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Statutory Rules, Common Law Rules and Public Policy in the Global Financial Crisis

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INTRODUCTION

The failure of Lehman Brothers is now old news, although it will be a considerable time before the underlying legal issues are fully unravelled. The scale of the task involved in unwinding its affairs is unprecedented. This insolvency is by far the largest insolvency in history: in pure financial terms, Lehman Brothers is estimated to be more than six times the size of Worldcom, which was previously considered the largest corporate insolvency ever.

This article uses the factual and legal background of this complex liquidation as the focus for an examination of the role of public policy in these testing situations, and also for a more general assessment of the legitimate limits to the use of public policy arguments by courts wishing to preserve the reputation of the UK’s commercial laws as “fit for purpose” in the current global economy.

In the Lehman Brothers’ insolvency litigation to date, at least in the UK (and this article restricts itself to the UK jurisdiction), some public policy inputs have passed without comment while others have attracted a
great deal of debate. There appears to be no middle ground. Where there has been debate, its ferocity is perhaps unexpected: the rules in play are not new; they are tried and tested national insolvency rules. However the scale of this liquidation makes a difference. It ensures that the legal arguments in play are important not only for the immediate practical task of administering the estate, but also for the future reputation and international competitiveness of the UK's national insolvency regime.

Public policy arises in different guises. It clearly has a role to play in the formulation of national statutory insolvency rules. It is also evident in the historical development of all the common law and statutory property rules which play such a crucial role in insolvency outcomes. And, finally, it is the explicit justification for an insolvency-specific overarching common law rule—the anti-deprivation rule—that effectively puts a higher public value on collective management of the insolvent's estate than on freedom of contract and party autonomy, at least once the debtor is insolvent. Each of these arenas for public policy engagement is discussed here. The degree of controversy surrounding each is quite different. Broadly speaking, it is accepted that parliament has a right to legislate, even if its efforts attract strong criticism. Judicial lawmaking is seen as quite another matter, however. There is, it seems, a fine and not universally agreed line between the proper adjudication of novel issues and the improper assumption of power to engage in judicial lawmaking. This article describes the role of public policy in each of these various arenas, concentrating on the more controversial end—the limits of judicial intervention on the grounds of public policy.

**Statutory Rules and Public Policy**

Every statute reflects a particular public policy stance. The UK's statutory insolvency rules are no different. Their objective is to provide a system of rules that determines how innocent parties should be treated when the resources of the insolvent debtor are insufficient to give everyone what they expected. In the UK, as in most developed economies, the baseline legal rule is pari passu—the pain will be shared equally—with the significant exception that pari passu applies only to the debtor's assets.

The first step in the management of any insolvency distribution, therefore, is to remove from the insolvency pool all those assets that are subject to proprietary claims by third parties. The consequence of this rule—at least as we are commonly minded to think of it—is that proprietary claims and personal claims are distinguished, as are the creditors asserting them. Different countries have different criteria for
what counts as the third parties' property; in the UK many of those rules are common law and equitable rules. These are considered later.

The second step is to distribute what remains according to the rules set out in the relevant insolvency legislation. Again, different countries have different national policies in respect of the insolvency distributions of the pool that is left.

Parliament has varied these two basic principles only slightly. A summary here does injustice to the detailed rules, but serves to highlight the public policy considerations in play. First, parliament has constrained the privileges of proprietary claimants in two respects: in certain circumstances the proprietary status of claims will not be recognised unless the claim is “perfected” by registration, or public notice is given to those who may be adversely affected by the proprietary claim.1 Secondly, some proprietary interests, even if registered, will not accrue solely for the benefit of the interest holder, but the benefits associated with them will be shared, according to different legislative formulae, either with certain nominated preferred personal claimants,2 or even with the ordinary general unsecured creditors.3 In short, parliament has seen the wisdom of ameliorating the impact of proprietary attributes, so that holders of proprietary interests have their rights qualified in certain respects if the defendant is insolvent. Put another way, the orthodox doctrinal attributes of proprietary interests are forced to give way in the face of the compelling policy concerns that arise in insolvency.

Secondly, even in dealing with the personal claimants, parliament has seen fit to vary slightly the pari passu—“equality is equity”—distribution rules. Personal claimants are categorised as “preferred,” “ordinary” and “deferred” creditors.4 The pool of assets available to pay personal claimants is used first to pay all the preferred creditors, in full if possible, but otherwise pari passu. If there are funds remaining, then the ordinary creditors are paid, again in full if possible but otherwise pari passu. If there is anything left (and there rarely is), then the deferred creditors share pari passu.

These rules are well known, and the point here is not to describe yet again their familiar details, but to reiterate the idea that insolvency law is

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1. For example, the requirement to register certain charges. These registration requirements only apply to legal securities (and, within that class, only mortgages and charges, not common law liens and pledges, where the protection is delivered by registration is not seen as necessary since the security holder has possession of the secured asset.) These registration rules do not apply to practical security devices, such as retention of title clauses and Quistclose trusts. Companies Act, 2006, §§ 860, 861.
3. Id. § 176A.
4. Id. §§ 115, 156, 175, 189, 178, 74 and Schedule 6.
largely a matter of policy. In the contest between innocent parties, and
the difficult determination of who will win and who will lose, parliament
has felt it necessary to intervene for better policy ends. Other regimes
are possible—that is obvious from an examination of the different
approaches adopted internationally. Indeed, other priorities might well
be fairer, but parliament has set out the rules for the time being, and they
determine the allocation of losses between innocent parties to the
debtor's insolvency.

