Debt Subordination

in Corporate Liquidation

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ABSTRACT

This work examines the validity and effectiveness of certain subordination techniques of unsecured debt in corporate liquidation under English law. In practice, the validity and effectiveness of debt subordination is only relevant when either the debtor or the subordinated creditor is, or is threatening to become, insolvent. The focus in the work is on contractual and turnover subordination.

It is proposed that the general picture of debt subordination becomes clearer when we examine it from the point of view of, first, the debtor's liquidation, second the junior creditor's liquidation and third when they are both in liquidation. The material questions dealt with go to the very fundamentals of insolvency law, ie the role of *pari passu* distribution, ascertainment of which assets constitute the insolvency estate and whether it is possible to deviate from these rules contractually.

In order to answer the question whether debt subordination is effective in corporate liquidation under English law, the thesis addresses the following sub-themes: (i) whether subordination may fail being a preference, transaction at an undervalue or otherwise voidable; (ii) whether subordination may be defeated as a result of the insolvency set-off provision; and (iii) the effectiveness of the trust arrangement used in connection with turnover subordinations. These issues are evaluated through so-called complete, springing and subsequent subordinations.

The thesis proposes that the often-difficult questions concerning debt subordination in corporate liquidation can be resolved through a systematic, concise evaluation of the basic principles of the insolvency law in each liquidation respectively and that careful contractual drafting can considerably reduce the risks often associated with debt subordinations.

TABLE OF CONTENTS

TABLE OF CASES

English cases

Australian Cases

Irish Cases

New Zealand Cases

ABBREVIATIONS

Derham	SR Derham *The Law of Set-Off* (3rd ed, OUP, Oxford 2003)
Ferran	E Ferran *Company Law and Corporate Finance* (OUP, Oxford 1999)
Goode I	RM Goode *Legal problems of Credit and Security* (3rd ed, Sweet & Maxwell, London 2003)
Goode II	RM Goode *Principles of Corporate Insolvency Law* (3rd ed, Sweet & Maxwell, London 2005)
Goode III	RM Goode *Commercial Law* (3rd ed, Penguin, London 2004)
Hayton-Underhill	DJ Hayton and A Underhill *Underhill and Hayton. Law Relating to Trusts and Trustees* (15th ed, Butterworths, London 1995)
Keay-McPherson	AR Keay and BH McPherson *McPherson's Law of Company Liquidation* (1st England and Wales ed, Sweet & Maxwell, London 2001)
Wood	P Wood *The Law of Subordinated Debt* (Sweet & Maxwell, London 1990)

TABLE OF STATUTES

IA	Insolvency Act 1986
IR	Insolvency Rules 1986 (SI 1986/1924)
CA	Companies Act 1985
IR 2005	Insolvency (Amendment) Rules 2005 (SI 2005/527)

Command papers

the Cork Report	Insolvency Law and Practice Cmnd 8558 (1982)

1 INTRODUCTION

1.1 OUTLINE OF THE WORK

Debt subordination is a legal technique whereby creditors can allocate the risk of the debtor not being able to repay all its debts. It is fundamentally an arrangement whereby secured or unsecured creditors vary contractually the priorities of their claims arising under the general law by accepting lower ranking for repayment than their debts would ordinarily enjoy.[1] As such, debt subordination can be a highly useful legal technique capable of being employed for many purposes, eg in structured financing, leveraged acquisitions, and bank capital maintenance.[2] In order to achieve its purpose, debt subordination should be supported by limitations on the subordinated creditor's right to take actions and enforce security interests, thus, avoiding extortion of the higher-ranking creditors, eg in debt restructurings.

An increased risk of the non-repayment of the subordinated debt means that such debt usually carries a higher risk premium in the form of higher interest rate compared to unsubordinated debt. However, any doubts about the validity of subordination distort the pricing of such risk restricting the effectiveness of debt subordination in corporate finance and the use of developed price and risk parameters eg in the mezzanine and high yield debt market. This risk materialises primarily in corporate insolvency. The fundamental question is therefore: Is debt subordination effective in the liquidation of the debtor, the subordinated creditor, or both, and under what conditions debt subordination is voidable either as a transaction at an undervalue or a preference? Answering this question is the central theme of this thesis.

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[1] E Ferran *Company Law and Corporate Finance* (OUP, Oxford 1999) 545 (hereafter "*Ferran*").

[2] See about the uses of various forms of debt subordination and its benefits and disadvantages: P Wood *The Law of Subordinated Debt* (Sweet & Maxwell, London 1990), (hereafter "*Wood*") 1.4.

I will discuss the validity and effectiveness of contractual and turnover subordination of corporate debt under English law. The distinction between the two is clear. Contractual subordination is effected by means of a contract involving generally a commitment by the subordinated creditor to rank behind all other unsecured debts of the company; and turnover subordination is effected either contractually or by means of trust involving an obligation to turn over the funds received by the junior creditor to the senior creditor until the latter's debt has been fully discharged.

I have used the terms 'junior creditor' and 'subordinated creditor' interchangeably referring to the creditor that has agreed to be subordinated to other creditors of the debtor, ie thereby becoming 'junior' or 'subordinated' to the other creditors. The term senior creditor, on the other hand, refers to the party to whose claim the junior debt is subordinated.

The above subordination methods constitute one aspect of the larger puzzle of structuring corporate debt and the priorities of various creditors in corporate finance. The material difference with debt subordination techniques compared to such other forms of arranging priorities is that debt subordination is a consensual variation of the statutory order of distribution of insolvent's estate. Therefore, perhaps the single most important question when evaluating the effectiveness of debt subordination structures is: to what extent is such a deviation possible without the arrangement being in breach of the mandatory rules in liquidation such as the *pari passu* principle of insolvency law, the efficient administration of insolvency estates or the rule against divestiture of the insolvent's assets? These questions are pronounced in contractual subordinations because of the House of Lords decisions in *British Eagle*[3] and *NatWest v Halesowen*[4].

I will use the terms *divestiture* and *divestment* of assets rather extensively throughout the thesis. The terms denote the rule enunciated in cases *Ex p. Mackay*[5], *Ex p Jay*[6] and most recently in *Money Markets v LSE*[7] that a debtor cannot, by stipulation with a creditor, agree that some of its assets will not be available to his creditors in his insolvency; or, analogously, that a creditor receives some additional advantage which prevents the property being distributed according to the insolvency laws.

Even though debt subordination appears to be recognized largely throughout the Commonwealth and most importantly by English High Court decisions *Re Maxwell*[8] and *SSSL Realisations (2002)*[9], certain of aspects of debt subordination remain moot points and cause difficulties when structuring financial transactions. In addition, even if debt subordination were effective under English law, it remains somewhat open as to what remedies are available to the unsubordinated creditors if such commitments are either modified or breached by the junior creditor or the debtor. One such a question is whether the right of set-off defeats subordination because the insolvency set-off provision is mandatory and automatic,[10] incapable of being contractually excluded.[11] Subordination is

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3 *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758 (HL).

4 *National Westminster Bank Ltd. v Halesowen Presswork & Assemblies* [1972] AC 785 (HL).

5 *Jeavons, Ex p Mackay, Re* (1873) LR 8 Ch App 643 (CA).

6 *Harrison, Ex p Jay, Re* (1880) 14 Ch D 19, 25.

7 *Money Markets International Stockbrokers Ltd (In Liquidation) v London Stock Exchange Ltd* [2002] 1 WLR 1150 (HC) [118].

8 *Re Maxwell Communications Corporation plc (No 2)* [1993] 1 WLR 1402 (HC).

9 *Re SSSL Realisations (2002) Ltd (formerly Save Service Stations Ltd) (In Liquidation)* [2004] EWHC 1760 (Ch). The correctness of the decision was affirmed in the Court of Appeal; see n 191.

10 *MS Fashions Ltd v Bank of Credit and Commerce International SA (In Liquidation)* [1993] Ch. 425 (CA).

11 *NatWest v Halesowen* (n 4).

naturally thwarted if the subordinated creditor can resort to set-off against the insolvent debtor.

Perhaps the most controversial issues with debt subordination arise when the junior creditor becomes insolvent.[12] In addition, a situation where both the junior creditor and the debtor are insolvent results in the question whether the effectiveness of subordination should be evaluated as a whole or separately in each insolvency. Such a situation is the crux of debt subordination because the commitments of both the debtor and the junior creditor are being scrutinized in respect of the mandatory provisions of the corporate insolvency law. However, in order to evaluate these situations critically, it is first necessary to study the effectiveness of debt subordination in the liquidation of the debtor and the junior creditor separately.

As I will propose, the legal policies and the law of debt subordination become considerably clearer and more structured when we approach the relevant questions in this manner. For this purpose, the focus of this thesis is on liquidation of the debtor and the junior creditor. I have excluded from the scope of the work other forms of corporate insolvency,[13] agreements relating to consensual variation of rights to security among creditors, and possible remedies that may be available upon failure of the debt subordination. Before embarking on the intricacies of debt subordination in corporate liquidation, I will first outline the more detailed questions addressed in the thesis that need to be resolved in order to give a plausible account of the topic.

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[12] Such a situation may arise eg in leveraged acquisitions and group financing where the financial performance of the debtor (target or subsidiary) and the junior creditor (acquirer/parent) are inherently intertwined.

[13] However, it is important to note that if debt subordination is to be effective, it has to stand whatever the form of insolvency.

1.2 The Structure of the Thesis

This thesis consists of four parts. The first part (chapter 2) contains an overview on various debt subordination structures constituting the basis for my subsequent evaluation of the topic. The following part (chapter 3) is a discussion on the effectiveness of debt subordination in the liquidation of the debtor focusing on the effects of the *pari passu* principle, certain public policy considerations, and insolvency set-off on debt subordination. These questions materialize primarily in debtor-creditor contractual subordination, where a creditor agrees to be subordinated to all or some of the other unsecured creditors of the debtor.

The main part of the thesis (chapter 4) is a discussion of the impact of the subordinated creditor's liquidation on the effectiveness of the debt subordination. Because the questions that arise in situations where both the subordinated creditor and the debtor are insolvent are inherently linked to the questions that arise in the subordinated creditor's liquidation, these two scenarios will be discussed together. The questions relating to 'double-insolvencies' are pronounced in leveraged acquisitions and group financing where the income stream of the operative companies is insufficient for the repayment of the group debt and where no debt rescheduling is warranted. To the extent there are differences between the two situations, they are discussed separately. The emphasis is on the question whether the subordination commitment is a qualification or limitation of the claim held by the junior creditor or a divestiture of the junior creditor's assets. In addition, some aspects of the *pari passu* principle, the rule against divestiture and the insolvency set-off provision acquire additional momentum in the insolvency of the junior creditor, not present in the debtor's insolvency.

The second part of the chapter is focused on the question under what circumstances debt subordination might be deemed a preference, a transaction at an undervalue or otherwise voidable. The third part is a discussion on the issues that arise with turnover trusts, especially whether such a trust may be recharacterized as a charge. I will conclude the thesis in chapter 5 with my account of the circumstances under which debt subordination is effective in corporate liquidation under English law.

2 SUBORDINATION STRUCTURES

2.1 CONTRACTUAL AND TURNOVER SUBORDINATION

A creditor may agree to subordinate either a security interest he holds or an unsecured debt owed to him by a debtor.[14] Subordination of an unsecured debt in insolvency may be achieved in practice either by:

1. an agreement between the debtor and the subordinated creditor stating that the subordinated creditor is entitled to be paid only after either some or all of the other creditors have been paid in full; or

2. a turnover agreement, which may be effected either by a contractual commitment by the junior creditor to account the funds received to the senior creditor or by means of trust for the benefit of the senior creditors.[15]

I will refer to the first of these as *contractual subordination* and to the latter as *turnover subordination*.[16] Direct contractual subordination, or *subordination simpliciter,*[17] is a technique where a particular creditor agrees to be ranked behind all other unsecured creditors of the company. The fundamental feature of this technique is that all of the debtor's unsecured creditors benefit from it and may even be protected against any variations of the subordination even though not being parties to it.[18] As Professor Wood states, in contractual subordinations the parties of the arrangement are the debtor and the junior creditor, whereas in the case of turnover subordination the agreement is typically concluded between the junior and the senior creditor.[19] It is desirable that the debtor is also a party to such an

[14] RM Goode *Legal problems of Credit and Security* (3rd ed, Sweet & Maxwell, London 2003) 55 (hereafter "*Goode I*").

[15] *Wood*, 1.1. In a sense subordination is the 'observe of the negative pledge', as Goode puts it, RM Goode *Commercial Law* (3rd ed, Penguin, London 2004), (hereafter "*Goode III*") 614.

[16] This terminology is also employed by Prof. Wood; see *Wood*, 1.1.

[17] *Goode III* 615.

[18] Eg under the provisions of Contracts (Rights of Third Parties) Act 1999.

[19] *Wood*, 7.1.

intercreditor agreement because direct undertakings by the debtor are likely to reduce the risk of unwarranted payments to the junior creditor.[20] Some creditors may also agree on a complex contractual ranking amongst themselves, leading to a situation where the junior creditor is subordinated to some but not all of the creditors. Turnover subordinations can in principle, take two forms:

1. Subordination trusts, where the junior creditor collects the dividends (or other payments) from the debtor, holds them on trust for the senior creditor turns them over to the senior creditor (or where the dividends are paid directly a common trustee for distribution in accordance with the order of priority); or

2. Debtor-creditor turnover subordinations, where the junior creditor is under contractual obligation to turn over the dividends (or other payments) to the senior creditor.

Compared to contractual subordination, turnover subordination has the benefit that both the junior and the senior creditor prove in the insolvency of the debtor and because the proceeds received by the junior creditor are held either on trust for the senior or are otherwise remitted to the senior creditor, it receives in effect a double dividend.[21] However, in debtor-creditor turnover subordinations the senior creditor carries the risk that the junior creditor is incapable of paying over the equivalent amount received from the debtor. Irrespective of this, debtor-creditor turnover subordinations may be useful especially in cross-border transactions if the trust is not recognized or if there are doubts about re-characterization of the trust.

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[20] Ibid.

[21] This means that it is nearly always more advantageous for the senior creditor to agree on turnover subordination instead of contractual subordination. However, this alternative may be restricted eg in cross-border transactions and where the debts are not linked to the same transaction.

Before the effectiveness of contractual subordination was affirmed in *Re Maxwell*,[22] most subordinations under English law were carried out either using a trust or as contingent subordinations whereby the structure is essentially the same with direct contractual subordination but the repayment of the junior debt is conditional the repayment of the senior debt in full.[23] The distinction between contractual subordination and contingent subordination is that whereas the latter relies on the doctrine that the junior creditor's asset is considered a 'flawed asset',[24] in contractual subordination the repayment of the debt is merely postponed to that of the unsubordinated creditors. Even though Vinelott J questioned in *Re Maxwell* the existence of the category of contingent debt subordination,[25] it can be argued that a debt contingent on occurrence of a specified event could be categorized as a conditional debt when the payment to the junior creditor is not something falling within the sole discretion of the senior creditor.[26]

An additional feature of debt subordinations is that they can be either complete or springing, ie inchoate,[27] subordinations. Under the first method, the subordination takes place immediately upon the debt coming into existence whereas under the latter only upon occurrence of some specified event, eg a payment default. In springing subordinations, the repayment of the interest and the capital of the junior debt may be made in an unsubordinated manner until the occurrence of the specified event.[28] In all cases, the

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[22] *Re Maxwell* (n 8).

[23] *Ferran* 564.

[24] RM Goode *Principles of Corporate Insolvency Law* (3rd ed, Sweet & Maxwell, London 2005), (hereafter "*Goode II*") 6-12. This means that the debt would have to be valued according to r.4.86 of the IR and, because of the debtor's inability to pay its debts, its value would likely be nil. It should be noted that Vinelott J doubted the existence of a specific category of contingent debt subordination in his decision in *Re Maxwell* (n 8) 1419.

[25] *Re Maxwell* (n 8), 1419.

[26] D D Prentice, All ER Rev 1994, pp 66-7.

[27] *Wood*, 2.1.

[28] Ibid.

subordination should become effective at the latest upon insolvency of the debtor.[29] Apparently, the most risk-laden form of subordination is subsequent subordination of an existing unsubordinated debt, eg in a workout.[30]

2.2 SECURED-DEBT SUBORDINATION

To the extent the debts are secured, the creditors may also conclude an agreement on their respective priorities in respect of particular security assets, irrespective whether the debtor is a party to it. Especially when the issue of subordinated debt is linked to a more extensive financing package, the material aspects relating to security priority agreements, their statutory and common law priorities and the priorities relating to the debt itself go hand-in-hand. Furthermore, the rights of enforcement of the junior security must not defeat the subordination of the junior debt.

It is rather commonplace, especially in case of acquisition finance transactions, that the debtor grants security to the senior and the junior creditor either respectively or to a common trustee holding the security for the benefit of the both of them.[31] However, in both of these situations, it may be relevant to consider variations to the priority rules arising under the general law of security. When the security is granted in connection with a transaction involving both senior and junior debt, the priorities are often either stipulated in the provisions of the trust deed or the intercreditor agreement relating to distribution of the enforcement proceeds of the sale of the security assets; or the priorities of the creditors are determined under the general priority rules, e.g. registration, notice etc.

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[29] P Wood, *Project Finance, Subordinated Debt, and State Loans* (Sweet & Maxwell, London 1995), 6-4.

[30] See especially chapter 4.4.

[31] See generally DJ Hayton and A Underhill *Underhill and Hayton. Law Relating to Trusts and Trustees* (15th ed, Butterworths, London 1995), (hereafter "*Hayton-Underhill*") 39-42.

Although there is no English case directly to the point, it appears that the holders of successive security interests may effectively vary their priorities whether the debtor is a party to the agreement or not.[32] The Privy Council decision *Cheah Theam Swee v Equiticorp Finance Group Ltd*, although concerning New Zealand law, provides strong support for the proposition that security priority agreements are effective also under English law.[33]

Priority agreements may also raise concerns relating to the manner of the enforcement of the security and, where a fixed charge is subordinated to a floating charge, whether also the preferential creditors are consequently subordinated to the floating charge creditors. Under general law, preferential creditors rank above floating charge creditors but behind fixed charge creditors.[34] In such cases, subordination leads to obvious circularity problems in creditor priorities.[35]

2.3 STRUCTURAL SUBORDINATION

Structural subordination is fundamentally an arrangement, where the junior and the senior debts are owed by separate entities of the same group, eg the holding company and the subsidiary carrying out the actual business. This is a highly useful technique in leveraged acquisitions where the high-yield bond (ie the structurally subordinated debt carrying the higher interest rate) is often issued by the company holding the shares in the acquiring company; whereas the senior debt (carrying the lower interest rate) is taken by the acquirer

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[32] *Goode I*, 1-80; and *Ferran* 546.

[33] *Cheah Theam Swee v Equiticorp Finance Group Ltd* [1992] 1 AC 472 (PC), where the Privy Council concluded that mortgagees could vary the order of priority of their mortgages without the mortgagor's consent, unless otherwise had been stipulated in the contract with the mortgagor. Lord Browne-Wilkinson continued that the mortgagor could not effectively require the mortgagee to satisfy the repayment of his debt from a particular individual security and that the alteration of the priorities did not adversely affect the mortgagor's right to recover the security eventually, at 477.

[34] S.175 of the IA.

