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Drawing the limits of the anti-deprivation rule in insolvency law

In this article, Dr Blanca Mamutse, an insolvency specialist at the University of Surrey, examines the recent Court of Appeal's judgment in two important cases on the scope of the anti-deprivation rule in modern day insolvency litigation.

Years from now, when we pause to reflect on the case law generated by the financial crisis, the Court of Appeal's judgment on the appeals of *Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd* and *Butters v BBC Worldwide Ltd* [1] will doubtless feature prominently among the decisions pertaining to the validity of certain contractual provisions in the event of a party's insolvency. The court considered the scope of the anti-deprivation rule, which has a long history in insolvency law.

The rule essentially provides that a contract whereby a person's property is transferred to a third party on his bankruptcy is void at common law. The facts giving rise to the *Perpetual* and *Butters* appeals demonstrate two different ways in which it may be called into application.

Facts of the *Perpetual* appeal

a) The claimants represented noteholders in respect of Notes issued by companies established as special purpose vehicles (SPVs) by Lehman Brothers Group.
b) Using the proceeds of the Note subscriptions, the SPVs acquired government bonds and other secure investments ('the collateral').
c) The collateral was vested in a trust corporation, BNY Corporate Trustee Services Ltd ('the Trustee').
d) The Notes issued by the SPVs were governed by trust deeds. In addition to these, a swap agreement was entered into between the SPVs and Lehman Brothers Special Financing Inc ('LBSF'). Under this agreement, LBSF paid the SPVs the amount due by them to the Noteholders, in exchange for an amount equal to the yield on the collateral. Insofar as the sum payable by LBSF under the swap agreement exceeded the yield on the collateral, the Noteholders received a premium for the credit insurance which they effectively provided to the Lehman Brothers Group. It was expressly provided that these transactions were governed by English law.
e) A charge over the collateral secured the SPVs' obligations to LBSF and the Noteholders. Under the terms of the trust deeds:
   i) this security would become enforceable if any amount due in respect of the Notes was not paid, or the swap agreement terminated with sums due to LBSF as swap counterparty; and

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ii) monies received by the trustee in connection with the realisation of the security were to be paid according to a specified order of priority. LBSF as swap counterparty would enjoy priority over the Noteholders unless an event of default occurred, and LBSF was the defaulting party. This would result in the priorities being reversed, so that the Noteholders would be paid before LBSF.

f) On 15 September 2008 Lehman Brothers Holdings Inc ('LBHI') applied to the United States ('US') Bankruptcy Court for protection under Chapter 11 of the US Bankruptcy Code. LBSF followed suit in October 2008. Both filings constituted an event of default for the purposes of the swap agreement, and activated the Noteholder priority.

g) After 15 September 2008 the periodic payments due by the SPVs to the Noteholders and by LBSF to the SPVs were not made.

h) The Noteholders sought to compel the trustee to enforce its security and apply the proceeds towards payment of their claims, in priority to LBSF.

Facts of the *Butters* appeal

This matter arose from the insolvency of the Woolworths group of companies.

a) A company referred to as 'Media' was a subsidiary of Woolworths Entertainment Group Ltd, which was in turn a subsidiary of the holding company Woolworths Group plc ('Group').

b) Media had a 40% shareholding in 2 Entertain Ltd ('2e'). The remaining 60% of shares were owned by BBC Worldwide Ltd ('BBCW'). Among 2e's subsidiaries was a company called BBC Video Ltd ('Video').

c) A Joint Venture Agreement ('JVA') entered into between BBCW, Group, Media and 2e set out the terms on which BBCW and Media held shares in 2e. The JVA contained provisions which enabled BBCW to purchase Media's shares in 2e on an insolvency event.

d) Completion of the JVA was conditional on BBCW granting Video a licence to exploit BBCW's video and DVD catalogue, and other rights in respect of the BBC's future television programmes. This was done in accordance with a Master Licence Agreement ('MLA') between Video and BBCW. A key provision of the MLA entitled BBCW to terminate the MLA on the happening of an insolvency event.

e) Group went into administration in January 2009. This was followed by Media's entry into the procedure in February 2009. Both of these occurrences constituted insolvency events under the JVA and MLA, *prima facie* empowering BBCW to purchase Media's shares in 2e and terminate the MLA.

f) When steps were taken to value the shares in 2e, Media raised the objection that the relevant clauses of the JVA and MLA were void.

