According to Chitty, there are a number of norms of the English law of contract that may be regarded as ‘principles’, but there are two principles which remain of fundamental importance: the principles of the binding force of contract, and freedom of contract. This article is concerned with the latter, which has historically been regarded as an end in itself, finding philosophical justification in the “will theory” of contract and economic justification in laissez-faire capitalism. The theory was embraced by the courts and expressed unequivocally in the second half of the nineteenth century: "if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by courts of justice". Parties were considered to be the best judges of their own interests, and should they freely enter into a contract, then the sole function of the courts would be to enforce it.

In the modern world, the principle of freedom of contract is subject to many qualifications. Rules relating to, for example, refusal to enter contracts, the law of discrimination and restricted freedom as to terms, have led parties to critique the traditional theory and to conclude ultimately that “the rigid conception of freedom of contract is highly unrealistic”. Patrick Atiyah documented the rise to prominence of freedom of contract as a social, political and legal ideal in his seminal work, *The Rise and Fall of Freedom of Contract*. Atiyah pitches the high point of the theory at around 1870, and then follows its gradual decline over a hundred years: "Freedom of choice was whittled down in many directions, government regulation replaced free contract,… and paternalism once again was the order of the day".

Insolvency law necessitates the imposition of statutory rules and procedures, and therefore involves from conception an interference with the freedom of parties to contract. This article will look at some recent cases involving contractual interpretation in the English courts, before considering developments in insolvency law which also have major implications in the arena of freedom of contract.

**CONTRACTUAL INTERPRETATION – A MOVE AWAY FROM LITERALISM**

In terms of contractual interpretation generally, there is a perception that the English courts are moving away from literalism and placing increased emphasis on commercial context. In *Re Sigma Finance Corp* [2009] UKSC 2, receivers sought the Supreme Court’s guidance on how to pay off the secured creditors. Reversing the Court of Appeal’s decision, four of five Supreme Court Justices said that they preferred a “business common sense” approach to contractual interpretation, rather than a “detailed semantic analysis”. In summing up the essence of the

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2. *Printing and Numerical Registering Co v Sampson* (1875) L.R. 19 Eq. 462, per Jessel M.R.
judgment, Lord Collins stated that "the instrument must be interpreted as a whole in the light of the commercial intention which may be inferred from the face of the instrument and from the nature of the debtor’s business".

The court therefore appeared to adopt a merits-based approach – preferring the more commercially sensible interpretation to the literal one. This is, no doubt, an interference with the principle of freedom of contract in its strictest sense. In his dissenting judgment, Lord Walker was of the opinion that "it is not for the court to make a new contract for experienced commercial operators advised by expert lawyers".

The Supreme Court judgment in *Rainy Sky SA v Kookmin Bank* [2011] 1 W.L.R. 2900 has more recently confirmed the courts’ approach. It was held that the ultimate aim of interpreting a provision (especially) in a commercial contract is to determine what the parties mean by the language used. This involves ascertaining what a reasonable person would have understood the parties to have meant (the relevant ‘reasonable person’ being someone with all the background knowledge reasonably available to the parties at the time of the contract). The court will have regard to all relevant surrounding circumstances and where there are two possible constructions the court will be entitled to prefer the construction consistent with business common sense. It is not necessary for a particular construction to have an absurd or irrational effect before the court can have regard to the commercial purpose of the agreement.

*Rainy Sky* supported and expanded on the conclusions drawn by the Court of Appeal in *HHY Luxembourg Sarl v Barclays Bank Plc* [2010] EWCA Civ 1248. In this case, the court considered two conflicting interpretations of a clause in an inter-creditor agreement. The clause concerned the ability of a security trustee to transfer the liabilities of the lenders and to release the security and guarantees given by various members of the group. The Respondents argued that the wording of the clause permitted the security trustee to release (from security or liabilities) only the very entity whose shares were being sold (either the Obligor or the Obligor’s Holding Company). The Appellants argued that the wording permitted release of an Obligor where either the shares of the Obligor itself or the shares of the Obligor’s Holding Company were being sold.

