APPENDIX A

Subordination Authorities

Ex Parte Mackay

1. The principle that it is not possible to agree by contract to alter the operation of the statutory scheme can be traced back to *Ex Parte Mackay* (1873) Ch App. 643. The principle was described as being one of "public policy".

2. In that case a contract was made under which it was agreed that half of the royalties payable under a patent for the improvement of armoured plates should be retained by the party contracting with the debtor. It was also agreed that "if the debtor should become bankrupt… the whole of the royalties might be retained by the other party." In his judgment James LJ said:[1]

> *"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."*

In his judgment Mellish LJ said:[2]

> *"[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."*

3. *Ex p Mackay* therefore established the principle that provisions which provide for a different scheme to the distribution of an insolvent's property should be avoided on public policy grounds.

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1 At page 647.
2 At page 648.

National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd

4. In *National Westminster Bank Ltd v Halesowen Presswork & Assemblies Ltd* [1972] AC 785 it was held that an agreement between a bank and its customer that the debit on one account could not be set off against the credit on another account was void.

5. Halesowen's account with Nat West was overdrawn. It was agreed between Nat West and Halesowen that the overdrawn account (account no.1) should be frozen and a new account (account no.2) be set up that could not go overdrawn. Halesowen went into liquidation. Account no.1 was overdrawn; account no.2 was in credit. In the liquidation, Nat West claimed to be entitled to set off the amount in account no. 2 against the company's indebtedness on account no. 1. It was held that the debit in account no.1 and the credit in account no.2 were "mutual dealings" and should be set off. The Bank could not retain the balance in account no.2 and separately prove for the debit in account no.1.

6. Section 31 of the Bankruptcy Act 1914 was similar in all material respects to the scheme in rules 14.26-14.30 of the 2016 Rules (and its predecessor, rule 2.95 of the Insolvency Rules 1986). Any agreement to the contrary was void because the set off in Section 31 of the Bankruptcy Act 1914 was mandatory.

7. Accordingly, once a creditor proves his claim, a set off will be applied.

Viscount Dilhorne said "*it is not possible to contract out of section 31.*"[3]

Lord Kilbrandon said:[4]

"...the rule now is that the terms of section 31 are mandatory in the sense that not only do they lay down statutory directives for the administration of claims in bankruptcy but they also make it impossible for persons effectively to contract, either before or after an act of bankruptcy has occurred, with a view to the bankruptcy being administered otherwise than in accordance with the statutory directives."[5]

Lord Simon made it clear that his comments on Section 31 were not the ratio of his decision, but he agreed with Viscount Dilhorne and Lord Kilbrandon.[6] Lord Simon also referred to

3 At page 805C-D.
4 At page 824A-B.
5 Lord Kilbrandon referred to Lord Denning's judgment in *Rolls Razor v Cox* [1967] 1 QB 552 at 570 *"the parties cannot contract out of the statute."*
6 At page 808E-F.

the maxim "*Anyone may at his pleasure, renounce the benefit of a stipulation or other right introduced entirely in his own favour*"[7] and said that set off in Section 31 was not introduced entirely for the benefit of anyone.[8] Lord Cross dissented.

8. *Halesowen* therefore established that the rules laid down for the administration of a company's assets in the process of a winding up did not involve exclusively private law rights, as there was a public interest that the assets were administered in an orderly way.

British Eagle International Air Lines Ltd v Compagnie Nationale Air France

9. *Ex parte Mackay* and *National Westminster Bank v Halesowen* were followed in *British Eagle International Air Lines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758.

10. *British Eagle* concerned the impact of a winding up on a clearing house mechanism agreed between various airlines. Under the clearing house regulations the airline operators agreed that they would not claim directly from one another and that they could only claim from IATA the balance due to them monthly under the clearing house scheme. Balances became payable to the airlines 5 days after "closure" which took place a month after the end of the accounting month. British Eagle went into liquidation in November 1968. The liquidator claimed the balance due from Air France having taken a bilateral account of the credits and debits between British Eagle and Air France. Air France relied upon the clearing house arrangements, the effect of which was that any sums due from Air France were accounted for after taking account of all other sums due to and from British Eagle and all the other airlines. The argument turned on whether the sums due from Air France to British Eagle were an asset of British Eagle to be distributed in accordance with the statutory scheme, whether the asset of British Eagle was the net claim due to British Eagle in the clearing house system, or whether the clearing house system was an attempt to provide, by contract, for a different distribution of British Eagle's assets.

