business in its ordinary course, as the case may be. In considering whether to make a validating order the court must always, in my opinion, do its best to ensure that the interests of the unsecured creditors will not be prejudiced. Where the application relates to a specific transaction this may be susceptible of positive proof. In a case of completion of a contract or project the proof may perhaps be less positive but nevertheless be cogent enough to satisfy the court that in the interests of the creditors the company should be enabled to proceed, or at any rate that proceeding in the manner proposed would not prejudice them in any respect. The desirability of the company being enabled to carry on its business generally is likely to be more speculative and will be likely to depend on whether a sale of the business as a going concern will probably be more beneficial than a break-up realisation of the company's assets. In each case, I think, the court must necessarily carry out a balancing exercise … Each case must depend upon its own particular facts.

Since the policy of the law is to procure so far as practicable rateable payments of the unsecured creditors' claims, it is, in my opinion, clear that the court should not validate any transaction or series of transactions which might result in one or more pre-liquidation creditors being paid in full at the expense of other creditors, who will only receive a dividend, in the absence of special circumstances making such a course desirable in the interests of the unsecured creditors as a body. If, for example, it were in the interests of the creditors generally that the company's business should be carried on, and this could only be achieved by paying for goods already supplied to the company when the petition is presented but not yet paid for, the court might think fit in the exercise of its discretion to validate payment for those goods …

It may not always be feasible, or desirable, that a validating order should be sought before the transaction in question is carried out. The parties may be unaware at the time when the transaction is entered into that a petition has been presented; or the need for speedy action may be such as to preclude an anticipatory application; or the beneficial character of the transaction may be so obvious **(p. 810)** that there is no real prospect of a liquidator seeking to set it aside, so that an application to the court would waste time, money and effort. But in any case in which the transaction is carried out without an anticipatory validating order the disponee is at risk of the court declining to validate the transaction. It follows, in my view, that the parties when entering into the transaction, if they are aware that it is liable to be invalidated by the section, should have in mind the sort of considerations which would influence the court's decision.

A disposition carried out in good faith in the ordinary course of business at a time when the parties are unaware that a petition has been presented may, it seems, normally be validated by the court … unless there is any ground for thinking that the transaction may involve an attempt to prefer the disponee, in which case the transaction would probably not be validated. In a number of cases reference has been made to the relevance of the policy of ensuring rateable distribution of the assets …

But although that policy might disincline the court to ratify any transaction which involved preferring a pre-liquidation creditor, it has no relevance to a transaction which is entirely post-liquidation, as for instance a sale of an asset at its full market value after presentation of a petition. Such a transaction involves no dissipation of the company's assets, for it does not reduce the value of those assets. It cannot harm the creditors and there would seem to be no reason why the court should not in the exercise of its discretion validate it. A fortiori, the court would be inclined to validate a transaction which would increase, or has increased, the value of the company's assets, or which would preserve, or has preserved, the value of the company's assets from harm which would result from the company's business being paralysed …

GOFF LJ and SIR DAVID CAIRNS concurred.

➤ Note

The transactions which were challenged in this case were payments into and out of the company's bank account, and the court held, or accepted concessions made by counsel, that all such payments were 'dispositions' by the company within s 127. But later cases have shown that this is not always true. In *Re Barn Crown Ltd* [1994] 2

BCLC 186 it was held that there was no 'disposition', but only an adjustment of entries in the statement recording the accounts between the customer and the banker, when cheques belonging to the company were paid into an account which was already in credit. (However, Professor Goode, *Principles of Corporate Insolvency Law* (3rd edn, 2005), paras 11.128ff, disagrees: if the bank were to become insolvent, the money would be lost, and accordingly there must have been a 'disposition'.) More recently, in*Hollicourt (Contracts) Ltd v Bank of Ireland* [2001] Ch 555, CA, it has been held that where a bank meets a cheque drawn by its customer (whether the account is in credit or overdrawn), it does so merely as the customer's agent. As a result, while there is clearly a disposition by the customer in favour of the payee, there is no disposition to the bank itself—as had been assumed in the *Gray's Inn* case. *Hollicourt* no doubt provides considerable comfort to the banking community, since it reduces concern about this type of restitutionary liability.

Preferences and transactions at an undervalue: IA 1986 ss 239 and 238.