[35] See *Re Portbase Clothing Ltd* [1993] Ch. 388 (Ch) and *Re Woodroffes (Musical Instruments) Ltd* [1986] Ch. 366 (Ch) (for a countervailing decision).

or by the target group. The idea is that the primary, and often the only, source of income of the acquirer or the holding company is the income stream generated by the target company or its subsidiaries. This income, on the other hand, may be extracted from these companies only through legally acceptable ways afforded by the company legislation, eg dividends.

Naturally, the effectiveness of such financing structures may be affected by group cross-guarantees or indemnities between the holding company, the acquirer and the target group making structural subordination more vulnerable to competing claims. However, the risk relating to group cross-guarantees and indemnities can be dealt with in the financing documentation by restrictive covenants and through subordination of such guarantees and indemnities. This is also a rather typical structure of European high-yield debt subordinations.[36] It should be noted, that some aspects of the structuring of leveraged financing are severely restricted in the company legislation, most importantly by the financial assistance restrictions of the CA.[37]

It is important to note that there are also other jurisdiction-specific forms of subordinating a debt or a security interest to those of the other creditors such as equitable subordination in the US; contracting into a subordination statute; subordination under s.74(2)(f) of the IA of sums due to the members held in their capacity as members in the company or under s.215(4) of the IA of the claims of directors found guilty of fraudulent or

[36] Various forms of subordination may naturally appear even in the same transaction. Alternatively to mezzanine debt, there may be a structurally subordinated high-yield debt issue on the holding company level. Furthermore, the operating companies of the target group may provide credit enhancement for the high-yield debt in form of subordinated guarantees – thus creating a 'mix' of structural and contractual subordination in the transaction.

[37] These arrangements usually invoke legal concerns because of the financial assistance provisions prohibiting the target financing the purchase of its own shares and to some extent granting loans or guarantees for the obligations of the loans of other group companies (ss.151-8 of the CA). One alternative is naturally to limit the coverage of any security or guarantees granted by or loans taken by the target or subsidiaries eg to working capital refinancing, thus excluding the acquisition portion of the financing.

wrongful trading.[38] It should be noted that although the above may technically result in subordination of the relevant claims, financial law is honeycombed with ways of attaining priority in the bankruptcy of either the debtor or the junior creditor.[39] All of these are, however, of non-consensual nature. Therefore, these methods, or structural subordination, although being of great practical importance, are not discussed in this thesis.

38 It should also be noted that technically a similar non-consensual deferral applies to a prescribed portion of the net property under the floating charge that must be made available to unsecured creditors.

39 See for a discussion on these methods, *Wood* 2.6-7.

3 Liquidation of the Debtor

3.1 Introduction

Because it is a fundamental aspect of contractual subordination that the junior creditor agrees to rank in the insolvency of the debtor after all other unsecured creditors, one is prone to ask whether such a deviation from the equal distribution of the assets is allowed within each class of creditors, ie what is its relation to the *pari passu* rule or is it otherwise contrary to the public policy as endorsed in the insolvency legislation.

However, such a question has an inherent caveat built into it, for the correct question should be two-fold. We need to distinguish for this purpose the role of the rule first in the debtor's insolvency and, secondly, in the junior creditor's insolvency. Much confusion surrounding the validity of debt subordination can be cleared out by adequately distinguishing these two sub-questions. This division emphasises the fact that the nature of the questions raised in each liquidation is different. The relevant question in the debtor's liquidation is the mandatory nature of the *pari passu* distribution clause and its exceptions; whereas the question in the junior creditor's liquidation is the scope of the rule against divestiture of the insolvent's assets.

I will deal in this chapter only with the first part of the question, ie whether contractual debt subordination is inherently against equal distribution of the debtor's insolvency estate. The latter question is discussed in chapter 4. It should be borne in mind that *pari passu* has no impact on the effectiveness of turnover trusts in debt subordination because trust assets as such are not part of the insolvent company's assets.

3.2 TWO VIEWS ON THE PARI PASSU RULE

According to Vanessa Finch, the principle of *pari passu* holds that where, in relation to preferential debts and ordinary debts, there is shortfall between the totality of liabilities within the category of priority and the sum of money available to discharge these, debts of equal rank shall abate in equal proportions as between themselves.[40] The principle is embodied in Section 107 of the IA (applying in voluntary winding up), according to which the company's property shall be applied in satisfaction of the company's liabilities *pari passu* and 4.181 of the IR (applying in a compulsory winding-up) according to which the company's debts[41] rank equally between themselves and if there are insufficient funds to pay all such debts, they abate in equal proportions between themselves.[42]

The textual interpretation of the provisions would warrant the view that they only regulate some aspects of the distribution of the insolvent's estate, and does not deal with the question what constitutes the insolvent's estate. This is determined by the general law.[43] However, as Goode states, the *pari passu* rule is all-pervasive and its broad effect is to strike down all arrangements, which have their object or result the unfair preference of a particular creditor or removal from the estate on winding-up of an asset that would

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[40] V Finch 'Is Pari Passu Passe' [2003] 5 Insolv L 194.

[41] The rule does not apply to preferential debts.

[42] It should be noted that it was mentioned in the United Kingdom Review Committee on Insolvency Law and Practice (Report of the United Kingdom Review Committee on Insolvency Law and Practice Cmnd 8558 (1982), 1448-9)(the Cork Report) that: '... all unsecured debts must be paid pari passu.... It is therefore not open to a creditor to advance money on terms that the debt will be subordinated to other claims in the event of the borrower's insolvency.... We can see no reason why a creditor who wishes to do so should not be permitted to subordinate his claim to those of all other creditors, or all other creditors except those of like degree. …We therefore recommend the inclusion of an appropriate proviso to [referring to the pari passu provisions] to allow effect to be given to subordination agreements.' This view would imply a broad reading of *British Eagle* (n 3). No legislative changes have been introduced due to the Cork Report.

[43] See generally AR Keay and BH McPherson *McPherson's Law of Company Liquidation* (1st England and Wales ed, Sweet & Maxwell, London 2001) (hereafter "*Keay-McPherson*") 11.02-03.

otherwise have been available for the general body of creditors,[44] ie apparently also divestiture or forfeiture of the insolvent's assets. The apparent latitude in the scope of the term, however, should not blur our analysis of the actual effects of the provision. Therefore, we should be wary of the actual extent of the rule first in ascertainment of the assets and second in their distribution.

The reason why the *pari passu* rule is of significance in evaluating the effectiveness of debt subordinations stems from the House of Lords decisions *NatWest v Halesowen*[45] and *British Eagle*[46] that are often seen as impediments to agreeing to give up ones right of *pari passu* distribution in corporate liquidation.[47] The latter case essentially warrants two different readings. First, there is the narrow view endorsed eg by Wood[48] and in the Australian case *Horne v Chester & Fein*[49] that the ambit of the case is just to avoid those contracts that prevent whole of the debtor's estate from being available for distribution to all creditors.[50] The broad reading of the case as endorsed by Goode[51]and in *Carreras v Freeman* is that:[52]

> …where the effect of a contract is that an asset which is actually owned by a company at the commencement of its liquidation would be dealt with in a way other than in accordance with section 302 of the Companies Act 1948, then to that extent the contract as a matter of public policy is avoided...

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44 *Goode II*, 7-02 and 7-03. Although there has been a lot of discussion about the actual scope and value of the rule, I will put those questions on one side here in this work. See in relation to such discussion eg: *Goode II*, 7-07 through 7-18; RJ Mokal 'Priority as Pathology: The Pari Passu Myth' [2001] 60 CLJ 581; *British Eagle* (n 3); and LC Ho 'The Principle against Divestiture Revisited: Fraser v Oystertec' [2004] 19 JIBLR 54.

45 *NatWest v Halesowen* (n 4).

46 *British Eagle* (n 3).

47 *British Eagle* (n 3). See especially LC Ho 'A Matter of Contractual and Trust Subordination' [2004] 19 JIBLR 494.

48 *Wood*, 3.1.

49 *Horne v Chester & Fein Property Development Pty Ltd & Ors* (1986 (V SC).

50 B Johnston 'Contractual Debt Subordination and Legislative Reform' [1991] JBL 225, 231-2.

51 *Goode II*, 7-02.

52 *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd (In Liquidation)* [1985] Ch 207, 226.

The fundamental difference from our point of view that the narrow reading warrants that contractual debt subordination cannot be struck down due to *British Eagle*[53] merely because it is a deviation from the pro rata *distribution* of the debtor's assets.[54] On the other hand, the broad reading implies that any dividends paid out of the debtor's estate must be paid equally to all creditors within each class. Should the case support only the narrow reading above, suggesting that the case is really one concerning divestiture of assets, it becomes relevant only in the insolvency of the junior creditor. The reason is that all assets are certainly available for all of the debtor's creditors whereas the same cannot necessarily be said of the assets of the junior creditor in its insolvency.

As I will propose, the *pari passu* rule and the rule against divestiture of the insolvent's assets evidenced in cases such as *British Eagle*,[55] *Ex p Jay*[56] and *Ex p. Mackay*[57] are distinguishable and this distinction has an impact on the evaluation of the effectiveness of, *inter alia*, debt subordination agreements.

3.3 BRITISH EAGLE AND PARI PASSU

British Eagle[58] concerned the effectiveness of a clearing house arrangement by international airlines under which the mutual obligations of the airlines were settled monthly through a clearing house. Only the net balance after the clearing and settlement was either due to or

53 *British Eagle* (n 3).

54 *Carreras Rothmans* (n 52).

55 *British Eagle* (n 3).

56 *Ex p Jay* (n 6)

57 *Ex p Mackay* (n 5)

58 *British Eagle* (n 3).

payable by a particular airline. The settlement mechanism of the claims that arose between the parties took place contractually and none of the participants could have invoked (at least while they were solvent) claims against one another but only a net claim against the clearing house. The liquidator of British Eagle claimed that Air France should pay its debt to the insolvency estate of British Eagle despite the clearing house arrangement. Air France disagreed. Among other things, the House of Lords held that contracting out of the provisions of section 302 of the Companies Act 1948 (the *pari passu* rule as it then was) was contrary to public policy.[59]

The first question was whether there was a gross debt payable for the services rendered or was there only a net claim that may or may not exist after having carried out the clearing and settlement. Lord Cross concluded that due to the clearing house agreement the legal rights were not strictly speaking debts, but *innominate choses in action*, having some but not all characteristics of debts.[60] This appears to have been the foundation on his subsequent analysis. Had there been no debt, there would hardly have arisen any question on whether or not such debt, ie the claim of British Eagle, would have been misappropriated from the estate. The reason why the question on *pari passu* arose was that the liquidator specifically referred to the s.302 Companies Act, which contained the *pari passu* rule, as it then was, and relying inherently in his arguments on the case *Ex p. Mackay*.[61]

The facts of *Ex p. Mackay*[62] were as follows. A sold a patent to B in consideration of B paying royalties to A. B at the same time lent A £12,500. The parties agreed concurrently that B retains one-half of the royalties towards satisfaction of the debt,

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[59] *British Eagle* (n 3) 780-1.

[60] Ibid. 779.

[61] *Ex p Mackay* (n 5)

[62] Ibid.

as they became payable. However, if A should become bankrupt or make an arrangement with his creditors, B would be able to retain the whole of the royalties in satisfaction of the debt. A became subsequently bankrupt. It was accepted that the retainer of half of the royalties constituted a valid lien on the property. However, the retainer in relation to the second half was deemed void. James LJ concluded that:[63]

> It is contended that a creditor has a right to sell on these terms; but in my opinion a man is not allowed, by stipulation with a creditor, to provide for a different distribution of his effects in the event of bankruptcy from that which the law provides. It appears to me that this is a clear attempt to evade the operation of the bankruptcy laws.

This view was also shared by Mellish LJ, who, referring to an earlier case of *Higinbotham v Holme*[64], stated that:[65]

> …a person cannot make it a part of his contract that, in the event of bankruptcy, he is then to get some additional advantage which prevents the property being distributed under the bankruptcy laws…

However, Air France asserted that the current case was not about creating encumbrances upon a bankruptcy situation but that the same clearing house agreement provisions applied irrespective of the bankruptcy of British Eagle. Lord Cross regarded Air France's view flawed because the clearing house parties did not intend to create charges but rather to set-off various claims in monthly intervals. He categorized the clearing arrangement as mini-liquidation and concluded that contracting out of the provisions in s.302 of the Companies Act 1948 was contrary to public policy.[66] Nevertheless, the public policy he was referring to in saying that appears to have been the one stipulated by James and Mellish LJJ in *Ex p.*

[63] Ibid. 647.

[64] *Higinbotham v Holme* (1812) 19 Ves 88.

[65] *Ex p Mackay* (n 5) 648.

[66] *British Eagle* (n 3) 781.

Mackay[67] that no creditor may obtain a preference in a situation (as was the case in *Ex p. Mackay*) without creation of a valid security interest.

Therefore, the underlying public policy endorsed in *British Eagle* was not that of mandatory equal distribution within each class of creditors but rather prohibition of 'snatching' away the insolvent's property without having a security interest on the property, ie preferring a particular creditor.[68] Lord Morris, who dissented, on the other hand, argued that the material question was in fact about the extent of the claim that British Eagle had. He concluded that due to the clearing house arrangement, there existed no such debt.[69] According to his view, Air France was not in fact contractually in a better position than the other unsecured creditors, ie no 'snatching-away' could occur. The property of British Eagle was the 'right, if on balance they proved to be in credit, to receive a payment from the clearing house'. Lord Morris emphasised that the liquidator takes no better title to property than that which was possessed by a bankrupt and he cannot remould contracts validly made.[70]

Therefore, under both the majority and minority decisions, it was a part of the *a priori* ascertainment of assets, preceding any divestiture or *pari passu* evaluations, that the liquidator finds the assets as they are. The moot point was the extent of the claim, whether it was the 'original debt' of Air France or the claim that may or may not have resulted from the settlement under the clearing house agreement, ie a matter of construction of the contract. Either way, it appears that all judges would have considered the clearing house agreement as

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[67] *Ex p Mackay* (n 5).

[68] *Wood,* 3.1.

[69] *British Eagle* (n 3) 766.

[70] Ibid. 770.

having been contrary to public policy if they all had agreed that there was an existing cross-claim under which Air France was indebted to British Eagle.

After having decided that there were indeed existing cross-claims, it was deemed that Air France would secure an advantage preventing a subsequent mandatory distribution regime. This is plainly correct. First, this view is directly supported by the words of James LJ and Mellish LJ in *Ex p. Mackay*, ie the must intend to get some *additional advantage* preventing the subsequent distribution according to the priorities recognized in the insolvency legislation.[71]

The above analysis supports the narrow reading of the case because when Lord Cross referred to the public policy under s.302 of the Companies Act 1948 he was in fact relying on the doctrine endorsed in *Ex p. Mackay*[72], ie preventing assets from being available for distribution to all creditors.[73] This means that *British Eagle* does not necessitate a *pro rata* distribution of assets but requires that all of the insolvent's assets are available for distribution. Second, it should be noted that British Eagle was not in compulsory winding-up, which meant that the rule s.127 of the IA (the post-petition disposals provision) could not be invoked by the liquidator.[74] Instead, he was forced to rely on the corresponding rule against divestiture of the insolvent's assets as embodied, *inter alia*, in *Ex p. Mackay*[75] and *Ex p Jay*[76], ie the policy underlying the *pari passu* clause. Having said that, it is hard to understand why *British Eagle* would provide any arguments against effectiveness of contractual

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[71] *Ex p Mackay* (n 5) 648.

[72] Ibid. 647.

[73] See for a refined analysis on the topic: *Fraser v Oystertec Plc* [2003] EWHC 2787 (HC) [111]-[119] and *MMI v LSE* (n 7) [118].

[74] In compulsory liquidation, any disposals carried out after the making of the winding-up petition require the court's approval. There is no similar rule in applying in voluntary liquidations.

[75] *Ex p Mackay* (n 5)

[76] *Ex p Jay* (n 6)

subordination in debtor's insolvency, because contractual subordination does not mean that all of the insolvent's assets would not be available for distribution to its creditors.

However, even though the public policy in the *British Eagle* was not that of a mandatory equal distribution of assets, the House of Lords case *NatWest v Halesowen* raises similar concerns about the mandatory nature of the *pari passu* rule.[77]

3.4 Effects of Public Policy and Set-off on Debt Subordination

The questions whether contractual subordination is in breach of the *pari passu* rule and whether the rule is mandatory, has also been founded on analogical reasoning of the insolvency set-off cases most importantly in *NatWest v Halesowen*.[78] There are two reasons why the cases on set-off are of significance to the evaluations of the effects of the *pari passu* rule on debt subordination. First, the texts of both statutory provisions appear to be mandatory. Second, the set-off cases reflect certain public policy arguments that restrict contracting out of such insolvency law provisions.[79]

In *NatWest v Halesowen*[80] the set-off section in r.4.90 of the IR was deemed mandatory (Lord Cross dissenting) and that there were public policy considerations prohibiting contracting out of such a provision.[81] The mandatory and automatic nature of insolvency set-off has been confirmed by the Court of Appeal in *MS Fashions*[82] and *obiter dicta*

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[77] *NatWest v Halesowen* (n 4).

[78] *Natwest v Halesowen* (n 4). The set-off clause in corporate liquidation can be found in r.4.90 of the IR, and the corresponding rule applying in administrations is found in r.2.85 of the IR.

[79] SR Derham *The Law of Set-Off* (3rd ed, OUP, Oxford 2003), (hereafter "*Derham*") 6-71.

[80] *NatWest v Halesowen* (n 4).

[81] Ibid. 805, 809 and 824.

[82] *MS Fashions* (n 10) 432. According to Derham, the rule has been followed a least in some of the Commonwealth countries, notably Australia and New Zealand. As he points out, the acceptance of the rule would mean that in addition to not being able to waive the operation of the rule by agreement a creditor could not be estopped by his conduct from asserting insolvency set-off; See *Derham,* 6-71.

in *Stein v Blake*[83]. This means that, even though contractual subordination were effective irrespective of *British Eagle*, the *pari passu* distribution clause could still, by analogical reasoning, require that every creditor must receive its *pro rata* share and cannot waive his right to do so.

In respect of the text of the insolvency set-off clause, Lord Cross referred in *NatWest v Halesowen* to Lord Selbourne's statement in *Ex p. Barnett*[84] that '…when there have been mutual credits, debts, or mutual dealings…there is to be a rule of set off, not, as I understand it, at the option of either party, but an absolute statutory rule'. Thus, the provision was not deemed optional.[85]

The two instances of waiver and agreement not to set off are likely to be treated similarly. This also affects contractual debt subordinations because, if correct, a unilateral waiver of a right to receive a payment *pari passu* and an agreement on the issue would be evaluated on the same grounds.[86] It should be noted that Lord Cross did not read *Ex p. Vaughan*[87] or *Ex p. Barnett*[88] in the same manner as Viscount Dilhorne, but went on to follow the Irish decision *Deering v. Hyndman*[89] in which the above-referred cases were interpreted as allowing contracting-out of the insolvency set-off clause. However, the majority favoured the reading of the cases as proposed by Viscount Dilhorne.

Perhaps an even more important aspect of the case is the public policy argument underlying the inability to exclude provisions of the insolvency legislation of a

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83 *Stein v Blake (No. 1)* [1996] AC 243 (HL). However, the case concerned personal bankruptcy.

84 *Re Deveze Ex p Barnett* (1874) LR 9 Ch App 293 (CA) 295.

85 *NatWest v Halesowen* (n 4) 813-4.