Quite predictably, this particular public policy element is never
questioned in court. There would be no point. The task facing the court
is to apply the existing law, not determine what improvements
parliament might have made.

PROPERTY RULES AND PUBLIC POLICY

Before these accepted statutory insolvency distribution rules can be
applied, there is a preliminary step. Creditors can only be paid out of the
debtor's assets; assets belonging to third parties must be returned to them
before the pool is disbursed. In the Lehman Brothers' liquidation, this
first task—determining which assets comprise the insolvent's own estate,
and which assets need to be excluded as legitimately the subject of
proprietary claims of others—has proved the most complex. The
complexity is exaggerated by the sheer scale of the operation: for
example, the balance sheet for Lehman Brothers International (Europe)
("LBIE") on November 30, 2007, showed debts in excess of $400
billion. But the issues themselves are also complicated: by 2007, the
global financial markets had developed a range of tools that had received
limited testing in the marketplace and even less testing in the courts.

The rules for determining which creditors have proprietary rights
are, by and large, common law and equitable rules, and the arena for
debate over the proper framing of these rules—including public policy
debate—seems far broader. But even a superficial examination of the
cases shows that this debate is usually confined to issues of doctrine and
precedent; it is rarely about principle, and never about public policy.
Perhaps Lord Millett's comments in Foskett v McKeown say it all:6

Property rights are determined by fixed rules and settled principles.
They do not depend upon ideas of what is

5. See Sarah Worthington, Proprietary Remedies and Insolvency Policy: The Need
   for a New Approach, in COMMERCIAL LAW: PERSPECTIVES AND PRACTICE 191-205
   (Lowry, John and Mistelis, Loukas eds., Lexis-Nexis/Butterworths 2006); see Vanessa
   Finch & Sarah Worthington, The Pari Passu Principle and Ranking Restitutionary
"fair, just and reasonable." Such concepts, which in reality mask decisions of legal policy, have no place in the law of property.

Any number of examples might be chosen to illustrate the absence of public policy argument in these cases. The options open to creditors intent on proving they have a proprietary interest in the debtor’s assets are limited: the interest can only be by way of ownership (at law, or in equity via a trust) or security (pledge, legal or equitable mortgage, or charge). Just because the options are limited does not mean that the issues are simple, however. Recall the long run of cases seeking proper interpretation of retention-of-title clauses, or adjudication on the valid creation of trusts, or assessment of whether an arrangement creates a security interest and what form that takes. In all these assessments the contract between the parties is crucial, not the label they use to describe it. Proper characterisation of the agreed rights and obligations is a matter of law, and it is this doctrinal analysis which provides the answer to the creditor’s question, “Do I have a proprietary interest?” Public policy does not emerge, or at least not explicitly.7

This can be seen clearly in Lehman Brothers’ litigation about “client money” and “client assets” in relation to test cases from amongst the thousands of prime brokerage agreements needing to be unwound.8 In the face of Lehman Brothers’ insolvency, the clients’ best argument was that these assets—the client money or client assets (generally securities)—were held by Lehman Brothers or its intermediary on trust for the clients. Assessing the merits of such a claim can be complicated in any event, but it was made even more so in the Lehman Brothers’ insolvency because there are no industry standards for prime brokerage agreements; each must be reviewed separately, and each must be read in the light of FSA (UK Financial Services Authority) rules as set out in the FSA’s Client Assets Sourcebook (“CASS”). In many cases, the outlook for clients is grim. These agreements are typically skewed in favour of the prime brokers so as to assist market activity; and in any event, the collapse of these brokers had always been assumed to be well nigh impossible.

Consider trusts of “client money.” The FSA rules look to be protective. They create a compulsory statutory trust on receipt of the client money, and require prime brokers to hold such money in a segregated account with a bank or a qualifying money market fund. If a

7. It is, of course, impossible to explain the evolution of trusts and securities without conceding some judicial public policy input, including some value judgement about the worth of enforcing the specific contractual or even non-contractual agreements between the parties.
client’s fund placed with the Lehman Brothers intermediary is “Client Money” (as defined under the FSA Client Money Rules), and if it can still be identified (either as a segregated pool or by tracing into non-segregated Lehman Brothers’ accounts), then the monies are prima facie trust funds and are excluded from the insolvent estate. The “ifs” are significant ones.9 The FSA Client Money Rules provide for several important exceptions to the definition of “Client Money,” and the client itself may agree to terms that exclude the notion of a trust of “Client Money.” If the money cannot be classed as Client Money, then it forms part of the debtor’s general estate and the relevant clients will—on these grounds—have only personal claims, not proprietary ones.

“Client assets” (usually securities) are assessed in a similar way. The terms of the prime broker agreement are crucial. At one end of the spectrum, some agreements clearly provide for the client’s retention of legal or beneficial ownership of the securities. At the other end of the spectrum, and less happily, other agreements clearly provide for outright title transfer of client assets to the Lehman Brothers prime broker. In these latter cases the client has no proprietary claim to its original assets, but only a (now not very valuable) contractual right to require Lehman Brothers to account to it for equivalent assets.

