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Insolvency set-off: "The mutuality of assignment in subordination"

Features

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KEY POINTS

- Mutuality is an essential requirement of insolvency set-off.
- Mutuality requires reciprocity rather than correspondence.
- Mutuality requires parties to deal with each other in the same capacity.
- An assignment expressed to be free of equities will destroy the mutuality between the insolvent and the assignor in respect of the assigned debt.

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This article considers the necessity of mutuality in insolvency set-off in England and Wales. The issue comes into sharp focus when considering the effect of insolvency where there is a turnover subordination agreement, under which the junior creditor assigns to, or holds on trust for, the senior creditor the junior/subordinated debt. The need for mutuality is explored by examining whether in such a scenario there is the mutuality necessary to expose any cross claim the debtor may have against the junior creditor to insolvency set-off. This issue is of some importance, as the effectiveness of turnover subordination agreements are essential to availability of credit from existing creditors.

INSOLVENCY RULE 4.90

Rule 4.90 of the Insolvency Rules 1986 provides as follows:

4.90-- Mutual credits and set-off

(1) This Rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming to prove for a debt in the liquidation.

(2) The reference in paragraph (1) to mutual credits, mutual debts or other mutual dealings does not include--

(a) ...

...

(d) any debt which has been acquired by a creditor by assignment or otherwise, pursuant to an agreement between the creditor and any other party where that agreement was entered into--

(i) after the company went into liquidation;

(ii) at a time when the creditor had notice that a meeting of creditors had been summoned under s 98;

(iii) at a time when the creditor had notice that a winding up petition was pending;

(iv) where the liquidation was immediately preceded by an administration, at a time when the creditor had notice that an application for an administration order was pending or a person had given notice of intention to appoint an administrator; or

(v) during an administration which immediately preceded the liquidation.

(3) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other.

...

(8) Only the balance (if any) of the account owed to the creditor is provable in the liquidation. Alternatively the balance (if any) owed to the company shall be paid to the liquidator as part of the assets except where all or part of the balance results from a contingent or prospective debt owed by the creditor and in such a case the balance (or that part of it which results from the contingent or prospective debt) shall be paid if and when that debt becomes due and payable.

..."

THE PURPOSE AND RULES OF INSOLVENCY SET-OFF

Insolvency set-off is intended to do substantial justice between the parties; its application is not limited to particular categories of claim, but applies to all cross claims provided they are mutual and measurable in money terms.

The following insolvency set-off rules can be distilled from the authorities:

- it is mandatory and occurs at the moment of liquidation;
- its effect is automatic and self-executing, without the need for any action by the creditor or the debtor;
- the operation of the statutory set-off cannot be excluded by agreement, and cannot be waived or renounced (consequently monies mistakenly paid over without set-off do not discharge the debt and are recoverable);
- a contractual right to set-off which goes beyond the statutory rules will be struck down as offending the principle of *pari passu* distribution between unsecured creditors;
- the court has no power to modify or disapply the statutory rules, for whatever reason.

THE CONFLICT BETWEEN THE FUNDAMENTAL PRINCIPLE OF PARI PASSU AND SUBORDINATION

Lord Hoffmann, in *Stein v Blake* [1996] AC 243 at 251, correctly characterised insolvency set-off as "affect[ing] the substantive rights of the parties by enabling the [insolvent]'s creditor to use his indebtedness to the [insolvent] as a form

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of security. Instead of having to prove with other creditors for the whole of his debt in [the insolvency], he can set-off pound for pound what he owes the [insolvent] and prove for or pay only the balance".

The underlying effect of set-off is to prefer one creditor over the general body of creditors, though it prevents the unfairness in respect of the single creditor of the insolvent who owes something to the insolvent. However, when a party becomes insolvent, the contest is no longer between the insolvent and the creditor, but between the creditor and the other unsecured creditors. In effect, the creditor is given, by such set-off, an unpublished security.

The purpose of turnover subordination agreements is to improve the "security" of senior creditors, but only in respect of a specified creditor -- the junior creditor. Such arrangements inevitably create a conflict with the fundamental principle of insolvency of *pari passu* distribution between unsecured creditors, as required by s 107 of the Insolvency Act 1986 and IR 4.181.

When *pari passu* applies, there are no ranking of debts. Whenever unsecured debts are ranked, (note preferential debts are an exception to the rule), the *pari passu* principle is breached.

The purpose of a subordination agreement is to rank debts. The subordination requires the parties not to share the debts on a *pro rata* basis. It requires a non-*pari passu* distribution in accordance with "contractual priority".