86 It should be noted that the mandatory nature of the insolvency set-off clause was also supported by the judgement of Lord Denning M.R. in *Rolls Razor Ltd. v Cox* [1967] 1 QB 552 (CA).

87 *Re Fletcher Ex p. Vaughan* 6 Ch. D. 350 (CA).

88 *Re Deveze* (n 84).

89 *Deering v. Hyndman* (1886) 18 L.R.Ir. 323.

mandatory nature. According to Lord Simon, the maxim *'Quilibet potest renunciare juri pro se introducto'* begged the question whether the statutory provision in the set-off provision was introduced 'for the benefit of any particular person or body of persons or was prescribing a course of procedure to be followed in the administration of the bankrupt's property'.[90] Importantly, he elaborated the above maxim as meaning 'Anyone may at his pleasure renounce the benefit of a stipulation or other right introduced entirely in his own favour'.[91] He considered that it was impossible to construe the wording of the set-off section in that way because the rule laid down a procedure for proper and orderly administration of the insolvent estates.[92] His Lordship continued that the commercial community generally has an interest in such an objective.[93]

The above indicates that the answer to the question whether the *pari passu* rule or another similar provision can be contractually excluded depends on the fact whether the provision is introduced solely for the benefit of any particular person or was prescribing a course of procedure to be followed in the administration of the bankrupt's property. Therefore, the case provides primarily *a rule of construction* of particular statutory provisions.[94] This naturally invokes the question whether contractual subordination is in breach of the *pari passu* rule thus preventing an orderly administration of an estate or restricts facilitating other interests of the commercial community. This issue came to be resolved in *Re Maxwell*.[95]

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[90] *NatWest v Halesowen* (n 4) 808.

[91] Ibidem. This deviation from the apparently imperative wording of the provision is also supported by the Privy Council decision *Vita Food Products Inc v Unus Shipping Co Ltd (In Liquidation)* [1939] AC 277 (PC).

[92] *NatWest v Halesowen* (n 4) 809.

[93] Ibidem.

[94] It can be argued that insolvency law should derogate from pre-insolvency creditor rights only when there is a perceived insolvency objective which would be compromised by the recognition of such right, see F Oditah 'Assets and the Treatment of Claims in Insolvency' (1992) 108 LQR 459, 472.

[95] *Re Maxwell* (n 8).

3.5 The Scope of Public Policy Arguments

3.5.1 Re Maxwell

The effectiveness of direct debt subordination in the debtor's insolvency has been confirmed in *Re Maxwell*[96], in *SSSL Realisations (2002)*[97] and in *Re British and Commonwealth Holdings*[98]. As I have proposed above, the doctrines in *Ex p Mackay*[99] and *British Eagle*[100] do not restrict simple debt subordination in the debtor's insolvency. What remained unclear was whether debt subordination indeed contains elements adversely affecting the general interests of the creditors and the commercial community as exemplified in *NatWest v Halesowen*.[101] The rule stipulated by Vinelott J in *Re Maxwell*[102] was that subordination clause is valid, effective and not avoided by public policy considerations. The effectiveness of trust subordination in the debtor's insolvency was affirmed by Vinelott J already a year prior to *Re Maxwell*[103] in *Re British and Commonwealth Holdings*[104].

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96 Ibidem.

97 *SSSL Realisations (2002)* (n 9). As Lloyd J succinctly put it: 'It is, however, established that, by contract, one creditor's rights can be subordinated to those of another or others, and this is a common feature of commercial dealings. It has a particular relevance to the capital adequacy of banks and other credit institutions under the regulatory regime applying to them, but it is used more widely.' [20].

98 *Re British and Commonwealth Holdings plc (No 3)* [1992] 1 WLR 672 (HC).

99 *Ex p Mackay* (n 5)

100 *British Eagle* (n 3).

101 *NatWest v Halesowen* (n 4) 809.

102 *Re Maxwell* (n 8). On the other hand, in the other leading case involving the question on effectiveness of debt subordination, *SSSL Realisations (2002)* (n 9), the validity of contractual subordination in the debtor's insolvency was not doubted by any of the parties.

103 *Re Maxwell* (n 8).

104 *Re British and Commonwealth Holdings* (n 98).

In *Re Maxwell* the parent company of the Maxwell Group, Maxwell Communications Corporation plc ("MCC") had granted a first demand guarantee for the repayment of a bond issued by one of its subsidiaries, Maxwell Finance Jersey ("MJF"). The guarantee was subordinated, *inter alia*, in insolvency of the MCC.[105] Both companies became insolvent. The question of the validity of the subordination clause came up in connection with a scheme of arrangement under s.425 of the CA in respect of the English assets of the group. The reason why the validity of the clause was challenged was that if the clause were valid, it would not have been necessary to take into consideration the bondholders when deciding on the approval of the scheme because the bonds would have been of no value and thus without interest in the arrangement.[106]

The question in *Re British and Commonwealth Holdings* was fundamentally the same as in *Re Maxwell*, since both concerned the question whether the subordinated creditors were entitled to participate in the voting whether to accept the s.425 of CA scheme of arrangement proposed by the administrators. The difference was that in *Re British and Commonwealth Holdings* the company had entered into a trust deed in relation to the issue of the convertible subordinated unsecured loan stock - there was no contractual subordination. Under the trust deed, the subordination applied in the event of the winding-up of the company.

Similarly to *Re Maxwell*,[107] the subordinated bondholders would have received nothing if the company were wound-up instead, provided that the subordination clause was effective. It should be noted that the intention on the subordinated creditors was to obtain a

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105 The reason why trust subordination was not used was that the contract was governed by Swiss law, which does not recognize trusts.

106 See for the valuation of subordinated bonds: *Re Tea Corp* [1904] 1 Ch. 12 (CA) and a more recent case *Re Mytravel Group Plc* [2004] EWCA Civ 1734 (CA).

107 *Re Maxwell* (n 8).

seat in the negotiating table in relation to the scheme of arrangement. Although they would not likely have received any direct financial benefit from their enhanced position, they could have held back the approval and thus been able to extort the senior creditors to pay a 'ransom' for their approval of the scheme. However, *Re British and Commonwealth Holdings*[108] does not afford too much lead to us, because Vinelott J was not forced to address the conflicting legal policy issues underlying debt subordination and the effectiveness of subordination in winding-up was not contended. Rather, he concluded that the subordination would operate by way of contract or by way of trust and the effectiveness on such a clause was taken at its face value.[109]

The first point to note in *Re Maxwell*[110] is that Vinelott J evaluated whether debt subordination involved in fact any general interests incapable of waiver. He concluded that there were no such interests.[111] First, a creditor is entitled to waive a debt after the insolvency or to decline to submit a proof in any case; therefore, a more 'lenient' method of debt subordination should not be prohibited.[112] Second, third parties may have relied on the effectiveness of the subordination when financing the company. Third, looking behind the proof is in fact no burden to the liquidator. The learned judge saw no inconvenience in the liquidator making the distributions in accordance with the subordination provision, thus the requirement of efficient administration of the estate argument had no significance in

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108 *Re British and Commonwealth Holdings* (n 98).

109 Ibid. 681.

110 *Re Maxwell* (n 8).

111 Ibidem, 1412. Sheller JA reached a similar conclusion in the New Zealand case *United States Trust Company of New York v Australia & New Zealand Banking Group* (1995) 17 ACSR 697, NSW CA at 139G, where he stated that (referring to the s 440 of the Companies (New South Wales) Code, which is comparable the English pari passu provision): 'On the other hand the provision has been treated as conferring a private right upon a creditor which the creditor may waive or renounce by contract or otherwise. The result would be no different than if the creditor decided not to lodge a proof of debt.'

112 *Re Maxwell* (n 8) 1412.

recognizing debt subordination.[113] It should be noted that rr.4.85 and 4.86 of the IR, which deal with most aspects arising in context with proof by the holders of the subordinated claim, support his view.

Vinelott J distinguished *British Eagle*[114] from *Re Maxwell*[115] on the basis that is was essentially a case of construction of the contract and proper analysis of the right and obligations arising under the clearing arrangement.[116] Importantly, he asserted that what the case actually proved was that a creditor cannot validly contract with his debtor that he will enjoy some advantage in a bankruptcy or winding-up which is denied to other creditors,[117] concurring with the Australian decision *Horne v Chester & Fein*[118] that the real policy underlying the case law was that the restrictions apply to contracts that would have had adverse consequences on others.[119] This view is also supported by the interpretation of the dicta by James LJ in *Ex p. Mackay*[120] I have endorsed above.[121] According to Vinelott J, a contrary decision would have had practical repercussions and English law should not in that sense deviate from the other common law jurisdictions.[122]

Vinelott's decision in *Re Maxwell*[123] is plainly correct. Importantly, he pointed out that the fundamental question in allowing debt subordination was that it was not deemed to

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113 Ibidem. 1413.

114 *British Eagle* (n 3).

115 *Re Maxwell* (n 8).

116 Ibidem, 1416.

117 Ibidem, 1417.

118 *Horne v Chester & Fein* (n 49).

119 Ibidem 488 and *Re Maxwell* (n 8) 1420 and 1421.

120 *Ex p Mackay* (n 5).

121 See chapter 3.3.

122 *Re Maxwell* (n 8) 1421.

123 Ibid.

have any adverse consequences on third parties. This view is of significance not only in more complex contractual subordinations but also in the junior creditor's liquidation.

3.5.2 Policy Aspects of Restitutionary Subrogation

The fact that debt subordination, as approved in *Re Maxwell*[124], should be allowed yields support also from another not so often taken perspective. It is well established under English law that a creditor having refinanced a particular secured debt will be subrogated to the rights of the secured creditor whose debt is being repaid provided that the general requirements of the remedy are met with.[125] Although the remedial aspects available for the failure of debt subordination are outside the scope of this work, it is important to note that the doctrine of restitutionary subrogation, as Lord Hutton concluded in *Banque Financiere de la Cite SA v Parc (Battersea) Ltd*,[126] is not limited to cases where there is necessarily a question about proprietary rights and it could be employed to determine priority matters generally.[127] The remedy can be divided into consensual and non-consensual subrogation, the first being based on an agreement and the latter arising by operation of law.[128] It is also clear from the opinion of Lord Hoffmann that the equitable remedy of subrogation may be awarded in an

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[124] *Re Maxwell* (n 8).

[125] See a description of the case law *Banque Financiere de la Cite SA v Parc (Battersea) Ltd* Banque Financiere de la Cite SA v Parc (Battersea) Ltd [1999] 1 AC 221 (HL). A failure of a creditor to obtain the priority it bargained for is of special relevance in debt restructuring and work-outs where it is usual that the either the entire existing debt or a part of it is repaid and financed with a new loan facility or term loans. The priority that the new creditor bargained for is often either a security interest or a package of security interests or another enhanced priority position.

[126] *Banque Financiere* (n 125).

[127] Ibidem 245. D Wright 'The Rise of Non-consensual Subrogation' [1999] 63 Conv 113.

[128] *Banque Financiere* (n 125) 231.

action to reverse unjust enrichment.[129] Restitutionary subrogation cannot be awarded if there are legal policy reasons against it.

The facts of the case were as follows. In 1988, Parc (Battersea) Ltd. ('Parc') obtained a bank loan secured by a debenture from Royal Trust Bank for the purposes of purchasing a development property. Omnicorp Overseas Ltd. ('OOL'), part of the same group as Parc, had a second legal charge over the property. The loan was refinanced by Banque Financiere de la Cité ('BFC') and arranged through the general manager of the Group in order to avoid the certain Swiss federal banking regulations. Parc provided no security for the loan, but BFC obtained an assignment from the general manager of a promissory note for the loan sum and a 'postponement letter', which read as follows:

> This is to confirm that we and all companies of our group will not demand any repayment of loans granted to Parc (Battersea) Ltd., London, until the full repayment of your loan of DM30m. granted to Mr. M. Herzig, which is secured by a deep discount promissory note amounting to £10m. issued by Parc (Battersea) Ltd.

Neither Parc nor OOL knew about the existence of the postponement letter and were not bound by it. Therefore, the letter was by law ineffective to subordinate their debts to that of BFC's. The Omni Group collapsed in 1991 and Parc became insolvent. Parc and OOL were of the opinion that OOL's claim took priority BFC's claim because of OOL's second charge. Their Lordships concluded that OOL would be enriched due to discharge of the Royal Trust Bank's security if BFC failed to obtain priority over the intra-group indebtedness. Although, the priority was eventually obtained through restitutionary subrogation relating to the BFC's security and not directly through giving effect to the postponement letter as an unsecured commitment, the decision is impliedly based on the fact that such a

[129] Ibid.

postponement letter would have been effective under English law had it bound all the group companies.[130]

Because subrogation based on failure of the postponement of the intra-group debts to take effect was approved, there could not have been any clear legal policy, eg *pari passu* or orderly management of insolvency estates, restricting subrogation. It appears that, whatever the scope of non-consensual subrogation in remedying failure of debt subordination, it is clear that at least in *Banque Financiere de la Cite SA v Parc (Battersea) Ltd*[131] the House of Lords wasn't reluctant to give effect to it through a restitutionary remedy and holding that the failure of the postponement would have led to unjust enrichment by OOL.

Thus, in line with *Re Maxwell*,[132] giving effect to the priority arrangement through subordination did not violate any legal policy objectives.

3.6 Complex Ranking of Creditors

The rule in *Re Maxwell*[133] also appears to apply to agreements purporting to create a complex ranking of creditors, ie through a contractual stipulation that a claim is subordinated to some but not all of the debtor's obligations. Once we accept that debt subordination is not contrary to public policy restricting the efficient administration of the estate, there appear to be no valid grounds for rejecting complex creditor priority agreements on this ground because the inconvenience caused to the liquidator is roughly the same under both methods. This view was adopted by Southwell J in the Australian decision *Horne v Chester & Fein*.[134]

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[130] Ibid. 226.

[131] Ibid.

[132] *Re Maxwell* (n 8).

[133] Ibid.

[134] *Horne v Chester & Fein* (n 49).

Complex ranking can be created either through turnover subordination or by 'short-circuiting' such subordination.[135] The latter arrangement is based on the assumption that the senior creditor proves for the debt instead of the junior creditor and that the proceeds are paid directly to the senior creditor. What is significant for the purposes of this chapter is that turnover obligations may indeed be effectively 'short-circuited' by complex contractual subordination. 'Short-circuiting' may also avoid the risk the junior creditor unlawfully diverting the proceeds it has recovered from the debtor.[136] Such a technique raises two questions. First, is short-circuiting technically possible and, second, is it allowed under the case law discussed earlier in this chapter 3.

Although complex direct contractual subordination need not be contained in an intercreditor agreement, they provide a good point of reflection how the issue can be regulated contractually. Putting aside the turnover obligation for now, intercreditor agreements usually contain clauses whereby eg a security agent is entitled to:[137]

1. Claim, enforce and prove for any junior debt;
2. Exercise all powers of convening meetings, voting and representation in respect of the junior debt (and the junior creditor will provide all proxies and of representation for these purposes);
3. File claims and proofs, give receipts and take any proceedings; and
4. Receive all payments of or in respect of the junior debt.

The above clauses are supported by r 11.11 of the IR according to which a junior creditor may give a notice to the liquidator that he wishes the dividend to be paid, or that he has assigned his entitlement, to the senior creditor. The liquidator is thereafter obligated to pay

135 Turnover subordinations do not as such raise any additional concerns in the debtor's insolvency and are not discussed here.

136 *Wood*, 3.3.

137 This is not the case if the subordinated debt is not linked to any broader financing arrangement, thus being eg a stand-alone issue of subordinated notes.

the dividend to the senior creditor. The court can also enable an assignee to file proof in substitution.[138]

The question whether complex subordination is permissible under the *pari passu* provision or the rule against divestiture is a more difficult one. The general form taken by complex contractual subordination is set out in the following example.[139]

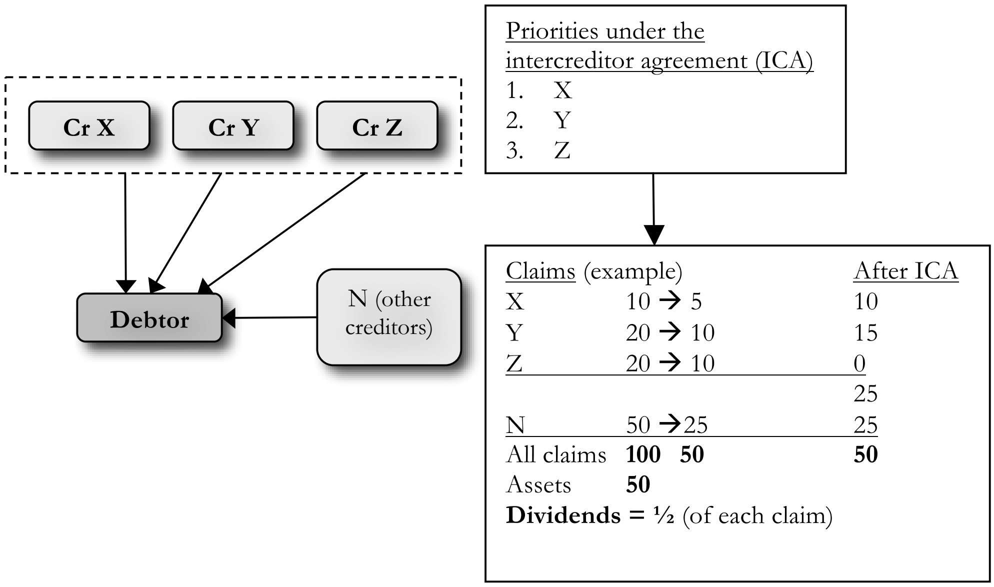

Figure 1. Complex contractual subordination.

A contractual subordination of the above type does not worsen the position of the creditors not parties to the intercreditor agreement. Therefore, the only remaining argument is that the parties X and Y in fact receive *additional advantage* from the arrangement not available to the other creditors.[140] This is plainly the case because X's dividend has increased 100 percent and Y's 50%, whereas the dividend of the other creditors has remained the same. The detriment of Z translates to the benefit of X and Y. It should be

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138 See the discussion on voting on junior debt, *Wood*, 3.5-7.

139 The figure follows roughly the examples presented by Wood in Ibid. 2.8.

140 See *Ex p Mackay* (n 5).

noted that because we are here talking about an asset of Z, the primary concern is whether the arrangement is valid in the liquidation of Z, not the debtor. However, we are concerned here about the liquidation of the debtor, not the junior creditor.

Horne v Chester & Fein[141] concerned a question whether a complex subordination is effective among the parties having concluded the priority agreement. Therefore, the structure of the case was substantially the same as depicted in Figure 1 with the exception that there was no class N (other creditors) present. There was an agreement among three creditors that any loans granted to the company in excess of the agreed loan accounts would be senior to the claims under the agreed loan accounts. Southwell J stated that the policy underlying the insolvency law as evidenced eg in *NatWest v Halesowen*[142] and *British Eagle*[143] 'was never intended to alter the rights and obligations of parties freely entering into a contract, unless the performance of the contract would upon insolvency adversely affects the right of strangers to the contract',[144] therefore distinguishing *British Eagle*[145] from *Horne v Chester & Fein*[146].

The New Zealand case *US Trust v ANZ Banking Group*[147] provides more guidance on the effects of a subordination agreement and a short-circuiting clause on non-acceding creditors. The case concerned a situation where certain corporate bonds were subordinated to some but not all of the company's other debt. Sherrel J held that there was no breach of the *pari passu* rule because the rule did not prohibit a creditor deferring its debt

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141 *Horne v Chester & Fein* (n 49).

