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Ipsa facto clauses and the anti-deprivation principle

Under common law developed in England as early as 1812, which also forms part of the common law of both Cayman and Australia, an *ipsa facto* clause is generally seen as valid subject to an 'anti-deprivation principle' which will be discussed below. By way of contrast, in the US the operation of such clauses is expressly precluded by §§365(e)(1) and 541(c)(1)(B) of Title 11 of the United States Code (the 'Bankruptcy Code').

The insolvency law system in the US is arguably debtor friendly and provides for a broad restriction of creditors' rights upon a bankruptcy filing subject to court intervention to maximise a debtor's chance of reorganisation. In contrast, the Cayman system is deliberately creditor friendly with less interference with creditors' rights and significantly less focus on rehabilitation. One could say that the English and Australian systems fall somewhere in the middle, providing procedures to assist with the rehabilitation of a debtor in certain circumstances but with strong recognition of creditor rights upon insolvency.

Notably, the legislature in Cayman has enacted broad reforms to its Companies Law which took effect in 2009, in which no English or Australian-style administration procedure was introduced. It is unlikely that any such procedure will be introduced in the foreseeable future given that the goal is to continue to be viewed as a creditor friendly jurisdiction: this is an important part of Cayman's attraction for a wide variety of financial transactions, in particular in the area of structured finance. There is some scope for reorganisation in Cayman via a creditor or member approved scheme of arrangement, subject to both creditor and court approval.

In late 2009 and early 2010, two conflicting decisions were delivered by the English and US courts respectively regarding the enforceability of a 'flip' clause (*Perpetual Trustee Company Limited v BNY Corporate Trustee Services Ltd* [2009] EWHC 1912 (Ch) and *Lehman Bros. Special Fin. Inc. v BNY Corporate Tr. Servs. (In re Lehman Bros. Holdings Inc.)*, 422 B.R. 407 (Bankr. S.D.N.Y. 2010)) demonstrating the practical effect of the two very different regimes in cross-border insolvency cases and highlighting the differences in approach and the effect of a debtor-friendly versus a creditor-friendly insolvency law system.

In modern times of increasing globalisation and cross-border transactions and insolvencies, as well as increasingly complex financial products offered by banking and other institutions, these cases demonstrate that there is a distinct absence of harmonisation across jurisdictions with respect to enforcement of such clauses in rehabilitation proceedings. Judge Peck in the US called for a status conference in the *Lehman* case discussed below with a view to 'exploring means to harmonize the decisions of this Court and the

A so-called '*ipsa facto*' clause is a provision in a contract which purports either to terminate a contract automatically or to confer on a contractor the right to terminate it when its counterparty enters into an insolvency proceeding.

English Courts'. (at 423) With respect, such harmonisation seems unlikely as the decisions are directly contrary to each other. However, these cases are useful as they demonstrate the fundamental differences in approach and effect of the US and English insolvency laws.

The purpose of this article is to compare the approaches to *ipsa facto* clauses in the US and at common law, and consider whether legislative intervention such as has taken place in the US would be consistent with their differing approaches to insolvency law.

As Cayman does not have a procedure like administration in its Companies Law, such reform is unnecessary in Cayman and would arguably be contrary to the goal of remaining creditor friendly to encourage onshore businesses to operate from offshore. To remove the uncertainty surrounding the anti-deprivation principle altogether would require legislation specifically permitting the use of *ipsa facto* clauses.

THE US POSITION

In the US, *ipsa facto* clauses were enforceable prior to sweeping reforms under the Bankruptcy Reform Act of 1978. It was recognised by Congress at that time that:

'automatic termination of a debtor's contractual rights "frequently hampers rehabilitation efforts" by depriving the chapter 11 estate of valuable property interests at the very time the debtor and estate need them most.' (*Summit Investment and Development Corporation v Leroux* 69 F.3d 608 (1st Cir. Mass. 1995) citing S. Rep. No. 989, 95th Cong., 2d Sess. 59 (1978) reprinted in 1978 U.S.C.C.A.N 5787, 5845)

Pursuant to §365(e)(1) of the Bankruptcy Code, the operation of provisions in an executory contract which give rights to terminate or modify upon the insolvency or financial condition of the debtor are expressly prohibited. Similarly, §541(c)(1) provides that all interests of the debtor in property become property of the estate upon bankruptcy notwithstanding any contrary provision in an agreement that is conditioned on the insolvency or financial condition of the debtor.

There are some exceptions to these general provisions relating to certain financial and other agreements, called the 'safe harbor' provisions. These provisions, which first appeared in US bankruptcy

law in 1978 and have been expanded over time, now contain relief against the automatic stay for securities contracts, commodities contracts, or forward contracts repurchase agreements and swap agreements. In each of these sections, the exercise of a contractual right to cause the liquidation, termination or acceleration of the contract because of a condition of the kind specified in §365(e)(1) is not stayed, avoided or otherwise limited.

THE COMMON LAW POSITION

None of England, Cayman or Australia has an express statutory prohibition on the enforceability of an *ipso facto* clause, and in fact these clauses are prima facie enforceable. This approach reflects the creditor friendly nature of these jurisdictions, and the emphasis on protecting the contractual rights of creditors, subject to some provisions for rehabilitation in England and Australia.

