out careful background checks and due diligence to ascertain the financial state of the target/debtor.[161]

Baird and Jackson have criticized the application of the Bankruptcy Code's fraudulent conveyance provisions to LBOs on the ground that fraudulent conveyance statutes are traditionally aimed at

[159] s. 238(5) of the Act.
[160] By virtue of s. 548(c) of the Code, even if it is proved that the LBO is a fraudulent transfer, the lender will not be vulnerable if it took its security interest in good faith and for value given to the debtor. However, the value in LBOs merely passes through the debtor to the acquirer, and as such is not given to the debtor. Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 613; David Gray Carlson, "Leveraged Buyout In Bankruptcy" (1985) 20 Ga. L. Rev. 73, 86.
[161] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 613.

preventing collusive transfers between individual debtors and their families and friends, and thus should be construed narrowly and only extended to invalidate sham transactions and gratuitous transfers.[162] They argue that fraudulent conveyance statutes should not affect any "arms-length" transactions such as LBOs, even if such transactions injure creditors. According to Baird and Jackson,

> "A firm that incurs obligations in the course of a buyout does not seem at all like the Elizabethan deadbeat who sells his sheep to his brother for a pittance."[163]

With respect, a blanket exemption of all LBOs from the avoidance rules as proposed above would unjustifiably eviscerate the transaction avoidance rule. Given that LBOs can harm creditors in the same way as the fraudulent conveyance provisions are designed to prevent, it would be inappropriate for courts in determining the rights of creditors to turn a blind eye on sham transactions masked as LBOs.[164] In addition, all LBOs are not automatically vulnerable transactions, and in any given case, either actual or constructive fraud must be established to make the LBO vulnerable.

In LBOs involving publicly owned corporations, selling shareholders may be immune from a constructive fraud challenge by s. 546(e) of the Bankruptcy Code. However, actual fraud is expressly excluded from that safe harbour. The section prevents

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[162] Douglas Baird, Thomas Jackson, "Fraudulent Conveyance Law and Its Proper Domain" (1985) 38 Vand. L. Rev. 829, 833-5, 840.
[163] Ibid. at 852.
[164] *Crothers McCall Pattern Inc. v Lewis* 129 B.R. 992, 998 (S.D.N.Y. 1991); *In re Healthco Int'l Inc.* 195 B.R. 971, 979-980 and fn. 5 (Bankr.D.Mass. 1996).

a trustee from avoiding a "settlement payment" that is made by or to a stockbroker, financial institution, financial participant or securities clearing agency.[165] This safe harbour is intended to reduce systemic risk to markets that may result from undoing transactions upon which counterparties have relied, hedged and reallocated profits.

4.4.3. Intra-corporate group guarantees

Business activities of companies in a corporate group are often closely linked and functionally integrated regardless of the doctrine of corporate personality. This enables the companies to maximise the benefits that such synergy generates.[166] The consequence is that some contractual arrangements may involve the transfer of assets from one subsidiary to another without any reciprocal benefit to the transferor. Obligations may also be incurred by the parent company or one of the subsidiaries without receipt of any reciprocal benefit. Although these contractual arrangements may be commercially expedient, they may breach the rules against contracts at an undervalue or fraudulent transfers if they are

[165] s. 546(e) of the Code. See also s. 101(51A) and s. 741(8) of the Code for definition of "settlement payment." *Kaiser Steel Corp. v Charles Schwab & Co* 913 F.2d 846, 848 (10th Cir. 1990); *In re Kaiser Steel Corp*. 952 F.2d 1230, 1237 (CA-10 1991). However see *Munford v Valuation Research Corp* 98 F.3d 604 (11th Cir. 1996) where it was held that s. 546(e) does not apply to selling shareholders. See also William Rand, "In *Re Kaiser Steel Corporation*: Does Section 546(e) Of The Bankruptcy Code Apply To A Fraudulent Conveyance Made In The Form Of An LBO Payment?" (1992) Fordham Urb. L.J. 87, 109 where it is suggested that s. 546(e) unjustly protects stockholders who have received leveraged buyout payments constituting fraudulent conveyances. See also Neil Garfinkel, "No Way Out: Section 546(e) Is No Escape For The Public Shareholder Of A Failed LBO" (1991) Colum. Bus. L. Rev. 68-69.

[166] E.g. Tax advantages.

done during the insolvency twilight period of the group or a subsidiary.

A common type of intra-corporate group contract that is capable of breaching the present contract avoidance rules is the intra-group guarantee contract. Some lenders may insist on the provision of sureties as a precondition for advancement of loans and may be unwilling to make advances to a company solely on the company's promise to repay, provision of collateral or credit rating report. It is often easier for companies in a group to obtain guarantees from an affiliate company in the group or the parent company. A typical case will be where a parent company guarantees advances made to a subsidiary company (a "downstream" guarantee). In other scenarios, a subsidiary may guarantee advances made to the parent company (an "upstream" guarantee) and a subsidiary company may guarantee advances made to a co-subsidiary in the group ("cross stream" guarantee).[167] The subsequent insolvency of the guarantor may give rise to an action for fraudulent conveyance or transaction at an undervalue if the guarantee was issued during the twilight period.

There is a dearth of judicial authorities on this issue in both jurisdictions. This thesis will therefore draw on the analysis of Goode and Tabb on this subject in relation to UK insolvency law and US

[167] Robert Rosenberg, "Intercorporate Guaranties and the law of Fraudulent Conveyances: Lender Beware" (1976) 125 U. Pa. L. Rev. 235, 238.

bankruptcy law respectively. The first issue that will naturally arise in the application of fraudulent transfer law to guarantee contracts is the seeming absence of consideration to the guarantor. The insolvent surety who guarantees the advance normally receives nothing *tangible* in return. However, as a general rule in guarantee contracts, any advance made to the principal debtor is sufficient consideration to the surety.[168] The fact that funds are made available to the principal debtor and not to the surety, does not in itself render the transaction one at an undervalue or a fraudulent transfer. As previously noted, the Bankruptcy Code also recognises indirect benefits in guarantee contracts.[169] Similarly, it is settled under the fraudulent conveyance regime that an "indirect economic benefit" is acceptable and can be evaluated in the absence of direct value.[170]

It is therefore settled that a surety in a guarantee contract receives consideration. However, the fact that the surety has received value does not mean that the value received is reasonably equivalent to the obligation incurred or is not significantly less than the guarantee obligation. Hence the next inquiry will be on how to ascertain whether the "value" of

[168] Rebecca Parry, *Transaction Avoidance in Insolvencies* (2nd edn, Oxford University Press, 2011) 89.
[169] *Telefest Inc. v VU-TV Inc*. 591 F. Supp 1368, 1378-1379 (D.N.J. 1984).
[170] *Rubin v Manufacturers Hannover Trust Co*. 661 F.2d 979, 991-992 (2nd Cir 1981): "if the consideration given to the third person has ultimately landed in the debtor's hands, or if the giving of the consideration to the third person otherwise confers an economic benefit upon the debtor, then the debtor's net worth has been preserved...provided, of course, that the value of benefit received by the debtor approximates the value of the property or obligation he has given up." See also *Mellon Bank v Metro Communications Inc*. 945 F.2d 635, 646-647 (3d Cir. 1991).

consideration received by the surety is reasonably equivalent with the value of the surety's guarantee obligation. This is the most difficult aspect of applying the rules against fraudulent conveyance and transfers at an undervalue to guarantee contracts.

As a matter of general principle, the relevant time for measuring values is the time of issue of the guarantee.[171] However, no payment or transfer is usually made or received by the surety at that time. The surety's obligation is contingent in nature and he may never be called upon to fulfil it. In addition, the loan is usually passed to the principal debtor and the surety's benefit from the contract can only be indirect or incidental. Furthermore, the value of a surety's guarantee to the lender is difficult to gauge. These facts make the determination of indirect economic benefits and detriments to a surety a daunting task.[172]

Tabb has observed that the only situation that should be relatively simple is the downstream guarantee, where a parent company guarantees the debt of a subsidiary.[173] His observation is premised on the ground that the parent company will benefit

[171] Roy Goode, *Principles of Corporate Insolvency* (4th edn, Sweet and Maxwell 2011) 548; *Phillips v Brewin Dolphin Bell Lawrie* [2001] B.C.C. 864, 870. The court will look at evidence of subsequent events to make its determination without applying a 'hindsight test'. s. 6 (5) Uniform Fraudulent Transfer Act.