The Court of Appeal's decision: general observations on the ambit of the anti-deprivation rule

Lord Neuberger MR began by acknowledging the uncertainty surrounding the application of the rule:

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

In determining the ambit of the anti-deprivation rule, certain principles had to be borne in mind. The first is that *British Eagle v Compagnie Nationale Air France* [2] is high authority for the proposition that the rule is founded on public policy to the extent that one cannot contract out of the insolvency legislation.

Second, echoing I*nternational Air Transport Association v Ansett Australia Holdings Ltd* [3], in cases where the rule was invoked it was vital to proceed from the elementary premise that 'insolvency law is statutory and primacy must be given to the relevant statutory text'.

Third, in considering whether the rule applied to a particular contractual provision, in principle there was no difference between cases where the provision was expressed to apply on insolvency or liquidation, and those where it was not so expressed.

Fourth, the courts should not extend the rule beyond its present limits, except to satisfy the needs of practicality and logic. Considering the basis of the rule, that one cannot contract out of the provisions of the insolvency legislation, it was hard to justify going beyond the established limits of the rule save to the extent required by legislation. The Insolvency Act 1986 ('IA 1986') has more detailed and wide-ranging provisions with regard to the effect of transactions entered into before winding-up, than the legislation which was in force when many of the English cases applying the rule were decided.

Fifth, it is important to ensure that judicial decisions in the field of insolvency remain clear and consistent. The need for consistency and clarity has become more pronounced due to the growing complexity of the nature and content of commercial contracts, as evidenced by the contracts in these appeals. Where possible, it is desirable that the courts give effect to the contractual terms agreed by the parties:

> *… there is a particularly strong case for party autonomy in cases of complex financial instruments … and in arrangements involving large corporate groups … in such cases, the parties are likely to have been commercially sophisticated and expertly advised.*

To this, Patten LJ added the observation that before a commercial contract can be struck down on the ground of public policy there must be certainty not only regarding the exact nature of the policy rule sought to be enforced; but also whether the unenforceability of the contract is necessary to give effect to the policy objective enshrined in the rule. His Lordship expanded on the notion of IA 1986 as a code, holding that where Parliament had expressly considered the kind of transactions which fall within the Act's anti-avoidance provisions, it was not appropriate for the court to seek to widen the scope of those provisions by extending a common law rule. The Insolvency Act 1986, in contradistinction to the common law in the 19th century, contains a detailed code for determining and regulating the property of an insolvent company for the benefit of its general creditors. The anti-deprivation rule could accordingly have no wider scope than the statutory provisions it was designed to enforce.

Validity of the provisions under consideration: Perpetual appeal

Validity on the basis of the true origin of the assets

In determining whether the 'flip' from swap counterparty priority to Noteholder priority brought about any deprivation which breached the anti-deprivation rule, the question was whether the 'flips' had the consequence of reducing the assets which would otherwise be available for distribution to the creditors. The essence of the arrangements embodied in the extensive documentation did not support this view:

- The collateral over which the rights were created was acquired mainly with money derived from the Noteholders through their subscription monies.
- LBSF provided little by way of subscription monies; it merely agreed to pay the interest and capital due to the Noteholders through the SPVs in exchange for the collateral.
- The scheme was sold on the basis that if LBSF or LBHI defaulted so that the interest and capital on the notes was not paid, then it would be the Noteholders who would have priority in relation to repayment.
- Effecting the 'flips' would not entitle the Noteholders to more than they had subscribed, and in the absence of a shortfall would not have left LBSF out of pocket.