There is an old common law principle, the anti-deprivation principle, which essentially provides that a person cannot make it a part of a contract that, in the event of bankruptcy, they are then to get some additional advantage which prevents the property being distributed under the bankruptcy laws.

Generally, under this principle and irrespective of the equality of application or the *bona fides* of the insolvent company or counterparty, if the effect of the provision is to enable the property of an insolvent company to be withdrawn from its creditors, the provision will be invalid.

Despite a long history, the anti-deprivation principle did not come to prominence until 1975 in the *British Eagle* case (*British Eagle International Airlines v Compagnie Nationale Air France* [1975] 1 W.L.R 758). In this case, a clearing house arrangement between a group of airlines which were members of the International Air Transport Association was held to be invalid as it was contracting out of the provisions for the payment of unsecured debts *pari passu* which was contrary to public policy.

The principle was most recently applied in *Mayhew v King* ([2010] EWHC 1121) in which the court confirmed that the anti-deprivation principle exists and is applicable in what the court may consider an appropriate case. This case concerned whether or not an obligation to indemnify which was expressly terminated on the occurrence of various insolvency related events survived the commencement of administration. Despite noting the uncertainty discussed by Lord Neuberger MR in the *Lehman* case, it was held that an indemnity was a valuable asset which constituted property, and that the *ipso facto* clause was inoperative as it violated the anti-deprivation principle.

However, the ambit and scope of the principle is not clear. In circumstances where the English Court of Appeal has declined to provide the necessary guidance, the legislature could usefully intervene to, at least, clearly define what transactions or clauses are invalid and in what circumstances.

THE LEHMAN CASES

In 2009 and 2010, the English Court of Appeal and the United States Bankruptcy Court for the Southern District of New

York both considered the enforceability of a provision in a swap agreement and other related documents pursuant to which, upon specified events of default, the priority of payment for proceeds of collateral (which was security for various repayment obligations) was to 'flip' from Lehman Brothers Special Financing Ltd ('LBSF') to the defined noteholders.

It is well known that Lehman Brothers Holdings Inc ('LBHI') filed for Chapter 11 protection on 15 September 2008. LBSF subsequently filed its own Chapter 11 petition on 3 October 2008.

The English decision

In the English decision, the Court of Appeal held that the flip clause was enforceable. After discussing the historical origin of the rule, Lord Neuberger MR held that the effect of the clause was not to deprive the debtor, but rather to change the order or priorities in which they were granted to it and that (at 102):

'it is not entirely easy to identify the rule's precise limits, or even its precise nature, from these cases, as the reasoning in the various judgments in which the rule has been considered is often a little opaque and some of the judgments are a little hard to reconcile.'

The decision appears largely determined on the basis that it was the noteholders' money which had been used to purchase the relevant collateral, and that the noteholders had permitted LBSF to have priority only so long as there was no event of default. The court then went on to find that even if the flip was a deprivation, the rule would not have applied as the triggering event of default was not conditioned on the insolvency of LBSF, but rather LBHI. As the LBHI Chapter 11 filing was 18 days before the LBSF filing, it was held that any deprivation therefore occurred prior to bankruptcy and was not precluded by the rule.

The court was not prepared to expand the rule to include either an event of default occurring pre-bankruptcy, or to include the deprivation of the asset of a subsidiary on the basis that if there is to be a prohibition on the use of *ipso facto* clauses then it is for Parliament to make this determination. Specifically, the court held that (at 118):

'It is ultimately up to Parliament to legislate against anti-avoidance devices in the insolvency field ... Especially in an area where Parliament has intervened so substantially and so significantly, it can only be very rarely, if ever, that it would be right for the court to invent its own anti-avoidance policies and frustrate the terms of commercial contracts freely entered into by sophisticated parties.'

Patten LJ agreed with Lord Neuberger MR, but for the reason that the relevant condition did not give the noteholders more than the right to recover the whole of the sums due under the notes in priority to any claim over the collateral by LBSF for the unwind costs, and that it simply adjusted the balances due to the noteholders on early

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termination which was held not to constitute the removal of an asset from LBSF (at 130).

Patten LJ held that a change in priority consequent upon the insolvency or liquidation of a company is not prohibited by any express term of the Insolvency Act 1986 and did not amount to a deprivation of property (at 131). As with the majority judgment, Patten LJ also left the decision to prohibit the use of *ipso facto* clauses squarely in the hands of Parliament, and held that (at 142):

'When Parliament has expressly considered the categories of transaction which should not be allowed to survive bankruptcy or liquidation I can see no proper basis on which the court can arrogate to itself the right to widen the sanction of invalidity so as to encompass transactions which the application of the Insolvency Act would leave untouched.'