[172] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 615. Tabb observes that the fact that the surety may receive indirect economic benefits is what makes the application of fraudulent transfer law to inter-corporate guarantees tricky.

[173] See also Jack Williams, "The Fallacies Of Contemporary Fraudulent Transfer Models As Applied In Intercorporate Guaranties: Fraudulent Transfer Law As A Fuzzy System" (1994) 15 Cardozo L. Rev. 1403, 1419; Keneneth Carl, "Fraudulent Transfer Attacks on Guaranties in Bankruptcy (1986) 60 AM. Bankr L.J. 109, 115: "Downstream guaranties do not pose special transfer problems since the guarantor owns the stock of the principal debtor."

directly from the enhanced value of its subsidiary.[174] With respect, this may not always be the case. A financially distressed parent company that guarantees the debt of an equally hopelessly insolvent subsidiary stands to gain nothing from such a contract.[175] In this case, the funds borrowed by the subsidiary will have to be applied first in satisfying the claims of creditors. It will therefore not necessarily increase the value of the parent's equity interest in the subsidiary in a manner equivalent to the assumed guarantee obligation. On the other hand, there is often a strong likelihood that upstream and cross-stream guaranties will be vulnerable to fraudulent transfer attacks. This is because only a portion or none of the total business benefits that result from the guarantee contract will be enjoyed or indirectly transferred to the guarantor.[176]

Goode argues that to a lender/creditor, the "value" it receives from the guarantor will depend on the principal debtor's financial strength.[177] If the principal debtor is financially strong, the lender/creditor's dependence on the guarantee and its value to him is correspondingly reduced. On the other hand, if the principal debtor is financially weak or on the verge of insolvency, the value is high. The problem with this analysis is that the mere fact that

[174] Charles Tabb, *The Law of Bankruptcy* (fn. 172) 615.
[175] *General Electric Credit Corp. v. Murphy* 895 F.2d 725 (11th Cir. 1990). Barry Zaretsky, "Fraudulent Transfer Law As The Arbiter Of Unreasonable Risk" (1995) 46 S. C. L. Rev. 1165, 1196.
[176] Kenneth Carl, "Fraudulent Transfer Attacks on Guaranties in Bankruptcy" (1986) 60 AM. Bankr L.J. 109, 115.
[177] Roy Goode, *Principles of Corporate Insolvency* (4th edn, Sweet and Maxwell 2011) 548; Rebecca Parry, *Transaction Avoidance in Insolvencies* (2nd edn, Oxford University Press, 2011) 90-91.

the principal debtor is solvent at the time of the guarantee does not by itself mean that the guarantee is of no value, considering that the guarantee relates to the future and the prospect of insolvency.

Goode admits that measuring value from the guarantor's perspective is a daunting task and argues that the state of solvency of the principal debtor will be critical in determining the value of the consideration to the surety. For instance where the principal debtor is already insolvent, there will be no value at all as the guarantee will be solely for the benefit of the principal debtor and this will almost certainly constitute a transaction at an undervalue.[178] On the other hand, where the principal debtor's business is financially sound and the infusion of funds will enable it to expand its activities and increase its profitability for the benefit of the group, it will not amount to a contract at a undervalue.

Goode's argument is plausible, given that in this latter case some value would be ascribable to the consideration given by the surety for its guarantee, provided that the value of the benefit is not significantly less than the burden that the guarantor will have to bear. Accordingly, it is suggested that an analysis of an alleged contract at an undervalue or fraudulent transfer in intra-corporate guarantee arrangements must be directed at what the debtor

[178] Indeed the directors of the guarantor company may well be in breach of duty to the company in authorising the issue of the guarantee in the first place. Roy Goode, *Principles of Corporate Insolvency* (n 26) 551.

surrendered as well as what it received in the pre-petition transaction, irrespective of what any third party may have gained or lost. However, the said benefit to the debtor need not be direct. In other words, it suffices for the debtor (i.e. guarantor) to indirectly derive value or economic benefit from the contract through benefit given directly to a third party i.e. the principal debtor e.g. a parent company, subsidiary or co-subsidiary.

Conclusion

This chapter has examined rules against contracts at an undervalue and fraudulent transfers under UK and US insolvency laws respectively. The rules have similar objectives and also operate in a substantially similar manner. The rules primarily protect assets of the debtor from depletion, ensuring that creditors are not deprived of their potential realisations prior to the commencement of formal insolvency proceedings. Accordingly, the rules aim to reverse advantages received by creditors in anticipation of formal insolvency. The justification for the reversal being that such advantages undermine the collective and mandatory nature of the insolvency law procedure by strategically albeit, unfairly, placing the party in an advantageous position in the procedure.

The rules against transactions at an undervalue and fraudulent transfers present arguably the most

notable case of insolvency law's interference with contracts, given that the rules apply to override contracts which would otherwise be unassailable under the non-insolvency law regime. As articulated in this chapter, the interference is underpinned by the fact that the debtor had received value which was significantly less than what it gave in the contract. This runs counter to the traditional contract law doctrine that consideration must be sufficient and not adequate and that courts will not enquire into the adequacy of consideration. For instance in *Chappell & Co Ltd v Nestle Co Ltd*[179] Lord Somervell noted that,

> "A contracting party can stipulate for what consideration he chooses. A peppercorn does not cease to be good consideration if it is established that the promisee does not like pepper and will throw away the corn."[180]

This principle is also well established under US contract law[181] where Judge Richard A. Posner has observed that,

> "To ask whether there is consideration is simply to inquire whether the situation is one of exchange and a bargain has been struck. To go further and ask whether the consideration is adequate would require the court to do what … it is less well equipped to do than the parties—decide whether the price (and other essential terms) specified in the contract are reasonable … courts do not inquire into the adequacy of consideration."[182]

Notwithstanding that the avoidance rules prima facie derogate from applicable non-solvency law, it is suggested that some aspects of the rules can be reconciled with non-insolvency law. It is arguable that the first limb of the Bankruptcy Code's

[179] [1960] AC 87.
[180] ibid. at 114. See also *Midland Lands Trust Co. Ltd v. Green* [1981] AC 513.
[181] *Hitchcock v. Coker* (1937) 6 Adol. & Ell. 438.
[182] Richard A. Posner, *Economic Analysis of Law*, New York Aspen, 1973), 46.

fraudulent transfer provision (i.e. *actual fraud*) and s. 423 of the Insolvency Act do not actually deviate from non-insolvency law. The analysis of these provisions in this chapter has noted that they owe their origins to the Fraudulent Conveyances Act 1571 (the Statute of 13 Elizabeth). The provisions therefore embody longstanding principles of non-insolvency fraudulent conveyance law. Again, worth noting is the fact that s. 423 is equally applicable outside insolvency and can be instituted by any affected creditor.

A further justification for s. 238 and the second limb of the Code's fraudulent transfer provision (i.e. rules against transactions at an undervalue) is that they operate to return to the insolvent estate the value of assets that were wrongfully transferred from it or to the extent that insufficient value was received by the debtor in the pre-petition exchange. Again, the rules are by no means absolute, but attempt to exclude certain legitimate contracts from its ambit. As articulated in 4.3.2(b), the good motive or intention of parties can remove a plainly vulnerable contract from the ambit of the rules.[183]

In spite of the objectives of the rules, an issue that may require judicial consideration is the destination of recoveries from avoidance actions.

[183] For instance, s. 238(5) of the Insolvency Act excludes contracts entered into in good faith and for the purpose of carrying out the business of the debtor from the avoidance provision. It also excludes vulnerable contracts where there were reasonable grounds for believing that they would benefit the debtor.

Under the UK regime, this will be in the light of s. 238(3) which mandates courts to restore the company to the position prior to the impugned transaction. Against this background, notwithstanding the merits of the prevalent approach, it may be the case that unsecured creditors may be receiving benefits which they are not entitled to, at the expense of charge holders. However, a review of the current position will have diverse implications as regards the efficacy of the stated asset-preservation and creditor-protection objectives of the rules. It may also influence decisions of officeholders whether to pursue avoidance actions or not.