The 'flip' provisions therefore did not operate to divest LBSF of money, property or debts vested in it and re-vest them in the Noteholders, or to divest LBSF of the benefit of the security rights granted to it. They simply changed the order of priorities in which rights over the proceeds of the collateral were to be exercised in the event of a default. The security right granted to LBSF was a security right over assets purchased with Noteholders' money, and the priority and extent of benefits LBSF enjoyed in respect of the security were contingent upon there being no event of default. Following the event of default, LBSF did not lose a right which it had been granted over the proceeds of sale of the collateral; rather, it retained its right but ranked behind the Noteholders in accordance with an agreed feature of that right.

Three principles extracted from decided cases on the anti-deprivation rule have a bearing on this situation. While the rule had been held to apply to assets which were vested in the person on whose bankruptcy the deprivation was to occur, in this case all that changed were the priorities relating to the right, pursuant to a provision in the very document creating the right. There is authority for the notion that the rule would not apply where the person in whose favour the 'deprivation' operated could show that the asset (or interest therein) was acquired with his money – a requisite satisfied in this case where the collateral was effectively purchased exclusively with the Noteholders' money [4]. Finally, the rule could not apply to invalidate a provision which enabled a person to determine a limited interest such as a lease or licence which he had granted over his own property, in the event of the lessee or licensee's bankruptcy. A charge, or provision for priorities for repayment, had similar features to a lease or licence, and differed from ownership. Applied to the facts of this case, these principles supported the conclusion that the anti-deprivation rule did not apply to the operation of the 'flips' in the relevant contractual provisions. The proper analysis of the documentation was that the Noteholders had granted rights to LBSF over assets derived from their monies, which rights were liable to be modified on the happening of an event of default. This was a valid agreement, enforceable on or after LBSF's Chapter 11 filing.

Lord Neuberger MR accordingly rested his conclusion on the ground that the assets over which the charge existed were acquired with money provided by the chargee in whose favour the 'flip' operated, and the 'flip' was included merely to ensure that the chargee was repaid out of those assets all that he provided (together with interest) before the company received any money from those assets pursuant to the charge. His Lordship emphasised the importance of scrutinising the transaction, as it could be argued that in the absence of these additional facts, the arrangement in this case would have fallen foul of the analysis in *Ex parte Mackay* [5].

Validity on the basis of a conditional interest in the security

Patten LJ reached the same conclusion as Lord Neuberger MR regarding the validity of the clauses, but focused on the relationship created by the collateral. His Lordship stressed that LBSF and its creditors had not been deprived of any property or asset to which they would have been entitled but for its bankruptcy. The only interest or property which the company had enjoyed was a charge granted by the SPVs, and this security interest remained part of the property of LBSF, unchanged by the event of its bankruptcy.

The reversal of the priority sequence was always a facet of the security, designed to regulate the competing interests of LBSF and the Noteholders over the collateral. To treat its operation in the event of LBSF's bankruptcy as constituting the removal of an asset from the insolvent estate was to confuse the security itself with the operation of its terms in the manner prescribed by the charge. LBSF retained the same amount as it had before its bankruptcy and likewise the Noteholders did not obtain any security over the collateral which they did not have before.

Enforceability of the contract, based on the timing of the deprivation

Even if the 'flips' had constituted a deprivation within the prohibition, the anti-deprivation rule would not have been engaged in the present case, since the triggering event was LBHI filing for Chapter 11. This occurred some 18 days before LBSF filed for bankruptcy protection. It being common ground that filing for Chapter 11 was for the purposes of the rule equivalent to the making of a winding-up order, the deprivation occurred before liquidation or its equivalent. As a general rule, a deprivation that takes effect before a winding-up order [6] is not caught by the rule, unless it is effected pursuant to a sham transaction. There is nothing inconsistent with the provisions of IA 1986 about a contractual agreement which effects a deprivation of an asset before a company goes into liquidation [7]. This was supported by the decision in *British Eagle* that any deprivations which occurred prior to the winding-up of British Eagle were not caught by the rule, even though it seemed likely that British Eagle had been insolvent some time before it was wound up.