The court looked beyond the plain “natural meaning of the words” and past the idea that had the parties wanted to include the concept of a sale of subsidiaries’ assets then it would have been easy enough for them to do so expressly. It was held that “when alternative constructions are available one has to consider which is the more commercially sensible”.

The trend in these cases demonstrates that where there are conflicting interpretations of a clause, the courts will be willing to uphold the less literal interpretation if it accords with the purpose of the agreement, the knowledge of the parties and commercial sensibilities. The apparent conclusion to be drawn is that the deterioration of the principle of freedom of contract is an ongoing process.

**FREEDOM OF CONTRACT AND INSOLVENCY LAW**

In analysing the role of freedom of contract within insolvency law, it is helpful to draw comparisons between English law and United States bankruptcy law. Chapter 11 of the United States Bankruptcy Code concerns reorganisation proceedings in the United States, and can usefully be compared with the administration regime governed by the Insolvency Act 1986.

The principal goal of Chapter 11 of the United States Bankruptcy Code is to reorganise the business of a company in financial distress, in order to allow it to emerge from Chapter 11 as a going concern, or for the business to be sold as a going concern to realise value for its creditors. Similarly, the primary objective of administration is the rescue of the company as a going concern. Only if the administrator thinks that this objective is not reasonably practicable
may he proceed to the second or third objectives. These are: achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up, and (if the second objective is not reasonably practicable) realising property to make a distribution to one or more secured or preferential creditors.

CHAPTER 11

Chapter 11 can be commenced by any eligible debtor who proceeds in good faith, files a petition at court and pays the filing fee. There is no requirement for the debtor to be insolvent, on either a cash-flow or a balance sheet basis. The filing of a Chapter 11 petition immediately triggers an automatic stay and creates the Chapter 11 estate. An involuntary Chapter 11 may be filed by creditors against any debtor that would be eligible to file a voluntary case that is not paying its debts, other than farmers, railways and not-for-profit corporations. Generally, at least three creditors holding in aggregate unsecured claims of US$14,425 that are not contingent as to liability or in dispute as to liability or amount, must execute the involuntary petition. If contested, the court may not order relief unless the debtor is generally not paying its debts as they become due (such debts not to be the subject of a bona fide dispute as to liability or amount).

The automatic stay is broad in scope and applies to almost all types of creditor actions against the debtor or the property of its estate. It prevents the commencement or continuation of any judicial or administrative proceeding or other action that was or could have been filed pre-petition against the debtor. Other principal features of the stay include the prevention of the enforcement of judgments, any acts to obtain possession of or to exercise control over property of the estate, and acts to create, perfect or enforce any lien against property of the debtor.

ADMINISTRATION

There are two routes into administration. The first is by court order, made in an open hearing, upon a formal application to court. The court will make an order if satisfied that the company is or is likely to become unable to pay its debts, and if an administration order is reasonably likely to achieve the purpose of administration. The second route involves the filing at court of a prescribed series of documents, but this can only be achieved by the company itself, its directors or the holder of a qualifying floating charge over the whole or substantially the whole of the company’s assets.

An interim moratorium comes into force on the date when an application is made for the appointment of an administrator or when notice of the intention to appoint an administrator is filed. Once the company goes into administration, the moratorium is made final. The moratorium provides that no legal process may be instituted or continued against the company or its property without the consent of the administrator or the permission of the court. Similarly, there is a moratorium on the enforcement of security and the repossession of goods.

CONTRACTUAL RIGHTS DURING INSOLVENCY

An important distinction between the administration regime and Chapter 11 cases was established in Re Olympia & York Canary Wharf Limited [1993] BCC 154. In this case it was held that the moratorium on "other proceedings… execution… or other legal process" under section 11(3)(d) of the Insolvency Act 1986 did not extend to "the taking of non-judicial steps such as the service of a contractual notice". This means that parties may terminate contracts with the debtor during its administration. The Enterprise Act 2002 has now altered the wording of the moratorium on legal processes (now found in para 43, Schedule B1 of the Insolvency Act 1986) but it is not believed that
the change was intended to alter the position as established in _Re Olympia._ By contrast, in the United States the automatic stay serves as a ban on contract termination provisions that have been triggered by the stay. This difference in the legal positions has been recently demonstrated in case law emerging from the financial collapse of Lehman Brothers Holdings Inc., the global financial services firm.

