The Nature and Scope of the Anti-Deprivation Rule in the English Law of Corporate Insolvency

James Davies
The Nature and Scope of the Anti-Deprivation Rule in the English Law of Corporate Insolvency – Part One

James Davies, Barrister

Introduction

The classic description of the so-called anti-deprivation rule was provided by Cotton LJ in the case of *Ex p Jay*, where the rule was expressed in terms that “there cannot be a valid contract that a man’s property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and shall be taken away from his creditors.” In spite of this seemingly straightforward formulation, the courts and commentators alike have struggled to elicit from the case law a coherent principle with well defined limits. Indeed the recent Court of Appeal case of *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd* seems to have done more to highlight the uncertainties as to the nature and extent of the rule than it has to settle them.

In the first part of this paper, I will seek to distinguish the rule from other rules and principles which operate in the English law of insolvency and therefore attempt to stem some sources of confusion. In the second part, I will go on to consider the scope of the rule.

Facts of the case

*Perpetual* involved two combined appeals to the Court of Appeal. The first arose out of the collapse of the global financial services group, Lehman Brothers in 2008. It involved a complicated synthetic collateralised debt obligation, by which a Lehman Brothers company set up a Special Purpose Vehicle (‘the Issuer’) in a tax-friendly jurisdiction, which sold notes to investors, including Perpetual Trustee. The Issuer used the proceeds of sale to purchase government bonds as collateral, which were vested in a trust corporation called BNY Corporate Trustee Services Ltd (‘the Trustee’). The Issuer also entered into a swap agreement with another Lehman Brothers company by the name of Lehman Brothers Special Financing Inc (‘LBSF’). The substance of the swap agreement was that LBSF would pay the Issuer the sums due to the noteholders in return for an amount equal to the yield on the collateral. This arrangement gave rise to a sort of credit insurance. The collateral was charged in favour of both the Trustee to secure the Issuer’s obligations to the noteholders and in favour of LBSF. The charge in favour of LBSF was to take priority over that in favour of the Trustee unless an event of default, as defined in the agreement, occurred and LBSF was the defaulting party. In this event, the priority would ‘flip’ and the charge in favour of note holders would take priority. The events of default included the insolvency or default of LBSF and the insolvency of the ultimate parent company of LBSF, Lehman Brothers Holdings Inc (‘LBHI’). The administrator of LBSF challenged the validity of the priority flip on the basis that it offended the anti-deprivation rule, by depriving LBSF’s estate of the priority that it enjoyed. Both at first instance and in the Court of Appeal, it was held that the anti-deprivation rule did not apply.

The second appeal in the *Perpetual* case, the Butters appeal, arose out of the administration of the Woolworths group of companies.

The anti-deprivation rule and the pari passu principle

It has been argued by Look Chan Ho that the Court of Appeal in the *Perpetual* case wrongly conflated the anti-deprivation rule with the *pari passu* principle. It is suggested that in this regard Look Chan Ho is absolutely correct and that distinguishing the *pari passu* principle

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1 James Davies is currently a pupil at Enterprise Chambers.
3 [2009] EWCA Civ 1160 (CA) (on appeal from [2009] EWHC 1912 (Ch)).
from the anti-deprivation rule is absolutely critical to an understanding of the latter.

It has been noted by a number of commentators that there are two versions of the pari passu principle. The first is the ‘orthodox pari passu principle’ and is enshrined in s. 107 of the Insolvency Act 1986 (‘IA 1986’) and in rule 4.181(1) of the Insolvency Rules 1986 (‘IR 1986’). This is the rule which requires insolvency law to take claimants ‘exactly as it finds them’ and treat them on an equal footing, so that any distribution will be pro rata, based on the claimants’ pre-insolvency entitlements. Therefore preferential claims and set-off will constitute exceptions to this principle. The second sense in which the term is used is to describe the pro rata distribution within the various classes established by insolvency law. Therefore paradoxically, s. 175(2)(a) IA 1986, which deals with preferential claims, can be seen both as an exception to the ‘orthodox pari passu principle’ and as an application of the pari passu principle, when that term is used in the second sense.

In the House of Lords case of British Eagle International Airlines Ltd v Compagnie Nationale Air France, the court clearly viewed the rationale of the anti-deprivation rule as based upon the orthodox pari passu principle. In this case, the liquidator of British Eagle International Air Lines (‘British Eagle’), the Claimant airline, claimed against Air France for sums allegedly owed by Air France in the liquidation of British Eagle. Both companies were members of the International Air Transport Association (‘IATA’), which established a clearing house so that all claims arising between the airlines, for the performance of services for each other, could be netted out on a monthly basis. Each month, each airline would thus either receive a payment from the clearing house, or would pay a sum to the clearing house, depending on the sum total of services which it had provided for other airlines and the services it had received. The question for the House of Lords was whether this netting house system could validly contracts the insolvent estate due to the fact that the multi-party netting arrangement which was put in place through the IATA, effected what was described in argument as a ‘mini-liquidation’. The House of Lords concentrated on the difference between the distribution effected under the IATA regulations and that under the pari passu regime enshrined in the insolvency legislation. In doing so, the House of Lords glossed over the fact that if the IATA arrangements were allowed to stand, the insolvent estate would effectively have been deprived of the sums owed to it by those airlines who owed debts to British Eagle. In effect, the House of Lords missed a step in the insolvency process. Before the insolvent estate can be distributed, on the basis of the orthodox pari passu principle, whether this netting house system could validly contract out of the insolvent estate for the benefit of the creditors and the pari passu principle simply ordains the way in which the insolvent estate will subsequently be distributed, what does the principle of pari passu have to do with the anti-deprivation rule? It seems the confusion may have begun in British Eagle.