CHAPTER FIVE
POST-PETITION CONTRACTS

5.0. Introduction

The commencement of formal insolvency proceedings does not deprive a company of its contractual capacity.[1] There is often life after debt. As earlier noted in chapter three, the officeholder may choose to perform or assume some pre-insolvency contracts that are beneficial to the debtor or bankruptcy estate.[2] In addition to pre-petition contracts, the officeholder may engage in new (post-commencement) contractual arrangements. In rescue procedures, engaging in these two categories of contracts is virtually inevitable. Given that the primary objective of a rescue procedure is to re-organise the debtor into a profitable concern, the officeholder must of necessity continue trading.

In appropriate cases, companies that are being wound up may perform or assume pre-petition contracts and also enter into some new essential contractual arrangements. Although the company will eventually be liquidated, engaging in those contracts may be commercially expedient to ensure that the losses incurred by unsecured creditors are minimised

[1] Ian Fletcher, John Higham, *Corporate Administrations and Rescue Procedures* (2nd edn, Tottel Publishing 2004) 153.
[2] Refer to Chapter 3 for analysis of disclaimer or rejection and assumption or performance of pre-insolvency contracts.

and realisations maximised. An example of this would be contracts for the supply of essential goods to the debtor to enable it carry out its operations. In other cases, it may be more beneficial (to unsecured creditors) for the debtor to complete certain contracts rather than default and face subsequent claims for damages for breach that will result in additional unsecured claims.

This chapter evaluates the legal frameworks for post-petition and post-commencement contracts in the UK and the US. It examines how the jurisdictions treat and compensate post-insolvency creditors who defy inherent risks to contract with insolvent companies. This chapter further considers the impact of the special treatment conferred on these post-insolvency creditors on existing creditors and how the law resolves the inevitable conflict of interests.

The importance of post-petition financing contracts to rescue procedures cannot be overemphasised. A reorganisation procedure without adequate finance can be likened to a canoe without a paddle. Without the necessary funds, the rescue procedure might be impeded and the debtor might be forced into liquidation. This chapter comparatively evaluates the legal frameworks for corporate rescue financing contracts in the two jurisdictions. It further evaluates the statutory incentives for post-petition lenders and the effect of the inducements on the rights of other post-petition and pre-petition creditors.

5.1. Post-petition contracts

5.1.1. Preformed or assumed pre-insolvency contracts

At the commencement of formal insolvency proceedings,[3] officeholders have the discretion to disclaim or reject executory contracts that have onerous obligations without corresponding benefits to the company or bankruptcy estate.[4] On the other hand, the officeholder may wish to continue with executory contracts that are beneficial to the debtor and will aid in achieving the objectives of the procedure.[5] If the officeholder opts not to disclaim a pre-petition executory contract or to assume it as required under the Code, the debtor's subsequent liabilities under the contract resulting from post-petition performance by the counterparty rank as expenses of the procedure ahead of pre-petition unsecured claims.[6]

Understandably, trade creditors may be reluctant to continue supplying goods and services to insolvent companies in exchange for a ranking alongside unsecured creditors. This would be akin to providing the goods and services to the debtor or the

[3] Winding up procedure under the Insolvency Act and both the Chapters 7 and 11 procedures under the Bankruptcy Code. As noted under chapter 3, under the Insolvency Act, Administrators are not expressly conferred with the powers to disclaim executory contracts. See a detailed analysis of disclaimer in Chapter 3.
[4] Refer to Chapter 3 for a detailed analysis of disclaimer.
[5] An administrator has no express power to disclaim or reject pre-petition executory contracts. He could decline performing such contracts but risks incurring liability for breach of contract and/or procurement of the breach of contract.
[6] David Reeder, "The Administrative Expense Priority In Bankruptcy - A Survey" (1987) 36 Drake L. Rev. 135, 144. Generally at insolvency all pre-petition unsecured creditors are subject to the pari passu regime of asset distribution. Consequently, they are usually among the lowest ranked category of debts.

bankruptcy estate without payment or assurance of payment. Hence such post-petition liabilities under a pre-petition contract that arise due to post-petition performance by a creditor are ranked as expenses of the liquidation or administration.[7]

Rental and lease expenses incurred after the commencement of the formal insolvency procedure are also accorded insolvency expense priority in the two jurisdictions. Under the Bankruptcy Code, the trustee or debtor-in-possession may assume leases which are beneficial to the estate. There are basically two consequences of a decision to assume the lease, namely:

i. All defaults under the lease by the insolvent company must be promptly cured and the terms of the lease will be binding on the bankruptcy estate; and
ii. Amounts due under the lease from the point of assumption will be entitled to priority as an administrative expense.[8]

An administrative priority is also accorded to rent that accrues within the period between the time of filing of an insolvency petition and the time when the officeholder makes a decision to assume or reject the pre-petition lease. This administrative rent is assessed in terms of the debtor's use of the property.[9] The

[7] r. 4.218 (3)(a)(ii) and r. 2.67.1(a) Insolvency Rules (for liquidators and administration respectively); s. 503(b) of the Code.
[8] David Reeder, "The Administrative Expense Priority In Bankruptcy - A Survey" (fn. 6) 139.
[9] ibid. at 140.

foregoing position is similar to that under English insolvency law. Leases and rents are payable as an administrative expense if the administrators retain or use the premises.[10]

5.1.2. New contracts

As is the case with liabilities that arise from post-petition performance of pre-petition contracts, all liabilities arising in relation to new contracts entered into by the debtor or bankruptcy estate after the commencement of insolvency rank as expenses of the procedure. Under both jurisdictions, claims that are incidental to the operation of the company's business during the period of reorganisation are given administrative expense priority.[11]

The administrative expense priority serves as an incentive to encourage creditors to contract with financially ailing firms. It gives suppliers of goods and providers of services the assurance that the officeholder will be required to make priority payment for the goods and services that they have supplied in comparison to pre-petition unsecured debts.

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[10] r. 2.67(1)(a) and (f) of Insolvency Rules. *Re Game Station Ltd* [2014] EWCA Civ. 180, [2014] W.L. 640371; *Re Lundy Granite Co*. (1871) L.R. 6 Ch. App. 462, 466 (Sir W. M. James L.J): "if the company for its own purposes, and with a view to the realisation of property to better advantage, remains in possession of the estate, which the lessor is therefore not able to obtain possession of, common sense and ordinary justice require the court to see that the landlord receives a full value of the property." *Goldacre (Offices) Ltd v Nortel Networks (UK) Ltd* [2010] B.C.C. 299, 303-305.

[11] David Reeder, "The Administrative Expense Priority In Bankruptcy - A Survey" (fn. 6) 139 and 144.

This arrangement is fair and commercially justifiable, as the contrary would mean that post-petition creditors would have to trade with the company without any assurance of payment. This would discourage prospective counterparties from doing business with companies undergoing rescue procedures thereby jeopardising the chances of the success of such procedures.

5.2. Restrictions on contracts

Companies undergoing formal insolvency procedures may continue engaging in contracts. However, their contracts are subject to certain statutory restraints. These restrictions are aimed at enhancing insolvency law's objectives of asset preservation, as well as the cardinal principles of collectivity and equality among similarly ranked creditors. The next paragraphs will evaluate these statutory provisions in the two jurisdictions as well as their efficacy in achieving their set objectives.

5.2.1. The UK regime

As previously noted in chapter one, in compulsory winding up proceedings in the UK, s. 127 of the Insolvency Act avoids any disposition of the property of the company,[12] transfer of shares and

[12] Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet &

alteration of the status of members of the company made after the commencement of the proceedings unless the court validates such contracts or dispositions. Fletcher has noted that the long-established practice is for courts to validate such dispositions if made honestly and for the benefit of the company and in the ordinary course of business.[13] Significantly, after the making of the winding up order, the winding up relates back to and commences at the time of the passing of the winding up resolution,[14] or at the time of the presentation of the winding up petition.[15]

The debtor's assets are often vulnerable to abuse or misuse during the period leading up to the making of the winding up order. Section 127 of the Insolvency Act preserves the assets of the company and prevents transactions that may result in asset diminution. In consequence, the provision also promotes the pari passu principle of asset distribution by frustrating attempts by creditors to gain a head start over similarly ranked creditors.[16] The primary distinction between s. 127's restriction and the

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Maxwell 2011) 613. Goode describes "disposition" to include "an agreement by which the company surrenders a lease or gives up its contractual rights, contractual set-off by which a debtor to the company is given and exercises the right to apply a cross claim of his own against the company in diminution of his indebtedness and arguably even the extension of further credit to the company during the post-petition period which leads to the exercise of the right of transaction set-off against the company's credit balance."