Moreover, in the interests of certainty it was necessary to maintain the simple proposition that if deprivation occurred before winding-up it did not fall within the scope of the rule whereas if it occurred after winding-up it risked doing so. This was because a party with the right to effect deprivation could not always know whether the company subject to the right was insolvent at a particular point prior to liquidation. By comparison, no difficulty arose in determining when a company went into liquidation. Furthermore, it was hard to see why the right to deprive for breach of contract or by means of notice should be defeated on the basis of a company's insolvency, even though it had not entered into any formal proceedings under IA 1986.

An additional element in the *Perpetual* case was that the 'flips' were brought about by the liquidation of a party other than the company which would suffer the deprivation. The rule could not be engaged by the insolvency of a party other than the company which would suffer the deprivation, and extending it to cover this would lead to confusion when it came to predicting its limits.

Validity of the provisions under consideration: *Butters* appeal

Similarly to *Perpetual* the two main issues were whether the relevant contractual clauses in any way gave rise to an infringement of the anti-deprivation rule; and if so, whether the fact that they were operated before Media went into administration meant that the rule did not apply. It was found that there was nothing in the JVA and MLA provisions, read separately or together, which could engage the anti-deprivation rule.

Termination of a limited interest

As regards the MLA, in the absence of special circumstances, a licence can be granted on any terms as to its termination which the licensor wishes to agree with the licensee. A provision for the termination of a licence in the event of bankruptcy is common in relation to intellectual property licences. The power to terminate a licence does not infringe the anti-deprivation rule because it does not remove from the estate property in which the insolvent company ever had an unfettered interest. The liquidator is bound to take the licence on the terms on which it was granted, the position being a fortiori if the event of insolvency which triggered the exercise of the right to terminate is that of a parent or group company rather than the licensee.

In this particular case, the termination clause did not infringe the rule because its invocation did not involve the property of the insolvent party becoming vested in a third party. It merely involved a limited interest being brought to an end in accordance with its terms, by the third party who had granted it to the now-insolvent party.

Acquisition for fair value

By contrast, the JVA clause under appeal involved property which had been owned by a now-insolvent party, namely Media's shares in 2e, becoming vested in a third party – BBCW. This clause, operating on the administration of Media, would have breached the anti-deprivation rule if the price payable for the shares was below market value. If the licence termination provision of the MLA and right of pre-emption under the JVA were each unexceptionable when read individually, it was difficult to see how their joint existence could render them objectionable.

Enforceability of the transaction, based on timing of 'deprivation'

Even if it were to be accepted that the JVA and MLA clauses infringed the anti-deprivation rule, as a matter of timing it would not have been engaged in this case. The insolvency event which triggered the service of the notice related purely to Group, and the notice enforcing the termination clause and purchase of shares was served on Media before the making of the administration order against Media. The point made in regard to *Perpetual* was reiterated, namely that both principle and practicality supported the view that the anti-deprivation rule had no application where the deprivation had been effected by the time a winding-up or administration order is made against the company 'deprived' of its property.

It was conceded that this conclusion meant that it would be reasonably easy in many cases to devise schemes to avoid the rule. However, the Master of the Rolls opined that the ultimate responsibility for guarding against anti-avoidance devices in the insolvency field lay with Parliament, as evidenced by ss238-239 IA 1986:

> *Especially in an area where Parliament has intervened so substantially and so significantly, it can only be very rarely … that it would be right for the court to invent its own anti-avoidance policies and frustrate the terms of commercial contracts freely entered into by sophisticated parties.*

Conclusion

Lord Neuberger MR carefully concluded his lead judgment with the observation that there had been no departure from the authority of *British Eagle*. Indeed, His Lordship considered that he had