In _Lehman Brothers Financing Inc. v BNY Corporate Trustee Services Limited_ 422 B.R. 407 (Bankr. S.D.N.Y. 2011) the United States Bankruptcy Court ruled that subordination provisions contained in the documentation of a Lehman synthetic CDO were unenforceable as _ipso facto_ clauses that are void under the United States Bankruptcy Code. An _ipso facto_ (“by the fact itself”, i.e. of insolvency proceedings) clause is a standard clause providing for default and termination of an agreement due to a company's bankruptcy. The contested provision in the case was a ‘flip clause’ that provided that the rights of noteholders would take priority to Lehman Brothers Special Financing (“LBSF”) if LBSF defaulted under its swap agreement with the SPV that had issued the notes. Section 365(e) of the US Bankruptcy Code states that:

“... an executory contract… may not be terminated or modified, and any right or obligation under such contract… may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such contract… that is conditioned on… the commencement of a case under this title...”

The transaction documents were held to be executory contracts and therefore section 365 was applicable. The flip clause constituted an unenforceable _ipso facto_ provision. The court further held that any attempt to enforce such provisions would violate the automatic stay under section 362(a)(3) of the Bankruptcy Code, which operates to prevent “any act to obtain possession of property of the estate or to exercise control over the estate”. LBSF held a valuable property interest in the transaction documents as at the date that LBSF had filed a petition at court and commenced Chapter 11. This interest was therefore entitled to protection as part of the bankruptcy estate.

The reasoning in _BNY_ was relied on in the later case of _Lehman Brothers Special Financing Inc. v Ballyrock ABS-CDO 2007-1 Limited_ No. 09-10132 (JMP) (Bankr. S.D.N.Y. May 12, 2011). This case reinforced the impermissibility of _ipso facto_ clauses, holding that the default provisions of the contracts in question were unenforceable because they effectively eliminated the right to receive a termination payment due to the commencement of the LBSF bankruptcy. The position in the United States is quite clear: where contractual provisions hinge on the insolvency of one party, they will be invalid under the Bankruptcy Code.

The ruling in _BNY_ contradicted the earlier ruling in the corresponding English litigation, which has now been confirmed in _Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services_ [2011] UKSC 38. Although there is no direct _ipso facto_ equivalent in the UK, the courts considered the priority of payments and the subordination provisions in light of the anti-deprivation principle. The anti-deprivation rule is that “no person possessed of property can reserve that property to himself until he shall become bankrupt, and then provide that, in the event of his becoming bankrupt, it shall pass to another and not his creditors”. The premise of the principle is simple: it provides that parties cannot, on bankruptcy, deprive the bankrupt of property that would otherwise be available for the creditors.

The judgment in _Belmont_ contains a lengthy analysis of the anti-deprivation principle and the historical body of case law (dating back to the eighteenth century) supporting it. It was held that for the anti-deprivation rule to apply, there must have been a deliberate intention to evade insolvency law. Commercial sense was also established

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6 _Whitmore v Mason_ (1861) 2 J & H 204, 212 per Sir William Page Wood V-C.
to be a “highly relevant factor”. Most significant for our purposes, however, is that the judgment framed the application of the principle within the context of insolvency legislation and its encroachment into the arena of freedom of contract:

"Despite statutory inroads, party autonomy is at the heart of English commercial law… And there is a particularly strong case for autonomy in cases of complex financial instruments such as those involved in this appeal."

The court stressed that “the answer is to be found in the fact that this was a complex commercial transaction entered into in good faith”. The subordination provisions were held to be valid and enforceable.