[16.15] Re MC Bacon Ltd [1990] BCLC 324 (Chancery Division)

The company, which carried on business as a bacon importer and wholesaler, had been profitable until it lost its principal customer. It continued trading on a reduced scale for a time, but eventually had to go into liquidation. This action was brought to challenge a debenture which had been given to its bank during this latter period, at a time when it was actually or virtually insolvent and could not have continued without the bank's support. Millett J held **(p. 811)** that the debenture was not liable to be struck down either (i) as a preference under IA 1986 s 239, since the directors in granting it had not been motivated by a desire to prefer the bank but only by a desire to avoid the calling in of the overdraft and their wish to continue trading, or (ii) as a transaction at an undervalue under s 238 because the giving of the security had neither depleted the company's assets nor diminished their value.

MILLETT J:…

Voidable preference

So far as I am aware, this is the first case under the section [s 239] and its meaning has been the subject of some debate before me. I shall therefore attempt to provide some guidance.

The section replaces s 44(1) of the Bankruptcy Act 1914, which in certain circumstances deemed fraudulent and avoided payments made and other transactions entered into in favour of a creditor 'with a view of giving such creditor … a preference over the other creditors'. Section 44(1) and its predecessors had been construed by the courts as requiring the person seeking to avoid the payment or other transaction to establish that it had been made 'with the dominant intention to prefer' the creditor.

Section 44(1) has been replaced and its language has been entirely recast. Every single word of significance, whether in the form of statutory definition or in its judicial exposition, has been jettisoned. 'View', 'dominant', 'intention' and even 'to prefer' have all been discarded. These are replaced by 'influenced', 'desire', and 'to produce in relation to that person the effect mentioned in sub-s (4)(b)'.

I therefore emphatically protest against the citation of cases decided under the old law. They cannot be of any assistance when the language of the statute has been so completely and deliberately changed. It may be that many of the cases which will come before the courts in future will be decided in the same way that they would have been decided under the old law. That may be so, but the grounds of decision will be different. What the court has to do is to interpret the language of the statute and apply it. It will no longer inquire whether there was 'a dominant intention to prefer' the creditor, but whether the company's decision was 'influenced by a desire to produce the effect mentioned in sub-s (4)(b)'.

This is a completely different test. It involves at least two radical departures from the old law. It is no longer necessary to establish a dominant intention to prefer. It is sufficient that the decision was influenced by the requisite desire. That is the first change. The second is that it is no longer sufficient to establish an intention to prefer. There must be a desire to produce the effect mentioned in the subsection.

This second change is made necessary by the first, for without it it would be virtually impossible to uphold

the validity of a security taken in exchange for the injection of fresh funds into a company in financial difficulties. A man is taken to intend the necessary consequences of his actions, so that an intention to grant a security to a creditor necessarily involves an intention to prefer that creditor in the event of insolvency. The need to establish that such intention was dominant was essential under the old law to prevent perfectly proper transactions from being struck down. With the abolition of that requirement intention could not remain the relevant test. Desire has been substituted. That is a very different matter. Intention is objective, desire is subjective. A man can choose the lesser of two evils without desiring either.

It is not, however, sufficient to establish a desire to make the payment or grant the security which it is sought to avoid. There must have been a desire to produce the effect mentioned in the subsection, that is to say, to improve the creditor's position in the event of an insolvent liquidation. A man is not to be taken as desiring all the necessary consequences of his actions. Some consequences may be of advantage to him and be desired by him; others may not affect him and be matters of indifference to him; while still others may be positively disadvantageous to him and not be desired by him, but be regarded by him as the unavoidable price of obtaining the desired advantages. It will **(p. 812)** still be possible to provide assistance to a company in financial difficulties provided that the company is actuated only by proper commercial considerations. Under the new regime a transaction will not be set aside as a voidable preference unless the company positively wished to improve the creditor's position in the event of its own insolvent liquidation.

There is, of course, no need for there to be direct evidence of the requisite desire. Its existence may be inferred from the circumstances of the case just as the dominant intention could be inferred under the old law. But the mere presence of the requisite desire will not be sufficient by itself. It must have influenced the decision to enter into the transaction. It was submitted on behalf of the bank that it must have been the factor which 'tipped the scales'. I disagree. That is not what sub-s (5) says; it requires only that the desire should have influenced the decision. That requirement is satisfied if it was one of the factors which operated on the minds of those who made the decision. It need not have been the only factor or even the decisive one. In my judgment, it is not necessary to prove that, if the requisite desire had not been present, the company would not have entered into the transaction. That would be too high a test.

It was also submitted that the relevant time was the time when the debenture was created. That cannot be right. The relevant time was the time when the decision to grant it was made. In the present case that is not known with certainty … But it does not matter. If the requisite desire was operating at all, it was operating throughout.