This distinction certainly seems to have a great deal of force. The principle of collectivity does not depend in any way upon the pari passu principle, indeed it is compatible with any form of distribution. Given that the anti-deprivation rule would seem to ensure the conservation of the insolvent estate for the benefit of the creditors and the pari passu principle simply ordains the way in which the insolvent estate will subsequently be distributed, what does the principle of pari passu have to do with the anti-deprivation rule? It seems the confusion may have begun in British Eagle. Indeed, Mokal has described the failure of the House of Lords in British Eagle to consider the principle of pari passu clearly as ‘deeply unsatisfactory’. In that case it seems that the House of Lords focussed on the distribution of the insolvent estate due to the fact that the multi-party netting arrangement which was put in place through the IATA, effected what was described in argument as a ‘mini-liquidation’. The House of Lords concentrated on the difference between the distribution effected under the IATA regulations and that under the pari passu regime enshrined in the insolvency legislation. In doing so, the House of Lords glossed over the fact that if the IATA arrangements were allowed to stand, the insolvent estate would effectively have been deprived of the sums owed to it by those airlines who owed debts to British Eagle. In effect, the House of Lords missed a step in the insolvency process. Before the insolvent estate can be distributed, on the basis of the orthodox pari passu principle, whether this netting house system could validly contract out of the insolvent estate for the benefit of the creditors and the pari passu principle simply ordains the way in which the insolvent estate will subsequently be distributed, what does the principle of pari passu have to do with the anti-deprivation rule? It seems the confusion may have begun in British Eagle. Indeed, Mokal has described the failure of the House of Lords in British Eagle to consider the principle of pari passu clearly as ‘deeply unsatisfactory’. In that case it seems that the House of Lords focussed on the distribution of the insolvent estate due to the fact that the multi-party netting arrangement which was put in place through the IATA, effected what was described in argument as a ‘mini-liquidation’. The House of Lords concentrated on the difference between the distribution effected under the IATA regulations and that under the pari passu regime enshrined in the insolvency legislation. In doing so, the House of Lords glossed over the fact that if the IATA arrangements were allowed to stand, the insolvent estate would effectively have been deprived of the sums owed to it by those airlines who owed debts to British Eagle. In effect, the House of Lords missed a step in the insolvency process. Before the insolvent estate can be distributed, on the basis of the orthodox pari passu principle, whether this netting house system could validly contract out of the insolvent estate for the benefit of the creditors and the pari passu principle simply ordains the way in which the insolvent estate will subsequently be distributed, what does the principle of pari passu have to do with the anti-deprivation rule? It seems the confusion may have begun in British Eagle. Indeed, Mokal has described the failure of the House of Lords in British Eagle to consider the principle of pari passu clearly as ‘deeply unsatisfactory’. In that case it seems that the House of Lords focussed on the distribution of the insolvent estate due to the fact that the multi-party netting arrangement which was put in place through the IATA, effected what was described in argument as a ‘mini-liquidation’. The House of Lords concentrated on the difference between the distribution effected under the IATA regulations and that under the pari passu regime enshrined in the insolvency legislation. In doing so, the House of Lords glossed over the fact that if the IATA arrangements were allowed to stand, the insolvent estate would effectively have been deprived of the sums owed to it by those airlines who owed debts to British Eagle. In effect, the House of Lords missed a step in the insolvency process. Before the insolvent estate can be distributed, on the basis of the orthodox pari passu principle.

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6 Re Smith, Knight & Co., ex p. Ashbury (1868) L.R. 5 Eq. 223, at 226 per Romilly M.R.
8 Ibid., at 780.
passu principle or otherwise, the assets of the insolvent estate must be collected in. In the case of British Eagle, the IATA arrangements purported to effect a multi-party set-off, which was inconsistent with the insolvency regime and if it were allowed to stand, would have had the effect that insolvent estate was deprived of funds which should have been available under the insolvency rules. Although the distribution which was effected by the IATA arrangement was different to that provided by the insolvency regime, it was the collective element of the regime which was infringed by the arrangement and not the distributive element.

Moreover, if it is accepted that the anti-deprivation rule may apply equally upon the commencement of an administration as upon the commencement of a liquidation, which it was by the Court of Appeal in the Butters case, then the rule may apply in the absence of any distribution at all. If the aim of the administration is to rescue the business as a going concern, then the rule will still apply but there may be no distribution. Surely this suggests that the rule has nothing whatsoever to do with the distributive aspect of the insolvency regime. By contrast, both an administrator and a liquidator are concerned with the conservation of the insolvent estate.

The case of British Eagle is often held up to be the ‘leading modern authority on the pre-eminence of the pari passu principle’, however, as Mokal has pointed out, this is not without its irony. As described above, the orthodox pari passu principle is concerned with treating claimants on an equal footing according to their pre-insolvency entitlements. However, in British Eagle, the airline, while solvent was not able to claim directly against the airlines that were members of the IATA, nor were they able to claim against British Eagle. Pre-insolvency therefore, the members of the IATA were in a quite different position to the other creditors of British Eagle who were able to claim directly against British Eagle. However, according to the majority of the House of Lords, post-insolvency the liquidator was able to claim directly against the individual airlines and therefore the pre-insolvency entitlements were not respected. For this reason, it has been suggested that a better way to understand the case is to look at the netting arrangements as an ‘attempt on the part of IATA to prevent its members from having to submit to the collective liquidation regime’.

On this basis therefore, it is suggested that the case is better understood against the backdrop of the so-called ‘principle of collectivity’ rather than that of the pari passu principle. However, cases following British Eagle repeated the mistake in that case and continued to analyse the anti-deprivation rule in terms of the pari passu principle. In Perpetual, the members of the Court of Appeal seem to accept that the anti-deprivation rule is, at least in part, based on the fact that it is impossible to contract out of the pari passu rule. Although at no point do any of the members of the Court of Appeal predicate their analysis upon the anti-deprivation rule being wholly based on the pari passu principle, the Master of the Rolls lists s. 107 IA 1986 as one of the provisions which underpins the rule and Patten LJ seems to accept the premise that the common law rule of public policy applied in British Eagle was no more than the application of the pari passu principle. This betrays a misunderstanding of the distinction between the collective aspect of the insolvency regime and the distributive aspect exemplified by the principle of pari passu.

The ‘contracting-out rule’ and the ‘insolvency-deprivation rule’

Another distinction which has been suggested by Worthington is between the anti-deprivation rule (which Worthington terms the ‘insolvency-deprivation rule’) and what she has termed the ‘contracting-out rule’. Worthington states that the contracting out rule ‘concerns arrangements that purport to provide for a different distribution of the insolvent’s assets than would be provided by the insolvency legislation’ and the insolvency-deprivation rule ‘concerns arrangements triggered by insolvency that purport to deprive the insolvent of assets on which the insolvency distribution can bite’. Further, Worthington states that while the basis of the contracting-out rule is simply the application of the insolvency legislation, the basis of the insolvency-deprivation rule is public policy.