142 *NatWest v Halesowen* (n 4).

143 *British Eagle* (n 3).

144 *Horne v Chester & Fein* (n 49) 917(39-47).

145 *British Eagle* (n 3).

146 *Horne v Chester & Fein* (n 49).

147 *United States Trust Company of New York v Australia & New Zealand Banking Group* NSW CA.

in favour of the payment of a debt of another creditor, if the rights or entitlements of the other creditors to payment remain unaffected.[148] The question in *US Trust v ANZ Banking Group* was dealt with in two separate stages. First, there was the subordination provision requiring payment of all amounts due to the senior creditors before any payment on the subordinated debt; and, secondly, there was the contractual clause regulating direct payment of the junior debt to the senior creditors by the liquidator of the debtor. Sherrel JA did not consider that such an arrangement would reduce the value of he junior debt to nil or make it contingent.[149] According to him, the subordination and the direct payment to the senior creditors merely meant that the monies available to repay the junior creditors would be used to repay the senior creditors and the entitlements of the other creditors were not affected.[150]

As we can see from the above Figure 1, it is clear that such a short-circuiting cannot disadvantage the other creditors. The fact that it operates at the advantage of the senior creditors should be of no significance in relation to the insolvency law because such a solution is already approved under r.11.11 of the IR. In legal policy terms and as the junior creditor is surely entitled to assign its debt or its proceeds to the senior creditor, the apparent advantage of the senior creditor should cause no concerns in the debtor's liquidation. Therefore, it appears that the validity of complex contractual subordination would be decided under English Law on a case-by-case basis – whether the transaction disadvantages the non-acceding creditors or not. However, if we accept he narrow reading of *British Eagle*,[151] and the public policy arguments proposed in *Re Maxwell*,[152] complex contractual

148 Ibid. 139D.

149 Ibid. 139B-D and 143F.

150 Ibid.

151 *British Eagle* (n 3).

152 *Re Maxwell* (n 8).

subordination should be valid if it does not operate to the detriment of any of the creditors not parties to the subordination. However, short-circuiting is likely to be ineffective in the junior creditor's insolvency. This aspect will be discussed in chapter 4.2.5.

4 LIQUIDATION OF THE JUNIOR CREDITOR AND 'DOUBLE LIQUIDATIONS'

4.1 GENERAL STRUCTURE

The set of questions that arises in the junior creditor's liquidation depends on the type of subordination. In contractual subordination, the main question is whether agreeing to subordination that springs up upon insolvency or another event may be void being in breach of the rule against divestiture. This question must be evaluated separately from the point of view of complete and springing subordinations.

The evaluation of the effectiveness of turnover subordinations, on the other hand, depends on whether we are dealing with turnover subordination based on contract or trust. The situation is rather straightforward in contractual turnover subordinations because the senior creditor would have to prove as an unsecured creditor in the liquidation of the junior creditor. However, short-circuiting turnover subordination by direct payments to the senior creditor is a more difficult question raising the issue on the applicability of the rule against divestiture. Trust subordination does not cause major problems in relation to the rule against divestiture or *pari passu* because the trust assets are not part of the junior creditor's estate, even if the proceeds were considered future assets, because the proceeds will become trust assets as soon as they come into existence.[153] The reason is that the junior creditor has in effect transferred the assets beneficially to the senior creditor before the onset of the liquidation.[154] On the other hand, the turnover may be created also, less commonly, through assignment of the junior debt as collateral security. In this case, the relevant legal questions

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[153] *Wood* 4.1.

[154] P Wood *Project Finance, Subordinated Debt, and State Loans* (Sweet & Maxwell, London 1995) 8-10.

concern the priorities between possible subsequent assignees and the junior creditor's own creditors.

However, neither trust nor debtor-creditor turnover subordination are protected from the liquidator claiming that subordination having occurred within the relevant suspect period is a preference, transaction at an undervalue or otherwise voidable. In addition, the question on the effect of the claim of insolvency set-off raises similar concerns both in contractual and turnover subordinations. I will discus each of the above issues in turn below.

4.2 SUBORDINATED DEBT AS PROPERTY OF THE JUNIOR CREDITOR'S ESTATE

4.2.1 Ascertaining the Assets of the Estate

The assets of the company comprise all property, which belongs to it at the commencement of the liquidation.[155] The relevant date in compulsory liquidation is the petition for winding-up of the company[156] and in voluntary winding-up the date the members resolved to wind up the company[157]. In respect of compulsory liquidation, any dispositions taking place between the petition and the actual winding-up order are void unless sanctioned by the court under s.127 of the IA. The rule is intended to preserve the assets of the insolvent party until the date the mandatory insolvency distribution regime starts to apply.[158] The same policy objective of maintaining the assets of the estate in relation to arrangements and dispositions having taken place within a prescribed period prior to the liquidation is regulated, *inter alia*,

155 *Re United Ports Insurance Co.* Co. 36 L.T. 457.

156 S.129(2) IA.

157 S.86 IA.

158 M Bridge 'Collectivity, Management of Estates and the *Pari Passu* Rule in Winding-up' in J Armour and HN Bennett (eds) *Vulnerable Transactions in Corporate Insolvency* (Hart Publishing, Oxford 2003) 1-58.

by the provisions on preferences and transactions at an undervalue. However, neither one of these provisions are based on the *pari passu* rule.[159]

Furthermore, the commencement of the liquidation results in the application of the mandatory corporate insolvency law distribution regime. It is clear that the contractual rights arising under the junior debt are an asset of the junior creditor's insolvency estate. This begs the question what is the effectiveness of contractual clauses limiting an interest held in a particular piece of property, or limiting their collectibility or suppression of claims in insolvency, or the effectiveness of subsequent subordination of a debt, eg in a work-out. Is subordinated debt an asset 'snatched away' or an asset subject to a qualification?

It is important to note that the liquidator takes control of the assets in the condition he finds them with qualifications and limitations. This is consistent with the view I have endorsed earlier that we will first need to determine the scope of the asset before we are able to apply the mandatory distribution regime.[160] This appears rather straightforward. However, the inherent tension in the law becomes evident when we ask, first, what is the difference between an agreement purporting to remove an asset from the insolvency estate and an agreement to qualify or limit such asset in some manner upon winding-up and, second, can a qualification or limitation having taken place before the onset of the liquidation be considered a voidable transaction.

Debt subordination, by definition, limits the junior creditor's claim against the debtor in three possible ways. First, it may limit the repayment of the debt *ab initio*, during the duration of the loan as in complete subordinations, where the receivable from the debtor

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[159] J Armour 'Transactions at an Undervalue', 2.23-29 in Ibid.

[160] See the discussion in chapter 3.3.

is limited by the subordination clause as of the beginning. Second, subordination may take effect upon a specified event, eg the debtor's or the junior creditor's liquidation, ie constituting a springing subordination. Third, a debt may be subordinated subsequently eg as a result of a workout, thus making a previously unqualified unsubordinated debt qualified and subordinated. Each of these should be evaluated separately.

4.2.2 Determinable and Absolute Interests in Property

English law does not contain an explicit rule prohibiting termination of rights in liquidation.[161] However, it draws a sharp distinction between *determinable interest*, ie an interest limited at its outset and coming to an end upon occurrence of certain event and *absolute interest* defeasible in the insolvency by a condition subsequent.[162] Goode has concluded that the latter one is void at least on two separate grounds. First, it is a repugnancy and, second, it runs counter to the principle of insolvency law that 'a man is not allowed, by stipulation with a creditor, to provide for a different distribution of his assets in the event of bankruptcy from that which the law provides', also the foundation of the *pari passu* rule.[163] In addition, he has pointed out that even though a grantor of an interest may make it determinable upon the bankruptcy of another he has never been allowed to make it determinable on his own bankruptcy.[164] The reason the matter is of importance in debt subordination is that the junior debt is an asset of the junior creditor's estate. Thus, we must ask whether subordination taking place in the junior creditor's liquidation is a deprivation of an asset held

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[161] *Goode II*, 7-11.

[162] Ibid. 7-11 and 7-14.

[163] *Ex p Mackay* (n 5) (LJ James).

[164] *Goode II*, 7-14.

by the junior creditor. However, why should the application of the rule be limited to the very moment of liquidation, eg instead of any event connected or close to liquidation?[165] The problem concerns mostly springing subordinations, not so much complete subordinations.

The rule on invalidating deprivation of an asset from the insolvency estate has been discussed in a number of English cases, unfortunately providing no absolute answers to what extent debt subordination could be deemed divestiture instead of just constituting a limitation or suppression to the collection of the asset, i.e. the debt. The case law was recently summarized and analysed by Neuberger J in *Money Markets v LSE*.[166] Although the case has wider ramifications to the law of absolute and determinable interests in insolvency, it provides us with some guidance on how subordination may be evaluated under the case law.

In summary, the case concerned a question whether a loss of a share held by a member of the London Stock Exchange due to a default of the member could be considered a divestment of the share in the light of the old legal principle in *Ex p Jay* per Cotton LJ:[167]

> '…that there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors.'

In *Money Markets v LSE*,[168] the share was not divested upon default because it concerned an asset, which was incapable of uncontrolled transfer, thus not a freestanding asset, being merely ancillary to membership in the London Stock Exchange. Neuberger J confirmed that

165 *MMI v LSE* (n 7), [100].

166 Ibid.

167 *Ex p Jay* (n 6) 26.

168 *MMI v LSE* (n 7).

there was no doubt that the principle as endorsed by Cotton LJ stands under English law and based on a common law rule and the long-established approach of the English law to the treatment of assets and creditors in insolvency.[169] Furthermore, based on the established rules in trust law[170], he considered that is was well-understood that an interest granted on the basis that it is inherently limited in insolvency should be recognized by the court and not be deemed a divestiture.[171] This position seems to accord with Goode's view that a determinable interest is an interest the quantum of which is limited by the stipulated event, so that the occurrence of that even marks the end of the duration of the interest.[172]

However, according to Neuberger J, if the particular clause does not fall within the concept of determinable interest, the court should scrutinise with particular care whether the provision has the effect of preferring the person to whom the asset reverts or passes in relation to the other unsecured creditors of the insolvent, whose estate is deprived of the asset pursuant to the provision.[173] Therefore, the ratio of *British Eagle*[174] and *Ex p. Mackay*[175], ie that the creditor must intend to get some *additional advantage* preventing the subsequent distribution according to the priorities recognized in the insolvency legislation in order to be qualified as divestiture, is also implied by Neuberger J in *Money Markets v LSE*.

It should be noted, that Neuberger J did not consider it decisive whether the deprivation provision applied only in insolvency or accept the view that a deprivation provision would be valid on insolvency or otherwise, only for the reason that it is a part of

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169 Ibid. [117].

170 See eg *Hayton-Underhill* 184-5; and J McGhee and EHT Snell *Snell's equity* (30th edition, Sweet & Maxwell, London 2000), 7-69.

171 *MMI v LSE* (n 7) [89].

172 *Goode II*, 7-14.

173 *MMI v LSE* (n 7) [118].

174 *British Eagle* (n 3).

175 *Ex p Mackay* (n 5).

the initial bargain or an inherent part of the claim. However, he provided certain traits upon which such contractual clauses can be evaluated where the provision is not linked specifically to the owner's (here the junior creditor's) insolvency. First, he stated that, instead of looking at the *intentions* of the parties one should primarily look at the *effect* of the particular provision. For the purposes of this evaluation, it should be noted that the category of effects of a particular transaction is logically broader that the intentions of the parties – a man may not intend all the consequences of his actions.[176]

Second, he pointed out that if the parties had an intention to evade the insolvency law rules, a court might invalidate an otherwise valid provision. On the other hand, if there was no such intention, the court will be more likely to uphold the provision if the agreement provides compensation for the deprivation.[177]

Third, Neuberger J considered that if a person has a specific asset not subject to a deprivation provision, then a subsequently included deprivation provision is unenforceable in the event of insolvency.[178] This would appear rather disturbing from the point of view of contractual work-out utilizing subordination as a means of facilitating the debt restructuring of the debtor. Once again, the important question is whether debt subordination is an acceptable qualification of the junior debt and, if not, what is the event triggering subordination. Therefore, we must be careful because the fact whose insolvency we are actually talking about is of significance in our evaluation. Therefore, if we do not accept at face value that debt subordination is always an acceptable qualification of the junior debt (and thus a determinable interest) it may be that the common view[179] that debt

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176 *MMI v LSE* (n 7) [118].

177 Ibid.

178 *MMI v LSE* (n 7) [100].

179 See eg *Wood*, 4.1.

subordination is valid provided that the triggering event is the debtor's insolvency rather than the junior creditor's is actually so not straight-forward. However, *Money Markets v LSE* does not provide straight-forward answers to the question whether debt subordination may be considered a divestiture.

Although, heavily criticised by Look Chan Ho,[180] in *Fraser v Oystertec Plc*[181] Mr Peter Prescott QC held that the categorisation of an alleged deprivation provision is supplemented with a test how the position *looks to the outside world*.[182] He emphasized that a situation where, according to the common expectation of mankind, the asset may well be determinable upon insolvency (eg as with a lease) is quite different from the situation where the asset that is held out to the outside world (eg through the Patent Office register, as in *Fraser v Oystertec Plc*) not being subject to a similar expectation. Based on his analysis, the expectations of creditors are indeed of significance, the evaluation varies from one asset to another, and that the rule against divestiture cannot be applied to all assets in a similar manner[183]

As Look Chan Ho has proposed, there should be no additional requirement on how the arrangement is portrayed to the outside world correctly noting that surely the IATA clearing arrangement in *British Eagle* was evident to everyone.[184] However, it may be that Mr Prescott's general qualification was influenced by the fact that the question in the case concerned a patent,[185] which is registered in a public register. Thus, his statement should not be read literally but referring to actual perception of the outside world if it is

180 LC Ho 'The Principle against Divestiture Revisited: Fraser v Oystertec' [2004] 19 JIBLR 54.

181 *Fraser v Oystertec* (n 71) [118].

182 Ibid. [111].

183 Ibid. [118].

184 LC Ho 'The Principle against Divestiture Revisited: Fraser v Oystertec' [2004] 19 JIBLR 54, 56.

185 *Fraser v Oystertec* (n 73) [118].

either publicly ascertainable by the outside world, such as with patents and other registrable assets, or recognized by the law, eg forfeiture of a lease. This interpretation of *Fraser v Oystertec Plc* would appear to yield more feasible answers with regard to debt subordination especially evaluated in connection with the fundamentally important case of *SSSL Realisations (2002).*[186] Is springing debt subordination then a divestiture of the junior creditor's asset?

4.2.3 Nature of Debt Subordination and SSSL Realisations (2002)

Wood has stated that when the diminution of the claim is not sparked of by the junior creditor's but the debtor's insolvency, the junior creditor has merely a limited or conditional asset from the start and there will be no violation of the rule against divestment of the insolvent's assets.[187] This view is also supported by *Ex p Jay*[188] as approved in *Money Markets v LSE.*[189] The first time an English court faced the claim that a contractual subordination might fall foul against the rule against divestiture in the junior creditor's liquidation was in *SSSL Realisations* where Lloyd J confirmed that contractual subordination, *per se*, does not breach the rule against divestiture.[190] Although the case confirms that contractual and turnover debt subordination are effective under English law, the rationalization of the decision with the earlier case law is somewhat difficult. The Court of Appeal gave its judgement on the matter in early 2006 affirming the Lloyd J's decision,[191] but it did not deal

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[186] *SSSL Realisations (2002)* (n 9).

[187] *Wood*, 4.1.

[188] *Ex p Jay (n 6)*

[189] *MMI v LSE* (n 7).

[190] *SSSL Realisations (2002)* (n 9) [43].

with the question of the effectiveness of debt subordination in the junior creditor's insolvency because there was no appeal on that part of the High Court's decision.[192]

The chain of events in *SSSL Realisations (2002)* concerned the insolvency of the Save Group, which primary business was selling of petrol. The parent of the group (here 'Group') purchased the petrol sold, *inter alia,* by one of its subsidiaries Save Service Stations Ltd. (here 'Save'). The sale of petrol to Save resulted in a considerable intra-group debt from Save to Group. In addition, the purchase of petrol by Group resulted in liabilities to HM Customs and Excise for duty. The liability could be deferred by providing the HM Customs and Excise a bond to secure the payment. Such a bond was provided by AIG Europe (UK) Ltd (here 'AIG'). However, AIG required that the group companies grant on-demand indemnities for the obligations of AIG under the bond.

Administration orders were subsequently made against Group and Save; the subsidiaries went into creditors' voluntary liquidation; and Group was compulsorily wound-up on the following day. The business and assets of the group were sold resulting in a considerable amount of cash in Save. The primary asset of Group was the intra-group debt from Save. Therefore, AIG was the creditor of both Group and Save and the intra-group debt owed by Save was purportedly subordinated to any other claims. If the clause were valid, the creditors of the Group would not receive payment under the intra-group debt, whereas the creditors of Save, primarily AIG, would have the benefit of the business transfer proceeds retained by Save. The subordination clause in the deed stipulated that none of the group companies (indemnitors) shall:

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[191] *Re SSSL Realisations (2002) Ltd (formerly Save Service Stations Ltd) (in liquidation) and another company* [2006] EWCA Civ 7 (CA).

[192] Ibid. [6].

1. be subrogated to any rights, security, cash cover or other monies received on account of that indemnitor's liability;
2. claim rank prove or vote as a creditor of any of the other indemnitors or their estate in competition with AIG;
3. receive, claim or have the benefit of any payment distribution or security from or on account of any other indemnitor; or
4. exercise any right of set-off as against any indemnitor until all amounts arising under the deed were irrevocably paid in full to AIG.

If any of the group companies received any payments irrespective of this subordination clause, such sums would be held in trust for AIG. The subordination clause led materially to the subordination of all claims whether arising under the deed or otherwise to those of AIG.[193] AIG contended in the Court of Appeal that the 'no proof' clause was capable of its unilateral waiver. However, Chadwick LJ concluded that on proper construction of the clause, this could not be done.[194] What is important for our purposes here is that although the 'no proof' clause was ancillary to the subordination and trust clauses, most intercreditor agreements actually contain such a clause. As Chadwick LJ stated, it is intended to ensure that every acceding company is indeed treated the same way. Therefore, any waiver of the clause would have required consent of all of the parties to the agreement.[195]

It should be noted that all parties appeared to accept that the subordination was valid in the liquidation of Save, following *Re Maxwell*.[196] However, the counsel to Group correctly raised the point that the current case was different from *Re Maxwell*[197], *Re British and Commonwealth Holdings*[198] and *Horne v Chester & Fein*[199] because none of these concerned a situation where the junior creditor was insolvent. Therefore, the questions on the

193 *SSSL Realisations (2002)* (n 9) [30] – [33]. This was fundamentally a question of construction, with which we do not need to detain ourselves here.

194 *SSSL Realisations (2002)* (CA) (n 191) [63] – [64].

195 Ibid. [65].

196 *Re Maxwell* (n 8).

197 Ibid.

198 *British and Commonwealth Holdings* (n 98).

199 *Horne v Chester & Fein* (n 49).

ascertainment of the assets of the junior creditor's estate, the division of determinable and absolute interest and the rule against divestiture attained great importance.