[His Lordship ruled that the directors had been motivated by the desire to continue trading and not by a desire to give the bank a preference in the event of a liquidation. He continued:]

Transactions at an undervalue

Section 238 of the 1986 Act is concerned with the depletion of a company's assets by transactions at an undervalue. [His Lordship read s 238(4) and continued:]

The granting of the debenture was not a gift, nor was it without consideration. The consideration consisted of the bank's forbearance from calling in the overdraft and its honouring of cheques and making of fresh advances to the company during the continuance of the facility. The applicant relies therefore on para (b).

To come within that paragraph the transaction must be (i) entered into by the company; (ii) for a consideration; (iii) the value of which measured in money or money's worth; (iv) is significantly less than the value; (v) also measured in money or money's worth; (vi) of the consideration provided by the company. 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.

In my judgment, the applicant's claim to characterise the granting of the bank's debenture as a transaction at an undervalue is misconceived. The mere creation of a security over a company's assets does not deplete them and does not come within the paragraph. By charging its assets the company appropriates them to meet the liabilities due to the secured creditor and adversely affects the rights of other creditors in

the event of insolvency. But it does not deplete its assets or diminish their value. It retains the right to redeem and the right to sell or remortgage the charged assets. All it loses is the ability to apply the proceeds otherwise than in satisfaction of the secured debt. That is not something capable of valuation in monetary terms and is not customarily disposed of for value.

In the present case the company did not suffer that loss by reason of the grant of the debenture. Once the bank had demanded a debenture the company could not have sold or charged its assets without applying the proceeds in reduction of the overdraft; had it attempted to do so, the bank would at once have called in the overdraft. By granting the debenture the company parted with nothing of value, and the value of the consideration which it received in return was incapable of being measured in money or money's worth.

Counsel for the applicant (Mr Vos) submitted that the consideration which the company received was, with hindsight, of no value. It merely gained time and with it the opportunity to lose more money. But he could not and did not claim that the company ought to have received a fee or other **(p. 813)** capital sum in return for the debenture. That gives the game away. The applicant's real complaint is not that the company entered into the transaction at an undervalue but that it entered into it at all.

In my judgment, the transaction does not fall within sub-s (4)…

➤ Notes

1. *Phillips v Brewin Dolphin Bell Lawrie Ltd* [2001] 1 WLR 143, HL, establishes that the consideration for a transaction may be provided by various parties, and that it may be appropriate to consider the details of a complex series of linked transactions to assess any 'undervalue'. Here, even doing that, the transaction was held to be one at an undervalue.

2. IA 1986 s 238(5) provides that the court shall not make an order in respect of a transaction at an undervalue if it is satisfied that the company entered into the transaction in good faith and for the purpose of carrying on its business, and that at the time it did so there were reasonable grounds for thinking that the transaction would benefit the company. This is clearly a difficult test to apply.

3. The time for judging whether the company was influenced by the requisite desire to improve the position of a creditor was recently considered in *Stealth Construction, Re*[2011] EWHC 1305 (Ch). The relevant time was held to be the time at which the decision to give the preference was made, not the time at which preference was actually given.

'Wrongful trading': IA 1986 s 214.

[16.16] Re Produce Marketing Consortium Ltd (No 2) [1989] BCLC 520 (Chancery Division)

This was the first reported case decided under IA 1986 s 214 ('wrongful trading'). The two directors, David and Murphy, had continued to run the company's fruit-importing business when they ought to have known that there was no prospect of avoiding insolvent liquidation. Knox J, in holding them liable for wrongful trading, emphasised that their conduct was to be judged, in part, by the objective standards laid down by s 214—that is, by more exacting criteria than those of the traditional common law, although CA 2006 s 174 now adopts this same s 214 standard (see 'The liquidator's ability to require wrongdoers to make personal contributions to the assets of the company', pp 806ff).

KNOX J: The first question is whether [s 214(2)] applies to Mr David and Mr Murphy. There is no question but that they were directors at all material times and that PMC [the company] has gone into insolvent liquidation. The issue is whether at some time after 27 April 1986 and before 2 October 1987, when it went into insolvent liquidation, they knew or ought to have concluded that there was no reasonable prospect that PMC would avoid going into insolvent liquidation. It was inevitably conceded by counsel for the first

respondent that this question has to be answered by the standards postulated by sub-s (4), so that the facts which Mr David and Mr Murphy ought to have known or ascertained and the conclusions that they ought to have reached are not limited to those which they themselves showing reasonable diligence and having the general knowledge, skill and experience which they respectively had, would have known, ascertained or reached but also those that a person with the general knowledge, skill and experience of someone carrying out their functions would have known, ascertained or reached …

The 1986 Act now has two separate provisions; s 213 dealing with fraudulent trading,… and s 214 which deals with what the sidenote calls 'wrongful trading'. It is evident that Parliament intended to widen the scope of the legislation under which directors who trade on when the company is insolvent may, in appropriate circumstances, be required to make a contribution to the assets of the company which, in practical terms, means its creditors.