[13] Ian Fletcher, *The Law of Insolvency* (4th edn, Sweet & Maxwell 2009) 814; A. McGee, G. Scanlan, "Section 127 Insolvency Act 1986: Practical problems in its application" (2004) Comp. Law 102.

[14] In cases of voluntary winding up. s. 129(1) of the Act.

[15] s. 129(2) of the Act. Note that in Members voluntary winding up the time of the commencement of winding up relates back to the time when the resolution for winding up is passed. This involves a solvent liquidation and is therefore not very relevant to this work.

[16] *Coutts & Co. v Stock* [2000] 1 B.C.LC. 183, 187; *Denney v John Hudson & Co. Ltd.* [1992] B.C.C. 503, 504.

administration moratorium analysed in chapter two is that the former protects debtor's assets from the activities of company directors and other insiders, as opposed to creditors and counterparties.[17] There is no provision which performs an identical role for the administration procedures.

Section 127 of the Insolvency Act operates in a manner similar to the moratorium in that it has the sweeping effect of invalidating contracts which involve dispositions of the debtor's assets between the time of the presentation of a winding up petition and the moment an order for winding up is granted. Accordingly, in *In re Gray's Inn Construction Co. Ltd* Buckley L.J. noted that the provision,

> "Effectively paralyses the company's business, for without the court's leave not so much as a stitch of cloth can be disposed of, not one penny spent even to acquire an asset worth a pound and technically the company cannot even pay cash into its bank account." [18]

The potential effect of this is that there is a total paralysis of the affairs of the debtor.[19] In consequence, it may have the unintended effect of invalidating dispositions or contracts which might be beneficial to the company.

In practice, prospective application to courts for validation prior to contracting may not always be feasible. The debtor may be in urgent need of supplies or the counterparties may be oblivious of the fact that

[17] David Milman, "Administration orders: the moratorium feature" (1992) 5(9) Insolv. Int. 73-75.
[18] [1980] 1 W.L.R. 711, 718
[19] Roy Goode, *Principles of Corporate Insolvency Law* (4th edn, Sweet & Maxwell 2011) 612.

a winding up petition has been filed. To surmount this challenge, validation of contracts under s. 127 can be sought retrospectively after the completion of the contractual disposition.[20] However, a creditor who opts for this approach would have to do so at his own risk considering that there is no guarantee of a retrospective validation of the contract.

5.2.2. The US regime

As is the case under UK insolvency law, in liquidation cases under the Bankruptcy Code, there is always an interval between the time a bankruptcy petition is filed and the time a trustee is appointed or takes over the bankruptcy estate. During this period, there is a possibility that a debtor might contract for the disposition of its assets, which are not in the best interest of the general body of creditors. Against this background, trustees are empowered to avoid and recover any unauthorised post-petition transfers of assets from the bankruptcy estate that do not fall within recognised statutory exceptions.[21]

To a large extent, s. 549 of the Bankruptcy Code performs a similar objective as s. 127 of the Insolvency Act. It protects the assets of the bankruptcy estate from premature dismemberment by reason of the debtor's post-petition contracts or

[20] *Bank of Ireland v Hollicourt (Contracts) Ltd*. [2000] B.C.C. 1210, 1214-1215.
[21] s. 549(a) of the Code. *In re Delco Oil Inc*. 599 F.3d 1255, 1258 (11th Cir. 2010); *Manuel v. Allen* 217 B.R. 952, 955 (Bankr.M.D.Fla.1998).

dispositions. The trustee is also empowered to avoid contracts that have the effect of breaching the fundamental insolvency law goals of collectivity and equality among similarly situated creditors.[22]

A significant distinction between the two post-petition invalidation provisions is that under s. 127 unauthorised post-petition contracts are void and can only be validated by the courts. The reverse is the case under s. 549 of the Code - post-petition contracts that breach the bankruptcy law policy are merely voidable. It is incumbent on the trustee to take steps to avoid the contracts. There are arguably merits and demerits of these approaches. The demerit of the UK position as previously noted is the fact that it imposes a statutory paralysis on corporate activities. This affects both beneficial and detrimental dispositions. On the other hand, the approach of the US regime would suggest that in every case, the officeholder must have to take active steps to avoid such contracts. Apart from the time and resources which would be expended in avoiding such contracts, there is the danger that certain dispositions may slip from the trustee's radar.

As previously analysed in chapter two, the Code's automatic stay provisions apply to both Chapter 7 winding-up procedures and the Chapter 11 reorganisation procedures. Consequently, although asset transfers in vulnerable post-petition contracts

[22] Charles Tabb, *The Law of Bankruptcy* (2nd edn, Foundation press 2009) 635.

will remain valid until avoided by the trustee, counterparties will be unable to enforce the contracts once the bankruptcy procedure commences due to the operation of the automatic stay.[23]

The debate over the effect of a contravention of the automatic stay has been previously analysed in chapter two.[24] The conflicting views of bankruptcy courts as to whether a transaction in contravention of the stay is *void*, *voidable* or *invalid* were evaluated, as well as their practical consequences.[25] Adopting the "voidness" argument will have an adverse effect on the potency of s. 549. For instance, if contracts in violation of the automatic stay are regarded as being void, s. 549 (a) will be rendered superfluous, as there will be no post-petition contracts for a trustee to avoid under the provision. Accordingly, in *Sikes v Global Marine Inc*. [26] the court noted that,

> "If everything done post-petition were void in the strict sense of the word, these provisions would either be meaningless or inconsistent with the specific mandate of s. 362(a)." [27]

In the leading case of *In re Russell Schwartz*[28] the court held that s. 549(a) has a purpose in bankruptcy beyond the potential overlap with the s. 362 automatic stay provision. The court ruled that, regardless of the circumstances where there may be an overlap between s. 362 and s. 549(a), the automatic stay provision can void certain violations and still

[23] Refer to chapter 2 for the analysis of the automatic stay.
[24] ibid.
[25] ibid.
[26] 881 F.2d 176, 179 (5th Cir.1989).
[27] ibid. at 179.
[28] 954 F.2d 569 (9th Cir. 1992).

leave s. 549 with a valid and important role in bankruptcy. Accordingly, the court held that s. 549(a) applies to unauthorised transfers of the bankruptcy estate's assets that are not otherwise prohibited by the Code.[29] In other words, it applies to contractual transfers in which the estate is a willing participant or which it has voluntarily initiated.[30]

With respect, the above reasoning does not accord with the relevant provisions of the Bankruptcy Code. First, s. 101(54) defines transfers to which s. 362 apply, as:

> "The creation of a lien; the retention of title as a security interest; the foreclosure of a debtor's equity of redemption; or each mode, direct or indirect, absolute or conditional, *voluntary or involuntary*, of disposing or parting with property or interest in property."

This clearly indicates that automatic stay provisions equally apply to voluntary transfers by the estate. As previously noted in 2.2.2., in *In re Germansen Decorating Inc*.[31] a voluntary payment by a debtor was held to be in breach of the statutory stay. In delivering his judgment, Ginsberg J. had noted thus,

> "This court will not sit idle and permit debtors to waive willy-nilly the automatic stay so that certain creditors may be preferred with impunity and the estate dismembered without reference to the Code … The automatic stay is meant to prevent one creditor from securing an advantage over its peers after a petition is filed by or against a debtor. *It makes no difference whether that creditor gets that advantage as a result of a voluntary or involuntary transfer*."[32]

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[29] ibid. at 574.
[30] *In re R & L Cartage & Sons* 118 B.R. 646, 650-655 (Bankr.N.D. Ind.1990); *In re Garcia* 109 B.R. 335, 339 (N.D. Illinois, 1989).
[31] 149 B.R. 517, 521 (Bankr. N.D. Ill. 1992).
[32] ibid. at 521-522.

The merits of this position have been extensively evaluated in 2.2.2. In addition, s. 362(a)(3) stays "all entities" (the debtor inclusive) from "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."[33]

It is indeed difficult to interpret s. 362 and s. 549(a) in a manner that does not allow for any overlap between the two provisions. The legislative history of the Code is not helpful, as very little analysis is given in respect of the latter provision. Clearly s. 549(a) constitutes an independent means for invalidating certain vulnerable post-petition contracts. However, most of the contracts that it is aimed at also violate the automatic stay, considering that all post-petition contractual transfers of the estate assets will be in violation of the automatic stay. Against this background, s. 549(a) may be a mere surplusage in many cases.