Given the explicit terms of these contracts, the conclusions should come as no surprise to the client. But that is not always the case. The terminology of “securities lending,” for example, is apt to suggest that the lender retains its property in the lent securities, and is therefore protected. Often nothing could be further from the truth. Beconwood Securities10 was a test case in the Australian Opes Prime collapse. There the securities “loan” was on terms that “all right, title and interest in [the securities] will pass absolutely from one Party to the other, free from all liens, charges, equities and encumbrances, on delivery or redelivery of the same in accordance with this Agreement.” It was perhaps unsurprising, therefore, that the protective “lending” label was held irrelevant given the explicit agreement for an outright transfer.

One further issue merits comment. Sometimes neither statute nor contract suggests that the client has a proprietary claim, but nevertheless

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9. Re Lehman Bros. Int’l (Europe) (in admin.), (2010) E.W.C.A. Civ. 917 (noting that client money became subjected to the statutory trust on receipt, not on segregation by the prime broker, so traceable monies that should have been segregated but were not were held on the statutory trust, and also noting that the clients entitled to share in the distribution of the client money pool were all those with the relevant claims, not simply those who had contributed to the pool).

the client can identify monies (or other assets) that it has paid over to the broker under the terms of the brokerage agreement. Can the client have “its” original assets back, in effect waiving the Lehman Brothers’ performance obligations in exchange for return of its own initial contractually agreed input? This can sometimes amount to a nice legal question, especially where brokers themselves voluntarily elect to hold client monies (or other assets) in segregated accounts, perhaps to provide alternative protection for a client’s position, but generally there is little chance of success with such claims: see, for example, *Re Goldcorp Exchange (in rec)*\(^{11}\) and a myriad of similar cases arising in different factual contexts, although also see *Re Global Trader Europe Ltd (in liq)*.\(^{12}\)

Even that is not the end of the matter. Two practical questions follow the initial doctrinal analysis that the client has a property right. The first is whether the client’s property can still be identified. If clients cannot point to particular assets as theirs, then no amount of preliminary doctrinal analysis will deliver the benefits of insolvency protection that are being sought. And, secondly, even if clients can point to particular assets as theirs, it is still necessary to ask whether there are any impediments to getting it back. Sometimes there are. Competing claims provide one common example of a legal impediment to recovery.\(^{13}\)

In short, any successful proprietary claim depends upon the identification of particular assets that can legitimately be described as “the client’s,” and not “the broker’s.” It is not enough to show that the broker’s pool of assets has somehow been enhanced by the injection of certain now non-identifiable client assets.\(^{14}\)

Perhaps the public policy input at this stage lies precisely in not interfering, not for example insisting on a mechanism that treats all creditors in precisely the same way. The usual justification for non-interference, even when the outcomes seem unfair, is that it eliminates the risk of tactical use of the insolvency legislation by disaffected creditors. If creditors’ rights are unaltered by insolvency, then there is no incentive to destroy viable businesses by tipping faltering debtors into early and unwarranted insolvency. The rule thus avoids economic waste, however fortuitously advantageous (or otherwise) that prohibition turns out to be for the individual creditors concerned.

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Similar difficult doctrinal and policy issues surround the use of security, yet here too the assessment of whether there is a security interest, and its proper characterisation, all follow a strict doctrinal analysis, eschewing policy input. Yet the policy issues are close to the surface. A debtor cannot simply agree that a particular creditor’s claim will be preferred on the debtor’s insolvency. To do so would clearly offend the policy of equal sharing of losses, or pari passu distribution to creditors. This commitment to equal loss-sharing is so strong that contractual set-off between the debtor and creditor is inoperative on insolvency if it goes beyond the statutory insolvency set-off rules. On the other hand, a debtor is free to agree that his creditor’s claim will be preferred to the extent of some security interest granted to the creditor. The policy that prevents one strategy but allows the other is often seen as controversial.

More generally, security is controversial because it permits powerful creditors to protect themselves in a way that works to the double disadvantage of the remaining unsecured creditors: there is a disproportionately depleted pool of assets remaining for distribution. For example, a floating charge over the whole of the debtor’s assets and undertakings would, if left untrammelled, give the secured creditor absolute priority to the whole of the pool of assets available for distribution on insolvency. On the plus side, of course, it is well recognised that security assists commercial activity; debtors can obtain credit that would not otherwise be available to them, and can do so with a minimum of transaction costs.

The point to note is the stage at which any public policy argument rears its head. The advantages and disadvantages of the creditors’ various possible proprietary interests are consciously weighed in the balance by the legislature, not by the judges—or at least not now, in the C21st; they may have been more interventionist when these proprietary rights were being invented. The judges confine themselves, almost without exception, to applying the statute, or applying common law doctrinal rules to determine questions about creditors’ property interests.