(p. 814) Two steps in particular were taken in the legislative enlargement of the court's jurisdiction. First, the requirement for an intent to defraud and fraudulent purpose was not retained as an essential, and with it goes what Maugham J[[65]] called 'the need for actual dishonesty involving real moral blame'.

I pause here to observe that at no stage before me has it been suggested that either Mr David or Mr Murphy fell into this category.

The second enlargement is that the test to be applied by the court has become one under which the director in question is to be judged by the standards of what can reasonably be expected of a person fulfilling his functions, and showing reasonable diligence in doing so. I accept the submission of counsel for the first respondent in this connection, that the requirement to have regard to the functions to be carried out by the director in question, in relation to the company in question, involves having regard to the particular company and its business. It follows that the general knowledge, skill and experience postulated will be much less extensive in a small company in a modest way of business, with simple accounting procedures and equipment, than it will be in a large company with sophisticated procedures.

Nevertheless, certain minimum standards are to be assumed to be attained. Notably there is an obligation laid on companies to cause accounting records to be kept which are such as to disclose with reasonable accuracy at any time the financial position of the company at that time: see the Companies Act 1985, s 221(1) and (2)(a) [CA 2006 s 386]. In addition directors are required to prepare a profit and loss account for each financial year and a balance sheet as at the end of it: Companies Act 1985, s 227(1) and (3) [CA 2006 ss 394 and 399]. Directors are also required, in respect of each financial year, to lay before the company in general meeting copies of the accounts of the company for that year and to deliver to the registrar of companies a copy of those accounts, in the case of a private company, within 10 months after the end of the relevant accounting reference period (see the Companies Act 1985, ss 241(1) and (3) and 242(1) and (2)) [CA 2006 ss 437 and 441, providing different rules].

As I have already mentioned, the liquidator gave evidence that the accounting records of PMC were adequate for the purposes of its business. The preparation of accounts was woefully late, more especially in relation to those dealing with the year ending 30 September 1985 which should have been laid and delivered by the end of July 1986.

The knowledge to be imputed in testing whether or not directors knew or ought to have concluded that there was no reasonable prospect of the company avoiding insolvent liquidation is not limited to the documentary material actually available at the given time. This appears from s 214(4) which includes a reference to facts which a director of a company ought not only to know but those which he ought to ascertain, a word which does not appear in sub-s (2)(b). In my judgment this indicates that there is to be included by way of factual information not only what was actually there but what, given reasonable diligence and an appropriate level of general knowledge, skill and experience, was ascertainable. This leads me to the conclusion in this case that I should assume, for the purposes of applying the test in s 214(2), that the financial results for the year ending 30 September 1985 were known at the end of July 1986 at least to the extent of the size of the deficiency of assets over liabilities.

Mr David and Mr Murphy, although they did not have the accounts in their hands until January 1987, did, I find, know that the previous trading year had been a very bad one. They had a close and intimate knowledge of the business and they had a shrewd idea whether the turnover was up or down. In fact it was badly down in that year to £526,459 and although I have no doubt that they did not know in July 1986 that it was that precise figure, I have no doubt that they had a good rough idea of what it was and in particular that it was well down on the previous year. A major drop in turnover meant almost as night follows day that there was a substantial loss incurred, as indeed there was. That in turn meant again, as surely as night follows day, a substantial increase in the deficit of assets over liabilities.

(p. 815) That deals with their actual knowledge but in addition I have to have regard to what they have to be treated as having known or ascertained and that includes the actual deficit of assets over liabilities of £132,870… It was a deficit that, for an indefinite period in the future could not be made good even if the optimistic prognostications of level of turnover entertained by Mr David and Mr Murphy were achieved …

Counsel for the first respondent was not able to advance any particular calculation as constituting a basis for concluding that there was a prospect of insolvent liquidation being avoided. He is not to be criticised for that for in my judgment there was none available. Once the loss in the year ending 30 September 1985 was incurred PMC was in irreversible decline, assuming (as I must) that the respondents had no plans for altering the company's business and proposed to go on drawing the level of reasonable remuneration that they were currently receiving …

The next question which arises is whether there is a case under s 214(3) for saying that after the end of July 1986 the respondents took every step with a view to minimising the potential loss to the creditors of PMC as, assuming them to have known that there was no reasonable prospect of PMC avoiding insolvent liquidation, they ought to have taken. This clearly has to be answered No, since they went on trading for another year …