The difficulty with this distinction is that both versions can be said to operate to prevent the insolvent estate being deprived of assets on which the distribution can bite. This is more obvious in the case of the insolvency-deprivation version, where the arrangement may purport to deprive the estate of one asset which is thereby not available for distribution. However, in the case of a clearing house, such as that involved in British Eagle, if the scheme was allowed to

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11 R. Mokal, n. 9 above, at 598.
12 Ibid., p. 599.
13 British Eagle, n. 7 above, at [50] and [118] respectively.
15 Ibid.
continue post-insolvency, the estate would similarly have been deprived of assets from Air France among others, which would therefore not be available for distribution to the non-IATA creditors. It can be said that such a contract purports to define what forms part of the insolvent estate, and more importantly, what does not form part of the insolvent estate. Similarly, both versions can be said to effect a different distribution of assets than that provided by the insolvency legislation. Worthington seems to focus on the distributive aspect in the contracting-out version and on the collective aspect in the insolvency-deprivation version. So what then is the difference between these two versions? It is true to say that while provisions to which the insolvency-deprivation rule apply will simply remove an asset from the scope of the insolvency regime, those provisions to which the contracting-out rule applies will effectively seek to displace the insolvency regime from the inside, by providing for a scheme of distribution which is different to that contained in the insolvency legislation. Broadly speaking, both the insolvency-deprivation and the contracting-out rule are underpinned by a similar rationale. Both versions can be analysed in terms of the counter-parties to the arrangement attempting to bargain for immunity from the collective insolvency regime.16 The rationale for both versions can therefore be seen as preventing parties to an agreement from gaining immunity from the collective insolvency regime. As Mokal has argued, it is the ‘whole collective system (emphasis added) for the winding up of insolvent estates’ which cannot be contracted out of.17 If a distinction is to be drawn between these two rules, a distinction other than the one suggested above must be found.

One of the major distinctions which can be drawn between these two rules is that the insolvency-deprivation rule applies to those provisions which purport to effect a change upon either insolvency or the commencement of formal insolvency proceedings. Whether the rule applies to deprivation provisions which purport to operate on mere insolvency or formal insolvency proceedings will be discussed in part two of this article. For the moment it may be useful to use the term ‘insolvency event’ to mean either one. Typically a provision which is subject to the insolvency-deprivation rule will purport to transfer ownership of an asset from the insolvent company to a third party on the happening of an insolvency event. In contrast, the contracting-out rule will involve a situation where a contract applies equally before and after the happening of an insolvency event. There is no change effected on the happening of the insolvency event and no reference is made to such an event in the provision. The case of British Eagle provides a prime example of the contracting out rule. As noted by the members of the House of Lords, ‘there was no change whatever on the winding-up; the same “clearing house” provisions applied both before and after…’.18 The provision operates entirely validly prior to the insolvency event and it is clear from British Eagle itself that it makes no difference that the parties did not intend to bargain for an insolvency advantage. Does this, however, amount to a normative distinction?

One consequence of this difference is that the legal effects of the two rules are likely to be different. Provisions to which the contracting-out rule applies are entirely valid before the insolvency event. Before this, they are entirely unobjectionable and certainly, as was argued in British Eagle, such arrangements may make a great deal of commercial sense for all parties involved. The provision will only become void upon the happening of the insolvency event, when the contractual regime will be displaced by the statutory regime. Provisions to which the insolvency-deprivation rule applies however, given that they effect the deprivation upon the happening of the insolvency event, are always objectionable and therefore are void ab initio. In the case of an agreement which contains such a clause, the court may therefore be able to apply the ‘blue pencil rule’ and delete the offending provision, without affecting the meaning of the part remaining. In the case of Fraser v Oystertec,19 it was argued that the deprivation agreement remained valid between the parties but void as between the insolvent company and its creditors. The judge rejected this argument, holding that the provision was void from the outset, and it is suggested that this is correct. The argument was based upon a passage in the judgment of Cotton LJ in Ex p Jay,20 where his Lordship stated that ‘...though the contract is good between the parties to it, it is on principle void in the event of the builder’s bankruptcy’. Yet as the Judge in Fraser points out, a transaction is either a nullity or it is not.

So can these two rules be separated by identifying that each has a different genesis? As stated above, Worthington has argued that the basis of the contracting-out rule is simply that one cannot contract out of the insolvency legislation. She argues that this is simply a matter of legislation trumping party autonomy and therefore there is no need to revert to public policy arguments to justify the rule. However, giving the leading

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16 R. Mokal, n. 9 above, at 597.
17 Ibid.
18 British Eagle, n. 7 above, per Lord Cross at p. 780.
speech for the majority of the House of Lords in *British Eagle*, Lord Cross of Chelsea stated that ‘[s]uch a “contracting out” must, to my mind, be contrary to public policy’. There seems consequently to be some dispute as to whether public policy needs to be invoked in order to justify the rule. When the High Court of Australia examined the basis of the rule in the case of *International Air Transport Association v Ansett Australia Holdings Ltd.*, the majority rejected the invocation of public policy and viewed the basis of the rule simply as an application of the insolvency legislation. This view seems persuasive. There seems to be little merit in invoking public policy, when the rule simply reflects the primacy of the legislation. In *Perpetual*, the Master of the Rolls seeks to identify the provisions of the IA 1986 which govern the way in which assets are dealt with in a liquidation and therefore cannot be contracted out of. He identifies ss. 107 IA 1986 and r. 4.181 IR 1986, which deal with pari passu distribution. As discussed above, this is unsurprising given the courts’ long-held misconception of the British Eagle principle being based upon the pari passu principle. More interesting however, are the remainder of the provisions which Lord Neuberger identifies as being incapable of being contracted out of. All of these sections involve provisions which constitute part of the collective element of the insolvency regime. Lord Neuberger refers in particular to ss. 143(1) and 144(1), which state that where a company is subject to a winding-up order, the liquidator must ‘secure that the assets of the company are got in, realised and distributed to the company’s creditors…’, and that he must ‘take into his custody or control all the property and things in action to which the company is…entitled’. It seems that taken together, these two sections represent exactly the collective regime which cannot be contracted out of. Although not mentioned by Lord Neuberger in the Perpetual case, a provision which encapsulates the same principle but for administration as opposed to liquidation can be identified in Paragraph 67 of Schedule B1 IA 1986, by which ‘[t]he administrator of a company shall on his appointment take custody or control of all the property to which he thinks the company is entitled’. It is interesting to compare the contracting-out rule to the case of *Halesowen Press and Assemblies Ltd v National Westminster Bank Ltd.*, where the House of Lords pronounced that the set-off regime provided for in the insolvency legislation is mandatory and consequently cannot be contracted out of. In that case, no reference was made to public policy. It was simply accepted that the primacy of the legislation trumped any agreement which purported to contract out of it. A party could not agree to forgo their right of contractual set-off, even though the disclaimer of that right was obviously to their detriment. It is suggested that there is no reason why public policy needs to be invoked in order to justify the inability to contract out of the collective aspect of the legislation when it is not required to justify the inability to contract out of the set-off regime contained in the insolvency legislation. The insolvency legislation is thus, both the basis and rationale for the contracting-out rule. As such, the contracting-out rule is devoid of any normative content.