> *… tried to adhere to the logic of that reasoning, while also bearing in mind the need for clarity and consistency in this area of the law, the undesirability of interfering with party autonomy in business transactions, the inappropriateness of the courts extending the law in areas where Parliament has enacted an extensive code, and the assistance which can be gleaned from a significant body of jurisprudence.*

These factors may nonetheless be seen as signifying a modern approach to decisions regarding the influence of *British Eagle*, and to this extent the court has rejuvenated the anti-deprivation rule. It has positioned the Insolvency Act 1986 as a boundary between these appeals and the 19th and early 20th century precedent on the rule. Furthermore, it has allowed the 'good business reasons' which could not prevail in *British Eagle* [8] to inform its analysis of the contractual documentation involved; and shown that the timing of the deprivation, and the role of related companies in triggering events may contribute to the validity of transactions.

This development is accompanied by a recognition that 'the multifarious, sophisticated and increasingly complex arrangements contained in modern financial instruments' are such that it remains difficult to precisely define the type of deprivation provisions caught by the rule. For this reason, the court indicated a preference for developing the law in this area 'on a relatively cautious, case-by-case basis.' An appeal to the Supreme Court is pending.

Endnotes

1. [2009] EWCA Civ 1160.
2. [1975] 2 All ER 390.
3. [2008] BPIR 57.
4. With respect to certain issues of notes, LBSF had contributed to the subscription. However, the level of contribution did not justify a different outcome with respect to those SPVs – at [77].
5. *Ex parte Mackay*, *Ex parte Brown*, *In re Jeavons* (1873) LR 8 Ch. App. 643
6. Or Chapter 11 filing, or an administration order – see para [70].
7. Save to the extent that the deprivation falls within the reach of provisions such as ss238 or 239, which did not apply in this case.
8. [1975] 2 All ER 390 at 411.

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Briefings

Financial crisis is not *force majeure*

Tandrin Aviation Holdings Ltd v Aero Toy Store [2010] EWHC 40 (Comm)

The facts

T sold to A a Bombardier executive aircraft for a price of US$31m. A paid a deposit of US$3m. T tendered delivery but A refused to take delivery. In the event, T had to sell the aircraft to another buyer for a sum of US$24m thereby incurring a substantial loss. They sought to claim the loss from A; A on the other hand sought to recover the deposit money.

A's case was that the contract was discharged as a result of *force majeure* and that the deposit was in fact a penalty and as such could be recovered.

The *force majeure* clause provided that:

> *'Force Majeure. Neither party shall be liable to the other as a result of any failure of, or delay in the performance of, its obligations hereunder, for the period that such failure or delay is due to: Acts of God or the public enemy; war, insurrection or riots; fires; governmental actions; strikes or labor disputes; inability to obtain aircraft materials, accessories, equipment or parts from vendors; or any other cause beyond Seller's reasonable control. Upon the occurrence of any such event, the time required for performance by such party of its obligations arising under this Agreement, shall be extended by a period equal to the duration of such event.'*

In reliance on the clause, A asserted that the 'unanticipated, unforeseeable and cataclysmic downward spiral of the world's financial markets' had made it impossible for them to take delivery of the aircraft. The *force majeure* clause was thus triggered allowing A to postpone the time to complete the purchase. It would also affect the price at which A should be entitled to purchase the aircraft.

There was also an allegation that it was inequitable to seek specific relief against a foreign defendant.

The decision

The court rejected the argument that it had no jurisdiction to make an order for specific performance of a contract as regards the foreign defendant.

As to the argument of *force majeure*, Hamblen J held that it was settled law that economic or financial hardship or change in market conditions could not be an excuse for non-performance. There was no case law authority for any contrary proposition. The *force majeure*, properly construed, did not assist the defendant. The clause did not expressly refer to a change in economic circumstances. Without specific terms to the effect the court would not, as a matter of general principle, extend the *force majeure* clause beyond what are the traditional boundaries of the doctrine of frustration.