Lloyd J considered *British Eagle* and *Ex p. Mackay* and stated that the 'mini-liquidation' in *British Eagle* involved the clearing house members being preferred over the other general creditors.[200] In effect, the subordination in *SSSL Realisations (2002)* led to the situation where the inter-company debt owed by stations would be used to pay AIG to the exclusion of the other creditors.[201] The proposition of the Group's counsel followed in that sense Goode's recent view (while admitting that there are doubts about the scope of the *pari passu* clause) that the *pari passu* clause retains practical importance (if only in a negative sense) in invalidating pre-liquidation transactions by which the creditor aims to secure an advantage and where invalidation may result in the expansion of the assets available for distribution.[202] In broad economic terms, this was the effect of the subordination deed. However, Lloyd J refused to accept the analogy between *British Eagle* and the current case and held that:[203]

> …in legal terms the preference of other creditors, which results from the alteration of the rules of distribution affecting inter-group creditors, does not involve the diversion of an asset of Group, but rather its suppression by subordination. (underlining added)

Lloyd J did not accept the submission of the Group's counsel that the validity of subordination depended on the fact whether the junior creditor was solvent or not because in his opinion such an exercise would introduce an 'element of conditionality' in the

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[200] *SSSL Realisations (2002)* (n 9) [43].

[201] Ibid. [42].

[202] *Goode II,* 7-04. However, it should be noted that Goode is of the view that debt subordination does not offend the *pari passu* clause, *Goode, II* 7-08.

[203] *SSSL Realisations (2002)* (n 9) [43].

argumentation.[204] Furthermore, he deemed that the agreement is valid and binding, notwithstanding that the creditors of the Group are not parties to the agreement; and that in the absence of some vitiating factor under insolvency law, it is for the Group to make its own agreements.[205] This part of the decision was not disputed in the Court of Appeal.

Importantly, Chadwick LJ concluded that Lloyd J was correct in stating that in debt subordination, which is relevant above all in insolvency, the court would and should enforce the negative obligation against proving in the liquidation by an injunction.[206] Chadwick LJ continued that it was *commercially important* that that, if group companies enter into subordination agreements of this nature with their creditors while solvent, they and the creditors should be held to the bargain upon the stipulated event, ie insolvency.[207]

What is of the utmost significance to the analysis whether debt subordination is an acceptable qualification of the asset or its divestiture is that according to Lloyd J 'The fact that Group will not be able to collect in its main asset, namely the inter-company debt, does not interfere with this principle'.[208] How does the case then sit with the earlier discussion on the scope of the *pari passu* rule and the subsequent question on the rule against divestiture? Lloyd J did not consider it relevant to discuss the situations where the subordination was a part of the initial terms of the agreement or was included in it at a later point, or for that matter, whether the debtor is a party to the agreement or not. Thus, no extensive analysis of the validity of the various debt subordination techniques was carried out.

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204 Ibid. [44].

205 Ibid.

206 *SSSL Realisations (2002)* (CA) (n 191) [66].

207 Ibid.

208 *SSSL Realisations (2002)* (n 9) [49].

Lloyd J held in *SSSL Realisations (2002)* that subordination of the debts does not infringe the *pari passu* principle and at the same time stating that the assets of the insolvent be applied rateably between all its relevant classes of creditors. However, as I have proposed earlier,[209] ascertaining too broad a scope to the rule blurs its implications and may eventually reduce commercial certainty. The rule in *SSSL Realisations (2002)* could perhaps be rationalized more easily if we were to look at it together with *Ex p Jay* and *Money Markets v LSE* on determinable and absolute interests and ascertainment of the junior creditor's assets, not so much as an instance of the *pari passu* rule, which is naturally of the utmost importance in the debtor's liquidation. I will examine in the following the rule of divestiture of the insolvent's assets as classified by Neuberger J in *Money Markets v LSE* and how *SSSL Realisations (2002)* actually fits into the existing case law.

4.2.4 The Scope of the Rule against Divestiture of the Insolvent's Assets

First, *SSSL Realisations (2002)*[210] is an authority for the proposition that debt subordination does not breach the rule against divestiture of the insolvent's assets because it is a qualification of the asset of the junior creditor, suppression of the asset, whether the subordination clause is a part of the initial bargain or included subsequently. This is the case even though the economic effect of suppression is that the receivable of the will most likely not be paid at all.

Second, as Lloyd J noted, the evaluation whether some creditors will be preferred is made on *legal terms* and separately in respect of each insolvency. Therefore, the

[209] See the second paragraph of chapter 3.2.

[210] *SSSL Realisations (2002)* (n 9).

fact that in broad economic terms debt subordination leads to preferring some creditors (of eg a group) over others, does not mean that a springing subordination would be a divestiture of its asset, because the court should not look at the broad economic effect of the subordination. Specifically, in the junior creditor's liquidation we should not ask whether the debtor's creditors would be preferred over the creditors of the junior creditor. In *SSSL Realisations (2002)* it was unobjectionable that the subordination of the intra-group debt meant that Save's creditors would benefit over Group's creditors – but only from the whole group's perspective.[211] Third, in approving debt subordination, the decisions both in the High Court and in the Court of Appeal were strongly influenced by commercial certainty. Fourth, *SSSL Realisations (2002)*[212] supports the general insolvency law principle that a liquidator takes the assets of the estate as he finds them, warts and all.[213]

What the case does not explain adequately is *under what conditions* debt subordination is deemed an acceptable qualification on the claim of the junior creditor. There appear to be two options, either debt subordination is always valid or it is valid with the exception of certain types of springing and subsequent subordinations.

The answer to the above questions depends on whether we are talking about complete subordination, springing subordination or a subsequent subordination. First, a complete subordination whereby the right to payment is subordinated, *ab initio,* falls rather well with the ratio of *SSSL Realisations (2002)* and accords with the view that an interest or quantum inherently limited in insolvency is recognized by the court.

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211 Ibid. [44] – [47].

212 Ibid.

213 See generally *Goode II*, 6.

Second, Lloyd J did not accept that there is a difference between the two cases of complete and springing subordinations.[214] In commercial terms, his view is sensible because debt subordinations are often springing subordinations triggered upon a payment default or another event of default (such as insolvency) or a potential event of default. Such an event often leads under an intercreditor agreement to a standstill period during which payments to and enforcement by the junior creditors are halted in order to facilitate reorganisation and negotiations with the debtor. There is commercially no reason to prohibit repayments or interest payments to junior creditors while the debtor is solvent and there has been no contractual event of default.

Even so, if the triggering event is the junior creditor's insolvency the dicta by Cotton LJ's in *Ex p Jay*[215] that a stipulation stating that a particular asset is vested in him until his bankruptcy is invalid, should apply unless suppression of a claim or turnover of a debt is always an acceptable qualification under the insolvency laws. In fact *SSSL Realisations (2002)* is not really an authority that debt subordination would always stand in the junior creditor's insolvency.[216] As Lloyd J stated:[217]

> In the absence of some vitiating factor under insolvency law which would enable the office-holder to challenge the agreement on some statutory or other basis, it is for a party such as Group to make its own agreements and dispositions, which will be binding on it and on those interested in its assets. (underlining added)

It is very hard to argue that even *SSSL Realisations (2002)* would validate a springing subordination triggered by the junior creditor's liquidation. I do not think that Lloyd J's

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214 *SSSL Realisations (2002)* (n 9) [45].

215 *Ex p Jay* (n 6).

216 *SSSL Realisations (2002)* (n 9) [44].

217 Ibid.

statement should be read as referring only to transactions at an undervalue or voidable preferences but more broadly. What is of importance here is that *Money Markets v LSE* supports the proposition that when the subordination clause takes effect otherwise than in the junior creditor's insolvency the evaluation should be focused primarily at the *effect* of the particular provision.[218] The fact that debt subordination is triggered by the debtor's insolvency is actually the whole purpose of subordination agreement. Its effect is not preference of anyone in the junior creditor's liquidation because the junior creditor's insolvency does not affect this nature of the asset in any way. It is a bargained for priority position if the debtor becomes insolvent. In insider subordinations, there is a strong likelihood that the two liquidations indeed go hand in hand. Irrespective of this, Lloyd J's dicta that the transaction should be evaluated separately in each insolvency and in *legal terms* should be apt to deal with such cases as well.

Lloyd J's view that it should be of no significance to the subordination whether it arises from the initial terms of the transaction creating the debt or from a later agreement, or whether the debtor is a party to such an agreement appears to be a correct one despite Neuberger J's statement that if a person has a specific asset not subject to a deprivation provision, then a subsequently included deprivation provision is unenforceable in the event of insolvency, even if the deprivation is not linked to the liquidation of the owner of the asset (here the junior creditor). However, such an issue should preferably be resolved by application of the avoidance provisions rather than through the determinable and absolute interest -distinction.

Another argument why the two cases do not actually conflict is, as may be inferred from *Fraser v Oystertec Plc*, that the expectations of creditors are of significance in the

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[218] *MMI v LSE* (n 7) [118].

evaluation whether a deprivation provision is valid.[219] On the other hand, these expectations vary from one asset to another; and that the rule of divestiture cannot be applied to all assets in a similar manner.[220] It is clear, both in practice and from the case law dealing with debt subordination, what the common expectations of the markets are and under what conditions 'the outside world' regards debt subordination as a qualification rather than deprivation of an asset. However, *Carreras Rothmans v Freeman*[221] supports the view that a clause is not void if it operates prior to the date of liquidation.[222] On the other hand, *Fraser v Oystertec* suggests that a clause may constitute a divestiture even if the triggering event is not the liquidation.[223] This apparent conflict between the two decisions is of importance in relation to the question whether springing subordination taking effect prior to the liquidation of the junior creditor is a divestiture of its assets. If *Fraser v Oystertec* is correct, the key to *British Eagle* may indeed be, not on the *pari passu* principle, but on a more general divestiture prohibition, which can also be applied pre-liquidation. Thus, there is an evident risk that certain types of debt subordination may be void as being divestiture and *Carreras Rothmans v Freeman* may not create a safe harbour for all debt subordinations taking effect prior to the junior creditor's liquidation – a risk that becomes apparent especially in insider subordinations. The risk is enhanced by the fact that Neuberger J's decision in *Money Markets v LSE*[224] directly supports the view taken in *Fraser v Oystertec* that a clause may constitute a divestiture even though it takes effect upon some other event than insolvency.

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219 *Fraser v Oystertec* (n 73).

220 Ibid.

221 *Carreras Rothmans* (n 52) 217.

222 Ibid. 217 and 226.

223 *Fraser v Oystertec* (n 73) 119.

224 *MMI v LSE* (n 7) [118].

Based on the above arguments, the only situations incapable of being considered an acceptable qualification are debt subordination triggered by the junior creditor's insolvency, an event inherently related to that, or short-circuiting of turnover subordination.

4.2.5 Short-Circuiting of Turnover Subordination

I have proposed earlier that turnover subordination may be short-circuited in the insolvency of the debtor company based on r.11.11 of the IR and on the relevant case law.[225] However, making direct payments to the senior creditor, whether the debtor is solvent or not, is considerably more difficult when the junior creditor is insolvent.[226] The reason for this is two-fold. First, the cases on divestiture of the insolvent's assets, such as *British Eagle*, are directly relevant and, second, the case law on direct payment clauses in construction contracts supports the view that short-circuiting clauses are ineffective in the junior creditor's liquidation.

It is rather commonplace eg to agree in construction contracts that, upon insolvency of the main contractor, the employer is entitled to use the sums payable to the main contractor for the payment of the claims the sub-contractor has from the main contractor, eg if the main contractor is insolvent.[227] The difference with debt subordination is that whereas in debt subordination both the senior and the junior creditor have independent claims against the debtor, in construction contracts normally only the main

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225 See the last paragraph of chapter 3.6

226 See *Keay-McPherson* 3-12 *et seq*.

227 Newman 'Direct Payments to Nominated Sub-Contractors' [1998] 14 Const LJ 385.

contractor has a claim against the employer. Putting this question to one side, short-circuited turnover subordination and direct payment clauses appear similar.

The case law is clear concerning situations where the payments are made from eg a retention fund where the main contractor's interest in the fund has ceased because the main-contractor had mortgaged the interest for the sub-contractor or agreed to hold the funds on trust for it.[228] Such cases, as we will see, are akin to subordination trusts discussed in chapter 4.5.[229] Excluding the cases where there is either a trust or an assignment of a receivable, *British Eagle* provides a considerable hurdle for direct payment clauses.[230] Goode has regarded especially the validity of a clause stipulating that the right to payment remains vested in the main-contractor but the employer is entitled to withhold payment to the main contractor until the sub-contractors have been fully paid under their respective sub-contracts a very difficult one.[231]

Direct payment clause has been approved at least in the Irish High Court decision *Glow Heating v Eastern Health Board*.[232] In that case, the head contractor had to prove that the sub-contractors had been duly paid before the employer would issue a certificate of payment. If that were not the case, the employer would pay the sums to the sub-contractors and deduct these from the sums owed to the head contractor. The court distinguished *British Eagle* on the ground that the liquidator took the right of payment subject to the direct payment and reduction clause.[233] As Keay points out, the validity of a direct payment clause

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228 *Re Tout and Finch Ltd* [1954] 1 All E.R. 127 (HC).

229 See *Goode II*, 7-16.

230 However, a direct payment clause involving no trust or assignment has been approved in the Australian decision *Re Gerewich Contracting Pty (in liq)* (1985) 3 ACLC 33.

231 *Goode II*, 7-16.

232 *Glow Heating v Eastern Health Board* (1988) I.R. 110.

233 Ibid. 120.

would appear to depend on the question whether the main contractor has an interest in the asset at the commencement of its liquidation.[234] In *Glow Heating v Eastern Health Board*[235], the asset of the main contractor was conditional on it proving the payment of all the sub-contractors' claims, thus making the head contractor's claim a 'flawed asset'.[236] As Capper has noted, the validity of the clause will then depend on the manner in which the clause is drafted.[237] However, it should be noted that the fact that a debt is repayable only upon fulfilment of a certain condition is quite another thing from a clause whereby an unconditional debt is, irrespective of the qualification, paid to a third party and in reduction of the debt.

The fact that a claim is a flawed asset should not validate a direct payment clause because of the rule against divestiture of the insolvent's assets. Therefore, the reasoning in *Glow Heating v Eastern Health Board*[238] should not stand in England. It should be noted, that the majority in the New Zealand case *Attorney-General v McMillan & Lockwood Ltd*[239] took the view that such a clause was ineffective because of *British Eagle*[240]. As Goode points out, this view has been followed also subsequently in a number of Commonwealth cases.[241] He concludes that in the absence of a trust or equitable assignment a mere contractual provision for direct payment to the sub-contractor does not affect the status of

234 *Keay-McPherson* 3-12 *et seq.*.

235 *Glow Heating* (n 232).

236 P Wood *English and international set-off* (Sweet and Maxwell, London 1989) 5-196 *et seq*, and *Goode I,* 1-21.

237 D Capper 'Direct Payment Clauses and the Pari Passu Principle' [1998] 2 CfiLR 54.

238 *Glow Heating* (n 232).

239 *Attorney-General v McMillan & Lockwood Ltd* [1991] 1 N.Z.L.R. 53.

240 *British Eagle* (n 3).

241 *Goode II*, 6-11.

the employer's debt or the debt being characterized as a flawed asset but it is a provision for divestment of the contractor's asset.[242]

The above view also seems to apply to short-circuiting in turnover debt subordinations. Such clauses do not afford much protection to the senior creditor upon liquidation of the junior creditor irrespective of whether the debtor is insolvent or not. It is, however, typical that such clauses are included in intercreditor agreements. If they are supported by a trust, the short-circuiting clause should be effective.[243]

4.3 INSOLVENCY SET-OFF

4.3.1 General Aspects

As Lord Hoffmann stated in *MS Fashions*, the insolvency set off provision is automatic and mandatory, ie the account is taken retroactively on the date of the winding-up.[244] This causes concerns especially in insider subordinations where it is more than likely that the debtor and the junior creditor are part of the same group and have mutual dealings leading to cross-claims between them. The mandatory nature of the insolvency set-off rule means that an agreement not to set-off a claim in the liquidation of the debtor would not be considered effective and a junior creditor would in effect obtain a priority position in relation to the senior creditors. Notably, while the junior creditor is solvent this problem is alleviated by extensive corporate lending and operational restrictions on the debtor company. The problem is usually resolved contractually by a stipulation that any recovery by the junior creditor whether in cash or in kind including set-off or combination of accounts is subject to

242 Ibid.

243 See eg *Re Tout and Finch Ltd* (n 228).

244 *MS Fashions* (n 10) 432.

the turnover obligation and the recoveries are held on trust for the senior creditor. As we will see in this chapter 4.3, it is not certain that this stipulation protects the senior creditor in the insolvency of the junior creditor.

Under r.4.90 of the IR, the insolvency set-off 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'. For our purposes here, we only need to concentrate on the requirements of mutuality and the nature of the junior debt.

As we have seen in chapter 3.4, the question whether insolvency set-off is mandatory or not was resolved affirmatively by the House of Lords in *NatWest v Halesowen.*[245] The correctness of the rule was evaluated again in *Stein v Blake*[246] and according to Derham, the rule has been followed a least in some of the Commonwealth countries, notably Australia and New Zealand.[247] In relation to corporate insolvency set-off, the leading case is *MS Fashions*[248] where Lord Hoffmann summarised the main traits of insolvency set-off.[249]

Derham has contrasted renouncing of the right-off set-off with the rule in *Cherry v Boultbee*[250], which states essentially that 'where a person entitled to participate in a fund is also bound to make contributions in aid of that fund, he cannot be allowed to

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[245] *Natwest v Halesowen* (n 4) 805, 809 and 824.

[246] *Stein v Blake* (n 83) 245, 255.

[247] *Derham*, 6-71.

[248] *MS Fashions* (n 10).

[249] Ibid. Note that one alternative on agreeing on not setting off the cross-claims is that the creditor agrees not to prove in possible insolvency of the debtor. However, as Derham mentions in *Derham*, 6-73 the price for such an agreement is that the creditor would not even be entitled to receive any dividends from the estate because he would not be able to prove (or claiming to prove) anything as regards to the estate.

[250] *Cherry v Boultbee* 4 My & Cr 442, 31 ER 171.

participate unless and until he has fulfilled his duty to contribute'[251]. As he points out, if it were possible to contract out of insolvency set-off, the rule in *Cherry v. Boultbee* should apply and, ie the estate could claim that the junior creditor is entitled to participate in the fund through its claim from the estate and is bound to contribute to the fund based on its debt to the estate; thus one could not avoid the extinguishment of the junior debt to the extent the debtor has a cross-claim against the junior creditor.[252]

The rule in *Cherry v. Boultbee* could still have, in theory, thwarted the debt subordination in *SSSL Realisations (2002)*, where the rule against double proof prevented mutuality for the purposes of the insolvency set-off provision.[253] Despite the lack of mutuality, the rule in *Cherry v Boultbee* could have become applicable in *SSSL Realisations (2002)*.[254] However, extinguishing the claims between Group and Save could only have occurred under *Cherry v Boultbee*[255] had the Group been entitled to prove in Save's liquidation. Such proving of debt would be have been caught by both the High Court's and the Court of Appeal's ruling in *SSSL Realisations (2002)* that the court will enforce the negative obligation not to prove where the claim related to subordinated debt.[256] In addition, intercreditor agreements often contain a non-proving clause usually sufficient to deal with the risk. Therefore, the risk of *Cherry v Boultbee* defeating debt subordination in cases not covered by r.4.90 of the IR is in practice rather insignificant – provided that the contract is properly drafted.