In validating or avoiding post-petition contracts under the Insolvency Act and Bankruptcy Code, courts in the two jurisdictions often rely on very similar principles. This is not surprising, considering that s. 127 of the Act and s. 549(a) of the Code have similar underlying policy goals, namely, preservation of the debtor's assets to ensure that insolvency law policy is not undermined. Hence, in

[33] Kelly Culpin, "Validity Of Post-Petition Transfers Of Real Property: Who Does The Bankruptcy Code's Section 549(c) Protect?" (2005) 40 Real Prop. Prob. & Tr. J. 149, 178.

validating post-petition contractual dispositions, UK courts ensure that the interests of unsecured creditors are not prejudiced. The courts will be reluctant to validate contractual arrangements where a pre-liquidation creditor would be paid in full to the detriment of other creditors who are given only dividends.[34]

Post-petition contracts involving the transfer of assets, in good faith and in the ordinary course of business at the time when parties were oblivious of the pending winding up petition are often validated by UK courts.[35] The Code also exempts good faith purchasers who contract without knowledge that a winding up petition has been filed and who have furnished consideration that is equivalent to the present fair equivalent value. This exemption is however only limited to the transfer of interest in real property.[36]

In addition, in involuntary cases, transfers made after the commencement of a case but before the order for relief, are exempted from the present rule to the extent of any value that is given after the commencement of the case in exchange for such

[34] *Denney v John Hudson & Co Ltd* [1992] B.C.C. 503, 504; *Re Gray's Inn Construction Co Ltd* (fn. 18) 718. Here it was suggested that special circumstances could warrant the validation in favour of pre-liquidation creditors. This could be in cases where it would be 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. Ian Fletcher, *The Law of Insolvency* (4th end, Sweet & Maxwell 2009) 814.

[35] *Denney v John Hudson & Co Ltd* [1992] B.C.C. 503, 505; *Re Gray's Inn Construction Co Ltd* (fn. 18) 718.

[36] s. 549(c) of the Code; William Rochelle, Gwen Feder, "Unauthorized Sales of a Debtor's Property: The Rights of a Purchaser Under Section 549 of the Bankruptcy Code" (1983) 57 Am. Bankr. L.J. 23, 23.

transfer. This is regardless of any notice or knowledge of the case that the transferee has.[37] Section 127 has no application to post-petition creditors, i.e. creditors who contract or make supplies to the company for full market value after the presentation of the winding up petition.[38] This is due to the fact that there is often no dissipation of the assets of the debtor or the value thereof.[39] The Bankruptcy Code treats post-petition creditors and contracts of this nature in a similar manner.

Finally, under the Insolvency Act, a post-petition contract that effects a disposition that is not validated by the court remains void.[40] Although the disposition is void and the transferee has no title to the assets, it may still be expedient to obtain an order for recovery from the court. This is also the practice under s. 549(a) of the Code notwithstanding that, under the provision, contractual transfers are merely voidable until avoided by the trustees.[41] Once the transfer has been avoided, the transferee will be required to return the transferred asset to the bankruptcy estate.[42]

[37] s. 549(b) of the Code.
[38] *Denney v John Hudson & Co. Ltd.* (fn. 35) 505; *Re Gray's Inn Construction Co. Ltd.* (fn. 18) 719.
[39] *Re Tramway Building and Construction Co. Ltd.* [1987] 3 B.C.C. 443, 449.
[40] Roy Goode, *Principles of Corporate Insolvency Law* (fn. 19) 619-620.
[41] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 634.
[42] s. 550(a) of the Code.

5.3. Post-petition financing contracts

The importance of adequate working capital in the reorganisation of insolvent companies cannot be overstated. Due to the risks involved, an officeholder will typically have an uphill task trying to negotiate and convince pre-insolvency and new financiers to lend to the debtor. This part of the chapter comparatively evaluates the legal framework for post-petition financing in the two jurisdictions. It further analyses the hierarchy of incentives for post-petition financiers and examines how the conflict between the rights of existing creditors and post-petition lenders are managed.

5.3.1. Statutory frameworks

One of the foremost challenges that an officeholder in both jurisdictions will encounter will be in sourcing funds to finance the rescue of the company or to trade for even a short time so as to maximise realisations. The officeholder will have a number of options at his disposal. He may opt to renegotiate and restructure existing pre-insolvency lending agreements or may enter into new contracts.

A debtor will often stand a better chance of obtaining credit from a creditor with an existing relationship and knowledge of the affairs of the debtor than from a total stranger. It may be easier to

convince an existing creditor to lend to the debtor, as this may be the only viable way of saving the debtor from complete collapse and also preserving the value of the creditor's previous investment in the debtor. Hence, further financing of a distressed company or insolvent estate may be viewed as a vehicle to asset recovery rather than a risk-prone venture. Another merit of obtaining credit from existing pre-petition creditors is that the transaction will be expedited and bureaucratic procedures avoided purely because the insolvent company and the lender have an existing relationship.[43]

Under the Bankruptcy Code, pre-petition financing contracts cannot be assumed.[44] In the same vein, an agreement by the parties for the financing contract to continue after the filing of an insolvency petition will be of no effect.[45] The Bankruptcy Code has a comprehensive and well-structured debtor-in-possession (DIP) financing provision.[46] Under DIP financing, the Code aims to balance the interests of pre-petition creditors with that of the post-petition lender, taking into account the risks associated with post-petition lending. In response to the reluctance and skepticism of prospective lenders towards financing the rescue procedure of insolvent

[43]The Insolvency Service, "Encouraging Company Rescue – A Consultation" (2009) 18 par 51: http://webarchive.nationalarchives.gov.uk/+/http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/con_doc_register/compresc/compresc09.pdf (accessed on 6 October 2012).
[44] *In re Sun Runner Marine Inc*. 945 F.2d 1089 (9th Cir. 1991).
[45] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 1074.
[46] s. 364 of the Code.

companies, s. 364 offers a progressive hierarchy of inducements to prospective lenders.[47]

In contrast, UK insolvency law does not have specific provisions that regulate corporate rescue financing.[48] As a matter of general principle, liabilities that arise from post-petition financing contracts rank in priority as expenses of the administration ahead of unsecured creditors (including the prescribed part) and floating charge-holders, but not in priority to fixed charges and quasi-security rights.[49] They however rank equally with other expenses of administration.[50]

A significant point to note is that, in contrast to the Code's DIP financing, a post-petition lender

[47] Craig Cooper, "The Priority Of Post-petition Retainers, Carve-Outs, And Interim Compensation Under The Bankruptcy Code" (1993) 15 Cardozo L. Rev. 2337, 2347; Paul Baisier, David Epstein, "Post-petition Lending Under Section 364: Issues Regarding The Gap Period And Financing For Pre-packaged Plans" (1992) 27 Wake Forest L. Rev. 103, 103.

[48] Stephen Davies, *Insolvency and the Enterprise Act 2002* (Jordans 2003) 13-14, 20-26. The Department of Trade and Industry (DTI) review of company rescue mechanisms that preceded the UK Enterprise Act 2002 had suggested that new secured finance should only be available to support a rescue procedure where existing secured creditors agree or where there are unsecured assets or sufficient equity in unsecured assets. During the parliamentary debates, government resisted an amendment that would have created a statutory framework for super-priority financing after the administration process was commenced. The basis for this opposition was to prevent creating a situation that would guarantee a return to lenders advancing funds on the basis of such priority irrespective of the commercial viability of the rescue proposals. Government's position was that the issue of "whether to lend to a company in administration was a commercial one that was best left to the business judgment of the lending market." See also Lijie Qi, "Availability of continuing financing in corporate reorganisations: the UK and US perspective" (2008) Comp. Law. 162, 166; Gerard McCormack, "Super-priority new financing and corporate rescue" (2007) J.B.L. 701, 702.

[49] r. 2.67.1(a) Insolvency Rules.

[50] Although there is no express provision for rescue financing in the Insolvency Act, McCormack has argued that post-petition financing is authorised by implication. He argues that the relative provisions of the Insolvency Act 1986 can be read in such a way as to permit new financing arrangements during administration that would take priority over both the administrator's remuneration and expenses and an existing floating charge. McCormack notes that a combination of para. 99(3) and (4) of Sch. B1 will have the effect of conferring contractual liabilities including loan obligations priority over the administrator's remuneration and expenses, which in turn are payable ahead of floating charge securities. Gerard McCormack, "Super-priority new financing and corporate rescue" (2007) J.B.L. 701, 727-728.

under the Insolvency Act has no priority over secured creditors,[51] except lenders secured by floating charges. In consequence, the chances of a company obtaining rescue finance may depend on its ownership of unencumbered assets or additional advances by pre-petition secured creditors.