COMMON LAW AND PUBLIC POLICY

With all this downplaying of public policy, it comes as some surprise, therefore, to find what is sometimes (perhaps unfairly) described as a radically different approach in the application of the common law anti-deprivation rule. The rule can be expressed simply; indeed, its C19th formulation remains apt: “there cannot be a valid

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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 be taken away from his creditors.”16 That is the UK version. The US version, the ipso facto rule, is enshrined in statute.17 A contractual arrangement which infringes the rule is void. Avoidance will increase the asset pool available for distribution to the debtor’s general creditors. Conversely, if the rule is not infringed, the agreement will operate according to its terms and deliver the intended insolvency advantage to the nominated party.

The rule has been applied by courts since at least the eighteenth century. On its face it looks uncontentious, yet the line between what is permitted and what is not remains surprisingly unclear. Lord Neuberger made this plain in both Perpetual Trustee and Money Markets.18 The only House of Lords authority is British Eagle.19

For present purposes, the proper workings of the rule are not the central issue.20 The focus here is its reliance on public policy inputs. The common law anti-deprivation rule is routinely justified on the grounds of public policy, empowering the courts to strike down arrangements where parties seek to contract out of,21 or evade,22 or


18. See Perpetual Trustee (CA), supra note 16, ¶¶ 32, 57, 93; and Money Markets, supra note 16, ¶¶ 87, 117.


21. Perpetual Trustee (CA), supra note 16, ¶¶ 50, 54, 73 (citing British Eagle, supra note 16) (both Lords Cross and Morris); Carreras, supra note 16, and Ansett, supra note 16; see also Perpetual Trustee (CA), supra note 16, ¶¶ 113, 118, 123.

22. Mackay, supra note 16, at 647; British Eagle, supra note 16, at 770 (citing Lord Morris (dissenting on the outcome, but not on the principle)).
defeat, or work a fraud on, the insolvency legislation. The modern (and perhaps also the historical) view is that the rule simply prevents parties from contracting out of the insolvency legislation. It targets arrangements which seek to implement either a different distribution of the insolvent’s assets from that which would obtain under the legislative rules, or which seek to reduce the pool of assets available for distribution. In shorthand, these different limbs of the anti-deprivation rule can be labelled “the contracting out rule” and “the insolvency-triggered deprivation rule.”

The global financial crisis has led to a number of corporate collapses: Perpetual Trustee is not the only modern case to raise the anti-deprivation issue, nor is it the most recent. However it is, to date, the only case to have reached the UK court of Appeal, and serves as a working illustration here.

In Perpetual Trustee, the Court of Appeal was asked to strike down a priority flip clause which switched the priority enjoyed over collateral away from a Lehman Brothers credit default swaps counterparty and in favour of third party noteholders (including Perpetual Trustee Co Ltd) in defined circumstances, to the potential detriment of the now insolvent Lehman Brothers counterparty. The administrators argued that the priority flip clause breached the “anti-deprivation rule” and was therefore void on the grounds of public policy. The Court of Appeal found against the administrators and in favour of the third parties, affirming the judgment of Sir Andrew Morritt, the Chancellor, in the High Court.

In the US Bankruptcy Court, Justice Peck applied the analogous US statutory ipso facto rule, perhaps rather more expansively than might have been predicted, and concluded that the priority flip clause offended the rule and was therefore void as a fraud on the creditors. Both cases were due to go on appeal, but Perpetual Trustee has now settled its claims in both jurisdictions.

The legal issues are clearly important,

24. Perpetual Trustee (CA), supra note 16, ¶ 152 (Patten LJ).
25. Id. ¶ 54 (Lord Neuberger).
26. Id.
27. Id.; see also Butters v. BBC Worldwide Ltd., [2009] EWHC 1554. (The court also addressed the treatment of so-called “unwind costs” between these parties, and determined the outcome of a related appeal which raised the anti-deprivation rule.)
29. In the UK Court of Appeal, two Noteholders were pursuing claims, Perpetual Trustee and Belmont. The Perpetual Trustee claims have been settled, but the Belmont claims remain scheduled for appeal to the Supreme Court in March 2011, see The Supreme Court—Case Details, http://www.supremecourt.gov.uk/current-cases/CCCaseDetails/case_2009_0222.html (last visited Jan. 30, 2011).
given the potential application of the same rule to other structured finance and securitisation deals and the value of the assets in dispute.\footnote{In the Lehman Brothers insolvency, billions of dollars are said to ride on the outcome of the anti-deprivation litigation: see, e.g., the Decision and Order of the United States District Court, Southern District of New York, Granting BNY Corporate Trustee Services Limited’s Motion for Leave to Appeal (against the decision of Peck J), handed down on 20 September 2010, copy on file with authors (see p 15).}

In the UK Court of Appeal, in upholding the flip clause, the Master of the Rolls, Lord Neuberger, (with whom Longmore LJ agreed\footnote{Perpetual Trustee (CA), supra note 16, ¶ 99.}) explained his conclusions as follows:

Patten LJ has reached the same conclusion on the simple basis that the “flip,” that is, the reversal of the order of priority against a company as the holder of a charge, in favour of another chargee over the same assets, cannot be caught by the rule, even if it operates after the liquidation of the company, at least if such a reversal was an original feature of the company’s charge when it was granted. I have considerable sympathy with that view, which has the merit of simplicity…. Further, it is fair to say that the principle of party autonomy\footnote{Which Lord Neuberger also favoured as a reason for upholding the contractual provision: see Perpetual Trustee (CA), supra note 16, ¶ 58.}… supports his view.

