Feature

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KEY POINTS

- In the author's opinion, if a creditor 'rests on its security' and submits no proof for a debt in the debtor's liquidation, automatic insolvency set-off under r 4.90 does not operate.
- In this scenario, the security remains outside the liquidation.
- The justification for this lies in the first instance decision of *Re Norman Holding Co Ltd* [1990] 3 All ER 757, although the reasoning in this case and the tenor of some of the subsequent authority shows that the rather important point which it purported to decide rests on a surprisingly shaky basis.

Insolvency set-off and security: anomaly or principled exception?

Shantanu Majumdar explores how a secured creditor's decision whether or not to lodge a proof in a debtor's liquidation can impact on the 'automatic' operation of insolvency set-off.

By practice which dates back to the time of Queen Anne, English insolvency law provides for the taking of an account of what is due from each of the insolvent company and its creditor to the other, for the setting off of those sums against each other and the payment only of the net balance. If this is in favour of the creditor it is provable in the insolvency and if in favour of the company it is payable to the liquidator. It applies in liquidations (r 4.90, Insolvency Rules ('IR'), in administrations (r 2.85 IR) and in bankruptcies (s 323) to substantially similar effect (especially since the amendments made from 1 April 2005 by r 23 Insolvency (Amendment) Rules 2005 (SI 2005/527)). For the purposes of (relative) clarity this feature will focus on the provisions applicable to liquidations under r 4.90.

The rule applies to mutual credits, mutual debts or other mutual dealings before liquidation between the company and 'any creditor proving or claiming to prove for a debt in the liquidation'. It has been said that:

> 'Set-off [in] insolvency creates for the creditor a position analogous to that of secured creditors without the need for a charge over assets, because it ensures that his claim, up to the value of his obligation to the insolvent, is paid in full' (see Benjamin *Financial Law* (OUP 2008)).

but what is the justification for this beneficial treatment? As long ago as *Forster v Wilson* (1843) 12 M&W 191 this was said to be 'to do substantial justice between the parties' on the footing that it would not be fair for a creditor to have to pay the insolvent and, *ex hypothesi* delinquent, debtor in full while only being able to receive a dividend in respect of its own debt.

As between those parties this is surely right but, within the wider context of the collective process which liquidation intends to be, the creditor which benefits from insolvency set-off thereby obtains an advantage over those creditors who are not so entitled in circumstances where, despite the similarity of result with the position of the secured creditor, the creditor has not bargained for such apparently preferential treatment but instead receives it almost by accident.

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A good answer to that criticism seems to lie in a proper appreciation of the assets which the unsecured creditors are entitled to share *pari passu*. To the extent that these assets consist in claims against third parties in respect of unpaid debts then the effect of insolvency set-off is no more than to attribute the correct value to those claims because recovery could not be obtained by the company without due allowance being made for the value of the debt owed by the company.

It is settled law that insolvency set-off is:

- self-executing *ie* that it operates automatically and that the statutory account is deemed to be taken on the date of the winding-up order – *Stein v Blake* [1996] AC 243; [1995] BCC 543 (a bankruptcy case);
- is mandatory and therefore:
  - cannot be contracted out of;
  - is not subject to a judicial discretion to disapply it;

as the rather unsatisfactory decision of the House of Lords in *National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] AC 785; [1972] 1 All ER 641 indicates.

It is also clear that its operation does not depend upon a proof in fact having been lodged (indeed, if the set-off is deemed to take place on the making of a winding-up order such lodgement will clearly not yet have occurred) but instead that the debt would be capable of proof if it were lodged (see *Mersey Steel and Iron Co v Naylor, Benzon & Co* (1882) 9 QBD 648 and *In re Bank of Credit and Commerce* (No 8) [1998] 1 AC 214) and in this important respect the words 'any creditor proving or claiming to prove for a debt in the liquidation' in r 4.90 do not mean or, more accurately, are not limited to what they say.

What then of secured debts? It seems that a security which the insolvent company holds for a debt owed to it is subject to insolvency set-off with the effect that it can be reduced or extinguished by a debt which it owes to the same party – see *Re Deveze, Ex p Barnett* (1874) 9 Ch App 293 and *Hiley v People's Prudential Assurance Co Ltd* [1938] 60 CLR 468. Both of these cases are somewhat ambiguous on the application of set-off to the creditor's security but given the normally bilateral effect of insolvency set-off one might expect that a security held by a creditor would be treated in the same way.