I am therefore driven to the conclusion that the court's discretion arises under s 214(1)…

In my judgment the jurisdiction under s 214 is primarily compensatory rather than penal. Prima facie the appropriate amount that a director is declared to be liable to contribute is the amount by which the company's assets can be discerned to have been depleted by the director's conduct which caused the discretion under sub-s (1) to arise. But Parliament has indeed chosen very wide words of discretion and it would be undesirable to seek to spell out limits on that discretion, more especially since this is, so far as counsel were aware, the first case to come to judgment under this section …

I take into account the following factors in addition to those set out above, which give rise to the existence of the court's discretion under s 214(1).

This was a case of failure to appreciate what should have been clear rather than a deliberate course of wrongdoing.

There were occasions when positive untruths were stated which cannot just be treated as unwarranted optimism …

The most solemn warning given by the auditor in early February 1987 was effectively ignored. The affairs of PMC were conducted during the last seven months of trading in a way which reduced the indebtedness to the bank, to which Mr David had given a guarantee, at the expense of trade creditors … The bank is, if not fully, at least substantially secured. If this jurisdiction is to be exercised, as in my judgment it should be in this case, it needs to be exercised in a way which will benefit unsecured creditors …

Taking all these circumstances into account I propose to declare that Mr David and Mr Murphy are liable to make a contribution to the assets of PMC of £75,000…

➢ Notes

1. Recall that the ‘fruits’ of litigation instituted under s 214 are not at any time assets or property of the company, but the outcome of a power vested in the liquidator which only he can exercise. It follows that a charge over the company’s assets—even if expressed to include its future assets—does not extend to sums ordered to be paid under s 214. The same reasoning applies to the various other ‘clawback’ provisions which vest similar powers in a liquidator, for example transactions at an undervalue (s 238) and preferences (s 239): *Re Yagerphone Ltd* [1935] Ch 392.

2. In contrast, it has been held that moneys recovered under the ‘misfeasance’ provision (s 212) are the fruits of a right of action which was vested in the company before it went into liquidation, and therefore an asset of the company capable of being caught by a suitably worded charge: *Re Anglo-Austrian Printing and Publishing Union* [1895] 2 Ch 891.

(p. 816) 3. It is also possible for a charge to extend to money or property which was disposed of by the company between the presentation of a winding-up petition and the making of a winding-up order but, as a result of the disposition being declared void under IA 1986 s 127, comes back into its hands (*Mond v Hammond Suddards*[1996] 2 BCLC 470).

4. The ‘charge’ issue is only one aspect of the more general question raised by the meaning of the term ‘assets (or property) of the company’. Schedules 1 and 4 to IA 1986 confer on an administrator and a liquidator respectively a statutory power to sell or otherwise dispose of ‘the property of the company’, and ‘property’ in this context plainly includes the right to bring proceedings to enforce any chose in action vested in the company (eg a right to sue a third party in tort: *Norglen Ltd v Reeds Rains Prudential Ltd* [1999] 2 AC 1, [1998] 2 All ER 218, HL). In *Re Oasis Merchandising Services Ltd* [1998] Ch 170, [1997] 1 All ER 1009, CA, however, it was held that this power did not extend to an assignment by a liquidator of the ‘fruits’ of a s 214 action, since the right to bring such proceedings does not belong to the company but is conferred exclusively on the liquidator by the statute. It followed that there was no statutory authority justifying the assignment, and so it was liable to be held void at common law on the ground that it was champertous and against public policy. (Paradoxically, given the ruling in *Mond v Hammond Suddards* (Note 3), it has been held that the right to have dispositions of the company declared void under s 127 is also an incident of the office of liquidator which he cannot assign: *Re Ayala Holdings Ltd (No 2)* [1996] 1 BCLC 467.)

5. In *Re DKG Contractors Ltd* [1990] BCC 903 the respondent was held liable to the company under IA 1986 s 212 (misfeasance), s 214 (wrongful trading) and s 239 (preference). The court ordered that these liabilities should not all be cumulative but that payments made under ss 212 and 239 should go towards satisfying the liability under s 214. The judge in *Re Brian D Pierson (Contractors) Ltd* [1999] BCC 26 was similarly considerate: not only did she rule that the respondents’ liability for wrongful trading should not be increased by sums recoverable from them as preferences and on the ground of misfeasance, but she held also that the company’s losses were in part due to extraneous factors, such as bad weather conditions, and reduced the contribution for wrongful trading by 30%. However, it is clear from other decisions that the jurisdiction is entirely discretionary, and that there is nothing to stop an order being made in an appropriate case which makes such liabilities cumulative (eg *Re Purpoint Ltd* [1991] BCLC 491).