However, while that view may well indeed be right, I prefer to rest my conclusion in this case on the more limited ground that, in addition to the facts relied on by Patten LJ, the assets over which the charge exists were acquired with money provided by the chargee in whose favour the “flip” operates, and that the “flip” was included merely to ensure, as far as possible, that that chargee is repaid out of those assets all that he provided (together with interest), before the company receives any money from those assets pursuant to its charge. It seems to me that there may be room for argument that, in the absence of these additional facts, the arrangement in this case would have fallen foul of the [anti-deprivation rule]. … There is also a danger that the simple analysis adopted by Patten LJ could, in the light of the very limited circumstances in which the court will hold a transaction to be a sham, make it very easy to dress up sale transactions in such a way as to enable the rule to be circumvented.\footnote{Perpetual Trustee (CA), supra note 16, ¶¶ 66-67. The reasoning is careful, but the analysis is difficult to defend. See supra note 20.}

Not only did the Court of Appeal conclude, unanimously, that the anti-deprivation rule had not been breached; it also expressed hesitation in applying the rule at all\footnote{Id. ¶¶ 171-172. See also id. ¶ 54, 113, 123. Seemingly confining intervention to “contracting out” provisions. But cf. id. ¶¶ 32 et seq., 152 et seq., 91 et seq.} and a concern not to extend its operation any
further.\textsuperscript{35} Equally, in the \textit{Ansett} litigation in Australia, the majority was clearly reluctant to reach a conclusion that might upset the commercially successful and internationally beneficial IATA clearing house scheme.\textsuperscript{36} Other modern cases are similarly cautious.

Certain commentators go further still, suggesting that the rule has no application in a modern insolvency regime: their argument is that the Insolvency Act 1986 ("IA") provides a comprehensive code, and should not be supplemented by the common law or by public policy interventions from judges.

This approach, denying the force of the common law rule, especially because it is based on public policy consideration, seems both flawed and counterproductive. A significant number of judicial precedents support the application of the rule, including \textit{British Eagle}\textsuperscript{37} in the House of Lords. No anti-deprivation case, even the modern ones, has suggested that the rule itself no longer exists; the debate is only ever as to whether the rule applies on the facts. Indeed, the anti-deprivation rule has a long history which was presumably familiar to the framers of the IA 1986 and its predecessors, and was reinforced by the particular statutory approach to protective trusts which implicitly assumes the existence of a common law anti-deprivation rule.\textsuperscript{38} Finally, judicial intervention which simply outlaws contractual evasion of the statutory insolvency distribution regime (and in particular contractual evasion that purports to prefer the contracting parties and effect a deprivation on the non-contracting parties) is surely not especially controversial. \textit{Perpetual Trustee} itself recognised this.\textsuperscript{39}

Yet another line of argument against the common law anti-deprivation rule suggests that contracts should be enforced according to their terms, especially contracts agreed by sophisticated parties with the benefit of legal advice.\textsuperscript{40} This effectively pits one public policy principle against another, and suggests that the principle of freedom of contract and party autonomy should win out against the principle of collective insolvency management. The reasons are not given.

This argument for freedom of contract was advanced in the recent case of \textit{Mayhew},\textsuperscript{41} where a settlement agreement provided that a promised indemnity would terminate if the indemnified party became

\begin{footnotes}
\begin{enumerate}
\item \textsuperscript{35} \textit{Id.} ¶ 57.
\item \textsuperscript{36} See, e.g. \textit{supra} note 16, ¶¶ 76-79. In this respect, the hesitancy also related to the notion that carefully negotiated contractual arrangements between sophisticated parties should be given their full effect.
\item \textsuperscript{37} \textit{Supra} note 16.
\item \textsuperscript{38} The Trustee Act, 1925, c. 19, § 33 (UK).
\item \textsuperscript{39} \textit{Supra} note 16, ¶¶ 32 et. seq, 152 et. seq.
\item \textsuperscript{40} See, e.g., \textit{id.} ¶ 58; see also \textit{id.} ¶¶ 91, 99.
\item \textsuperscript{41} \textit{Mayhew} v. \textit{King} [2010] EWHC 1121.
\end{enumerate}
\end{footnotes}
insolvent. Sir Edward Evans-Lombe refused to accept the supremacy-of-contract argument, responding that, as a matter of policy, such an approach would enable routine avoidance of the anti-deprivation rule in almost every imaginable case; and, as a matter of precedent, the proposition ran contrary to both modern and older authorities.

But even this does not put the case strongly enough. The principle of freedom of contract might justify a pro-party approach to the interpretation of bilateral arrangements. But the same pro-party approach is quite inappropriate when the arrangement affects the rights of non-contracting third parties. However much the contracting parties wish it, a bilateral arrangement cannot deprive innocent third parties of their legitimate statutory rights: freedom of contract cannot trump the collective management rules enshrined in the insolvency legislation—the only freedom that exists is the freedom of contract within the law.