The courts have now confirmed in *Re Maxwell Communications Corporation plc* (No 2) [1994] 1 All ER 737 and in *Re SSSL Realisations (2002) Limited* [2006] EWCA Civ 7, (where the Court of Appeal affirmed the decision of Lloyd J [2005] 1 BCLC 1), that while the set-off rule is mandatory, parties as between themselves can "contract out" of the *pari passu* rule by contractual subordination, providing the arrangement does not involve a divesting of the estate of the insolvent. The "subordination" in *Re SSSL Realisations (2002) Limited* included an obligation by the junior creditor not to "claim, rank or vote as a creditor" and not to "receive claim or have the benefit of any payment distribution" until the senior creditor had been paid.

It is this tension between, on the one hand, the general body of creditors and, on the other, the arrangements between specific creditors that makes the issue of mutuality vital to the imposition of insolvency set-off.

MUTUALITY

Unlike ordinary/legal set-off, mutuality is an essential requirement of insolvency setoff. Insolvency Rules 2.85 and 4.90 provide that insolvency set-off only applies where "there have been mutual credits, mutual debts or other mutual dealings" between the company and any creditor of the company proving or claiming to prove for a debt. Mutuality "conveys the notion of reciprocity rather than of correspondence"; see: *Gye v McIntyre* (1991) 171 CLR 609, at 623 (an Australian case dealing with s 86 of the Bankruptcy Act 1966 which is in similar terms to Insolvency Rule 4.90). It is important to note that:

- as the effect of set-off is automatic and cannot be contracted out of, the subjective intention of the parties is irrelevant to the question of mutuality;
- mutuality is concerned with the status of the parties and their relationship, not with the nature of the claims;
- mutuality is concerned with equitable rather than legal interests;
- mutual dealings may be continuous and complex, or short-term, or isolated. All that is required are dealings in an extended sense.

Mutuality does not require that the cross claims:

- arise at the same time;
- nor that there should be any connection between them;

- nor that they should be of the same nature.

For a claim to be mutual it:

- must be between the same parties;
- must be between a debtor and creditor or between parties with commensurable cross-obligations with each obligation arising in the same capacities, right or interest. A debt owed by A, acting in the capacity of trustee for B, to C and a debt owed to A by C personally, cannot be set-off. That exception was recently confirmed in *Simpson and Spratt v Kaupthing Singer & Friedlander (Isle of Man) Limited* (October 31 2011; App Div Isle of Man), a claim concerning the liability of Elle Macpherson. It is to be noted that in the scenario where B alleges that debt owed by A to C is in fact held by C as trustee for B, the court will allow set-off, in respect of a debt owed by B to A, only where the debt is clear and ascertained and where B is the sole beneficiary and entitled without further inquiry to demand that the debt be transferred to him; see: *Ex p Morier* (1879) 12 Ch D 491 and *Bank of Credit & Commerce International SA (In liq) v Prince Fahd Bin Salman Abdul Aziz Al-Saud* [1997] BCC 63;
- must sound ultimately in money and includes both debts immediately due and debts due at a future date.

EXAMPLES

Mutuality exists in the following situations:

- An equitable assignee of a debt can set off that debt against sums owing to the insolvent; see: *Daleri Limited v Woolworths plc* [2008] EWHC 2891 (Ch).
- Damages arising out of a contract or damages for fraudulent misrepresentation, may be set off against damages for actual breach of contract; see *Peat v Jones* (1881) 8 QBD 147 and *Jack v Kipling* (1882) 9 QBD 113, CA.

Mutuality does not exist in the following circumstances:

- A joint debt cannot be set-off against a several debt; see *Re Pennington and Owen* [1925] 1 Ch 825.
- Where parties are dealing in separate capacities. Money due to an executor cannot be set off against money due from him personally; see *Bishop v Church* (1748) 3 Atk 691.
- Where a debt is due to the liquidator arising from his dealings, and a debt due from the company before winding up; see *Alloway v Steere* (1882) 10 QBD 22.
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- Where the creditor's obligation is not a debt, but an obligation to contribute; eg, where a director is ordered to pay costs of proceedings to recover monies received by him in breach of s 127, a liquidator may simply deduct that amount from the dividend payable to the director *qua* creditor.
- In respect of a monetary claim and a proprietary (*in rem*) claim.

ASSIGNED DEBTS

Subordination agreements involve demoting the priority of a junior debt and appropriating it for the benefit of the senior creditor.