With regard to the insolvency-deprivation rule, Worthington argues that this is rooted entirely in public policy. This seems to be confirmed by the long line of case law that has involved the insolvency-deprivation rule type provisions as opposed to those seen in *British Eagle or Ansett*. There is no provision in the insolvency legislation which embodies the insolvency-deprivation rule and prohibits the insolvent depriving itself of property on its insolvency. The provisions in ss. 238 and 239 of the IA 1986, which allow the court to avoid antecedent transactions where the company has given a preference, or entered into a transaction at an undervalue may overlap with the insolvency-deprivation rule, but their function is not the same. Unlike the contracting-out rule therefore, the insolvency-deprivation rule cannot be said to be a direct application of the insolvency legislation. The rule has emerged from the common law in order to ensure that the insolvency regime is not subverted. Its rationale is to prevent the value of the estate being diminished by transfers to third parties at the expense of the creditors. It prevents the parties to a contract agreeing to effectively avoid the scope of the collective system of insolvency. While the contracting-out rule attempts to prevent parties agreeing to manipulate the collective statutory regime, the insolvency-deprivation rule prevents parties agreeing that certain assets should never become subject to the regime. The courts have applied this rule in cases which date back at least to the 19th century. In the case of *Money Markets International Stockbrokers Ltd v London Stock Exchange*, Neuberger J as he then was, stated that the rule ‘is essentially based on a common law rule of public policy, which is itself based on the long-established approach of English Law to the treatment of assets and creditors on insolvency’. This description would seem to be a fair assessment of the genesis of the insolvency-deprivation rule.

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21 *British Eagle*, n. 7 above, at 780.
24 [2002] 1 WLR 1150, at 1173.
Applicability of the rule solely to agreements entered into by the insolvent

Another clarification which can be made regarding the nature of the rule is that it now seems fairly clear that both the contracting-out rule and the insolvency-deprivation rule only apply to agreements entered into by the insolvent. It is the insolvent itself who is not allowed to contract out of the insolvency legislation or agree to deprive itself of assets upon its insolvency. The creditors of the insolvent may enter into whatever agreement they wish with regard to the distribution of their share of the estate. Thus, in this context it is entirely legitimate to agree to a different distribution of assets than that provided by the IA 1986. This seems entirely correct. There is no rationale for preventing creditors from contracting to define their entitlements as between each other, upon the company’s insolvency. Obviously, such an agreement would not be valid in so far as it purports to redistribute assets to which creditors who are not a party to the agreement would be entitled.

The inapplicability of the rules to such agreements underlines the fact that both the contracting-out rule and the insolvency-deprivation rule are concerned with the conservation of the insolvent estate and not with the pari passu principle or any other mode of distribution. An agreement between two or more creditors to split their share of the insolvent estate in a way which is at variance to the distribution which would be effected under the insolvency legislation does not in any way undermine the principle of collectivity.

A common example of an agreement whereby creditors agree that the assets to which they are entitled should be redistributed in a fashion other than that provided in the insolvency legislation is a subordination agreement. This is an agreement whereby one creditor agrees that debts owed to him shall rank below other debts owed by the debtor. Following the House of Lords decision in British Eagle, some doubt was cast on the validity of such agreements due to the fact that they seemed to involve a contracting out of the legislation by providing for a distribution which was different to that under the statutory scheme. This concern was heightened given the misunderstanding of the contracting-out rule as being an application of the pari passu principle. The validity or not of subordination clauses was a matter of substantial importance, given the commercial value of being able to enter into such agreements.

Even after the case of Re Maxwell Communications Corporation plc,25 where Vinelott J expressly considered the implications of British Eagle upon the validity of subordination clauses and considered that in spite of that case, such an agreement could be valid, doubt remained. Following the case of Re SSSL Realisations,26 the question seems to have been put beyond doubt. This case involved Save Group plc (‘Save’), which was the parent of a number of subsidiaries, of which one was SSSL Realisations (‘SSSL’). SSSL owed substantial inter-company debts to Save. The group of companies owed substantial amounts to HM Customs and Excise. A third-party company AIG Europe (UK) Ltd (‘AIG’) agreed to provide a bond to HM Customs and Excise on behalf of the group. AIG entered into an indemnity agreement with Save and SSSL, among other members of the group, whereby the companies agreed to indemnify AIG against all claims incurred under the bond. The agreement contained subordination provisions to the effect that until all sums payable by the group companies to AIG had been paid in full, no group company should be able to prove as a creditor of another group company in competition with AIG. Both SSSL and AIG went into liquidation and AIG argued that by virtue of the agreement SSSL’s debt to Save was subordinated to that of AIG. In effect, nothing could be paid to Save until the amount due to SSSL had been discharged in full. In the Chancery division of the High Court, Lloyd J held that ‘the situation is...quite different from that in British Eagle, or in Ex parte Mackay and other cases of that kind’27 and therefore the subordination agreement was valid. Indeed, the IR 1986 expressly recognise the right of a creditor to assign his right of dividend to another creditor, which is effectively exactly what occurs when one creditor agrees to be subordinated to another.