Looking back at all this detail, what conclusions might be extracted about the role of public policy in the collective management of insolvency? On one view, the role of public policy is steadily diminishing. Historically, there must have been substantial public policy intervention from the courts in order to develop all the different proprietary interests that are now so crucial in determining the proper distribution of the insolvent debtor's assets. The development was slow, it is true, so no one case marks out a paradigm shift in legal thinking, but the net result is nonetheless dramatic. And yet the analysis in this domain now appears to be based on strict doctrinal analysis without even a nod to public policy. Equally, but less radically, the judges centuries ago must have developed and refined the common law anti-deprivation rule. It still appears to meet a need, and judges (as distinct from counsel) do not question its existence, although their mood is clearly to limit its modern operation as much as possible. Finally, and by contrast, the statutory insolvency rules are roundly embraced; their clear public policy motivation comes from parliament, however, not the courts.

All of this raises very directly the obvious question—what role should public policy play in modern judicial activity? Is it proper to allow judicial resort to public policy? More fundamentally, is resort to public policy the best—or the worst—way to deliver a modern, effective and globally competitive commercial law regime?

42. A similar argument emerged in the litigation of Spectrum Plus Ltd (In Liquidation), Re [2005] UKHL 41, but there too the House of Lords refused to favour the clear intention of the contracting parties in the face of the disadvantage that would thereby be wreaked on non-contracting creditors seeking their due protection under the IA 1986.

43. See supra note 20.
The debate about whether judges allow their decisions to be influenced by public policy is essentially a debate about judicial lawmaking. At one extreme, judges are conceded to be legitimately making the law; at the other, they merely administer it, and should therefore confine their deliberations to a rigorous doctrinal analysis of the relevant statutes or common law precedents.

Between these two positions, the attitude of the English courts to any explicit engagement with issues of public policy has ebbed and flowed. Outright hostility is not uncommon. Mr. Justice Burrough famously remarked in *Richardson v Mellish* that public policy is a "very unruly horse and when once you get astride it, you never know where it will carry you," adding that an argument founded on public policy "leads you from sound law, and is never argued but when all other points fail." Even in those early days, it seems, the King's Courts understood something of the administrative/legislative power division behind the divine right of kings, the precursor to the more modern principle of parliamentary sovereignty.

And yet it is also conceded that judge-made law is precisely the distinguishing feature of the common law. It is what sets it apart from civil law. Without judicial lawmaking, the common law could not have developed. Beyond public policy it is difficult to imagine what other basis might have guided common law judges in their task. So it is perhaps predictable—indeed more than predictable—that, as well as judicial assertions against the role of public policy, there are often even stronger claims in its favour. In *Egerton v Brownlow*, for example, Lord Chief Baron Pollock described the long history of public policy intervention in this way:

This doctrine of the public good or the public safety, or what is sometimes called "public policy," being the foundation of law, is supported by decisions in every branch of the law; and an unlimited number of cases may be cited as directly and distinctly deciding upon contracts and covenants as the avowed broad ground of the public good and on that alone; and the name and authority of nearly all the great lawyers (whose decisions and opinions have been extensively reported) will be found associated with this doctrine in some shape or

45. Anthony Lester, *English Judges as Law Makers*, 1993 PUB. L. 269, 270 (1993) (traces this perspective back to the King's Court and concludes that "a monarchical view continues to shape the modern British constitution. The divine right of kings has been replaced by the divine right of the Crown in Parliament.")
other. It is distinctly laid down by Coke (66 a), "nihil quod est inconveniens est licitum."

Both the pro- and anti-public policy camps must inevitably come together on some matters. At the least controversial end of the scale, both camps will generally concede that there is necessary and inevitable judicial resort to public policy whenever courts are required to apply notional "public standards" in legal tests of "reasonableness," or "unconscionability," or "good faith," or "arbitrariness." In all these determinations, individual views will frequently differ, and judges cannot be allowed simply to give vent to their own personal biases; they are charged with acting in accordance with public norms. To that extent, public policy becomes an essential element in the exercise of judicial discretion.

But judicial lawmaking often goes well beyond these simple standard-setting exercises that are an inevitable part of judicial decision-making. A conscious resort to arguments from public policy was largely responsible for delivering the sophistication, subtlety, fleetness and dynamism that make the common law (including equity) so attractive internationally. In Davies v Davies, which is a leading early restraint-of-trade decision, it was "considered public policy to assist England to become a nation of traders."47 In Donoghue v Stevenson, the "neighbour principle" was enunciated for the first time on the basis that there is a "general public sentiment of moral wrongdoing for which the offender must pay."48 There is no shortage of similar examples: consider the judicially-inspired developments in the field of trusts, fixed and floating charges, assignment of choses in action, interference with contractual rights, equitable relief in cases of mistake or accident, and the rules on frustration and failure of consideration. This list is almost endless.

At times, of course, these judicial efforts were seen to overstep the mark. Then they were reined in, either by the House of Lords (or, now, the Supreme Court) or by parliament. Lord Denning’s term as Master of the Rolls in the 1970s is often seen as the high water mark in this regard. His promotion of the "deserted wives’ equity" in National Provincial Bank v Ainsworth49 was promptly overruled by the House of Lords,50 although later re-enacted in the Matrimonial Homes Act 1976. His new model constructive trust in Eves v Eves51 has not been adopted in subsequent cases, and his early views on equitable mistake are now

47. Davies v Davies (1887) 36 Ch. D 359, 365.
doubted. But his wins far outweigh his losses, and a number of his public policy interventions have stood the test of time: as a result of his judgments, the common law now includes rules on promissory estoppel; tort liability for negligent misstatement; freezing injunctions (Mareva injunctions) and search orders (Anton Piller orders); and of course judicial recognition of the public interest in cricket.