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251 *Re Peruvian Railway Construction Co Ltd [1915] 2 Ch 144, 150, per* Sargant J.

252 *Derham* 6-71.

253 *SSSL Realisations* (2002) (CA) (n 191) and *Cherry v Boultbee* (n 250).

254 *SSSL Realisations* (2002) (n 9) [72], *SSSL Realisations* (2002) (CA) (n 191).

255 *Cherry v Boultbee* (n 250).

256 See the four last paragraphs of chapter 4.2.3.

4.3.2 The Risk in Contractual Set-Off

Derham has outlined two policy reasons for prohibiting set-off in debt subordination. First, subordination may be interpreted in a way that the junior debt is not provable prior to the payment of the senior debt. Second, there is nothing 'due'[257] under the agreement to the junior creditors prior to the senior creditors having been paid in full.[258] However, it appears that neither one of the arguments can stand. First, the junior debt is an existing debt even though its repayment is subordinated to that of the senior creditors. If the junior claim would be considered a flawed asset, a category which existence has been doubted by Vinelott J,[259] the claim would still be a contingent one and susceptible to insolvency set-off under r.4.90(4), which states that:

> A sum shall be regarded as being due to or from the company for the purposes of paragraph (3) whether -
>
> (a) it is payable at present or in the future;
>
> (b) the obligation by virtue of which it is payable is certain or contingent; or
>
> (c) its amount is fixed or liquidated, or is capable of being ascertained by fixed rules or as a matter of opinion.

A contractually subordinated claim falls under point (a) or (b) above. As such, a contingent debt will be valued in liquidation according to r.4.86 of the IR. However, because debt subordination is generally considered valid under English case law, the subordination affects

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257 See r.4.90: "…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.".

258 *Derham*, 6-75.

259 Re Maxwell (n 8) 1419.

the valuation directly and the likely value of the subordinated debt will be nil.[260] This means that in practice the risk of insolvency set-off should be small in contractual subordinations.

As regard to Derham's second argument, it is clear that the junior debt is an existing debt once again as long as it is not a flawed asset. The possibility of using a claim for set-off depends on when the relevant obligation was entered into. The fact that it is not yet due for payment is irrelevant from the insolvency set-off point of view.

The real risk of insolvency set-off defeating debt subordination is when the liquidator of the junior creditor does not consider the junior creditor's claim contingent and sets off the whole of the junior creditor's claim against a counter-claim by the debtor. Wood has stated that the courts should arrive at the same result with 'non-contingent' subordinated claims as with the contingent ones.[261] This is a sensible solution but the case law is not clear on the matter.[262] Both Wood and Derham are of the opinion that a subordinated debt should not be subject to insolvency set-off.[263] However, these view cannot adequately be supported by either insisting that the junior debt is not 'due' until the full repayment of the senior debt, or by relying on Cotton LJ's decision in *Badeley v Consolidated Bank*[264] or the Partnership Act 1890 s.3, which are relied on by both Wood and Derham. None of these arguments relate specifically to the exceptions of the statutory insolvency set-off provision. Furthermore, it should be noted that the insolvency set-off section should be construed under Lord Simon's dicta in *NatWest v Halesowen*[265] that the rule lays down a procedure for

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260 P Wood *English and international set-off* (Sweet and Maxwell London 1989) 7-71.

261 *Wood,* 6.7.

262 However, see *Badeley v Consolidated Bank* (1888) L.R. 38 Ch. D. 238 (CA) to which Wood refers in *Wood*, 6.7.

263 Ibid. 6; *Derham* 6-71 through 6-75.

264 *Badeley* (n 262).

265 *Natwest v Halesowen* (n 4).

proper and orderly administration of the insolvent estates to which commercial community generally has an interest in.

The better alternative would be to regard the subordinated debt as a contingent claim, because subordinated debts are in fact contingent upon full repayment of the senior debt and as a result, value the claim under r.4.86 of the IR – which should in normal circumstances be nil, thus, minimising the risk of the insolvency set-off on debt subordination.

4.3.3 Turnover Trusts and Insolvency Set-off

The insolvency set-off provision requires that the cross-claims are mutual at the commencement of the liquidation. This question is pronounced in trust subordination where the trust should normally avoid the mutuality of the cross-claims of the junior creditor and the debtor. The matter raises two issues. First, there is the general question whether a trust destroys the mutuality between the junior creditor and the debtor. Second, is it relevant that the trust is normally over the proceeds of the debt instead of the debt itself, ie what is the subject matter of the trust? Therefore, we need to be concerned about both the identity of the parties and the nature of the trust assets.

It is well-established that a beneficiary of a trust has a proprietary interest in the trust assets and this proprietary interest destroys the mutuality for set-off purposes.[266] However, it has been suggested by Jonathan Parker J in *Re ILG Travel Ltd* that the parties cannot avoid the insolvency set-off provision merely by using the word trust in the

266 *Archer Shee v Garland* [1931] AC 212 (HL).

agreement,[267] but as Derham notes, after the trust has been validly established, *prima facie*, the principle excluding insolvency set-off should apply.[268]

The situation is more a difficult one when we distinguish between trust of the junior debt and the trust of the proceeds of the debt.[269] As I will propose later, the distinction is of importance when determining whether the trust may be recharacterized as a charge.[270] For set-off purposes, the distinction between the trust of proceeds and the debt itself should be maintained. Therefore, a trust of the proceeds would not, as such, mean that the senior creditor would be the beneficial owner of the junior debt, thus, there would still appear to be the mutuality required for carrying out insolvency set-off between the debtor and the junior creditor. Lord Templeman observed in *Barclays Bank Ltd v TOSG Trust Fund Ltd*[271] that equity does not overlook the distinction between a debt and the dividend on a debt.[272] Derham has concluded that if the trust extends merely to the proceeds of the debt, the equitable ownership of the junior debt is still vested in the junior creditor and there will be mutuality for set-off purposes.[273] However, as Wood has pointed out, that under the doctrine of set-off mutuality, one party's money should not be used to pay another's debt.[274] He continues that allowing set-off between the junior creditor and the debtor in such a case would be precluded on grounds of lack of mutuality because it would in essence lead to the junior creditor using the senior creditor's ultimate asset to pay the junior creditor's debt

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267 *Re ILG Travel Ltd (In Administration)* [1995] 2 BCLC 128 (Ch) 160-1.

268 *Derham* 10-05.

269 Ibid. 6-74.

270 Chapter 4.5.2.

271 *Barclays Bank Ltd v TOSG Trust Fund Ltd* [1984] AC 626 (HL).

272 Ibid. 674.

273 *Derham* 10-03.

274 P Wood *English and international set-off* (Sweet and Maxwell London 1989) 14-1 *et seq*. However, it can be argued that this is conceptually circular an argument because the real question should be: 'how do we determine who's money it actually is?'.

contrary to the principle on which mutuality is based.[275] This appears to be commercially a more feasible solution to the problem, because what else is the essence of a debt claim if not the proceeds received from it.

As we will see later on, the certainty of a subject matter does not necessarily entail segregation of the property, constituting the subject matter of the trust as in *Hunter v Moss*, where the subject matter was 50 indistinguishable shares (1000 in all), thus capable of satisfying the trust.[276] Therefore, it can be argued that the subject matter of the trust is only a part, not the whole, of the junior debt. Consequently, insolvency set-off may be allowed to the extent the recoveries from the debtor exceed the amount of the unpaid senior debt. This is because a subordination trust is usually limited to the amount of unpaid senior debt from time to time. As there is no difficulty in allocating the beneficial ownership of the proceeds, there should not be difficulty in ascertaining what amount can be used by the junior creditor for set-off.

Although in a somewhat different situation, in *Lee Chapman's Case*, the company had assigned before the commencement of the company's liquidation to Lee & Chapman the company's right to receive, to the extent of their debt, the money payable under a contract.[277] Cotton LJ concluded that there was no longer a mutual credit or the possibility of a mutual credit between the company and the commissioners in relation to the assigned sum.[278] Because the company had handed over to the mortgagees its right to receive

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275 *Wood* 6.5(a).

276 *Hunter v Moss* [1994] 1 WLR 452 (CA) 457-9. It should be noted, that the ratio of the case is, by no means, an undisputed one.

277 *Lee Chapman's Case* (1885) L.R. 30 Ch. D. 216 (CA) 224.

278 Ibid.

what was payable under the contract to the extent of its debt, the mutual credit clause did not apply.[279] Cotton LJ did not raise the question of distinguishing debt from its proceeds.

Although Bacon CJ's decision in *Re Irving Ex p. Brett*[280] supports the view that proceeds of a debt may be assigned without assigning the debt itself, the assignment of the proceeds should negative mutuality between the parties because set-off is essentially an alternative method of fulfilling the party's contractual obligations. Carrying out the set-off is in practice equivalent to using the proceeds for the payment of the junior creditor's cross-claim and it is exactly the proceeds that are subject to the trust fund. In fact, this is just another view of Wood's position that allowing insolvency set-off would mean that one person's debt is paid of using another person's property.[281]

4.4 AVOIDANCE OF TRANSACTIONS

The liquidator may seek to avoid debt subordination in the liquidation of the junior creditor in a number of ways. As I have proposed earlier in chapter 4.1, the question whether debt subordination may be avoided in the junior creditor's insolvency has to be evaluated separately from the perspective of complete, springing and subsequent subordinations. Because the risk for avoidance of subordination is pronounced in corporate restructurings, I will focus in this chapter especially on the avoidance of subordination of an existing debt in such circumstances.

Although there are several ways in which a debt subordination agreement may become voidable, I will concentrate in this chapter on the two most important situations, ie

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279 P Wood *English and international set-off* (Sweet and Maxwell London 1989) 14-1 *et seq.*

280 *Re Irving Ex p. Brett* (1877 (Ch).

281 P Wood *English and international set-off* (Sweet and Maxwell London 1989) 14-1 *et seq.*

transactions at an undervalue and preferences, which could invalidate the agreement.[282] In addition, I will address the question whether debt subordination may be disclaimed by the liquidator as an onerous property or an unprofitable contract.

4.4.1 Disclaiming Onerous Property

Any subordination agreement, whatever the form, may naturally seem like a disadvantageous contract from the view of the creditors of the junior creditor. Even though the subordination commitment may be seen as effective as an acceptable qualification on the collection and priority of the junior debt, the liquidator may still invoke a claim that such an agreement falls under the provisions on disclaimer of onerous property under s.178 of the IA. The provision applies to unprofitable contracts and to any other unsaleable or not readily saleable property or arguably giving rise to a liability to pay money or perform any other onerous act.[283]

The matter was litigated also in *SSSL Realisations (2002)* where Lloyd J gave a rather detailed account of whether subordinated debt may constitute an onerous property capable of disclaimer. He considered that the actual subordination imposed on the junior creditor a negative obligation or disability, preventing it from collecting an asset, rather than any type of a positive obligation.[284] Furthermore, he considered that although 'obligations' as such feature in the determination of what constitutes property under s.436 of the IA, they should arise out of property or be incidental to it.[285] Although in *SSSL Realisations (2002)*

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[282] The rules concerning provisions on defrauding of creditors are not discussed here.

[283] s.178(3) of the IA.

[284] *SSSL Realisations (2002)* (n 9) [60].

[285] Ibid.

Lloyd J deemed that the Deed (of subordination) did not 'do with the property' in any way, one may surely argue that if the subordination is not a stand-alone commitment contained in the junior debt agreement, the obligation albeit a negative one would surely be incidental to property ie the claim under the junior debt.

However, even if that were the case, Lloyd J's opinion leads to the correct conclusion for two reasons. First, it is required that the property is not saleable or readily saleable, which is not the case, because there is indeed a market for distressed debt, at least where there is a possibility of getting the senior creditors to the negotiation table. Second, subordination does not necessarily give rise to a liability to pay money or perform any other onerous act. The latter qualification would only be an issue in turnover subordinations not utilizing a trust. In this case, the issue of disclaiming onerous property is unlikely to arise because the senior creditor is usually a mere unsecured creditor of the junior creditor.

The question whether subordination is an unprofitable contract is a more interesting one. In his decision, Lloyd J applied the Australian case *Transmetro Corporation Ltd v Real Investments Pty Ltd*, where Chesterman J provided a thorough account on the English and Australian case law[286] outlining five principles under which a contract may be deemed unprofitable:[287]

1. If it imposes on the company continuing financial obligations, detrimental to the creditors, presumably meaning that the contract confers no sufficient reciprocal benefit;
2. It must give rise to prospective liabilities;
3. If it delays the winding-up process due to its performance over a substantial period of time and involving irrecoverable expenditure;
4. A mere financial disadvantage will not suffice - the relevant cases focus on the nature and cause of the disadvantage; and
5. A mere claim that there could have been a better bargain will not suffice.

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286 *Transmetro Corporation Ltd v Real Investments Pty Ltd* (1999) 17 ACLC 1314. The Australian statutory law relating to the matter is codified in the Bankruptcy Act 1966 s 133(1A) and (5A) and Corporations Law s 568(1)(f) and (1A).

287 *Transmetro Corporation Ltd v Real Investments Pty Ltd* (1999) 17 ACLC 1314. 21.

Lloyd J concluded that the subordination deed in *SSSL Realisations (2002)* did not fulfil any of the above conditions. In addition, even though the deed was surely seen as disadvantageous from the junior creditor's point of view, a sufficient reciprocal benefit was indeed conferred on the junior creditor when AIG agreed to provide guarantees on behalf of the group companies – surely a benefit to the company at that time. The Court of Appeal affirmed Lloyd J's decision but refined a few points in it. Chadwick LJ emphasised that the material question is whether the fact that Group cannot prove in the liquidation of its subsidiary impeded the Group's liquidators from discharging their functions in the liquidation.[288]

Importantly, the Court of Appeal actually referred to instances where a debt subordination agreement or commitment not to prove might actually be capable of being disclaimed. Chadwick LJ stated that the case might be such where, on the facts, there was:[289]

> …a prospect that there would come a time when "all amounts which may be or become payable by the Indemnitors to the Surety under this deed have been irrevocably paid in full"; so that the restrictions imposed by clause 8.2 fell away.

However, this type of conditionality in the application of the provision appears dubious. Surely, it may be the case that the debtor repays the senior debt one day. There is generally always a prospect of such an event happening. The real question is, how does this qualification fit with the general conditions for the applicability of s.178 of the IA, that:

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[288] *SSSL Realisations (2002)* (CA) (n 191) [52].

[289] Ibid. [53].

1. a contract is not unprofitable merely because the company could have made a better bargain; and
2. obligations accrued in the past are not liabilities that can be terminated by disclaimer.

It would appear dubious that a mere prospect of the senior debt being repaid at some point in the future would thwart these arguments. In addition to that, if the liquidator would be entitled to disclaim the 'not proving' –clause, it would in fact receive a full premature payment for its conditional debt that should be valued under r.4.86 of IR. The likelihood of a contingent claim materialising should be handled through some other method than by disclaimer of the contingent contract.

4.4.2 Transactions at an Undervalue

General Aspects of the Provision

It is arguable that a complete or springing subordination would not be considered transaction at an undervalue under s.238 of the IA if the relevant transaction has been concluded before the applicable suspect period, which is generally 6 months (2 years for connected persons) before the commencement of the insolvency but the subordination springs up during the suspect period. The reason is that the parties are not 'entering into transaction' during the suspect period but rather that the conditionality of the subordination is being fulfilled. Application of the provision requires that the insolvent company enters into the transaction at an undervalue when it is unable to pay its debts when due within the meaning of s.123 of the IA or becomes unable to pay its debts because of such transaction.

However, a subsequent subordination of an existing debt or a security is more likely to be voidable under the provision.[290] Wood has asserted that it is plain that a turnover subordination of an existing debt may be set aside if there is an element of undervalue and there are no statutory defences to the claim. According to him, also a contractual subordination may be subject to a similar risk.[291] The risk is more likely to arise in the junior creditor's liquidation than in the debtor's liquidation. Therefore, the focus of the chapter is on the first of these scenarios.

The applicability of the provision depends on three specific issues each requiring separate evaluation because debt subordination does not fall neatly into any simple category of transactions susceptible to avoidance as a transaction at an undervalue. These three issues are: (i) the concept of a 'transaction'; (ii) categorization of debt subordination, especially subsequent subordination, as a 'gift', or concluded without 'consideration'; and (iii) the consideration being valued significantly less than the value received for the subordination commitment.

Debt Subordination as a Transaction

Whether the subordination is an inherent part of a debt-rescheduling package or an independent postponement letter, it is likely to be caught by the term 'transaction'. The term is defined in s.436 of the Insolvency Act as 'a gift, agreement, or arrangement' and construed rather broadly in the case law. As Robert Englehart QC (sitting as a Deputy Judge) stated in *Re Taylor Sinclair Ltd*, it is right to say that 'transaction as a matter of ordinary language

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[290] *Wood* 4.3.

[291] Ibid.

embraces a potentially wide range of possibilities.[292] He continued that apart from a case of a mere gift, the transaction is something involving at least some element of dealing between the parties of the transaction.[293] Despite the broad scope of the concept, there are material exceptions to it, such as granting of security interests.[294]

Furthermore, the finding of a 'transaction' in debt subordination of almost any kind is supported by *Department for Environment, Food and Rural Affairs v Feakins*[295] in which Hart J stated that there is no authority requiring that two or more linked transactions should not be read as one under s.423 of the IA.[296] Hart J concluded that: [297]

> …if the reason behind the linkage of two or more individual transactions is to achieve by that means the object which the section is designed to frustrate, that may itself in my judgment be a justification for treating them as one composite arrangement for the purposes of the section.

Hart J's statement is relevant to debt subordination arrangements because debt subordination is usually a part of a composite transaction involving many elements such as disposal of some of the company's assets, conversion of debt to equity, etc. The fact that the junior creditor is a party to more than just the subordination arrangement may lead to a question whether the other parts of the transaction should be considered when evaluating whether it has received any valuable consideration for entering into the transaction. It should be noted, that there needs to be some element of dealing despite the generality of the

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292 *Re Taylor Sinclair (Capital) Ltd (In Liquidation)* [2001] 2 BCLC 176 (Ch) [20].

293 Ibid.

294 *Re MC Bacon Ltd* [1990] BCLC 324, 340-1.

295 *Department for Environment, Food and Rural Affairs v Feakins* [2004] EWHC 2735 (Ch).

296 Ibid. 45. It should be noted that although the case concerned the provision concerning defrauding of creditors, it is of relevance also to s.238 because the provision on defrauding of creditors in essence requires that (i) there has been a transaction at an undervalue and (ii) that the purpose for such a transaction was putting assets beyond the reach of the company's creditors.

297 Ibid.

requirement. The concept of a transaction is extended under *Phillips v Brewin Dolphin* and *Department for Environment, Food and Rural Affairs v Feakins*[298] also to any linked arrangements.

It should be noted that linked transactions are taken into consideration primarily for the purpose of evaluating the value of the consideration that the junior creditor may or has extracted from the arrangement. This view was emphasized in *Phillips v Brewin Dolphin*[299] where Lord Scott stated that the finding of the 'consideration' is a question of fact and he indicated that for this purpose the identification of 'transaction' should not be too limited.[300] However, the finding of a transaction is of importance because the liquidator needs to be able to challenge a particular arrangement in order to be successful, which in turn may be difficult if various parts of a larger transaction, such as a debt-rescheduling package, are closely intertwined.[301]

Therefore, the senior creditor is likely to argue for a wider interpretation of 'transaction' whereas the liquidator would be most likely to argue for a narrower one. The importance of this is the establishment of significant undervalue received by the junior creditor. For s.238 of the IA to apply, the composite transaction should, however, contain at least one transaction entered into by the junior creditor (eg the subordination commitment). The other parts of the debt arrangement will be taken into account if entered into under a common understanding and if they are connected to the same composite transaction.