11. Section 302 of the Companies Act 1948 provided:

"Subject to the provisions of this Act and to preferential payments, the property of a company shall, on its winding up, be applied in satisfaction of its liabilities pari passu ...."

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7 This maxim can be applied to agreements to subordinate debt. It is possible for a creditor to "renounce" the benefit of a right entirely in his own favour. It is not possible for a creditor to purport to renounce a right that is not entirely in his own favour or that is in favour of someone else.

8 At page 808E-H.

The equivalent provision in relation to administration is rule 14.12 of the 2016 Rules.[9] That also provides that the debts rank equally between themselves and "*must be paid in full unless the assets are insufficient for meeting them in which case they abate in equal proportions between themselves.*" Whilst the language used is different there is no substantive difference between the two provisions.[10] In the House of Lords in *British Eagle* it was held 3:2 that the clearing house system was a contracting out of the statutory scheme and that a contracting out of the provisions of section 302 of the Companies Act 1948 was contrary to public policy, and that accordingly, the statutory scheme prevailed.

12. The decision in *British Eagle* was that the company in liquidation was entitled to recover from the airlines the net sums due to British Eagle after the taking of a bilateral account, and that the airlines owed money by British Eagle after taking a bilateral account had a right to prove in the liquidation and then share in the assets of the company.

13. The leading speech was given by Lord Cross of Chelsea with whom Lords Diplock and Edmund-Davies agreed. Lord Cross described the contractual arrangements as a simple contractual clearing house:[11]

"The documents..set up by simple contract a method of settling each other's mutual indebtedness at monthly intervals."

Lord Cross's view was that this was contrary to public policy:[12]

"[w]hat [Air France] are saying here is that the parties to the "clearing house" arrangements by agreeing that simple contract debts are to be satisfied in a particular way have succeeded in "contracting out" of the provisions contained in section 302 for the payment of unsecured debts "pari passu".... Such "contracting out" must, to my mind, be contrary to public policy."

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9 Throughout these submissions we have had in mind Lord Neuberger's warning in *The Joint Administrators of LBHI2 v the Joint Administrators of LBIE* [2017] UKSC 38 (**"Waterfall I"**) at paragraph 12: *"Most, indeed probably all, fundamental principles apply just as they always have done – the pari passu principle is an obvious example. However, when it comes to less fundamental procedures and rules, it cannot be assumed that judicial decisions, even at the highest level, relating to the previous insolvency legislation necessarily hold good in relation to the 1986 legislation. Where the wording of a provision in the 1986 legislation has not changed from that of a provision in previous legislation, then, at least prima facie, it may normally be assumed that the effect of the provision was intended to be unaltered, but where language has been significantly changed, such an assumption may easily lead to error."* In these submissions where the language is materially the same, and has not significantly changed, we say that it is in all material respects the same as the previous provision (which we also identify).

10 In *Waterfall I* Lord Neuberger said at paragraph 20 of rule 2.69 of the Insolvency Rules 1986 (the predecessor rule) that *"This embodies the fundamental principle of equality, which applies similarly to liquidations – see rule 4.181."*

11 At page 780C-D.

12 At page 780G-H.

14. It was therefore held that notwithstanding the clearing house arrangements British Eagle on its liquidation became entitled to recover payment of the sums payable to it by other airlines and that airlines which had rendered services to British Eagle were entitled to prove for the sums payable to them.[13]

15. Lords Morris and Simon dissented. The dissent concerned whether or not, as a matter of contract, a debt was due from Air France to British Eagle. Lords Morris and Simon found that there was no debt due and therefore no contracting out of the statutory scheme. On analysis both Lords Morris and Simon agreed with Lord Cross that it was not possible to contract out of the statutory scheme. Lord Morris' characterisation of the issue makes clear that he agreed that if there was a debt due from Air France to British Eagle it had to be distributed in accordance with the statutory scheme:[14]

> *"If [Air France] owed £7,925 1 s. 3d. to [British Eagle] then clearly the right to receive that sum was part of the property of [British Eagle] and would be receivable for the benefit of all creditors generally. If, on the other hand, the contract made between the two companies did not result in any sum or sums becoming payable or being payable then the property of [British Eagle] did not include any right to receive that or any other sum from [Air France]."*