In view of the importance of corporate rescue finance, the UK Insolvency Service has recommended the provision of a "range of increasingly enhanced security" to providers of rescue finance to serve as an incentive for them to lend to companies in administration.[52] Significantly, these incentives are to a large extent a transplant of the DIP financing provisions under s. 364 of the Bankruptcy Code. The next paragraphs will evaluate the hierarchy of incentives under the DIP financing and their effects on the rights of pre-petition and other post-petition creditors. This will be comparatively evaluated with the current approach of UK insolvency law alongside the recommendations of the UK Insolvency Service.

The first incentive under s. 364 of the Code for a provider of DIP financing is priority as an expense of the reorganisation. Hence, if the post-petition loan is given to the bankruptcy estate in the ordinary course of business, the creditor's claim will

[51] Rebecca Parry, "Is UK Insolvency Law Failing Struggling Companies?" (2009) 18 Nottingham L.J. 42, 51.
[52] The Insolvency Service, "Encouraging Company Rescue – A Consultation" (2009) 18 par 54: http://webarchive.nationalarchives.gov.uk/+/http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/con_doc_register/compresc/compresc09.pdf (accessed on 6 October 2012).

be treated as an "administrative expense."[53] As noted previously, UK insolvency law generally grants administration-expense status to post-petition lenders.[54] However a distinction between the two regimes is that the Code has additional requirements where the loan was not given in the ordinary course of business. These additional requirements are, notice to creditors, a court hearing and approval.[55] These requirements are plainly justifiable.

In certain instances, inducement by way of administrative expense priority may not be sufficient to encourage a lender to contract with the bankruptcy estate. This may be the case where the incentive is not viewed as being commensurate with the level of the potential risk.[56] Where the trustee or debtor in possession shows that he has unsuccessfully made reasonable attempts to obtain credit based on the above incentive, the Code permits credit to be obtained and secured by one of the varieties of special priorities.

Accordingly, the following three special types of priorities can be conferred on a lender after notice to creditors and a court hearing:

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[53] s. 364 (a) and (b) of the Code.
[54] r. 2.67.1(a) IR: "Expenses properly incurred by the administrator in performing his functions in the administration of the company."
[55] s. 364 (b) Bankruptcy Code. *In re Straightline Investment Inc*. 525 F.3d 870 (9th Cir 2008). Courts have adopted two tests for measuring "ordinary course of business." First, the *vertical dimension test* focuses on the reasonable expectations of a hypothetical creditor. To pass the test, it must be a type of transaction that a creditor would expect the debtor in his business to enter into. Secondly, the *horizontal dimension test* considers the transaction in the context of the industry by comparing the debtor's business and transaction to businesses in the same industry.
[56] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 1077.

i. A super priority for the debt or credit, with priority over all administrative expenses;[57]
ii. A lien on unencumbered estate property;[58] or
iii. A lien on the equity in property of the estate that is already subject to a lien.[59]

Post-insolvency lenders under the UK regime are not entitled to any of the above three special priorities. Their incentive is limited to having priority as administration expense. In addition, the administration expense priority under r. 2.67 is not the preserve of post-petition lenders. Post-petition lenders will rank equally with other post-petition creditors whose claims fit the description.[60] An agreement to confer a "super" administration expense priority or any of the special priorities on a lender in the UK regime will constitute an attempt to contract out of the mandatory insolvency distribution scheme considering that no such priority is recognised by the Insolvency Act.

The range of increasingly enhanced security which the UK Insolvency Service has proposed as incentives to post-petition lenders in order to encourage the financing of corporate rescue are similar to the inducements under the Bankruptcy

[57] s. 364(c)(1) Bankruptcy Code.
[58] s. 364(c)(2).
[59] s. 364(c)(3).
[60] r. 2.67(1)(f) IR: "Any necessary disbursements by the administrator in the course of the administration." In *Exeter City Council vs Bairstow* [2007] B.C.C. 236, 250-251, it was held that the expenses under r. 2.67(1)(a) i.e. "expenses properly incurred by the administrator in performing his functions in the administration of the company," are limited to those for which the administrator made himself personally liable.

Code. For instance, as is the case under the Code, the Insolvency Service has recommended that, in appropriate cases, properly incurred rescue finance costs should rank ahead of other administrative expenses.[61] The Insolvency Service rightly posits that granting greater priority to repayment of such funding will serve as a motivation to banks and lenders, giving them a greater assurance of repayment.

As is the case under s. 364(c) of the Code, the UK Insolvency Service has recognised the fact that in certain instances, mere granting of priority ahead of administration expenses may not be sufficient to attract prospective lenders due to the increased risk. The Insolvency Service thus recommends other increased ranges of incentives.[62] For instance, in appropriate cases where the foregoing incentives are not commensurate with the potential risks which the post-petition lender may incur, the Insolvency Service has recommended that the post-petition finance can be secured,

i. Against any property which is not already encumbered by fixed security; or
ii. As an additional (subordinate) fixed charge on any property; or
iii. Subject to the agreement of the existing fixed charge-holder(s) or the court, and only where there is no scope for new or subordinate fixed charges, as a first charge (ahead of other fixed

[61] The Insolvency Service, "Encouraging Company Rescue – A Consultation" (n 41) 19 para. 61 proposal C.
[62] ibid. at 21 par 67; 19 para. 57.

charges) or an equal first charge on property already subject to a fixed charge.[63]

Given that (iii) above entails overriding an existing (fixed) security interest, an attempt is made to limit the incursion into the rights of secured creditors by way of preconditions. Hence, before the priority is conferred, the officeholder must be satisfied that granting the security is necessary to obtain finance. The decision to grant the security must be in the interest of affected secured creditors who must also be adequately protected. In addition, this option must be in the best interest of creditors generally.

The foregoing conditions for overriding security interests are consonant with those under the Bankruptcy Code.[64] Under the Code, the court can approve secured financing wherein the lender will be secured by a senior or equal lien on a property of the insolvent estate that is already subject to a lien. This incentive can only be used as a last resort when the preceding incentives do not suffice. [65] The consequence of this is that the pre-existing senior lien will be subordinated in favour of a new lender and the latter will be granted the senior or first lien.[66]

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[63] ibid. at 20 proposal D para. 65.
[64] s. 364(d) Bankruptcy Code. Mark Prager, "Financing the Chapter 11 Debtor: The Lenders' Perspective" (1989) 45 Bus. Law 2127, 2135-2136; Daniel Goodsell, "Extending Post-Petition Credit to Reorganizing Debtors: Understanding the Tricks and Traps of Bankruptcy Code Section 364" (1990) Utah L. Rev. 93, 104.
[65] s. 364(d) Bankruptcy Code.
[66] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 1078-1079: "The new senior lien (the post-petition lender) is said to 'prime' the prior first lien, which now is relegated to the junior lien status."

Finally, post-insolvency lenders under the Code are protected from being adversely affected by a subsequent modification or reversal by the order of court granting the super-priority or lien.[67] Some creditors would be reluctant to extend credit to reorganizing debtors if the court's order granting them protection could be overturned subsequently, leaving them without any protection. Accordingly, creditors who rely on a bankruptcy court's order in good faith are adequately protected.[68]

It has been argued that introducing a provision for leapfrogging finance to the Insolvency Act would be a bold step, and one that would likely be resisted by institutional lenders.[69] This observation is plausible considering that such prime finance would inevitably render security interests uncertain and make lending riskier. On the other hand, priming finance will have the potential to encourage pre-insolvency secured creditors to advance further funds in order to avoid being bypassed in priority. Hence, it may make it easier for some corporate debtors to exit administration.

Generally post-insolvency contractual liabilities of a debtor rank as expenses of the procedure ahead of pre-insolvency claims. However, the Code's DIP financing regime sanctions the

[67] s. 364(e) Bankruptcy Code.
[68] Daniel Goodsell, "Extending Post-Petition Credit to Reorganizing Debtors: Understanding the Tricks and Traps of Bankruptcy Code Section" (1990) Utah L. Rev. 93, 104.108.
[69] Rebecca Parry, "Is UK Insolvency Law Failing Struggling Companies?" (fn. 51) 51.

conferment of greater protection and privileges to creditors who are willing to finance a corporate rescue. The option of overriding existing security interests is by far the most significant and far-reaching of the incentives offered to post-petition lenders.