This case was of particular importance because it upheld the validity of an agreement, in spite of the fact that the subordinated creditor was also in insolvent liquidation. In this case, although the debtor company, SSSL was a party to the contract, it was Save who has agreed to be subordinated to AIG. In that regard, it can be distinguished from the situation whereby the insolvent has purported to agree with a creditor to contract out of the insolvency legislation, or to deprive itself of an asset upon its insolvency, which would be invalid.

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27 Ibid, at [45].
The Nature and Scope of the Anti-Deprivation Rule in the English Law of Corporate Insolvency – Part Two

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In the second part of this article, I will consider the scope of the anti-deprivation rule in the English law of corporate insolvency. Particular consideration will be given to the case of *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd*, the facts of which are stated in the first part of this article.¹

**When will a purported deprivation be caught by the rule?**

If the distinction, which is made by Worthington between the contracting-out rule and the anti-deprivation rule, is to be drawn, it must be considered at what stage a purported contracting-out or deprivation will be invalid. Given that, as discussed in the first part of this article, the contracting-out rule is no more than a reflection of the primacy of the insolvency legislation, that rule cannot have a wider reach than the provisions of the insolvency legislation itself. However, given that the anti-deprivation rule is a common law rule of public policy, would the rule invalidate a deprivation which was triggered by the mere insolvency of a company as opposed to the commencement of formal insolvency proceedings?

Part of the confusion has been formed by the conflation of the rule with the *pari passu* principle. It is evident that if the *pari passu* principle is seen as the basis for the anti-deprivation rule, the rule, like the *pari passu* principle will only operate in the context of formal insolvency proceedings. However, given that the anti-deprivation rule is concerned with the conservation of the insolvent estate, it might at first glance seem sensible that the rule would apply to deprivations which occur prior to formal insolvency proceedings in order to protect the creditors of the insolvent company. Indeed a good example of this reasoning can be seen in the case of *Fraser v Oystertec*.² In this case, Peter Prescott Q.C., sitting as a Deputy High Court Judge, held that an agreement which provided that a patent owned by a company would be assigned to a third party upon the company becoming unable to pay its debts was void. In support of his finding, the judge cited the nineteenth century case of *Whitmore v Mason*,³ in which Page Wood V-C held that the rule applied to deprivations triggered by mere insolvency and was not dependent on bankruptcy proceedings having been commenced. Page Wood V-C considered that if this was not the case, it would mean that ‘the bankrupt laws might, in all cases, be defeated’.⁴ Apart from this case, there seems to be no authority in the case law to support the contention that the rule operates to invalidate deprivation provisions triggered by mere insolvency as opposed to the commencement of formal insolvency proceedings. It may be helpful however, to examine, as a matter of policy, whether it would be sensible and logical for the rule to apply to deprivations which occur upon mere insolvency.

If the rule were only to apply to deprivations triggered by the commencement of insolvency proceedings, it may lawfully be agreed that the insolvent company may be deprived of assets upon its insolvency. If the company was later subject to formal insolvency proceedings, provisions of the IA 1986 may invalidate such deprivations. In particular, the provisions relating to transactions at an undervalue contained in s. 238 and those relating to preferences in s. 239 are likely to be particularly relevant. However, if the rule does not apply to deprivations effected upon mere insolvency, in those cases where the company does not latterly become subject to formal insolvency proceedings, as happened in the *Oystertec* case, the insolvent company may be lawfully stripped of its assets. It is suggested that this is correct since as Patten LJ noted in

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1 James Davies is currently a pupil at Enterprise Chambers.
2 [2009] EWCA Civ 1160 (CA) (on appeal from [2009] EWHC 1912 (Ch)).
4 (1861) 2 J & H 204.
5 Ibid., at 215.
Perpetual, it would seem to be wrong in principle if ‘the anti-deprivation rule can apply to invalidate contracts even where no bankruptcy or winding-up order is ever made’. This would place an unnecessary restriction upon a company, which may be in no danger of becoming subject to formal insolvency proceedings, yet may be momentarily insolvent, whether on the cash-flow test or the balance-sheet test.

If the rule only applies to deprivations which occur upon the commencement of formal insolvency proceedings, certain deprivations may escape the scope of ss. 238 and 239 even if the company is unable to pay its debts at the time the deprivations occur. The deprivations will be incapable of avoidance by ss. 238 and 239 if they occurred outside of the time limits set by s. 240. Consequently, certain deprivations will be lawful even if they occur after the company becomes insolvent. At first glance, this may seem to run counter to the rationale of the anti-deprivation rule as conserving the insolvent estate and preventing the insolvency regime being circumvented. However, if the rule was to apply to deprivations triggered by mere insolvency as opposed to formal insolvency proceedings, this would allow the application of ss. 238 and 239 to be subverted. Parliament placed time limits on the application of ss. 238 and 239 in s. 240 and consequently transferees of property from the company and those who receive payments from the company know that under the statutory regime, those transactions cannot be challenged after six months has passed or after two years if the party is a connected person as defined by ss. 249 and 435 IA 1986. There is a clear conflict here between protecting the interests of the general creditors of a company and giving legal certainty to the transferees of property from the company. Parliament has sought to regulate this conflict through the time limits imposed in s. 240. To allow the anti-deprivation rule to apply outside of the time limits would be to subvert the will of Parliament and it is suggested that if there is a lacuna to be filled, it is up to Parliament to legislate and not up to the courts to seek to fill it. While the anti-deprivation rule itself is not based upon the insolvency legislation, the courts should be extremely careful not to impinge upon areas which are comprehensively covered by the statutory scheme.