The march has continued. Consider the more recent judicial developments in the law relating to undue influence, unjust enrichment, contract damages, or trusts.

Sometimes the judges downplay their inventiveness; Mr. Justice Neuberger (as he then was) in Murphy v Murphy described his role as refining rather than inventing a new area of law:

In so far as this case involves (as I accept that it does) extending the principle identified in A. v. C., I think that it is perhaps more a case of an existing child developing rather than a new child being born.

But even if this is the case—and the line appears difficult to draw—then the distinction seems to do no more than reflect the truth that the common law and equity proceed incrementally, building up from real examples, until eventually a general principle emerges. In this way, as Lord Neuberger recognised, the cases demonstrate that the law (although Lord Neuberger’s focus was equity alone) “continues, when necessary, to develop, to extend.”

Whether this judicial lawmaking role is an appropriate one is a different question, of course. Going back over three centuries, there have been endless clashes between the views of contemporaries. Sir Owen

62. Id. at 291.
Dixon and Lord Reid, for example, readily illustrate opposing schools of thought on judicial activism. Sir Owen Dixon, writing in 1965, asserted that judicial method should employ "strict logic and high technique," and that a judge's decisions should not be subjective or based on political or sociological propensities.64 By contrast, Lord Reid, writing in the early 1970s, roundly dismissed the declaratory theory of common law as a fairytale65 and promoted the importance of common sense and public policy as elements of the judicial armoury, along with legal principle.66

While legal opinion and rigorous jurisprudence find support in each of these two schools, the majority, and probably all civil lawyers, think of the common law quite simply as judge-made law. Lord Goff said that "case law is independent of statute, of itself a source of law,"67 and Sir George Baker P adopted and promoted Lord Reid's views (outlined above), suggesting that, "in the search for a middle way between certainty and justice, judges must prevent precedent becoming master, and with this in view a court should have regard to common sense, legal principle and public policy in that order."68

This same approach to judicial lawmaking is also supported by the overwhelming body of academic and extra-judicial commentary. Michael Lavarach, writing in the Australian context, argues that "[p]roposals to return the court to a non-policy role of mere interpretation of laws belong in the realms of legal fiction."69 And Sir Gerard Brennan says that "[i]n today's changing world, the courts would forfeit their integrity if they failed to exercise their legitimate jurisdiction to declare the general law in terms which . . . accord with the enduring values of our society."70 In the same vein, Justice Williams goes so far as to suggest that "[p]ublic policy is the backbone of the common law."71

66. Id. at 25; see also infra note 68.
The real debate, however, is put rather more sharply by a number of C21st extra-judicial comments. Lord Neuberger suggests that, in the UK, the capacity for judicial lawmaking is both necessary and beneficial because Parliament has provided too much ill-thought-out legislation in some areas, and has consistently failed to legislate in other arenas which are both controversial and sensitive. In both these situations, he argues, judges have to go further than mere interpretation of legislation and reliance on precedents if they are to deliver sensible results.\(^2\) By contrast, Sir Harry Gibbs (who served on the Australian High Court) was far more reserved.\(^3\)

It is sometimes argued that one justification for judicial activism is that the legislature is uninterested in reforming the law and that the judges should therefore assume that task. It has been said that since the legislatures have failed to keep the law in a serviceable state, “the courts have been left with a substantial part of the responsibility for keeping the law in a serviceable state, a function which calls for the consideration of the contemporary values of the community.”\(^4\) Lord Reid answered the argument that it is the task of the judges to do what the legislature should have done, but failed to do, by saying that “where Parliament has feared to tread it is not for the courts to rush in.” To say that the courts have that role is to confound the distinction between legislative and judicial functions, and in that respect is contrary to constitutional principle. Also the suggestion that the court should formulate a new rule in the light of contemporary values is open to the objection that there is usually a diversity of opinion as to what those values are. . . .

This latter position has a clear ideological basis in the separation of powers and appeals to many in terms of democracy and the rule of law. Lord Evershed noted how the House of Lords (in its judicial capacity) had more than once “emphasised that judicial legislation is apt to be a dangerous usurpation of Parliamentary functions.”\(^5\) It also appeals to many on the basis of certainty and predictability, since public policy considerations are not uniform, and judicial assessment of them is likely to be subjective.

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\(^2\) See Lord Neuberger, supra note 63, ¶ 27.


\(^4\) Dietrich v. the Queen, (1992) 177 C.L.R. 292, 329.

\(^5\) Lord Evershed, Equity is not to be presumed to be past the age of child-bearing, 1 SYDNEY L. REV. 1, 7 (1953).
But arguments about the role of public policy intervention are not confined to this theoretical high-ground. The public policy questions raised by the anti-deprivation rule (which was in issue in the Perpetual Trustee\textsuperscript{76} litigation) can be addressed at this high level of theory, and probably were in the C18th when the rule was in its early stages of development. But its modern antagonists need not run their arguments quite so widely. For many, the issue is much narrower: where parliament has legislated to provide a comprehensive national insolvency regime, they suggest there is no room for the operation of a public policy rule injected via common law judicial intervention. In other words, where parliament has spoken, public policy interventions should implicitly be prohibited.