6. A transaction at an undervalue may also be challenged under IA 1986 s 423 (‘*transactions defrauding creditors*’), which replaces earlier legislation that can be traced back at least as far as 1571. Under this provision there are no time limits and the company need not be in liquidation or even insolvent. However, it must be shown that the transaction was entered into *for the purpose* of putting assets beyond the reach of a creditor or potential creditor or of prejudicing the interests of such a person. For an example, see *Arbuthnot Leasing International Ltd v Havelet Leasing Ltd (No 2)* [1990] BCC 636, where a company’s business and assets had been transferred on legal advice to an off-the-shelf company shortly before it went into receivership, and the court ordered the reversal of the transaction.

➢ Questions

1. What difference might the insolvency legislation of 1986 have made to the outcome of the following cases:

(i) *Salomon v Salomon & Co Ltd* **[2.01]**;
(ii) the *Multinational Gas case* **[7.39]**;
(iii) *Re Horsley & Weight Ltd* **[4.30]**;
(iv) *Re Halt Garage (1964) Ltd* **[5.03]**.

(p. 817) 2. Would any of the persons concerned in the cases (i) to (iv) have been liable to disqualification or compensation orders, as directors or shadow directors?

The common law 'anti-deprivation principle'

The next case is one of the earliest cases to set out what is now known as the anti-deprivation principle. This is a common law principle which renders void contractual arrangements which provide for the forfeiture of proprietary interests where the forfeiture is triggered by the debtor's bankruptcy or liquidation.[66] These arrangements have re-emerged for judicial consideration in the fallout from the recent financial crisis, and in *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc* **[16.18]** the issues were litigated all the way to the Supreme Court. The Supreme Court affirmed the existence of the principle, but attenuated its operation in ways which make any simple formulation now exceptionally difficult.

[16.17] Re Harrison, ex p Jay (1879) 14 Ch D 19 (Court of Appeal)

A term in a building contract which provided for the forfeiture of the builder's materials to the landlord on the bankruptcy of the builder was held to be void, as contrary to the policy of the bankruptcy law, and accordingly, where the purported forfeiture had been triggered by that clause, the materials on the land did not thereby become the property of the landlord, but became instead the property of the trustee in bankruptcy in the builder's liquidation.

> JAMES LJ: The case has been very well argued. But it appears to me that it is governed by [earlier] decisions of this Court … which only followed much older decisions. The principle of those decisions is this, 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 bankrupt law. Now that we have all the facts before us, I think we cannot escape from applying that principle to the present case. According to the debtor's own evidence everything that he was bound to do under the agreement had been performed by him up to the date of the bankruptcy, and therefore no right was vested in the lessor except by virtue of the bankruptcy. Her title is founded only on the stipulation that in the event of the builder's bankruptcy the materials which had been placed on the land should become her property. It seems to me impossible to distinguish the case from those authorities to which I have referred.

[16.18] Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc [2011] UKSC 38 (Supreme Court)

In the context of complicated derivative investments held by creditors of the Lehman Brothers Group, the Supreme Court held, amongst other matters, that a clause which flipped secured charge priority from one creditor (Lehman Brothers Special Financing Inc) to another (Belmont Park Investments Pty Ltd) in the event of the original secured creditor's insolvency did not offend the common law anti-deprivation principle. The case is important. The seven judges were unanimous in their conclusions, although Lord Mance gave quite different reasons.

> **(p. 818)** LORD COLLINS (with whom the majority agreed[67]):
>
> 75 From the earliest days of the [anti-deprivation] rule, it has been based on the notion of a fraud, or 'a

direct fraud' (Lord Eldon LC in *Higinbotham v Holme* 19 Ves Jun 88, 92), on the bankruptcy laws, and that decision was taken to be authority for the proposition that where a person settles property in such a way that his interest determines on his bankruptcy 'that is evidence of an intention to defraud his creditors': *In re Stephenson; Ex p Brown* [1897] 1 QB 638, 640, per Vaughan Williams J. 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. By contrast, in the leading pari passu principle case, *British Eagle* **[16.19]**, 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. …

78 Thus [after looking at a long line of authorities] there is an impressive body of opinion from some of the most distinguished judges that, in the case of the anti-deprivation rule, a deliberate intention to evade the insolvency laws is required. That conclusion is not affected by the decision in *British Eagle* **[16.19]**. The pari passu rule is clear. Parties cannot contract out of it. …