The Master of the Rolls in Perpetual criticised the application of the rule to deprivations triggered by mere insolvency and wondered what would happen if the company was insolvent at the time of the deprivation, but subsequently recovered.6 In response to this criticism, Look Chan Ho has stated that the principle of collectivity would not therefore have been transgressed and no creditors would suffer any loss.7 The difficulty with this reasoning is that if the rule applies to deprivations which are triggered by mere insolvency, any provision which purports to provide for such a deprivation will be void from the outset. The subsequent recovery of the company can have no effect on this state of affairs. Henderson took the reasoning of the Master of the Rolls in the Perpetual case a step further and wondered what the situation would be if the company, which had recovered, after five years fell back into insolvency.8 If the company entered into formal insolvency proceedings at that point, would the liquidator or administrator be able to look back to the first period of insolvency and seize the assets of the company which had been transferred? At that point, the transferee may have felt that any question as to the validity of his title to the assets would have been definitively resolved by the effluxion of time given the time limits set out in s. 240 IA 1986. These difficulties can clearly be avoided if the rule only operates upon the commencement of formal insolvency proceedings.

The judge in Fraser was of the opinion that if the law was such that the rule applied only to deprivations, which occur on the commencement of formal insolvency proceedings, ‘it would be mere pointless form and the mischief would not be addressed fully’.9 However this doesn’t seem to take into account the provisions of the insolvency legislation which may apply to avoid such mischief transactions. It has been argued that it would seem arbitrary if a deprivation were to be lawful a minute before the presentation of a winding up petition or the appointment of an administrator and be unlawful following such a presentation or appointment. Look Chan Ho has argued that this means that Claimants such as those in Fraser must race to put the company into formal insolvency proceedings before the deprivation occurs, and this may not necessarily be the most efficient or optimal outcome. As the judge pointed out, ‘[a] better remedy may be for the directors to try to save it – perhaps by offering one of its principal assets for sale at full value, or by further support from its investors’.10

This serves to highlight another problem with the application of the rule to deprivations effected upon mere insolvency. It has the consequence that the rule may be used by the shareholders of the insolvent company, the insolvent company itself or the transferee of the asset to have the deprivation declared as void. It is

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### Notes

6 Perpetual, n. 2 above, at [72].
9 Fraser v Oystertec, n. 3 above, at [119].
10 Ibid., at [116].
suggested that the rule will therefore be stretched beyond its intended limits and its rationale of protecting the collective basis of the insolvency regime may be of only historical relevance. This is exemplified by the case of *Fraser*, where the Claimants were creditors of the company but claimed in their capacity as minority shareholders by way of derivative action. It is suggested that shareholders have adequate protection under company law legislation without the need to extend the anti-deprivation rule for their benefit.

To the extent that *Whitmore* and *Fraser* accepted that the rule should apply to deprivations which occur upon mere insolvency, it is suggested that they were wrongly decided.

**What about deprivations which occur upon some other event?**

So how should provisions which allow a company to be deprived of an asset upon the happening of an event other than mere insolvency or the commencement of formal insolvency proceedings be treated? There is no doubt that deprivations which occur before insolvency should be valid. Indeed, the Court of Appeal concluded in *Perpetual* that even if the priority flip clause may have amounted to an unlawful deprivation if it had occurred on the insolvency of LBHF, the trigger was LBHI filing for Chapter 11 Bankruptcy and therefore was lawful. The Court of Appeal rejected submissions that given the ubiquitous nature of group company cross-guarantees, it was unrealistic to treat members of the same group as separate entities and therefore LBHI’s insolvency should be treated as having engaged the rule.

In light of the judgment in *Re Polly Peck International plc*, in which the ‘single economic unit’ argument was emphatically rejected, it is hardly surprising that this submission failed to impress the members of the Court of Appeal. Clearly therefore, deprivations which occur upon the insolvency of a company other than that which is being deprived of the asset, will be valid.

In the preceding section, it was suggested that the anti-deprivation rule should only apply to those provisions which occasion a deprivation following the commencement of formal insolvency proceedings. On this basis, provisions which purport to deprive the company of an asset while it is insolvent but before it becomes subject to formal insolvency proceedings, whether due to its insolvency or on the happening of some other event, will be valid subject to the provisions of the insolvency legislation.

So what is the position when the deprivation trigger occurs after the company enters formal insolvency proceedings? If the courts hold that the rule does not apply to such deprivations, the rule will be easily circumvented by parties providing for deprivations to occur on a whole host of other events. In *Ex p Newitt*, a landowner who had granted a builder possession of his land had agreed with the builder that the landowner had the right to re-take possession and to forfeit any of the builder’s chattels which were on the land ‘as and for liquidated damages’ in the event that the agreement was breached. Subsequent to the agreement being made, the builder had been declared bankrupt. In that case, James LJ in holding the forfeiture valid, declared that the court has ‘no power to add to the Act for the purposes of making this security for the performance of the contract, which was bona fide taken by the landlord, bad by reason of the bankruptcy of the builder’. This can be contrasted with the case of *Ex p Jay*, which involved almost identical factual matrix except for the fact that the forfeiture of the chattels was expressed to be conditional on the bankruptcy of the builder, the builder was not in breach of contract and the right to forfeit was not expressed to be in respect of any money claim. In that case, the court held that the deprivation had infringed the rule and was therefore invalid.

The determination of this point was not necessary in the *Perpetual* appeal, however, the Court of Appeal were of the opinion that such a purported deprivation after the commencement of insolvency proceedings operating on grounds other than insolvency, would be caught by the rule. In particular, Patten LJ expressed the view that ‘[o]nce the Insolvency Act regime has come into effect a contractual provision which seeks to remove property out of the estate and to vest it in a third party cannot override the provisions of the Act’. In support of this position, Patten LJ cites the example of *British Eagle*, where in spite of the fact that the airlines had made no specific provision for the liquidation of one of the member airlines, the arrangement was still held to contravene the anti-deprivation rule because it had the effect of excluding the property of British Eagle from the operation of the insolvency regime. It is suggested that the reasoning of Patten LJ would have benefited from distinguishing the contracting-out rule from the insolvency-deprivation rule. Indeed, it is true to say that the House of Lords in *British Eagle* were concerned with the effect of the IATA regime and not with the fact that the provision was not expressed to take effect upon British Eagle becoming insolvent, however, this is the distinction that can be drawn between the

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12 *Ex parte Newitt, re Garrud* (1880) 16 Ch D 522.
13 Ibid., at page 530.
14 *Perpetual*, n. 2 above, at [163].
anti-deprivation and the contracting-out rule. It is a feature of the latter that the provision purports to apply equally both pre and post-liquidation and therefore, the court will always be concerned with whether the effect of the provision post-liquidation amounts to a contracting out of the insolvency legislation. However, for the purposes of the insolvency-deprivation rule, the event upon which the deprivation takes effect is vital. Newitt would support the view that a deprivation which operates upon the happening of an event other than the insolvency of the transferee may be valid, even if this event occurs post-insolvency.