The issue raised by Lord Morris did not concern whether the statutory scheme had to apply to the company's assets, rather whether or not there was a debt due from Air France to British Eagle. As regards the mandatory nature of the statutory scheme Lord Morris said:[15]

> *"... if [Air France] had owed money to [British Eagle] but if there was a direction to [Air France] which required them in the event of a liquidation to pay the money to some particular persons rather than for the benefit of all the creditors the liquidator could prevent what would be an invasion of law (see Ex parte Mackay (1873) 8 Ch App 643)."*

On this point the House of Lords were in unanimous agreement. Lord Morris' view was that there was "no trace in the scheme of any plan to divert money in the event of a liquidation"[16] because when British Eagle went into liquidation "the "property" of the company could not and did not include any claim to receive money from [Air France] for the reason that [Air France] did not owe any money to [British Eagle]…the property of the company included the contractual right to have a clearance in respect of all services which

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13 At page 781A-B.
14 At page 761C-D.
15 At page 761E-G.
16 At page 763C-D.

had been rendered on the contractual terms and the right to receive payment from IATA if on clearance a credit in favour of [British Eagle] resulted."[17]

16. Lord Simon's reasoning also turned on a conclusion that British Eagle's right was to claim the net sum due through the clearing system and that British Eagle no longer had a right to claim the sum due from Air France. He said[18]:

"British Eagle had long since deprived itself of the right to claim from Air France payment for the interline services British Eagle had performed for Air France."

The significance of this approach is that Lord Simon's view was that there was not a debt due from Air France as a matter of contract and so there was no asset to be distributed in accordance with the statutory scheme. He said that[19]:

"the "property" of British Eagle (for the purposes of section 302) did not include any direct claim against Air France for the value of the interline services performed by British Eagle for Air France but merely the right to have the value of such services brought into the monthly settlement account."

17. However, on the question of whether or not it was possible to contract out of the statutory scheme, the point relevant to the present case, Lord Simon agreed with the majority that it was not possible to contract out of the statutory scheme[20]:

"I agree that Halesowen Presswork & Assemblies Ltd v National Westminster Bank Ltd [1972] AC 785 applies by analogy to section 302 of the Companies Act 1948, so that one cannot contract out of its terms."

Re: Maxwell Communications Corp Plc

18. In *Re: Maxwell Communications Corp plc (No 2)* [1994] 1 BCLC 1, Vinelott J held that neither the rule making insolvency set off mandatory nor the pari passu rule of distribution made a contractual subordination provision in a guarantee invalid.

19. The subordination provision was in the following terms:

17 At page 765A-C.
18 At page 771F-G.
19 At page 772A-B.
20 At page 771H.

*"The guarantee … constitutes an **unsecured and subordinated obligation** of the Guarantor in that in case of any distribution of assets by the Guarantor, whether in cash or otherwise, in liquidation or bankruptcy of the Guarantor …creditors of unsubordinated indebtedness of the Guarantor should be **entitled to be paid in full before any payment** shall be made on account of payments under the Bonds … but that payments to Bondholders … shall be made before any payment shall be made in such cases to the holder of any class of stock in the Guarantor."* (emphasis added)

20. Vinelott J concluded that the subordination was by agreement and that unsubordinated creditors were entitled to be paid in full before any payment was made to the Bondholders. He held that:[21]

*"The question is whether this underlying consideration of public policy should similarly invalidate an agreement between a debtor and a creditor postponing or subordinating the claim of the creditor to claims of other unsecured creditors and preclude the waiver or subordination of the creditor's claim after the commencement of bankruptcy or winding up. I do not think that it does. It seems to me plain that after the commencement of a bankruptcy or winding up a creditor must be entitled to waive his debt just as he is entitled to decline to submit a proof. … If the creditor can waive his right altogether **I can see no reason why he should not waive his right to prove, save to the extent of any assets remaining after the debts of other unsecured creditors have been paid in full**; …"* (emphasis added)

<u>Re SSSL Realisations Ltd</u>

21. In *Re SSSL Realisations Ltd.* [2004] EWHC 1760 (Ch), Lloyd J considered, among others, Vinelott J's decision in *Re: Maxwell Communications Corp plc (No 2)* [1994] 1 BCLC 1, summarising the principle derived from that case as follows:[22]