Where such appropriation involves an assignment, if an assignee tenders proof, there is authority that suggests that the liquidator may set-off against the debt any claims which lay against the assignor at the time of the assignment; he may set-off claims arising subsequently only if these arise out of the same contract as gave right to the assigned debt and are intimately connected with it; see *In Re South Blackpool Hotel Co, ex p James* (1869) LR 8 Eq 225 and *Re Pinto Leite and Nephews* [1929] 1 Ch 221 at 232 and 286 per Clauson J. In the former case, Lord Romilly stated that "these cases are not to be decided on technicalities, but on principles of common sense" (a statement which resonates with Lord Hoffmann's statement in *Stein v Blake*).

In a simple assignment, the assignee *prima facie* takes subject to all equities existing between the debtor and assignor and consequently the junior creditor is still technically a party (in equity) to the debt. Not allowing the setting-off of a cross claim against such equities may result in substantial injustice where the parties and the status of the parties in that cross claim are the same, particularly if the assignor is insolvent. That injustice is underlined by the automatic effect of set-off where, in effect, the original chose in action is replaced on liquidation with a claim to a net balance; per Lord Hoffmann in *Stein v Blake* at 255A-B. Some commentators have suggested there should not be such set-off because of the absence of mutuality. Strictly speaking, there is no mutuality because the assigned debt is held by the assignee and the insolvent debtor's claim is against the assignor. In reality, the assignee only takes subject to the procedural defence that would have been available to the debtor in an action brought against it by the assignor.

Insolvency Rule 4.90(2)(d) appears to recognise that an assignment that does not fall foul of that exception will give rise to a set-off and will satisfy the requirement of mutuality between the assignee (in this scenario the senior creditor) and the company. If that is the case, it would be odd if, in respect of the same claim (or part of it), mutuality existed between the assignor (the junior creditor) and the company. While insolvency set-off involves substantial justice, that justice must be confined within limits which protect creditors from being disadvantaged by a set-off where debts, credits or other dealings are not genuinely mutual as a matter of substance.

Further, as stated above, where the debt owed by A to C (the junior creditor) is, in fact, held by C as trustee for B (the senior creditor), there is no set-off on A's insolvency between A and C. That was the position in *Kaupthing Singer & Friedlander Limited (in Administration)* [2009] EWHC 740 (Ch), where the court concluded that there was no set-off, even in circumstances where the creditor seeking the set-off was not aware that the counter party had taken on the obligation as trustee for an undisclosed beneficiary.

Further, if the company has permitted assignment free of all equities, then the liquidator will be precluded from setting off any right it may have had against the original or intermediate assignor (see *Farmer v Goy & Co* [1900] 2 Ch 149, *Re Blakely Ordinance Co* (1867-68) 3 Ch App 154), unless the assignee is a mere trustee for the assignor.

It is clear that so long as the relevant parties are solvent, the owner of a claim can authorise the use of his assets to pay the claim of another, but the authorisation must be clear. Accordingly, the parties are free to arrange their affairs to deal with an assigned debt in a manner that takes into account (or probably more appropriately "discounts") the issue of mutuality. As the parties are free to enter into such arrangements, as Chadwick LJ stated in *Re SSSL Realisations (2002) Limited* [2006] EWCA Civ 7 at para 66, the parties should be held to their bargain in the event of insolvency.

It follows that there is nothing commercially objectionable in treating the liabilities of a junior creditor to a company remaining mutual with any claims it has against the company assigned to the senior creditor, which technically (on the authorities), is the effect of a simple untrammelled assignment. As insolvency set-off is mandatory; the simple way to avoid any risk of the finding of such mutuality (whether procedural or otherwise) is to ensure that any such assignment is either effected: (i) by an assignment free of all equities, in the event that such assignment is permitted by the company; or (ii) by effecting the assignment/subrogation by requiring the junior creditor to hold its claim on trust for the senior creditor to the extent required to discharge the liabilities of the senior creditor. Such contractual/trust arrangement will destroy any mutuality the debtor company may have in a cross claim against the junior creditor.

CONCLUSION

Mutuality is a mandatory requirement of insolvency set-off. It is likely that in a simple assignment any cross claim by the debtor against the assignor will retain its mutual character with the assigned debt. However, that "mutuality" is precarious and can be removed by simple, but careful drafting. Accordingly, the risk posed to a senior creditor (and consequently to the availability of credit) can easily be avoided by clear terms excluding prior equities or by the inclusion of a trust arrangement in the turnover subordination agreement to deal with the debt due to the junior creditor.

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Further reading

- The troubled waters of insolvency set-off: mutuality, the *pari passu* principle and other considerations [2010] 5 *JIBFL* 282.
- Set-off and assignment in administration [2011] 2 *JIBFL* 92.
- Lexis PSL: Banking & Finance: Set-off and Netting: Insolvency Set-off Practice Note.

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