However, *Re Norman Holding Co Ltd* [1990] 3 All ER 757, [1991] BCLC 1, a brief first instance decision determining a preliminary issue, holds otherwise. There, Mervyn Davies J considered that the wording of r 4.90 was unclear and that there was no clear authority on the question. The relevant assumed facts were:

- that the creditor was owed £400,000, for which it had security in the form of a charge, and upon which it was continuing to rely and in respect of which it had (therefore) submitted no proof;
- that it was owed a further unsecured sum in respect of which it had submitted a proof;
- that the creditor owed a sum to the insolvent company in respect of its breach of a contract.

It was common ground that there had been mutual dealings between the company and creditor within the meaning of the rule. The judge rejected (it is submitted correctly) the contention that by proving in respect of the unsecured debt the creditor had brought insolvency set-off into play in relation to all of the sums which were owed to it (ie the secured as well as unsecured). Although the judge thought that this was an available interpretation of the language of the rule, he distinguished between debts which were in (unsecured) and outside (secured) the liquidation:

> 'As a secured creditor he does not (unless he so elects) prove or claim to prove for his debt in the liquidation. He relies on and realises his security. But as an unsecured creditor he proves in the liquidation and so is caught by set-off as to the unsecured debt. Thus I read r 4.90 as affecting debts proved in the liquidation and not as affecting debts that are elected not to be proved therein.'

The judge went on to hold, without further reasoning but 'with some hesitation', that:

> '… while r 4.90 set-off applies to an unsecured creditor who proves in the liquidation, that creditor is not obliged to bring into account any secured debt owing to him by the insolvent company if the secured debt is not proved in the liquidation. As I have said, *r 4.90 affects debts proved in the liquidation but does not affect debts that are elected not to be proved.'* [emphasis added]

But why is this so? A little earlier in his judgment the judge had identified the submission (in reliance upon *Re Daintry, ex p Mant* [1900] 1 QB 546 at 568, [1895-9] All ER Rep 657 at 670-671) that a creditor claiming to prove a debt is (or includes) a creditor who has a right to prove a debt and therefore that since a secured creditor has a right to prove it is 'claiming to prove' within the meaning of r 4.90. The judge rejected that submission: 'No doubt [the creditor] has a right to elect to prove for its secured debt but it is choosing not to do so.'

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It is unclear whether the judge is there accepting that a secured debt is provable but, if it is, then, as indicated earlier in this feature, the law before as well as since *Re Norman* is that having a *provable* debt is sufficient to fulfil the requirement of 'claiming to prove' and therefore that insolvency set-off applies even though the creditor has not (yet) chosen to prove. To the extent, therefore, that the judge's reasoning seems to rest on the (mere) choice of the creditor it is insufficient since this does not prevent the operation of set-off in relation to an unsecured debt even where the creditor deliberately delays in lodging its proof.

So what is special or different about a secured debt? A secured creditor has four choices open to it:

- it can abandon its security and prove for the whole of the debt due;
- it can value its security in its proof and prove for the deficiency;
- it can enforce its security and prove for any shortfall; and
- it can 'rest on its security' and submit no proof.

Which of these options it will take will obviously depend on the particular circumstances but it is equally obvious that, even on the footing that the decision to submit a proof is the trigger for the application of set-off in the case of a secured debt, three of these four options have that effect to varying degrees.

Yet why not the fourth? Is it because without the submission of a proof it is not provable? The difficulty with that bald proposition is that a debt in respect of which a proof could be submitted must in one sense *ipso facto* be provable. As Lord Hoffmann put it in (the subsequent decision in) *Stein v Blake* a creditor 'claiming to prove' means: 'any creditor of the bankrupt who [but for insolvency set-off] would have been entitled to prove for a … debt' (at [1995] 2 All ER 961 at 966).

Why does this (indeed how can it) not apply to a secured creditor who is entitled to do any (or at least three) of the things above?

In *Stein v Blake*, *Re Norman* was cited in the printed cases of the parties but no reference was made to it in the judgments. This was the platform from which it was submitted in *Stewart v Scottish Widows and Life Assurance Society plc* [2005] All ER (D) 247 (Jun) that it could be taken impliedly to have been overruled by the decision in *Stein*. The judge in *Stewart* thought otherwise but, although he was correct to identify that the central issue in *Stein* was whether the original choses in action comprising the claims giving rise to the debts survived the operation of insolvency set-off (they did not), it is submitted that he does not sufficiently explain how *Re Norman* with its exclusive emphasis on the voluntary conduct of the creditor (to prove or not to prove) can be reconciled with what Lord Hoffmann says in *Stein* about the mandatory and automatic nature of insolvency set-off. Indeed, the timing of the deemed taking of the statutory account – at the date of the winding-up order – might be thought

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to be consistent with a set-off which pre-empts whatever decision the secured (as well as unsecured) creditor might subsequently make about proof.