Although the reasoning of Patten LJ may have been flawed due to his misunderstanding of the distinction between the insolvency-deprivation rule and the contracting-out rule, it is suggested that his conclusion that a purported deprivation after the commencement of insolvency proceedings operating on grounds other than insolvency, would be caught by the rule, was fundamentally correct. Given that the rationale of the insolvency-deprivation rule is based upon the principle of collectivity, from a policy point of view, to allow post-insolvency deprivations upon the happening of an event other than insolvency, would undermine the rule. It is suggested that the only authority for the validity of post-insolvency deprivations, Newitt, was wrongly decided. To allow a deprivation of property in which the landowner previously had no interest due to default on the part of the builder, which coincided with the builder’s bankruptcy means that the rule can easily be subverted. Default will always be a likely consequence of a company becoming insolvent and entering into formal insolvency proceedings and allowing deprivations to occur as and for liquidated damages would provide an easy way to circumvent the rule. In a case such a Newitt, the landowner should have to prove in the liquidation in the normal manner.

What constitutes a deprivation?

This was the major issue in the Perpetual appeal and the issue seems no clearer for the court’s judgment in that case. So how can a deprivation be defined? Peter Smith J, the judge in the Butters case at first instance, believed that the scope of rule could be defined by assessing the economic impact of the transaction upon the estate. Potentially this could mean that any contractual provision which takes effect upon insolvency and leads to a diminution in value of the estate, however small, could be caught by the rule and would therefore be invalid. Indeed, as is discussed below, where the asset of which the insolvent is deprived has no value, or where the insolvent estate is adequately compensated for the removal of the asset from the estate, there will be a deprivation, but that deprivation will be valid. It is clear therefore that in some circumstances, the economic impact of the provision can be conclusive as to the validity of the deprivation, but not as to whether a deprivation has occurred. As Patten LJ pointed out in Perpetual, it is well established in the case law that the forfeiture of a lease or licence upon insolvency is valid, and this could clearly involve a diminution in the value of the estate. On this basis, it is suggested that the Court of Appeal were correct to reject the application of a purely economic test to define a deprivation.

Some arrangements are not problematic and clearly constitute invalid deprivations. Examples of these can be seen in cases such as Ex parte Mackay, re Jevons; where the arrangement purports to deprive the insolvent of an asset which he already owns upon the happening of an insolvency event.

Similarly, there are arrangements which do effect a deprivation of the insolvent’s property, however this deprivation will be valid. In Money Markets, Neuberger J, as he then was, noted that cases where the right or property that is subject to the deprivation provision, has no value, is incapable of assignment, or depends on the character or status of the owner, all constitute examples of where public policy considerations may mean that deprivation provisions would be upheld. In these situations, it is clear that there is no rationale for the application of the rule. Another scenario in which it seems clear that the rule has no application is where fair value is given for the asset of which the insolvent is deprived.

In Perpetual, the Master of the Rolls partly based his reasoning as to why the priority flip provision did not engage the rule, on the fact that the third party who stood to benefit from the flip in priority, that is the note-holders, had themselves provided the money for the collateral, over which the security was taken. Authority for the proposition that ‘the rule may have no application to the extent that the person in whose favour the deprivation of the assets takes effect can show that the asset, or the insolvent person’s interest in the asset, was acquired with his money’ was said by the Master of the Rolls to be the case of Whitmore. This did not form the ratio of this case and was therefore obiter. The fact that a third party has provided the purchase money for the asset does not in itself prevent ownership in the newly acquired asset becoming vested in the company which

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15 (1873) LR 9 Ch App 643.
17 [1901] 1 Ch 279.
18 Perpetual, n. 2 above, at [64].
later descends into insolvency. The third party could easily protect itself by taking security over the asset, or by other means and therefore there seems no reason to extend the rule in this way. Allowing a deprivation in favour of a third party who has provided the purchase money for an asset, would effectively elevate the third party to the status of a secured creditor. Interestingly, Patten LJ who gave the other full judgment in the Court of Appeal, did not base his reasoning on this argument, but based it on the narrower ground that the reversal of priority could not be caught by the rule because it was an original feature of the charge and did not amount to a disposition of any property of the company.

A major difficulty arises where the insolvent receives and only ever holds the asset subject to the deprivation provision. It seems absolutely beyond doubt that a forfeiture provision in a lease or licence, which takes effect upon the insolvency of the lessee or tenant, is valid. Authority for the validity of a provision for determination of a lease in the event of the tenant’s bankruptcy can be traced back as far as 1787.\(^\text{19}\) Indeed, s. 145 of the Law of Property Act 1925 recognises the validity of such a provision.

Other arrangements however, have been held to be void. There are plenty of examples in the case law where the insolvent receives and only ever holds assets subject to the deprivation provision, and that provision has been held to be void. In Whitmore, for example, it was clear that the partnership deed had always contained the provision which excluded the mining lease from the market valuation and therefore the bankrupt’s interest in the partnership had always been subject to this exclusion. Page Wood V-C held that insofar as it infringed the rule.