The contradictory outcomes of BNY and Belmont are surprising in light of the fact that they stem from two jurisdictions with insolvency regimes that purport to have the same objective – the rescue of companies in financial difficulties. Both the ipso facto rule and the anti-deprivation principle supposedly exist in order to protect the value of the estate of the bankrupt party against unjust extraction. However, application of the ipso facto rule in the United States has resulted in interference with contractual rights. In England, the anti-deprivation rule has been construed particularly narrowly, subject to good faith and commercial sense. This difference in approach between the jurisdictions serves to highlight a defining characteristic of English law – the continuing importance of freedom of contract. The statutory rules governing insolvency must necessarily interfere with that principle but, in the UK at least, at a relatively late stage.

The case of Lomas v JFB Firth Rixson Inc [2010] EWCH 3372 (Ch) concerned interest rate swaps governed by the ISDA 1992 Master Agreement. Each party’s obligation to make payments to the other party was subject to the condition precedent that the other party was not in default (insolvency constituting an event of default) by virtue of section 2(a)(iii) of the agreement. The Court of Appeal found that the anti-deprivation principle was not engaged; the indefinite suspension of the payment obligation of the non-defaulting party might be criticised as imperfect but, following Belmont, it could not be said to be uncommercial. Lord Justice Longmore stated that he could see no reason why the law should preclude two commercial parties from negotiating such a clause: “It is a prudent limitation on the duration and operation of the contract”.

Meanwhile in the United States, the case of Lehman Brothers Special Financing Inc. v Metavante Corporation, No. 08-13555 (JMP) (Bankr. SDNY Sept. 15 2009) had reached the opposite conclusion. Peck J ruled that section 365(e) of the Bankruptcy Code prohibited a non-insolvent party from relying on a condition precedent (such as section 2(a)(iii) of the ISDA Master Agreement) in order to withhold payments indefinitely.

In these two cases we can see the very same provision of the ISDA Master Agreement, upheld in Firth Rixson and declared prohibited in Metavante. It has been said that “the UK has positively set its face against the broader approach to creditor protection favoured in US bankruptcy legislation,” and the administration regime has come under much criticism for failing to achieve its primary purpose of facilitating the rescue of companies. It has been noted that a key requirement for a successful restructuring under administration is contractual stability, and “ironically, the administration step which starts the restructuring process is the very step that destabilises the company’s contracts”.

7 Sarah Worthington, Good Faith, Flawed Assets and the Emasculation of the UK Anti-Deprivation Rule, (2012) 75(1) MLR, 78-121.
The UK is traditionally regarded as a more creditor-friendly jurisdiction than the United States. However, in considering the recent developments in insolvency law, it becomes apparent that the approach of the courts has truly been informed by a respect for the fundamental principle of freedom of contract. To this end, the courts have followed Parliament. During the Standing Committee stage of the Enterprise Act 2002, an amendment was proposed to effect the suspension of *ipso facto* clauses in administration. In rejecting the amendment, the Minister stated that “a keystone of jurisprudence north and south of the border is freedom of contract and that is the fundamental difficulty with the amendment”. There is an overriding reluctance to encroach upon parties’ rights to contract freely on such terms as they see fit, in spite of the existing interferences that are an inescapable aspect of any statutory insolvency or restructuring regime.

CONCLUSION

What emerges from the case law is an apparent and significant divergence in the approach of the UK courts to freedom of contract. Where general commercial contractual interpretation is concerned, there is a marked trend away from the literal interpretation associated with freedom of contract, and toward the consideration of commercial sense and other external factors: the purpose of the instrument when regarded in its entirety and the intentions and knowledge of the parties. Where there is an alleged conflict between contractual provisions and elements of insolvency law, however, the courts have proved more willing to honour the contract as freely entered into by the parties involved. This willingness stands in stark contrast to the approach adopted in the United States, where the Bankruptcy Court has declared invalid the very same contractual provisions that the English courts have upheld. It is clear that in the UK judgments relating to the anti-deprivation rule have been informed largely by the prevailing importance of the fundamental principle of freedom of contract while the US continues to focus on the policy objectives of the Chapter 11 process to the detriment of the parties’ rights to secure their own outcome through the contract.