In *MS Fashions Ltd v Bank of Credit and Commerce International SA (in liquidation) (No 2)* [1993] 3 All ER 769 Dillon LJ said that:

> 'If there are indeed mutual credits or mutual debts or mutual dealings between a company, or a bankrupt and a creditor, then the set-off applies notwithstanding that one or other of the debts or credits may be secured.'

In so saying, Dillon LJ relied upon *Re Deveze* and *Hiley* which, as has been mentioned, are somewhat ambiguous on the point but his reference to 'one or other of the debts or credits' being secured seems plainly to include a secured debt owed to the creditor. (*MS Fashions* is not mentioned by the judge in *Stewart* and it is not clear whether it was cited to the court.)

In *BCCI* (No 8) in the Court of Appeal ([1996] 2 All ER 121) Rose LJ referred to 'trust property and security' standing 'outside the scheme of distribution and the scope of insolvency set-off' but this point was not mentioned by the House of Lords in its judgment on the appeal and the position now and for some time has been an unsatisfactory one. *Re Norman* seems generally accepted to be the law but both the reasoning in that case and the tenor of some of the subsequent authority shows that the rather important point which it purported to decide rests on a surprisingly shaky basis, at least so far as express reasoning is concerned.

It is submitted that what was said in *Re Norman* and elsewhere on the relationship between insolvency set-off and secured debts is pregnant with certain assumptions which are insufficiently expressed but which are capable of explaining the exceptional treatment accorded to secured creditors under r 4.90. These assumptions proceed from the special status accorded to security interests in English law. It has been said (see *Goode Principles of Corporate Insolvency Law* (Sweet & Maxwell, 3rd Ed 2005) that the policy justification for upholding security interests is simply that the relevant creditor has bargained for the priority which it gives him and that in those circumstances (and so long as there is no unfair preference and other creditors have notice of the security) the unsecured cannot legitimately complain.

Policy apart, the juridical basis of that beneficial treatment is that security interests are property interests and, in English law, property interests trump merely personal interests. In the context of insolvency secured assets simply do not, to the extent of the security, form part of the assets of the company available for distribution and the entitlement of the security holder to stand outside the winding up (see *Sowman v David Samuel Trust Ltd* [1978] 1 All ER 616) then seems to follow, ineluctably.

This point was starkly made by James LJ in *Re David Lloyd & Co* (1877) 6 Ch D 339 (at 344) in the slightly different context of a mortgagee seeking the permission of the court to enforce his mortgage against an insolvent company:

> 'But [the purpose of the requirement for leave] has really nothing to do with the case of a man who for present purposes is to be considered as entirely outside the company, who is seeking to enforce a claim, not against the company, but to his own property. The position of a mortgagee under such circumstances is, to my mind, exactly similar to that of a man who said, "You the company have got property which you have taken from me, you are in possession of my property by way of trespass and I want to get it back again".'

As James LJ then went on to say:

> 'The mortgagee says "There is some property upon which I have a certain specific charge, and I want to realise that charge. I have nothing to do with the distribution of your property among your creditors, this is my property".'

That being so, *Re Norman Holding* becomes easier both to understand and to justify. The choice whether and when to prove in respect of a secured debt is not a decision about when to prove for a provable debt (to which set-off would automatically have applied) but instead a decision about whether a debt which is outside the company's assets and their liquidation will become at least to some extent provable and thereby subject to set-off. This will occur if, but only if, the creditor takes one of the first three of the courses of action open to it and listed earlier in this feature and which fundamentally depend upon proving what is not (or, in the case of surrender, no longer) secured.

It is possible then to discern that when Mervyn Davies J said: '[n]o doubt [the creditor] has a right to elect to prove for its secured debt but it is choosing not to do so' the words 'to elect' make all the difference.

This conceptual recognition that security and proof are incompatible lies at the heart of the matter and the fact that one of the things which – in the nature of security – the creditor has bargained for is the right not to rely on its security is nothing to the point. If it does nothing ('rests on its security') then the security remains and it and the creditor remain outside the liquidation. As Lord Hoffmann said in *Re BCCI (No 8)* the secured creditor is not obliged to prove and if it really is outside the liquidation then Rose LJ's statement in his judgment in the Court of Appeal in the same case that '[s]et off ought not to prejudice the right of a secured creditor to enforce his securities in any order he chooses and at a time of his choice' is no more than obvious. ■

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