Valuation of Debt Subordination Arrangements

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[298] Ibid.

[299] *Phillips (Liquidator of AJ Bekhor & Co) v Brewin Dolphin Bell Lawrie Ltd* [2001] UKHL 2 (HL) 20.

[300] Ibid.

[301] *Keay-McPherson* 269.

Debt subordination may be considered a transaction at an undervalue if it is either a gift, the junior creditor does not receive any consideration for postponing its debt or there has been a significant imbalance in the consideration received and the benefit obtained. I will discuss here primarily the last one of these. Subordination arrangements, both complete and subsequent ones, are structured in such a manner that the question whether it is a pure gift is quite unlikely to arise. There is nearly always a good commercial motive behind the transaction, whether securing the financial condition of a strategic subsidiary or something else. The same argument applies to the requirement that there has to be some consideration for entering into the transaction. At least under contract law rules, the fulfilment of the requirement is inferred rather easily in commercial dealings, because the consideration need not be adequate but at least of some value.[302] Second, subsequent subordination arrangements are often made by way of deed, avoiding the requirement of consideration, which is under general contract law a necessary precondition for the enforceability of an agreement. This technique may also be advisable in respect of debt restructurings, where it may be argued that subordination is in effect accepting a payment of a lesser sum in satisfaction of the greater.[303] The enhanced probability of repayment of the debt through the debt-rescheduling does not necessarily constitute a valid consideration for the subordination.

The question whether debt subordination may be considered a gift is not actually important here because the third possible instance of a transaction at an undervalue is where the value of the consideration received by the company is significantly less than the same provided by the company – a category logically containing also gifts. First, showing

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302 See eg GH Treitel The Law of Contract (10th ed, Sweet & Maxwell, London 1999) 70.

303 *Pinnel's case* (1602) 5 Co Rep 117a, and *Foakes v Beer* (1884) 9 App Cas 605 (HL). However, it should be noted here that the requirement of 'consideration' under s.238 is a statutory requirement, whereas 'consideration' under common law of contract may be understood differently.

that there has been a significant imbalance in the consideration received and the benefit obtained, falls upon the liquidator.[304] Second, valuation of the debt subordination commitment depends inherently on the composite debt-rescheduling transaction (if there is one) and, because of the nature of debt subordination commitment, its valuation is not straightforward. Third, the valuation principles should be the same for the valuation of the subordination commitment and the consideration received by the junior creditor.

As Millet J stated in *Re MC Bacon Ltd*,[305] it is required that the consideration received by the company must not be in money or money's worth is significantly less than the value (also measured in money or money's worth) of the consideration provided by the company for the s.238 of the IA to apply. Therefore, both values must be measurable in money or money's worth and both must be considered from the company's point of view.[306] The relevant question is then: What is the value of postponing ones debt to those of others in monetary terms and what is the consideration received by the junior creditor for such a transaction?

It may be that the junior creditor's insolvency is unrelated to that of the debtor but it is rather common that the question arises in a debt restructuring where a parent company (here the junior creditor) agrees to subordinate its receivables from its subsidiary, i.e. the debtor.[307] Therefore, the junior creditor may have a group interest in the solvency of its operative subsidiary. This can be measured in monetary terms and, even though the valuation may be of considerable difficulty, it should be noted that under *Ramlort Ltd v*

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304 *Re MC Bacon Ltd* (n 294) 340-1.

305 Ibid.

306 Ibid. 340.

307 *Wood* 1.3 and 2.1.

Reid[308] the transaction at an undervalue provision applies whenever the court is satisfied that, whatever the precise values may be, the incoming value is on any view 'significantly less' than the outgoing value.[309] Jonathan Parker LJ concluded that it is possible to find a range of possible values and subsequently examine whether this range (notably the highest value) is within an 'acceptable range' from the consideration provided by the company, ie here the postponement of its claim or security.[310]

It should be noted, that when a debt is subordinated *ab initio* the subordinated position is usually balanced by a higher interest rate, a matter than affects the evaluation whether the transaction is one of undervalue. The fact that the subordinated debt carries a higher interest rate is a benefit to the junior creditor and such benefit is naturally valid consideration for the subordinated position. However, when the debtor is in financial difficulties, the value of the postponed debt cannot be measured in relation to the face value of the claim or the interest rate. It was established in *Agricultural Mortgage Corporation Plc v. Woodward*[311] and in *Phillips v Brewin Dolphin*[312] that the valuation should be based on the reality of the benefit.[313]

One important question is whether future events, in this case the liquidation or financial difficulties of the junior creditor, affect the valuation of the benefits received. Lord Scott stated in *Phillips v Brewin Dolphin*[314] that where the events which might have depended on uncertainties have actually happened, it would be 'unsatisfactory and

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308 *Ramlort Ltd v Reid* [2004] EWCA Civ 800 (CA).

309 Ibid. [103].

310 Ibid.

311 *Agricultural Mortgage Corporation Plc v. Woodward* (1995) 70 P. & C.R. 53 (CA).

312 *Phillips v Brewin Dolphin* (n 299).

313 *Agricultural Mortgage* (n 311), 64 and *Phillips v Brewin Dolphin* (n 299). See also *Barclays Bank Plc. and Others v. Eustice and Others* [1995] 1 WLR 1238 (CA) [26].

314 *Phillips v Brewin Dolphin* (n 299).

unnecessary for the court to wear blinkers and pretend that it does not know what has happened'.[315] Goode has stated that Lord Scott was not in fact applying a hindsight test but merely relying on evidence of subsequent events to show that a particular covenant was as of the outset so speculative that it could not have been ascertained any value to it, drawing parallels to the accounting distinction 'adjusting event'[316] and 'non-adjusting event'[317]. According to Goode, in *Phillips v Brewin Dolphin* Lord Scott merely took into consideration the subsequent event as validating that the covenant had no value at the transaction date.[318] In respect of debt subordination, the accounting treatment of the postponement and other consideration could play some part in the evidentiary process concerning a claim under s.238 of the IA. The correct way to understand the 'hindsight test' in *Phillips v Brewin Dolphin* is that where the risk is clear a the time when the transaction was entered into, subsequent events may be taken into account in the valuation; whereas the risks were not clear at that time, the subsequent event should not affect the valuation.

We may draw three conclusions from the above. First, the value received by the junior creditor for the subordination depends on the value of the entire debt rescheduling transaction (composite transaction) to the extent there is financial benefit to the junior creditor capable of being measured in monetary terms. Second, the value of the benefit given up depends also on the composite transaction and it does not represent the face value of the debt but rather the realistically recoverable value, which in most debt reschedulings would likely be the value received in liquidation.[319] On the other hand, the

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315 Ibid. [26].

316 An event helping to establish the value at the transaction date.

317 An event reducing or increasing the initial value subsequently.

318 *Goode II*, 11-31.

319 See for valuation, albeit in a different context and not applicable to the current situation: *Re Mytravel Group Plc* [2004] EWCA Civ 1734 (CA) [35].

value received by the senior creditor may be measurable rather easily as the additional dividend it would receive in the junior creditor's insolvency or the amount of the turnover of the junior creditor's debt. Third, and subject to the rule in *Phillips v Brewin Dolphin*, the valuation is a question of fact and the court may look at the subsequent events to determine the value of the subordination at the date of the transaction. This means that the benefits of the subordination and the effects of the likely default scenarios by the debtor should be documented and evaluated carefully - albeit not only for the purposes of s.238 IA risk but also for general company law purposes.

<u>Defences to Avoidance</u>

If a debt subordination transaction was deemed to fall into the scope of s.238 of the IA, the general statutory defence under s.238(5) may still be available. First, the company must have acted in good faith and for the purpose of carrying on its business. Second, at the time of the transaction there must have existed reasonable grounds for believing that the transaction would benefit the company.

At first sight, the defence would appear to create a relatively extensive 'safe harbour' for most debt subordinations not involving fraudulent elements or intentional circumvention of the mandatory insolvency law. This may not be the case because, first, it is the senior creditor who has to establish the defence (which may be difficult because it may be unaware of the company's motivations and benefits in entering into the transaction) and, second, because the test for the existence of reasonable grounds is an objective test, not what the directors of the junior creditor subjectively thought. In addition to that, as Goode mentions, the good faith requirement is not a general requirement of honesty but a genuine belief that the transaction would benefit the company's business.[320] There is no English case law on the matter. It may well be that overcoming the finding that there has been a transaction at an undervalue may in fact be rather difficult, unless there is a close business connection between the junior creditor and the debtor and the rescheduling is intended as a whole to facilitate the continuance of this business.

4.4.3 The Rules on Preferences

The rules on preferences are important both in the in liquidation of the debtor and the junior creditor. The conditions of the application of the s.239 of the IA are that:

1. the preferred person is company's creditor, surety or guarantor;
2. the company does or suffers anything putting that person into a better position than without the action or suffering, should the company go into insolvent liquidation; and
3. the insolvent company was influenced by a desire to produce in relation to that person.

The preference provision applies in the junior creditor's insolvency only to the extent the senior creditor is already either its creditor, surety or guarantor, which means that unless there are other mutual dealings with the junior and the senior creditor the risk of avoidance is minimal. It should be noted that the provision is very likely to apply, at least in subsequent subordinations and where the junior creditor is either the debtor's parent or another connected party. Subsequent turnover subordinations are usually at the most risk to be avoided under the preference provision. However, as Wood has noted, contractual subordinations are as well at risk because postponement of one creditor improves directly

320 *Goode II* 11-40.

the position of all the unsubordinated creditors.[321] Another form of debt subordination likely to be avoided under the provision is short-circuiting of turnover subordination, which is discussed in chapter 4.2.5.

<u>Putting Creditor Into a Better Position</u>

Although the recipient of the benefit needs to be an existing creditor, surety or a guarantor of the insolvent party, it is not required that the transaction sought to be recovered is concluded directly with that party. What the text of the statute says is that the company 'does anything or suffers anything to be done' which consequently has the effect of putting a creditor in a better position. This merely means that the act or 'suffering' leads to such a result not that there is any direct agreement or transaction between the parties. For example, a subordination agreement between a junior creditor and the debtor means in effect that either one or some senior creditors will be preferred. The rule does not require that the other creditors knew anything about the transaction. As a matter of a fact, nothing in the provision turns on the motives of the senior creditor.[322]

What is required, however, is that the payment or other action or suffering comes out of the assets of the insolvent party.[323] For this purpose, as Goode has pointed out, it is sufficient that the company permits or allows circumstances where the company's permission for the transaction is needed and can be refused.[324] Therefore, eg a contractual subordination suppressing the junior creditor's right to collect its debt leads logically to increase in the dividend of the other creditors, thus putting them into a better position.

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[321] *Wood* 4.4.

[322] *Keay-McPherson* 11-55.

[323] *Goode II* 11-89.

[324] Ibid.

There appear to be at least two significant differences between turnover and contractual subordination in relation to the preferences provision. First, if the debtor is not a party to the intercreditor agreement (eg in turnover subordination) and the junior creditor is insolvent, there can be no preference in the liquidation of the debtor because it has not agreed to anything. Therefore, even though it may be beneficial that the debtor is a party to such agreement, it may indeed increase the likelihood that the transaction is avoided in its insolvency. Second, contractual subordination improves the position of all the unsecured creditors except the junior creditor. Therefore, the improvement of the position of the other creditors is at the expense of the junior creditor that has already contractually waived or suppressed its right of payment. It would be odd if the liquidator would be able to avoid the agreement even though the junior creditor has specifically agreed to be subordinated. On the other hand, in turnover subordinations the improvement of the position of the senior creditors at the expense of the unsecured creditors of the junior creditor in its liquidation is obvious and likely to be avoided, if the 'commercial pressure' defence discussed below does not apply.

Influenced by a Desire to Prefer

Millet J stated in *Re MC Bacon Ltd*[325] that every word in the formulation of the s.239 of the IA is of importance in its application. He affirmed that unlike under the old law, the current rule does not require that the 'desire' would be the dominant reason for giving the preference but rather one of the reasons. He furthermore, distinguished between an 'intention' and a 'desire' in the sense that intention refers to all the necessary consequences of ones actions whereas one does not necessarily desire all the consequences of ones

325 *Re MC Bacon Ltd* (n 294) 335.

actions.[326] This is important for our purposes because if we accept Millet J's proposition, it is possible to carry out a workout that includes debt subordination when knowing that one of the necessary consequences is preferring one creditor over another. However, the provision tells us nothing how dominant the desire to prefer needs to be before the provision applies. Millet J asserted in *Re MC Bacon Ltd* that 'there must have been a desire to produce the effect mentioned in the subsection, that is to say, to improve the creditor's position in the event of an insolvent liquidation' and that the test would be whether the insolvent positively wished to improve a creditors position in the stated manner.[327] He continued:[328]

> Some consequences may be of advantage to him and be desired by him; others may not affect him and be matters of indifference to him; while still others may be positively disadvantageous to him and not be desired by him, but be regarded by him as the unavoidable price of obtaining the desired advantages. <u>It will still be possible to provide assistance to a company in financial difficulties provided that the company is actuated only by proper commercial considerations</u>. (underlining added)

Finding the desire to prefer is a question of fact much like in transactions at an undervalue. Nevertheless, what is important is that the desire needs to be one of the factors influencing the representatives of the company to carry out the transaction.[329] As Millet J put it in *Re MC Bacon Ltd*, there is no need to adduce direct evidence of 'desire' but it could be inferred from the circumstances of the case.[330] Although, the doctrine in *Re MC Bacon Ltd* has not been followed in all cases,[331] perhaps the most fundamental point to note in relation to debt

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326 Ibid.

327 Ibid. 335-6.

328 Ibid.

329 See Verrill *'Attacking Antecedent Transactions'* [1993] 7 JIBL 485, 489.

330 *Re MC Bacon Ltd* (n 294) 336.

331 Ibid. and *Re Fairway Magazines Ltd* [1992] BCC 924 (Ch D) (Companies Ct).

subordination agreements is that Millet J drew his conclusions based on the following findings of fact:[332]

1. The company was probably insolvent and might not be able to avoid an insolvent liquidation;
2. The continuance of the business was entirely dependent on the continued support of the bank;
3. If the debenture were not forthcoming the bank would withdraw its support; and
4. If the bank withdrew its support, the company would be forced into immediate liquidation.

Thus, Millet J concluded that the company's representatives continued trading in a genuine belief that the company could be rescued and that they had no choice but to accede to the bank's request for a debenture.[333]

In order to establish the desire to prefer, it is important to look at the knowledge and intentions of the board of directors of the debtor or the junior creditor (or both if both are insolvent).[334] However, even though proving the desire eventually turns on the facts of the case,[335] the requirement is alleviated at least in insider subordinations by s.239(6), which states that there is an assumed but rebuttable desire to prefer in transactions with connected parties. It should be noted that it was held in *Re Exchange Travel Holdings Ltd* that this presumption cannot be rebutted merely by showing that the connected parties were unaware of the insolvency.[336]

However, the most notable defence against there being a desire to prefer is that the creditor has exerted commercial pressure on the debtor or the junior creditor for

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332 *Re MC Bacon Ltd* (n 294) 336-7.

333 Ibid. 336.

334 *Re Transworld Trading* [1999] BPIR 628 (Ch D) 629.

335 As in *Re Agriplant Services Ltd (In Liquidation)* [1997] BCC 842 (Ch) 851.

336 *Re Exchange Travel (Holdings) Ltd* [1999] BCC 291 (CA).

making a payment or entering into the transaction. Although not an absolute defence, it stems from the long-standing view of the English insolvency law that a creditor is entitled to promote its own interests in collecting its receivables.[337] The presence of commercial pressure in subsequent debt subordination is obvious and related to the very fact that the debtor or the junior creditor is close to insolvency and the company will be liquidated provided there is no agreement on the debt-rescheduling package. This is clear-cut. First, in legal terms, commercial pressure rebuts free will of the debtor, ie the free will to enter into the transaction. Second, under English law the motives or desires of the creditors are irrelevant when determining the avoidance rules.[338]

Therefore, the risk of subsequent debt subordination being deemed a preference is considerably alleviated because of the commercial pressure rule just as long as the creditors are not imposing extortionate terms to the company in the meaning of s.244 of the IA.[339]

We are able to make three conclusions about the effects of the preferences provision on avoidance of debt subordination arrangements. First, the provision applies despite lack of any direct contractual or transactional relationship between the debtor or junior creditor and the senior creditor. Second, debt subordination is not avoided as a preference even if one of the necessary consequences would be preferring one creditor over others in liquidation as long as that was not the predominant motive in the minds of the company's representatives

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[337] M Bridge 'Collectivity, Management of Estates and the *Pari Passu* Rule in Winding-up' in J Armour and HN Bennett (eds) *Vulnerable transactions in corporate insolvency* (Hart Publishing, Oxford 2003).

[338] *Keay-McPherson* 11.71-11.73.

[339] See generally *Goode II*, 11-105 through 11-107. Note also *Agriplant Services* (n 335) where Parker J was unwilling to accept the argument that the motivation in the transaction at question was to retain possession of the equipment necessary for the business and that the real underlying desire was to reduce the potential liability of a director having guaranteed the debt that was repaid.

at the time of the transaction and this can be inferred from the circumstances of the particular case. Third, even if there were a desire to prefer one creditor to others, the provision does not apply if:

1. there were sound commercial reasons for entering into the subordination commitment; and
2. it can be shown that such a transaction was required in order to avoid cessation of the company's trade or that the relevant loans would otherwise be accelerated thus causing insolvency.

It should be mentioned that careful documentation of the actual intentions of the parties in a workout in respect of debt subordination might be a two-edged sword. On one hand, it may help to establish the actual financial realities for the workout and the creditor pressure against the debtor or an affiliated junior creditor. On the other hand, it may be self-incriminating to document the benefits of the transaction to various parties too extensively perhaps evidencing that the real motivation was creation of a priority position for some creditors, not the rescue of the company as going-concern.

4.5 TURNOVER TRUST

4.5.1 Effectiveness of the Trust

As Wood states, most Anglo-American turnover subordinations are trusts of proceeds occurring upon a contingency, eg the debtor's insolvency.[340] Turnover trusts avoid most of the problems of debt subordination encountered in the liquidation of either the debtor or the junior creditor. The main reason is that the senior creditor and not the trustee, ie the junior creditor or a separate trustee, is the beneficial owner of the trust assets. In order to

[340] *Wood*, 7-2.

avoid the above problems, the trust will have to be a completely constituted trust and the trust property and the beneficiaries will have to be ascertained or ascertainable. Furthermore, the risk for insolvency set-off defeating the subordination is avoided because there is no mutuality between the cross-claims of the junior creditor and the debtor in the sense that the proceeds of the junior debt are held on trust for the senior creditor(s). However, I will address below the question whether the mutuality may still be preserved if the trust is for the proceeds of the debt and not the debt itself. The answer to the question depends on whether it is possible to create a trust of the proceeds of the junior claim and whether it is possible to limit the trust sum to the outstanding balance of the senior debt.