"It was argued that the pari passu distribution of assets among unsecured creditors was a general rule of insolvency law from which it was not possible to contract out, even to one's own disadvantage, particularly by analogy with cases on set-off in insolvency. The judge decided that this was not the law. He said that there was no reason why a particular creditor should not waive his right to prove altogether, or save to the extent of assets remaining after another creditor is satisfied, and that he could do this either in the insolvency or in advance of it. He considered the British Eagle case , and other authorities, and held that they did not force him to hold that a contract between a company and a creditor, providing for the debt due to the creditor to be subordinated in the insolvent winding-up of the company to other unsecured debt, is rendered void by the insolvency legislation (see p. 1416F). He held that such an agreement could be valid, and that in the case before him it was."

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21 At page 11c to e.

22 At paragraph 24.

22. Lloyd J held that the effect of the relevant subordination in that case (clause 8.2)[23] was that, as "*a matter of construction of clause 8.2 of the Deed, the clause prohibits Group from proving for its inter-company debt due from Stations and from receiving a dividend in respect of such debt in the liquidation of Stations at a time when the debt to AIG remains unpaid*."

23. Further, Lloyd J held that a breach of a negative obligation not to prove could and should be enforced by way of injunction in the subordinated debt context:[24]

> "*More generally, however, it seems to me that, in the case of an agreement of this kind for the subordination of debts, whose relevance is above all to the case of an insolvency, the court would and should, if necessary, enforce the negative obligation against proving in the liquidation by an injunction. Of course the consequence is unfortunate for Group's other creditors, but that is the intended result of the agreement which Group entered into freely, in order to secure the advantage of deferment of duty. It is impossible to tell what the position would have been as regards other creditors, by comparison with the present situation, if Group had not obtained that advantage*."

24. The critical distinction drawn in the case is between an agreement that purports to alter the operation of the statutory scheme and an agreement that alters the personal rights of the creditor to his detriment in relation to his debt claim against the company. The former is against public policy, not permissible as a matter of law and void. The latter is permissible and full effect will be given to the contract by which the creditor has agreed to alter his rights.

Waterfall I

25. In *Waterfall I* Lord Neuberger summarised the scope for a creditor to agree to vary his rights by contract in the following passage:[25]

> *"..I can see no objection to giving effect to a contractual agreement that, in the event of an insolvency, a contracting creditor's claim will rank lower than it would otherwise do in the*

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23 This clause provided:
"8.2 Postponement of Indemnitors' Rights
Until all amounts which may be or become payable by the Indemnitors to the Surety under this deed have been irrevocably paid in full no Indemnitor shall after a claim has been made by the Surety hereunder or by virtue of any payment made by it under this deed:
(a) be subrogated to any rights, security, cash cover or other monies received on account of that Indemnitor's liability hereunder.
(b) claim rank prove or vote as a creditor of any Indemnitor or its estate in competition with the Surety: or
(c) receive, claim or have the benefit of any payment distribution or security from or on account of any Indemnitor or exercise any right of set-off as against any Indemnitor."

24 At paragraph 78.

25 *Waterfall I* at paragraph 66.

"waterfall". James LJ's dictum in Ex p Mackay, Ex p Brown; In re Jeavons (1873) LR 8 Ch App 643, 647 that a person "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" is correct, albeit that it should be treated as subject to two qualifications. First, that it does not apply where the "different distribution" involves the creditor in question ranking lower in the waterfall than the law otherwise provides. Secondly, even if the "different distribution" involves him ranking higher than he otherwise would, the dictum would not apply if all those who are detrimentally affected by his promotion have agreed to it (unless there was some public policy reason not to accede to the "different distribution")."

26. Lord Neuberger concluded that it would not be open to the creditor to lodge a proof in respect of the subordinated debt until the senior liabilities have been paid in full (in relation to which, he also included the payment of statutory interest).[26] The effect of the subordination clause in that case, which was also based upon the FSA standard terms, was that the creditor cannot submit a proof of debt until the senior liabilities have been paid in full.

[26] At paragraph 70.: "*It therefore follows that, in my view, it would not be open to LBHI2 to lodge a proof in respect of the subordinated debt until the non-provable liabilities have been paid in full, or at least until it is clear that, after meeting that proof in full and paying any statutory interest due on it, the non- provable liabilities could be met in full*".