As for the argument that the deposit was a sum in terrorem, the court held that the sum was not a penalty because at merely 9.5% of the purchase price, it was by no means unreasonable. Indeed, it would fall short of the actual damage suffered by the claimant. It was therefore to be treated as liquidated damages or a genuine attempt at making a pre-estimate of potential loss.

Comment

The decision, while not breaking new ground in terms of general principle, is important because it makes it plain that extraordinary economic or financial difficulties could not constitute a frustrating event. A *force majeure* clause must be so explicitly drawn up if it is to be extended to discharge the parties from contractual liability in such an event. General words will not be extended to cover situations not covered by the doctrine of frustration, as a matter of principle.

On the issue of penalties, it is interesting academically to see Hamblen J use a somewhat technical approach. The judge considered the issue methodically by asking a series of discrete questions:

- first, whether such deposit clauses are commonplace in aircraft sale contracts;
- whether the amount was unusual;
- was it a genuine or reasonable pre-estimate of loss; and
- was it a true bargain between the parties.

Recent decisions have demonstrated a less methodical or step-by-step approach to the issue; the preference being for a more holistic and freedom of contract principle led approach. The starting point in recent cases seems to that in commercial contracts, such a payment clause would be treated as liquidated damages unless it is exorbitant and unconscionable. That said, the difference in approaches is largely an academic question for our purposes in the present context.

Lease guarantors as the assignee's surety and the Landlord and Tenant (Covenants) Act 1995

Gold Harvest Partnership Ltd v Centaur Services Ltd [2010] EWHC 330 (Ch)

The facts

Gladman demised the property by an underlease to Chiron for 10 years. Centaur acted as Chiron's guarantor and was also made a party to the underlease. Gladman Chiron and Centaur then signed an 'authorised guarantee agreement'. Under the guarantee agreement, Gladman gave Chiron a licence to assign the underlease to Total Home, which Chiron did. The guarantee agreement also stated that Chiron and Centaur each covenanted with Gladman that Total Home would pay rent and perform the lessess covenants 'until the next lawful assignment of the Underlease'.

A few months later, Gold Harvest took over the headlease and thus became Total Home's direct landlord. Total Home fell into arrears and Gold Harvest demanded that Centaur, as guarantors, should pay. Centaur argued that s25 of Landlord and Tenant (Covenants) Act 1995 ('the Covenants Act') nullifies the guarantee agreement to the extent that it imposes liability on Centaur. The issue was therefore whether that section precludes a person who has guaranteed a tenant's obligation under a lease from being required to give a further guarantee in respect of an assignee of the lease.

Gold Harvest, on the other hand, contended that the guarantee did not exclude, modify or frustrate the operation of the Act and was therefore not avoided by the Act. They argued that if it was Parliament's intention to interfere with the guarantor's ability to give guarantees for assignees, it could have made such a prohibition clear. Parliament's omission must therefore mean that it did not consider guarantors to need protection in this respect. Additionally, there was no good reason to bar guarantors from giving guarantees for assignees. Where a tenant gives a guarantee for an assignee, it is open to the original guarantor to provide a sub-guarantee of the tenant's obligations as guarantor; it would be anomalous if the guarantor could not enter into a direct guarantee for the assignee.

The decision

The High Court ruled that the guarantee was unenforceable. It held that it was unlawful for a landlord to require an assignee's obligations to be guaranteed not only by the outgoing tenant under a guarantee agreement but also by the outgoing tenant's guarantor.

Comment

Readers will appreciate that the Covenants Act has abolished the old rule that a tenant remained liable to pay the rent and perform the tenancy's obligations throughout the whole term of the lease, even after the lease has been assigned away. The Act provides that for leases granted after 1995 the tenant will automatically be released from those obligations as soon as the lease has been assigned. The law also renders that any guarantee of the tenant's obligations will lapse when the lease is assigned.