79 That does not mean, of course, that a subjective intention is required, or that there will not be cases so obvious that an intention can be inferred, as in *Ex p Jay***[16.17]**. But it does suggest that in borderline cases a commercially sensible transaction entered into in good faith should not be held to infringe the anti-deprivation rule. Although he did not accept that absence of good faith was a necessary element, Neuberger J suggested in *Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd* [2002] 1 WLR 1150, para 103 that if a deprivation provision, which might otherwise be held to be valid, could be shown to have been entered into by the parties with the intention of depriving creditors of their rights on an insolvency, then that might be sufficient to justify holding invalid the provision when it would not otherwise have been held invalid. …

80 By contrast with the pari passu principle, it is well established that if the deprivation takes place for reasons other than bankruptcy, the anti-deprivation rule does not apply. In *British Eagle* **[16.19]** the clearing house system was ineffective to avoid the pari passu principle, even though it applied throughout irrespective of whether the airlines went into liquidation. But the position is different with regard to the anti-deprivation rule, which is intended to operate only where provision is made for deprivation on bankruptcy. Thus in *Ex p Jay* **[16.17]**… both Brett and Cotton LJJ accepted, at p 26, that if forfeiture had taken place on the builder's breach (as the provision [also, in the alternative] envisaged) then it would have been valid …

➢ Note

Although the ancient and underutilised concept of anti-deprivation has now been given a new lease of life by the Supreme Court's decision, much work remains to be done in defining its precise modern scope and ambit. Relying on notions of 'good faith' and 'commercial reasonableness' may have their attractions in suggesting no intention to commit a fraud on the statute,[68] but may also undermine much-needed certainty when not only are the deals typically commercial, but the parties' rights are in stark conflict given the insolvency context. Also see the recent decisions in *Lomas v JFB Firth Rixon Inc* [2012] EWCA Civ 419, CA; *Folgate* **(p. 819)** *London Market Ltd v Chaucer Insurance plc* [2011] EWCA Civ 328 and *Revenue and Customs Commissioners v Football League Ltd* [2012] EWHC 1372 (Ch).[69]

Assets available for distribution by the liquidator

The assets available to the liquidator in a winding up will include the following (or their proceeds after realisation):

(i) all property beneficially owned by the company at the commencement of the winding up, apart from any property that the liquidator elects to disclaim under IA 1986 ss 178ff;
(ii) calls recovered from contributories;

(iii) moneys paid out of capital within the preceding 12 months for the repurchase of shares and recovered from past members and directors (s 76);
(iv) money or property recouped as a result of a court order nullifying a 'transaction at an undervalue' entered into within the preceding two years (ss 238 and 240);
(v) property and money paid away by the company within the preceding six months (or, if the recipient is a 'connected person', two years) and recovered by the liquidator as a preference (ss 239 and 240);
(vi) property disposed of after the commencement of the liquidation under transactions which are invalidated by s 127, unless the court orders otherwise;
(vii) property not fully seized in execution or distress (s 183), or attached after the commencement of the winding up (s 128);
(viii) property recovered and compensation ordered to be paid by court order made against directors and others on the grounds of misfeasance (s 212), fraudulent trading (s 213) and wrongful trading (s 214).

The liquidator will take the assets—with one important qualification—subject to any security validly created in favour of a debenture holder or other creditor prior to the commencement of the winding up unless it is:

(i) void against the liquidator for non-registration under CA 2006 s 874;
(ii) void as a preference under IA 1986 s 239;
(iii) a *floating* charge created within the preceding 12 months (or, if the chargee is a 'connected person', two years), except to the extent that it is valid under s 245.

The one qualification is that such security can be created only over *the property of the company* (present or future), and some of the categories of assets listed are regarded as falling outside this description—for example, money recovered by the liquidator as a preference: see Note 1 following **[16.16]**, p 815. These sums are therefore freely available for distribution among the company's unsecured creditors.

Property in the hands of the company will also be taken by the liquidator subject to any equities and set-offs enforceable against the company before it went into liquidation.

(p. 820) Application of assets by the liquidator

The claims of a secured creditor to the secured assets rank in principle ahead of any claim in the winding up—including even the costs of the liquidation. But recall that a*floating* charge holder must meet: (i) the claims of the unsecured creditors to a statutory share of the assets (IA 1986 s 176A, and Insolvency Act 1986 (Prescribed Part) Order 2003 (SI 2003/2097) art 3); (ii) the claims of the preferential creditors under s 175; and (iii) somewhat anomalously, the expenses of the winding up (including the liquidator's remuneration): see IA 1986 ss 175(2)(a) and 197ZA (see 'Distribution of assets subject to the receivership', p 787).