This question reflects the reality that the common law is changing. As Parliament legislates more frequently, and the volume of case law grows, there are fewer gaps that need to be filled, and when these gaps do arise, there is less reason why the judges rather than Parliament should act to fill them. As Lord Neuberger notes:\textsuperscript{77}

> It was acceptable for the court to invent new Common Law and Equitable rights, remedies and principles in earlier times, when Parliament sat infrequently and for short periods, and when England had not yet moved from monarchy to democracy. In such earlier times there was less of a clear dividing line between the various branches of the state: separation of powers had not yet crossed the mind of either John Locke or Montesquieu. In the 1770s, the Lord Chief Justice was a member of the Cabinet.

Indeed, reduced judicial activity may even align better with many parties’ commercial objectives. In the short term at least, reduced opportunity for judicial interference will leave commercial parties free to arrange their affairs as they wish; and yet if things do go wrong, decreased flexibility in the judicial role may ensure greater certainty from the courts in the decisions which they deliver.

And yet... is this really the ideal? Will it deliver the type of legal regime that is needed for an effective, functioning modern global democracy?

Party autonomy and legal certainty are undoubtedly attractive, but a short pause for thought about national legal developments over the past century shows how often the needs of the parties are delivered more

\textsuperscript{76} See Perpetual Trustee (CA), supra note 16.

\textsuperscript{77} See Lord Neuberger, supra note 63, ¶ 40; see also P.H. Winfield, Public Policy in English Common Law, 42 Harv. L. Rev. 76, 85 (1928-1929) (“Case-law and statute between them were rapidly reducing to certainty what had been under the vague control of reason, convenience and policy”).
rapidly, in a more context-sensitive manner, and more nimbly by incremental changes in the common law than by ad hoc statutory interventions, or by decade-long consultations on major statutory reforms.

Of course there is enormous value in improved legislation and legislative practices. Without this route, law reform and modernisation would be ad hoc, piecemeal and lacking any overarching objective focus. Legislation also has the twin advantages of being motivated by general need, not particular litigants, and delivering its rules by way of succinct principles or clear demands. In a broadly similar way, international conventions, model laws, and legislative guides can provide the means for more rapid and considered global solutions promoting the harmonization and modernization of commercial practices. These “legal technologies” operate supra-nationally, often through the work of bodies such the United Nation Commission on International Trade Law (“UNCITRAL”).

Yet even the very best parliamentary legislation or international convention will fail if it is not administered with a hefty dose of analytical rigour and careful judgement—common sense, legal principle and public policy as Lord Reid put it. This is because no legislator can possibly anticipate all the eventualities, and even if it could, the resulting detail would make the whole legislative enterprise unworkable. More than that, in any package of rules, it is inevitable that some of our most fundamental goals for society will be in direct conflict. Consider the tension between freedom and equality: the more freedom there is, the less equality, and vice versa. If the law supports one goal it loses the other. So when these two goals are in conflict, what is to be done—how is the balance to be played out?

It is impossible to deal with these problems, whether legislative or founded in judicial precedent, unless judges are trusted to exercise discretion. And since their discretion cannot simply be a matter of personal preference, it has of necessity to adopt public policy preferences.

If this is not done, then—practically—we will be left without workable avenues for the delivery of adjustments and modifications to the legal regime. How else, in this climate of codification and increased legislation, and in an environment that is increasingly subject to European, global and comparative influences can a commercially competitive system be served? Are there other alternatives to the judicial policy approach that work better? What is the best mechanism for lawmaking that is attuned to public policy goals?

78. See Lord Reid, supra note 65, at 25.
CONCLUSION

The allure of the law as an antidote to social ills is powerful. However, any legal system has to be judged by its functionality. In the words of Lord Denning: 79

the law ... has two great objects: to preserve order and to do justice; and the two do not always coincide. Those whose training lies towards order, put certainty before justice; whereas those whose training lies towards the redress of grievances, put justice before certainty. The right solution lies in keeping a proper balance between the two.

In a perfect world, the law would be clear, certain and comprehensible. The reality is some way from this. However the better the courts become at delivering the desirable goal of certainty in the law, the less they are able to keep pace with the speed and need for differentiation in modern social and commercial developments, so the less well they serve the real demands of the community they exist to support. If the common law is to continue to survive and prosper, it needs a mechanism for ensuring flexibility, responsiveness, subtlety and differentiation in the law. How is this flexibility built in, and especially how is it built in by an unelected and unrepresentative minority sitting on the bench in a court of law? If the courts cannot perform this function, then it is necessarily left to the legislature, and almost everywhere the consensus seems to be that this is too slow, too political and too generalised.

This is a difficult issue. Here it is suggested that the goals can be delivered only if judges are trusted to take some decisions with an eye to public policy. This option has its risks, of course, but they seem preferable to an alternative which seems likely to neuter the common law's evolutionary and adaptive power, and lead inexorably to the stultification of the entire common law regime.

79. NORMAN ANDERSON, FREEDOM UNDER LAW 39 (Kingsway Publications 1988).