However, an authorised guarantee agreement ('AGA') (s16, Covenants Act 1995) may be permissible. The AGA imposes a liability on the outgoing tenant to guarantee the liability of the assignee. Such an agreement therefore does not guarantee the tenant's obligations but those of the tenant's assignee. By and large there are two ways of achieving this. One is where the guarantor directly guarantees the obligations of the assignee. Another is where the guarantor does not guarantee the assignee's obligations but the assignor's obligations under the authorised guarantee agreement – namely, there exists not a direct guarantee but a sub-guarantee (because under the authorised guarantee agreement, the assignor is presumptively guaranteeing the assignee's obligations).

The present case concerned the first type of guarantee. Mr Justice Newey decided that if a guarantor is allowed directly to guarantee the assignee's obligations that would frustrate the Act's requirement that a guarantor's obligations must terminate following an assignment (s24, Covenants Act 1995). As for sub-guarantees Newey J said: 'I do not think it is by any means clear that the Covenants Act permits a guarantor to sub-guarantee a tenant's obligations under an AGA.' If Newey J is right about sub-guarantees, then the consequence is that guarantors of either the assignee or the assignor could not be touched. Pending an appeal being allowed, this decision will have important bearings on the law on landlord and tenancy.

At one level, landlords will be seriously affected because while they can enforce an AGA against the outgoing tenant, they will not be able to enforce a direct guarantee against a guarantor and they may not be able to enforce a sub-guarantee. An appeal clarifying the position would be useful.

If Newey J's decision is confirmed, landlords must therefore take other forms of security if they consider an AGA which binds only the outgoing tenant not to be sufficient.

EU legal developments
Directors' remuneration policies in financial services

The European Parliament's ECON Committee has recently published report instigating a motion for the Parliament to take regarding action to formulate policy on remuneration policies for directors of listed companies and employees in the financial services sector. At one level, it is immediately a matter of some query and controversy that the two distinct areas should be lumped together for policy making. That said, the explanatory statement in the report states that excessive risk taking was prevalent in the financial services sector which led in turn to the 'aggregate build up of systemic risk' and that such risk taking should therefore be properly controlled and managed. In the report little distinction is made between firms in the financial sector and listed companies. The general assumption seems to be that listed companies raise finance in the financial markets and as such, should be treated as part of the build up of systemic risk.

What the report advocates

The report finds that while there are national initiatives having been taken to moderate some remuneration policies and bonus excesses by tax measures, salary caps and corporate governance rules, the matter should be addressed by coordinated action at EU level. It supports in general the several recommendations taken by various committees and arms of the EU. It calls for the adoption of binding principles on remuneration policies – there is perhaps a contradiction in terms here. Can principles be binding without their being conferred legislative status? On the specifics, the report emphasises that every financial institution and listed company should have a remuneration committee. That committee should be independent of the directors and should be accountable to shareholders and regulators and supervisors. Non executive board members' remuneration should comprise only fixed pay. There should be no performance or share-based remuneration.

As to the composition of remuneration, the report stresses that an appropriate balance between fixed and variable remuneration must be maintained (probably by rules). In particular, an individual's bonus must not be in excess of 50% of his or her total annual remuneration.

The monitoring of pay policy is entrusted to remuneration committees. The report considers that a stronger role must be given to the committee; the scope of the committee's powers should be a matter for discussion between risk managers, shareholders and the supervisors.

An external measure also suggested by the report to ensure that remuneration policies are properly controlled is the imposition of higher taxes on financial institutions whose directors are paid a compensation package above a prescribed level. The Commission is also invited to consider a proposal to impose on financial institutions a fee to be used to fund an insurance scheme to prevent financial crises. Another somewhat radical measure being proposed is the naming and shaming of listed companies which do not adhere to the principles on remuneration policies.

These are some of main recommendations of the report. It is clear that the report is replete with implicit condemnations for fat cat bankers and directors. It is wondered if that is the right spirit to take on the subject of managing financial risk. There is also a distinct lack of objective clarity as who causes what in the financial crisis – as alluded to above, there is no distinction made between financial institutions and listed companies where remuneration policy is concerned.

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