In Perpetual, the Master of the Rolls explained that

‘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 with its terms, by the third party who had granted it to the party who has become insolvent’.\(^\text{20}\)

In the former case, there is a transfer of an absolute interest subject to a condition subsequent, that the asset will re vest upon the company’s insolvency. Indeed this type of provision will be void not only because it offends against the anti-deprivation rule, but will be rejected for repugnancy, due to the severance of the right of alienation being inconsistent with the outright transfer of ownership. In the case of a provision which merely brings to an end a limited interest in an asset however, the asset is at no point the outright property of the company and the interest is merely determinable upon the company’s insolvency. This distinction is a very fine one. It has been suggested that the difference may be as slight as the use of the word ‘until’ to create a determinable interest, as opposed to ‘but if’ which may create a conditional interest. If this is so, the insolvency-deprivation rule can easily be avoided where an asset is transferred to the company on terms which use the ‘until’ formulation. If this distinction is based on form rather than substance, more sophisticated parties would be able to validly circumvent the rule, whereas the less sophisticated or well advised parties may still be caught by the rule if they use the wrong form of words. It is a distinction which has been applied in other areas of the law but seems particularly arbitrary in the current context. Rightly so, it has been described as ‘nothing short of disgraceful to our jurisprudence’ considering that it is applied to ‘a rule professedly founded on considerations of public policy’.\(^\text{21}\)

In Money Markets, Neuberger J discusses an exception to the rule that a deprivation effected upon insolvency is invalid, which suggests a different distinction. He states that a deprivation may be valid

‘where the asset is inherently determinable or where there is some sort of superior reversionary interest and the terms under which the asset was created or granted include a provision for its determination in the event of insolvency, or indeed, on the happening of any other event’.\(^\text{22}\)

This suggests that the nature of the asset itself is important as well as the form of the words used in the deprivation provision. Perhaps the most obvious assets which are capable of falling into this category of assets which are inherently determinable, or subject to some sort of superior reversionary interest, are leases and licences. Other assets such as shares or patents for example are clearly not either inherently determinable or subject to a superior reversionary interest. This perhaps goes some way to explaining the seemingly special treatment which has historically been accorded to leases and licences. It also seems less arbitrary than a distinction solely based upon the form of words used, given that it seems to restrict the type of assets which can be subject to a deprivation provision to those that are by necessity ‘determinable’ or capable of reversion. Still, the wording of Neuberger’s formulation is vague and in that respect it is unsatisfactory.

\(^{19}\) Roe. d. Hunter v Galliers (1787) 2 TR 133.\

\(^{20}\) Perpetual, n. 2 above, at [83].\

\(^{21}\) Re King’s Trust (1892) 29 L.R. Ir 401, per Porter M.R. at 410.\

\(^{22}\) Money Markets, n. 16 above, at [37].
Worthington has suggested a different distinction, which she argues avoids the arbitrariness of that between determinable and conditional interests. Although her suggested distinction has not been expressly mentioned in any of the case law, she argues that the outcomes of those cases support her suggestion. Worthington’s suggestion is that

‘If the proprietary interest in question can only and must necessarily be defined in a time-limited way, then it is legitimate to define the time limitation in any way the parties choose, including by reference to the insolvency of the interest-holder’.

According to this distinction, because leases and licences are necessarily time-limited, it would be legitimate to allow them to determine upon the insolvency of the tenant or licensee. Other property such as rights over shares, patents, debts or royalties are not necessarily time limited. Ultimately, this may amount to exactly the same distinction as that suggested by Neuberger J in Money Markets, with Worthington perhaps putting a little more flesh on the bones of the formulation in that case. In any event, this suggestion seems eminently sensible and it is one which the Supreme Court should consider at length if they are faced with elements of the appeal in Perpetual. It would preserve the validity of the forfeiture of leases and licences, while giving the anti-deprivation rule the widest possible application.

In light of this discussion on what constitutes a deprivation, it is interesting to examine briefly whether the Perpetual appeal involved a deprivation and if it did, whether that deprivation was caught by the rule or whether it constituted one of the valid exceptions. Although the members of the Court of Appeal expressed their opinions on both of these questions, they were of secondary importance given the fact that the court held that the rule would not apply in any event because the trigger was LBHI filing for Chapter 11, and not LBSF’s own insolvency.

Interestingly, Patten LJ placed considerable emphasis on the fact that the provision which purported to effect the flip in priority, was an original feature of the contract and the security was always subject to it. He reasoned that the asset in question was the security interest and the priority was merely a ‘facet’ of that security. Patten LJ thus reasoned that

‘to say that its operation in the event of the company’s bankruptcy constitutes removal of an asset from the liquidation is to confuse the security itself with the operation of its terms in the events prescribed by the charge. LBSF retains the same asset as it had before its bankruptcy’.

However, it seems that Patten LJ rather missed the point in that surely the priority itself was an asset within the meaning of s. 436 IA 1986. There is no doubt that the priority has commercial value and at the very least, it was ‘incidental to…property’ and therefore came within the definition in that section. Indeed, the Master of the Rolls in that case seems to have recognised this point, stating that ‘the right to recoup money under a change in priority is every bit as much of an asset as the right to monies (in the form of royalties) arising in the future’, as was the case in Ex p Mackay. Looked at this way, it seems a deprivation did occur.

The question can be put as to whether the priority enjoyed by LBSF in the Perpetual appeal, which was clearly always subject to the flip provision, was more akin to a conditional or a determinable interest. The Master of the Rolls in that case was of the opinion that ‘[w]hile not identical to a lease or licence, a charge, or provision for priorities for repayment, has features of similarity to a lease or licence, and differs from ownership’. The question in effect is whether the priority which was enjoyed by LBSF was an interest which determined upon the happening of the relevant event of default, or whether it was retransferred to the Trustee in favour of the noteholders. Conceptually, it is possible to argue that either was the case. Perhaps this case clearly illustrates that the distinction between conditional and determinable interests is not only arbitrary, but difficult to apply to more complicated commercial transactions.

If one then turns to the formulation of Neuberger J in Money Markets and the suggestion of Worthington and applies them to the facts of Perpetual, it seems that had the deprivation occurred upon LBSF entering formal insolvency proceedings, the deprivation would have been caught by the rule and consequently would have been invalid. This is so because neither the charge, nor the priority (if that is taken to be the relevant asset), is either ‘inherently determinable’ or subject to a superior reversionary interest, nor are they necessarily defined in a time limited way.

Ultimately, it will be for the Supreme Court to determine the nature and scope of the anti-deprivation rule in the law of English insolvency if elements of the Perpetual appeal come before it in the early part of 2011. At the moment, the law in this area is in confusion with much of the case law being seemingly contradictory. If the Supreme Court is unable to clarify the rule, it may be that Parliament will have to step in and legislate in order to provide certainty.

Notes

24 Perpetual, n. 2 above, at 135.
25 Ibid., at [67].
26 Ibid., at [64].
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