The special treatment accorded DIP financing creditors in comparison to other pre- and post-petition creditors can be justified on at least two grounds or circumstances. Firstly, it can be justified on the basis that unsecured creditors whose interests are being overridden will eventually benefit from the post-insolvency financing contract and have their positions improved.[70]

Secondly, it is a means of compensating post-petition lenders for the risks they undertake in financing insolvent companies. In addition, the special treatment serves an inducement to prospective lenders in view of the commercially unattractive nature of DIP financing contracts.

Notwithstanding the above, it is difficult to justify the erosion of the rights of secured creditors in favour of DIP financing creditors. From the perspective of secured creditors, this interference is unfair and untenable, as they do not stand to derive any benefit from such DIP financing contract unless

[70] However, there is usually no guarantee that the rescue attempt will succeed. Hence in the case of failure, the post-insolvency financier is secured to the maximum extent but those junior creditors who have found themselves relegated by virtue of the Code, receive less than they originally would have received.

and to the extent that they are under-secured. Indeed rather than the prospects of their positions being improved, their security interests are being risked.[71]It is arguable that although the Code provides for adequate protection for secured creditors when their rights are interfered with, there is no absolute guarantee that they will always recover from their security interests. In practice, if the rescue attempt fails, secured creditors will be relegated to such an extent that the super-priority eats into the value of their security -- the post-insolvency lender can only recover by grabbing fixed charge assets.

It is arguable that the intrusion into the rights of secured creditors has the potential to adversely affect the perception and attitude of creditors towards secured credit transactions generally. Considering that unsecured creditors and the business itself are the ultimate beneficiaries of post-insolvency financing contracts, it can be argued that in this case, the pendulum has been made to shift away from the protection of secured creditors towards the protection of the company's business and the interests of unsecured creditors.

It has been suggested that the conferment of a super-priority status on post-insolvency lenders has the potential to increase borrowing costs and to

[71] Adequate protection can be deemed to have been provided where the debtor has a sizable equity cushion sufficient to cover both the original secured creditor and the post-insolvency lender. The condition could also be satisfied if the officeholder can convince the court that the loan it has received will enable the debtor enhance the value of its collateral so as to fully secure the original secured creditor and the post-insolvency lender.

effectively veto the company against entering into certain future contractual relationships. [72] This assertion is plausible give that counterparties may be reluctant to trade with the debtor, knowing fully well that their administrative expense status would be subject to a super-priority debt. However, a counterargument could be that this is indeed a price worth paying to keep the company alive. This is in view of the fact that there would be no future contracts if the company opted for liquidation rather than negotiating a post-insolvency financing contract.

Finally, the protection offered by the so-called super-priority may not be so "super" in all circumstances. The status is not foolproof and may not always guarantee repayment. First, the bankruptcy estate must have enough assets to be able to repay the super-priority debts when due. If there are no funds, then repayment will not be feasible. Secondly, if the case is converted to a Chapter 7 liquidation procedure, there is the likelihood that the administrative expenses incurred in the superseding Chapter 7 case will have priority over the pre-conversion expenses including any super-priority interest therein.[73] Hence in *In re Vissionaire Corp*.[74] where a Chapter 11 case was converted to Chapter 7, McDonald J. held that the Chapter 7 administrative expense claims had priority

[72] Charles Tabb, *The Law of Bankruptcy* (2nd edn., Foundation Press 2009) 1078.
[73] s. 726(b) of the Code.
[74] 290 B.R. 348 (Bkrtcy. E.D. Mo. 2003). See also *In re Sun Runner Marine*, 134 B.R. 4, 7 (9th Cir. B.A.P. 1991); *In re Summit Ventures, Inc*. 135 B.R. 478, 483 (Bankr. D. Vt. 1991). However in *In re Energy Cooperative, Inc*. 55 B.R. 957, 963 n. 20 (Bankr. N.D. Ill. 1985) Hertz J. noted in *dicta* that a pre-conversion super-priority administrative expense claim has priority over a post-conversion administrative priority claim.

over pre-conversion Chapter 11 administrative expense/super-priority claim of the post-petition lender.[75]

5.3.2. Cross-collateralisation

A common post-petition financing technique outside s. 364 of the Bankruptcy Code is cross-collateralisation. Cross-collateralisation may entail granting a post-petition lender security on assets generated pre-petition to secure the lender's loan. It may also entail granting a pre-petition creditor security on post-petition assets to secure the creditor's post-petition and pre-petition claims.[76] Cross-collateralisation has been described as "an extremely controversial form of Chapter 11 financing" which utilises an inducement-based approach.[77] In deed, it is the character of the inducement it offers that makes the technique controversial to an extent. As is the case under s. 364 of the Code, the inducements are meant to incentivise existing and prospective lenders to provide new credit facilities to the debtor company.[78]

There are two basic forms of cross-collateralisation, namely, the *forward cross-collateralisation* and the *backward cross-*

[75] ibid. at 352. Affirmed on appeal in 299 B.R. 530 (2002).
[76] Lawrence Oscar, "Saybrook Manufacturing: Is Cross-collateralisation Moot?" (1993) 2 J. Bankr. L & Prac. 163, 183.
[77] *In the Matter of Saybrook* 963 F.2d 1490, 1493 (11th Cir. 1992).
[78] Jeff Bohm, "Legal Justification for the Proper Use of Cross-collateralisation Clauses in Chapter 11 Bankruptcy Cases" (1985) 59 Am. Bankr. L. J. 289, 290.

collateralisation.[79] A backward cross-collateralisation can only be carried out with a pre-petition lender/creditor. It involves a debtor extending security that it has granted to a lender for a post-petition loan to also secure outstanding unsecured pre-petition debts owed to the lender.[80] This enables the lender to kill the proverbial two birds with one stone.

A typical backward cross-collateralisation will take the following form: A lender, L, whom the debtor, D, owed the sum of $3 million prior to the formal insolvency proceedings (which was secured with collateral worth only $1.5 million) agrees to lend a post-petition secured loan of $1 million to D. D profitably invests the $1 million in the purchase of an asset worth $2 million and grants L security in the asset. In consequence, L's post-petition loan to D (i.e. $1 million) will be fully secured. In addition, due to the cross-collateralisation clause, the $1 million unsecured part of D's pre-insolvency debt to L (i.e. £1.5 million) will also become secured.

[79] Most decisions in the late 80s and early 90s on cross-collateralisation did not make this distinction. In consequence, a number of such decisions only considered the workings of a backward cross-collateralisation and based their disapproval of the practice on that. See *In the Matter of Saybrook* (fn. 77) 1490; *In re Roblin Ind. Inc*. 52 B.R. 241 (Bankr. W.D.N.Y. 1985); *In re Vanguard Diversified Inc*. 31 B.R. 364 (Bankr. ED. N.Y. 1983).

[80] *In re Antico Manufacturing Co. Inc*. 31 BR 103, 105 (Bankr. E.D.N.Y. 1983). The backward cross-collateralisation can be distinguished from a "critical vendor order" in that while the former grants a creditor security interest in collateral, critical vendor order empowers a creditor to exact *actual, immediate payment* on its pre-insolvency unsecured claims as a prerequisite for continuing to supply the business debtor in bankruptcy with often highly-specialized goods or services that it needs to operate. The critical vendor order is also antithetical to insolvency policy's principles of equality and collectivity. Craig Bucki, "Cracking the Code: The Legal Authority Behind Extra-statutory Debtor-In-Possession Financing Mechanisms And Their Prospects For Survival" (2005) Colum. Bus. L. Rev. 357.

A variant of the backward cross-collateralisation is the forward cross-collateralisation. This form of cross-collateralisation involves the debtor granting the lender a security interest in assets owned pre-petition to secure post-petition indebtedness. A number of judicial decisions suggest that bankruptcy courts will be more inclined to uphold forward cross-collateralisation arrangements as opposed to backward cross-collateralisation. This is because forward cross-collateralisation neither improves a lender's pre-petition position nor does it alter insolvency law's distribution scheme by converting a previously unsecured claim into a secured claim. It merely exacts as security for future advances a lien or interest in an asset which in some cases may be the debtor's only valuable asset and means of raising funds.[81]

Forward cross collateralisation is not in conflict with any fundamental principle of insolvency law.[82] Indeed there are substantial similarities between the incentives which forward cross-collateralisation grants post-petition lenders and the inducements under s. 364(c) of the Bankruptcy Code.