At least in England, it is clear that the courts are unwilling to intervene to expressly prohibit the use of *ipso facto* clauses in insolvency cases which are largely governed by statute, even in administration cases in which the goal of the procedure in appropriate cases is rehabilitation. By way of contrast, Cayman has not enacted legislation aimed at rehabilitation, and in fact such provisions have deliberately been omitted from the Companies Law. As a result, reform in Cayman to make *ipso facto* clauses unenforceable is unnecessary and contrary to the interests of creditors which Cayman lawmakers are keen to protect.

The US decision

In reviewing exactly the same transaction documents, the United States Bankruptcy Court for the Southern District of New York held that the provisions were unenforceable under § 365 of the Bankruptcy Code, and that the safe harbor provisions were not applicable to the transaction. In a very different interpretation of the effects of the flip clause, Judge Peck held that the right to priority provided was valuable property of the estate upon the bankruptcy filing by LBHI and LBSF. It was also held that the filing of a Chapter 11 petition by LBHI on 15 September 2008, being the commencement of a case (cf. the case) under the Bankruptcy Code, was sufficient to trigger the protection as the parent and subsidiary were so closely interrelated that the bankruptcy of the parent resulted in the bankruptcy of the subsidiary.

Judge Peck acknowledged that the Bankruptcy Code provides far greater protections for the debtor than are available under applicable foreign law and as a result he declined to give *res judicata* effect to the English decision on the basis of comity. The court also refused to characterise the agreement as a subordination agreement which would be enforceable under the Bankruptcy Code.

The court did acknowledge that the issue which arose in the case was 'unique' and 'unprecedented' and that (at 422):

'No case has ever declared that the operative bankruptcy filing is not limited to the commencement of a bankruptcy case by the

debtor-counterparty itself but may be a case filed by a related entity.'

When the two decisions are considered within the legislative framework in which they were decided, the creditor/debtor focus of the different jurisdictions becomes apparent. In England and arguably to the benefit of creditors, *ipso facto* clauses are enforceable, subject to a limited and poorly defined rule that a debtor should not be deprived of valuable property. Conversely, in the US and arguably to the benefit of debtors, *ipso facto* clauses are not enforceable subject to some carve-outs for specific types of contracts.

REHABILITATION PROCEDURES

In both the UK and Australia, reforms to the relevant insolvency statutes have been enacted to provide for an Administration regime. The procedures, though slightly different, have similar characteristics – namely a procedure in which there is a moratorium on claims to give the company some breathing room to provide time for an independent third party to investigate the affairs of the company and to report to creditors. Administration in both the UK and Australia can result in an arrangement being voted for by the creditors of the company to effect an orderly reorganisation. In Cayman, in the absence of any formal administration procedure the court has in a few cases used the appointment of provisional liquidators which results in a moratorium on claims to similar effect. However, the appointment of provisional liquidators in this context is only to provide time for a scheme of arrangement to be considered by creditors and is only made in cases where there is widespread creditor support.

Companies carrying on business as a going concern may have valuable contracts. In jurisdictions that have adopted rehabilitation regimes, these arguably should not be able to be terminated solely because the company has decided to take advantage of the rehabilitation regimes which have been enacted. Allowing contract counter-parties to rely on *ipso facto* clauses in the event of an administration is arguably contrary to the purpose of such procedures – namely rehabilitation – in circumstances where the result of commencing an administration is that valuable contracts are lost to the detriment of the stakeholders.

CONCLUSION

It is clear that the English law with respect to *ipso facto* clauses is unsettled and lacking the certainty which is necessary to give contracting parties confidence when entering into commercial agreements. As demonstrated by *Mayhew v King*, the English courts have been willing in recent times to use the anti-deprivation principle to strike down *ipso facto* clauses, but the courts have not articulated what this principle actually is with any clarity. Despite having the opportunity to do so the courts have declined to decide that such clauses are generally unenforceable in the absence of legislative reform.

Where the insolvency procedure commenced is one in which the goal is rehabilitation, rather than liquidation, it would be appropriate and consistent for there to be a general prohibition on enforcement of

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Biog box

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ipso facto clauses subject to some carve-outs for financial contracts. As the US Congress acknowledged in 1978, the loss of executory contracts upon the commencement of an administration hampers rehabilitation efforts and it is time for the English and Australian law-makers to recognise the negative impact of *ipso facto* clauses and legislate accordingly. Implementing such a prohibition would both allow the debtor to truly have the breathing room it needs to effect a successful reorganisation whilst retaining valuable contracts, and would reduce the likelihood that conflicting decisions like the *Lehman* cases will be delivered in future cross-border insolvency cases.


As Cayman has not enacted any administration or other rehabilitative provisions, it is unnecessary for Cayman lawmakers

to take any steps to legislate against *ipso facto* clauses. It is unlikely that any such legislation will be enacted in Cayman as this would be contrary to the creditor-friendly regime and the general overriding principles of freedom of contract upon which the Cayman insolvency system is based.

The Cayman courts have not yet been called upon to consider the anti-deprivation principle and the recent English authorities, though persuasive, are not technically binding, so it remains to be seen how the matter would be addressed. If legislative reform to remove current uncertainty surrounding the anti-deprivation principle does occur in Cayman, such reform is more likely to make it clear that *ipso facto* clauses are enforceable. ■

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