4.5.2 Validity of the Trust

As Wood notes, a subordination trust is in economic effect a collateral charge by the junior creditor over the junior creditor's debt or its proceeds.[341] The line between a subordination trust and a charge of the junior debt securing the repayment of the senior debt is a fine one. He continues that the most notable consequences of recharacterization are that a charge may be void for want of registration, creation of a charge may breach negative pledge clauses or regulatory prohibitions, the senior creditor might not be able to vote in the junior creditor's insolvency to the extent its claim is secured by the charge, and the charge may become subject to a freeze in administration proceedings.[342]

The risk is largely avoided if the parties use a trust deed whereby the junior debt is payable to the trustee holding the recoveries on trust, first, for the senior creditor(s)

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[341] *Wood* 5.1.

[342] Ibid. 5.2.

and, second, to the lower ranking creditors. The debtor's covenant in favour of the trustee may be a 'covenant parallel', ie the debtor pays both to the junior creditors and to the trustee (but payment to the junior creditors extinguishing the obligation to pay to the trustee) until an event of default, eg the debtor's liquidation, after which the debtor is obligated to pay only to the trustee. This appears to be a rather typical feature of English subordinated bonds. It is arguable that the issue of recharacterization cannot arise in such a case because the trustee has no asset, which it could charge in favour of the senior creditor, and the junior creditor has merely a limited interest under the trust.[343]

Recharacterization of a turnover trust as a charge depends fundamentally on the question what is the subject matter of the turnover trust, whether a trust of proceeds is a trust at all and, if so, what are the requirements of the trust in such a case. It should be noted that under intercreditor agreements a turnover trust usually applies to all recoveries, except specific permitted payments, received by the junior creditor. Therefore, even though the economic effect is largely the same, it is the proceeds, not the debt that is being transferred to the senior creditor. The question whether a charge of an asset includes a charge of its proceeds is quite different from the question whether a charge of the proceeds extends to the underlying assets. The first question is not discussed here because it does not actually arise with turnover trusts, even though there are different opinions about the question.[344]

Lord Millet stated in *Foskett v McKeown* that a beneficiary of a trust is entitled to a continuing beneficial interest not merely in the trust property but also in its traceable proceeds.[345] However, as Goode notes, the converse proposition (ie one would be entitled to

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343 *Hayton-Underhill* 43.

344 See eg: A Besser 'Subordination and Priorities' in R Talbot *Practical Lending and Security Precedents* (Longman Law Tax and Finance, London 1992), H-7.

345 *Foskett v McKeown* [2001] 1 AC 102 (HL).

the underlying property when it only has an interest in the proceeds) does not hold because if this were the case, a chargee of a debt would automatically acquire a charge over the trading stock and to all assets higher up in the trading process.[346]

First, of all, Goode's statement is supported by *SSSL Realisations (2002)*[347] where Lloyd J stated that 'it is possible to create a charge over a sum of money held by a person once it has been paid to him, without necessarily also creating a charge over the debt or other right in respect of which it may come to be paid'.[348] Second, it is possible under English law to assign the proceeds of the debt as opposed to the debt itself. As Bacon C.J. stated in *Re Irving, Ex p. Brett*:[349]

> …he binds himself to pay over to the bank those dividends when he receives them. He does not promise, as in the cases that have been cited, that he will pay them out of an uncertain fund, but he undertakes to pay over the very fund itself, and yet it is doubted whether that is an equitable assignment. The letter does not create a charge or lien on the dividends, but it is a good equitable assignment of the entire dividends.

Even if the above argument holds, we need to ask whether proceeds of the debt could be deemed future assets arising only after the liquidation of the debtor.

It can be argued that creation of a turnover trust is not an assignment of a future debt because the junior debt surely exists at the time of the creation of the trust - even though not the junior debt but its proceeds form the subject matter of the trust. This view is supported by *Tailby v Official Receiver* where Lord MacNaghten stated that future property, possibilities and expectancies are assignable in equity for value and that the mode

[346] *Goode I* 1-68.

[347] *SSSL Realisations (2002)* (n 9).

[348] Ibid. [54].

[349] *Re Irving Ex p. Brett* (1877 (Ch) 422.

or form of assignment is absolutely immaterial if the intention of the parties is clear.[350] He continued that such an assignment for present value has always been regarded in equity as binding in relation to the subject matter of the contract when it comes into existence - if capable of being ascertained and identified.[351]

Because the creation of a trust over proceeds of the junior debt appears to be possible, we must then ask under what conditions it can be recharacterized as a charge. The case law relating to retention of title provides some guidance on the issue. It is clear that if eg a supplier and a purchaser purport to create a trust for the supplier extending to goods produced from the supplier's materials and extending to their sales proceeds held on a trust account as security for sums owed to the supplier, the 'trust' is deemed as a charge.[352] The same argument applies when the legal title to the materials has already passed to the purchaser.[353] However, this does not mean that it would not be possible to create a trust of the sales proceeds representing the amount owed to the supplier.[354]

What is of significance here is the existence of 'equity of redemption' by the alleged chargor. Lord Hoffmann emphasised in *BCCI (No. 8)* that:[355]

> A proprietary interest provided by way of security entitles the holder to resort to the property only for the purpose of satisfying some liability due to him (whether from the person providing the security or a third party) and, whatever the form of the transaction, the owner of the property retains an equity of redemption to have the property restored to him when the liability has been discharged.

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[350] *Tailby v Official Receiver* (1888) L.R. 13 App. Cas. 523 (HL).

[351] Ibid. 543.

[352] *Hayton-Underhill,* 39-40. *Compaq Computer Ltd v Abercorn Group Ltd (t/a Osiris) and others* [1993] BCLC 602 (Ch).

[353] *Hayton-Underhill,* 39;. *Clough Mill Ltd v Martin* [1985] 1 WLR 111 (CA).

[354] *Clough Mill Ltd v Martin* (n 353) 188 (Goff LJ).

[355] *Re Bank of Credit and Commerce International SA (In Liquidation) (No.8)* [1998] AC 214 (HL) 32. His view was adopted in the Australian case *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd 2000 HCA 25.*

Similarly, Slade J stated in *Re Bond Worth* that:[356]

> …any contract which, by way of security for the payment of a debt, confers an interest in property defeasible or destructible upon payment of such debt, or appropriates such property for the discharge of the debt, must necessarily be regarded as creating a mortgage or charge, as the case may be. The existence of the equity of redemption is quite inconsistent with the existence of a bare trustee-beneficiary relationship.

Consequently, if there is an equity of redemption, a trust may be recharacterized as a charge. This is one of the reasons, why a subordination trust is always limited to the sums owing to the senior creditor, ie no equity of redemption can arise. However, the limitation of the trust interest to the sums owing to the senior creditor appears at least at first sight to be inconsistent with the first part of Slade J's proposition in *Re Bond Worth* that an interest defeasible upon payment of the debt is characteristic of a charge.[357]

It should be noted that, *Re Bond Worth* was not a decision about subordination trusts but about retention of title clauses. Even so, we still must be able to overcome the argument that in reality the payment of the senior debt results in dissolution of the trust, and to the risk of recharacterization. As Lloyd J stated in *SSSL Realisations (2002)*, 'the turnover trust would have created a charge in that case if, but only if, it were construed as applying to all receipts, rather than to sums received up to the amount owed to AIG'.[358] According to Lloyd J, 'the trust provision and the payment obligation as applying to the same subject matter, so that the payments which an Indemnitor has to pay over to AIG are limited to those necessary to pay AIG in full what is owed to it'.[359] However, we will have to find a

356 *Re Bond Worth Ltd* [1980] Ch. 228 (Ch) 248.

357 Ibid.

358 *SSSL Realisations (2002)* (n 9) [51].

359 Ibid. [37].

valid legal argument why 'a limitation up to an amount' would be treated differently from creation of a charge over the debt. There is a two-step solution to the problem.

First, the tension between the two cases would not appear to be as strong in light of *Compaq Computer Ltd v Abercorn Group*.[360] Although, the case also supports the position taken by Slade J in *Re Bond Worth* that a determinable interest in the proceeds of sale is characteristic of a charge and not a trust,[361] importantly, Mummery J implied in *Compaq Computer Ltd v Abercorn Group*[362] that the rule need not be that absolute. He concluded that the buyer's interest in the proceeds of sale in excess of the debts owing to the seller was more consistent with the existence of a charge over the proceeds than with a fiduciary obligation on the part of the buyer operating as vesting of the absolute interest in all the proceeds automatically in the seller.[363] What is important here is that in turnover subordinations the excess never passes to the senior creditor but is always limited by the trust obligation. Because there can be no interest in the excess that has never passed, there is nothing characteristic of a charge either.

The second aspect of the solution relates to the nature of the trust assets. The division of the proceeds into trust assets and assets of the junior creditor should not be too difficult in the light of *Hunter v Moss*.[364] In that case, it was accepted that the requirement for the certainty of a subject matter did not necessarily entail segregation of the property which was to form the subject matter of the trust; and that the declaration of trust by the defendant

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360 *Compaq Computer Ltd v Abercorn Group* (n 352).

361 *Re Bond Worth* (n 356) 248.

362 *Compaq Computer Ltd v Abercorn Group* (n 352).

363 Ibid. 616. The seller was deemed to have in that case a limited interest in those proceeds by way of security for outstanding debts rather than by way of bare trust.

364 *Hunter v Moss* [1994] 1 WLR 452 (CA). However, it should be noted that the case is a controversial one and somewhat difficult to reconcile with certain other cases dealing with the same issues.

was sufficiently certain as to subject matter, because the shares (which were the subject matter of the trust) held by the defendant were of such a nature as to be indistinguishable from each other, ie fungible. Dillon LJ stated that there was no question of a mere equitable charge over a mixed fund in the case. He continued that:[365]

> …just as a person can give, by will, a specified number of his shares of a certain class in a certain company, so equally, in my judgment, he can declare himself trustee of 50 of his ordinary shares in M.E.L. or whatever the company may be and that is effective to give a beneficial proprietary interest to the beneficiary under the trust. No question of a blended fund thereafter arises and we are not in the field of equitable charge.

Hunter v Moss[366] is reinforced by the maxim that equity treats as done that which ought to be done and there will be a tracing remedy available even though the debt proceeds would eg be paid into a general bank account of which the recipient was only entitled to hold a specified portion.[367] This remedy can be supported by including a clause in the intercreditor agreement concerning the junior creditor's obligation to remit the proceeds (often named "non-permitted payments") to the senior creditor within a relatively short period, eg 10 days from their receipt.

The distinction of a trust limited to 'an unpaid amount' from charge over proceeds of a debt is of great importance in turnover subordinations. The question is essentially about whether the proceeds can be the subject matter of the trust and whether it makes a difference if the subject matter is the entire junior debt or the amount of the debt up to the amount of the senior debt.

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[365] Ibid. 460.

[366] Ibid.

[367] See *Hayton-Underhill* 15-16 and the example in *fn 11*.

The question was addressed in the Australian case *Associated Alloys*[368] where it was deemed upon proper construction of the arrangement that the trust subject matter was indeed the state of indebtedness between the seller and the buyer.[369] It was concluded that had the trust been expressed to cover the entire sales proceeds of the buyer of the materials, the question would have arisen whether the parties had intended to create a beneficial interest to the seller in the profits of the buyer.[370] However, *Associated Alloys* is an authority that limitation of the trust to the monies owed by the buyer to the seller from time to time is effective and is not a charge.[371] Were there an actual excess remaining after the discharge of the trust, there would be no equity of redemption but the court would be able to imply a term for reimbursement.[372]

The above view was affirmed by Lloyd J in *SSSL Realisations (2002)*[373] where he stated that 'the trust obligation, which is a continuing obligation, is conditioned and limited by the payment obligation'. This meant in effect that the trust obligation was limited, at any given moment, what was required to pay AIG in full. What is important from a practical point of view is that Lloyd J read the trust provision and the payment provision in the subordination deed as referring to the same subject matter and that the payments which any other group company had to pay to AIG were limited to those necessary to pay AIG in full what is owed to it.

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[368] *Associated Alloys* (n 355).

[369] See for a thorough discussion in Ibid. 599-610.

[370] Ibid. [39]. See also *Clough Mill Ltd v Martin* (n 353) 119.

[371] *Associated Alloys* (n 355).

[372] Ibid. [30]-[32].

[373] *SSSL Realisations (2002)* (n 9). The amount of the turnover obligation was at no point in dispute in the case. Rather the dispute arose over what was the actual scope of the trust. However, Lloyd did not discuss extensively the question how possible excess in the trust funds could be reimbursed to the junior creditor.

Although the Court of Appeal did not discuss the question at too great a length in *SSSL Realisations (2002)*, Chadwick LJ concluded that he agreed with Lloyd J on the issue especially because the trust clause in the Indemnity Deed was ancillary to the subordination and turnover clause and that the trust would be recharacterized as a charge only if the trust obligation were construed as applying to all receipts, rather than to sums received up to the amount owed to AIG.[374]

However, even though there is a risk of recharacterization, we must bear in mind that, unless the transaction is a sham, recharacterization may occur under the rule in *Welsh Development Agency v Export Finance*, only when the agreement when looked as a whole in substance amounts to something else than named by the parties, ie whether there is some objective criterion evidencing that the transaction falls into some other legal category than sought in the agreement.[375] However, such recharacterization may only be carried out after examining every part of the mutual agreement of the parties and the court cannot discard for this purpose a plain meaning of any term of the agreement 'unless there can be found within its four corners other language and stipulations which necessarily deprive such term of its primary significance'.[376] The real question is then: does equity of redemption negate a trust. This is not clear. However, if there is no equity of redemption, in a typical trust subordination, there is most likely nothing that would necessarily deprive the trust stipulation of its primary significance.[377] Conclusions from the above cases can be summarised as follows:

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374 *SSSL Realisations (2002)* (CA) (n 191) [122].

375 *Welsh Development Agency v Export Finance Co Ltd* [1992] BCC 270 (CA) 279, 280.

376 *McEntire v Crossley Brothers Ltd* [1895] AC 457 (HL) 462, 463.

377 However, McKnight has argued that if the Group had not owed anything to AIG in *SSSL Realisations* (2002) (n 9) and (CA) (n 191) the turnover arrangement would be defeasible, being conditional upon AIG not receiving the payment from other sources. According to McKnight, in this case the trust might be considered as constituting a charge because the trust

1. Turnover trust will be recharacterized as a charge if the trust is for the entire proceeds of the junior debt;
2. Turnover trust should not be recharacterized if the trust is limited to the amount equal to the senior debt, thus there will never arise a question of the existence of equity of redemption; and
3. There is no legal restriction to limit the trust assets to the amount owed to the senior creditor because beneficial ownership of an asset can be split.

4.5.3 Registration of the Charge

If a turnover trust is recharacterized as a charge, the junior creditor still holds its claim against the debtor beneficially. Such recharacterization is not necessarily detrimental to the senior creditor because it is in a similar position to a beneficiary of a trust for its rights are equitable and can only be overridden if the assets are purchased by a bona fide third party, for value and without notice.[378] This means that in practice recharacterization is not a major concern if the charge is not categorised as 'a book debt' registrable under s.395 of the CA. If this is the case, the recharacterized trust may be a voidable charge for want of registration. However, it is unlikely that a turnover trust of proceeds of the junior debt as opposed to the debt itself is a 'book debt' under the CA because the debt does not arise in the junior creditor's business that ought to be entered into the junior creditor's books.[379] Lloyd J stated in *SSSL Realisations (2002)* that:[380]

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ceases if AIG were to receive payment from other sources. Thus, Group would have had a residual interest in the trust assets, which could be classified as being in the nature of equity of redemption; A McKnight 'a Review of Developments in English Law during 2006: Part 2' [2007] 22 JIBLR 199. However, for the purposes of recharacterisation, this creates a kind of conditionality into the evaluation that is not warranted by the recharacterisation rules as stipulated in *Welsh Development Agency v Export Finance* (n 377) or *McEntire v Crossley Brothers* (n 378). Surely, it it possible to determine under the trust instrument, *ex post facto*, the limitation of the trust funds to the debts owed to the senior creditor – this can be ascertained by inquiry; see *Welsh Development Agency v Export Finance* (n 377) 278.

378 *Parker v Judkin* [1931] 1 Ch. 475 (CA).

379 See *Tailby v Official Receiver* (n 351) and P Wood *Project Finance, Subordinated Debt, and State Loans* (Sweet & Maxwell, London 1995) 9-3.

380 *SSSL Realisations* (2002) (n 9) [52].

> A book debt means, for this purpose, a debt owing to a company connected and arising out of the company's trade and business which is entered, or commonly would be entered, in the ordinary course of business, in well kept books of a trade or business…

Lloyd J did not accept the submission by the liquidator's counsel that the debt and its proceeds would be intertwined for the purposes of the question so that a sum received by any of the Save Group companies would have to be equated with the 'debt' owed to AIG under the deed.[381] His reason was that once a sum is paid to the company, there is not debt at all, merely an obligation to remit the cash the company has received. In this sense, Lloyd J relied on the proposition that relation back to previous assets is not possible. However, he did not question the converse proposition that a charge over a debt carried with it inevitably a charge over its proceeds.[382] His view was supported by Chadwick LJ in the Court of Appeal.[383]

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381 *SSSL Realisations (2002)* (n 9) [53] – [54].

382 See Chapter 4.5.2. and *Re Spectrum Plus Ltd (In Liquidation)* [2005] UKHL 41 (HL).

383 *SSSL Realisations (2002)* (CA) (n 191) [122].

5 CONCLUSIONS

Is debt subordination then effective in the liquidation of the debtor or the subordinated creditor or is it voidable either as a transaction at an undervalue or a preference? Although, the decisions of both the High Court and the Court of Appeal in *SSSL Realisations (2002)* afford strong support the validity of debt subordination both in the debtor's and in the junior creditor's liquidation and in most other situations, the validity of debt subordination clauses taking effect close to the insolvency of the junior creditor have not been distinguished or resolved conclusively in the case law. However, based on the analysis of the case law concerning the *pari passu* clause and the rule against divestiture of the insolvent's assets, the effectiveness of debt subordination in corporate liquidation appears relatively certain – albeit with a few exceptions. What is clear from *SSSL Realisations (2002)*[384] is that debt subordination is a clear exception to the pro rata distribution clause (or *pari passu* clause) in s.107 of IA or 4.181 of IR.

The main risks involved in English debt subordinations are:

1. the possibility of the subordination commitment being deemed a divestiture if the triggering event of the subordination is the junior creditor's insolvency or an event inherently related to its insolvency;
2. invalidity of direct payment clauses in junior creditor's insolvency; and
3. the risk of (especially subsequent and insider) subordination being avoided either as a transaction at an undervalue or a preference.

Importantly, even though the questions concerning recharacterization of the turnover trust have raised certain concerns in practice, it appears that a turnover trust is very unlikely to be recharacterized as a charge. Even if such recharacterization were to take place, the risk for

[384] *SSSL Realisations (2002)* (n 9).

the charge being void for want of registration would be minimal because turnover of dividends or proceeds of a debt is not a book debt and thus not a registrable charge.

Therefore, the main issues that have caused doubts about the effectiveness of debt subordination under English law are to a large extent questions whether the subordination commitment is an acceptable qualification of the junior creditor's debt and whether entering into such a commitment is a voidable transaction. These questions are also the crux of debt subordination under English law. It appears that the debt subordination structures currently used in the financial markets are to a large extent effective under English law and the Court of Appeal decision in *SSSL Realisations (2002)* (CA) should provide further comfort in this regard to the markets. Although the risks outlined above are present in most debt subordinations, they are risks that can be managed effectively and with reasonable commercial certainty through careful contractual drafting.

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