Forward cross-collateralisation may have a detrimental effect on unsecured creditors as previously unencumbered assets may become encumbered. However, it may be argued that

[81] *In re Antico Manufacturing Co. Inc*. 31 BR 103, 105 (Bankr. E.D.N.Y. 1983).
[82] s. 364(c) and (d) Bankruptcy Code.

unsecured creditors will stand to eventually benefit from the corporate rescue financing contract if the procedure succeeds. In addition, in permitting forward cross-collateralisation, courts have the responsibility of protecting rights of pre-insolvency creditors by ensuring that the officeholder fulfills the pre-conditions which the Bankruptcy Code has set out for DIP financing.[83]

Backward cross-collateralisation works at cross-purposes with the well-established insolvency distribution scheme that favours equal treatment of similarly situated creditors.[84] In addition to promoting inequality, the arrangement also infringes the rights of unsecured creditors. Assets that would otherwise have been available for distribution to unsecured creditors are encumbered in favour of the lender.[85] Backward cross-collateralisation encourages opportunistic behaviour by previously unsecured creditors who are often allowed to use their leveraged position to strong-arm the debtor into granting security for past

[83] s. 364(d). See paragraph 6.4.1. *In re Vanguard Diversified* 31 B.R. 364, 366 (Bankr. ED. N.Y. 1983).

[84] Charles Tabb, "A Critical Reappraisal Of Cross-Collateralisation in Bankruptcy" (1986) 60 S. Cal. L. Rev. 109, 175. Tabb has observed that cross-collateralisation is an evil, but not a necessary or even a permissible evil. Thus, courts should always refuse to approve cross-collateralisation clauses if requested in a financing order. He stresses that a blanket rule against allowing cross-collateralisation should not be relaxed even if procedural safeguards are followed. Although Tabb made no distinction between the two types of cross-collateralisation, it is safe to assume that this statement was made in relation to the backward cross-collateralisation as the preceding arguments he has given against the financing technique all relate to the deficiencies of the backward cross-collateralisation.

[85] *In re Texlon Corp.* 596 F.2d 1092 (2nd Cir. 1979); In *In re Vanguard Diversified* 31 B.R. 364, 366 (Bankr. ED. N.Y. 1983): The court described backward cross-collateralisation as a "disfavored means of financing which may only be authorized after its necessity has been established at a hearing held on notice to creditors." Mark Prager, "Financing the Chapter 11 Debtor: The Lenders' Perspective (1989) 45 Bus. Law 2127, 2146.

debts.[86]

Section 364 outlines the methods of post-petition financing as well as the circumstances under which the rights of creditors can be interfered with. The section also provides safeguards for the interests of pre-petition creditors. [87] Backward cross-collateralisation has the tendency to create loopholes in the safety net for pre-petition creditors under s. 364.

Cross-collateralisation is alien to UK insolvency law. Granting collateral to a lender for a post-petition advance is perfectly justifiable. However, extending the security to cover pre-petition claims which were previously unsecured clearly violates the pari passu principle.[88] Hence backward cross-collateralisation as a corporate rescue financing technique is antithetical to UK insolvency law policy.

In addition, it is germane to note that the Insolvency Act prohibits suppliers of essential supplies (gas, water, electricity and communications services) from demanding payment of pre-insolvency

[86] *In The Matter Of Saybrook Manufacturing Co. Inc.* (fn. 77) 1495: "(The) bankruptcy court has the ability to deviate from the rules of priority and distribution set forth in the Code in the interest of justice and equity. The Court cannot use this flexibility, however, merely to establish a ranking of priorities within priorities. Furthermore, absent the existence of some type of inequitable conduct on the part of the claimant, which results in injury to the creditors of the bankrupt or an unfair advantage to the claimant, the court cannot subordinate a claim to claims within the same class." Donald Jordan, "Cross Collateralisation In Chapter 11: Protecting The Small Business" (1993) 40 Wayne L. Rev. 219, 228-229.
[87] s. 364(d) and (e) Bankruptcy Code.
[88] s. 107 of the Act; rule 4.181(1) of IR; *Re Smith, Knight & Co, ex p Ashbury* (1868) LR 5 Eq 223, 226.

debts as a condition for further supply.[89] Such utility suppliers may only seek personal guarantee from the officeholder as a condition for making future supplies.[90] The Enterprise and Regulatory Reform Act 2013 gives the UK Government the power to create regulations extending to IT supplies the protections available to insolvent companies in relation to "essential supplies" (water, gas, electricity and communications).[91]

On the other hand, it is suggested that UK courts will be inclined to recognising and enforcing forward cross-collateralisation agreements. This is because the financing arrangement neither effects a redistribution of pre-petition entitlements nor does it alter insolvency law's ranking of unsecured creditors. Accordingly, the lender's position in relation to his pre-petition unsecured or under-secured claim is not improved by the lending arrangement.

Conclusion

The commencement of formal insolvency does not strip a corporate debtor of its capacity to engage in contracts. A company in liquidation may continue trading until its eventual liquidation so as to maximize realizations for the general body of creditors. In

[89] s. 233(2)(b) Insolvency Act.
[90] s. 233(2)(a) Insolvency Act.
[91] s. 92(a) of Enterprise and Regulatory Reform Act 2013. The rationale of this provision is to allow debtor-companies to continue to operate for sufficiently long time to allow all or part of them to be saved, or sold through some form of effective insolvency administration.

rescue procedures where the central objective is the rehabilitation of the debtor, the corporate debtor will of necessity continue transacting. The capacity to contract post-petition in liquidation procedures in both jurisdictions is however subject to limitations, which again are aimed at achieving asset-preservation and value-maximisation for the benefit of unsecured creditors.

The imperative of post-petition financing in rescue procedures cannot be overstated. The Bankruptcy Code has a comprehensive legal framework for debtor-in-possession financing alongside the hierarchy of inducements aimed at incentivizing prospective lenders to finance rescue procedures. There is no similar legal framework in the UK. [92] However, the yet-to-be adopted recommendations from UK Insolvency Service as regards post-petition financing alongside a hierarchy of inducements is substantially similar to the Code's DIP financing regime.

A significant feature of the post-petition financing framework is the super-priority which is

[92] This position can be compared to the debtor-in-possession financing in Canada where in the absence of express statutory authority, Canadian courts usually invoke their "inherent jurisdiction" to create super-priority charges, giving DIP lenders a super-priority first ranking security interest. This allows the DIP lender to stand at the front of the line in terms of priority of payment if the restructuring fails and the process shifts into a liquidation and winding up proceeding. In granting DIP financing the court considers if all or substantially all existing secured creditors consent or if it can be demonstrated that the existing secured creditors whose interests are being primed or subordinated will not be materially prejudiced by the DIP financing. *Re Sky Dome* (1998) 16 C.B.R. (4th) 118 (Ont. Gen. Div.). Janis Sarra, "Debtor in possession (DIP) financing: The jurisdiction of courts to grant super-priority financing" (2003) 21 Dalhousie Law Journal 337; Michael Rotsztain, "Debtor-in-Possession Financing: Current Law and a Preferred Approach" (2000) 33 Can. Bus. L.J. 283, 284.

conferred on post-petition lenders in certain circumstances to incentivize and/or compensate them. Special priority for rescue financing is globally recognised as a feature of insolvency law reform. It is listed as one of European Bank for Reconstruction and Development's (EBRD) ten core principles.[93] Similarly the United Nations Commission for International Trade Law (UNCITRAL) also recognises the relevance of post commencement financing with super-priority status.[94] Nevertheless, it is difficult to justify the erosion of pre-petition security interests in the course of trying to induce or compensate post-petition lenders. It is arguable that this amounts to the use of insolvency law for effecting redistribution, considering that the secured creditors stand to gain nothing from such rescue finance contracts. [95] The ultimate beneficiaries of any successful rescue are unsecured creditors.

[93] http://www.ebrd.com/downloads/legal/insolvency/principle.pdf (accessed 7 May 2013).
[94] http://www.imf.org/external/pubs/ft/orderly/ (accessed 7 May 2013).
[95] The Code provides for "adequate protection" for secured creditors when their rights are interfered with.

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