Assets will be applied, after the claims of secured creditors (other than holders of floating charges) have been satisfied, in the following order of priority:

(i) the expenses of the liquidation (including the liquidator's remuneration, post-liquidation debts and certain pre-liquidation debts) (s 115 (voluntary liquidations) and s 156 (compulsory liquidation)). What amounts to an expense of winding up has been the subject of major litigation: *Re Toshoku Finance UK plc, Kahn v IRC* [2002] UKHL 6, [2002] 1 WLR 671, HL, concluding that IR 1986 r 4.218 is a definitive statement of what counts as a liquidation expense[70] and of the priorities as between expenses;
(ii) the debts declared to be preferential debts by s 386 and Sch 6;
(iii) floating charge holders (but see 'Distribution of assets subject to the receivership', pp 787ff, for the precise working out of this, including the statutory share to unsecured creditors, if the assets are not sufficient to meet (i)–(iii) in total);
(iv) unsecured creditors—but note that some debts owed by the company to shareholders, such as moneys paid in advance of calls and sums due by way of dividends, are postponed to outside creditors (s 74(2)(f));
(v) interest on all debts proved in the winding up (s 189);
(vi) money due to a member under a contract to redeem or repurchase shares which has not been completed prior to the winding up (CA 2006 s 735);
(vii) the debts due to members mentioned in (iv);

(viii) repayment of capital to preference members; and
(ix) repayment of capital to ordinary members.

Any 'surplus assets' then go to whoever is entitled under the company's constitution; normally, this will be the ordinary members.

A Department of Trade and Industry review, now rather dated, suggested that average recovery rates in formal insolvency procedures were: 77% for the bank; 27% for preferential creditors; and virtually nil for unsecured creditors.[71]

(p. 821) ***A contract under which creditors agree to vary the statutory rules governing the distribution of a company's assets in a liquidation is contrary to public policy and void.***

[16.19] British Eagle International Air Lines Ltd v Cie Nationale Air France [1975] 1 WLR 758 (House of Lords)

Many airlines set up a 'clearing house' scheme under which their mutual debits and credits were not set off one against another but were pooled with a third party, IATA. Under the agreement, participants could not claim against each other but only against IATA for any net balance due to the particular airline under the scheme. British Eagle went into liquidation at a time when it was a net debtor to the scheme in respect of its aggregated claims but, as between itself and Air France, it was a net creditor. The liquidator successfully challenged the legality of the clearing house arrangement.

> LORD CROSS OF CHELSEA: [What] the respondents are saying here is that the parties to the 'clearing house' arrangements by agreeing that simple contract debts are to be satisfied in a particular way have succeeded in 'contracting out' of the provisions contained in [CA 1948 s 302] [IA 1986, s 107] for the payment of unsecured debts 'pari passu'. In such a context it is to my mind irrelevant that the parties to the 'clearing house' arrangements had good business reasons for entering into them and did not direct their minds to the question how the arrangements might be affected by the insolvency of one or more of the parties. Such a 'contracting out' must, to my mind, be contrary to public policy. The question is, in essence, whether what was called in argument the 'mini liquidation' flowing from the clearing house arrangements is to yield to or to prevail over the general liquidation. I cannot doubt that on principle the rules of the general liquidation should prevail …
>
> LORDS DIPLOCK and EDMUND-DAVIES concurred.
>
> LORDS MORRIS OF BORTH-Y-GEST and SIMON OF GLAISDALE dissented.

➢ Notes

1. The Supreme Court reaffirmed the strictness of this rule, *obiter*, in *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd and Lehman Brothers Special Financing Inc* **[16.18]**.

2. There may be strong public policy arguments for allowing creditors to vary the statutory priorities by arrangement among themselves. One such situation is when the existing creditors of a company in difficulties are willing to let a new creditor advance money in an attempt to save the company from liquidation, on the understanding that if the attempt is unsuccessful the claim of the 'rescuer' should not rank equally with their own, but have priority. Following *British Eagle*, there was for a time considerable uncertainty whether such an arrangement—at least if effected by contract between the parties—would be lawful. There was pressure for legislation to be passed which would expressly permit subordination agreements. However, in two decisions of Vinelott J, *Re British & Commonwealth Holdings plc (No 3)* [1992] BCLC 322 and *Re Maxwell Communications Corpn plc (No 2)* [1994] 1 BCLC 1 (where the agreements took the forms respectively of a trust and a contract), it was held that no violation of the *pari passu* principle is involved, where all that the subordinating