BANKING & FINANCIAL SERVICES LAW ASSOCIATION ANNUAL CONFERENCE 2010

UNRAVELLING CORPORATE GROUPS

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1 PART 1: DEALING WITH SURPLUS PROCEEDS OF SALE

1.1 THE RELEVANT FACTS

In 2007, Allfoods Holdings Limited (***AHL***) borrowed moneys consecutively from the syndicate lenders ($250M pursuant to the syndicate facility agreement), Merbank Limited (***Merbank***) ($100M pursuant to the working capital facility agreement) and its shareholder, Consolidated Foods Limited (***CFL***) ($30M).

The subsidiaries of AHL each gave a guarantee and indemnity to each of the syndicate lenders, Merbank and CFL, to guarantee repayment of their respective loans. (It is assumed that these are entire and not limited guarantees and that they are given separately to the syndicated lenders, Merbank and CFL, rather than under the one global document.)

The subsidiaries, and AHL, each gave fixed and floating charges of their assets and undertakings (the "***Securities***")to a security trustee who held the ~~charges~~ Securities (and the guarantees with respect to the syndicate facility agreement) for the benefit of the syndicate lenders.

Subsidiary A Co, and AHL (but, extraordinarily, not s~~S~~ubsidiary B Co), each gave further fixed and floating charges of their assets and undertakings to Merbank. _Those charges were second in time and priority to the charges given to the security trustee.

Again, quite surprisingly, there was no intercreditor or priority agreement entered into between the parties.

CFL's loan is unsecured (although it has the benefit of the guarantees and indemnities mentioned).

CFL has entered into a subordination deed with the syndicate agent for the syndicate lenders and Merbank to subordinate the debt owed to it by AHL, on the usual terms.

In mid-2009, AHL defaulted under the syndicate facility agreement.

The syndicate agent gave notice of an event of default, and accelerated payment of the entire loan amount ($250M). - Merbank, exercised its rights under its cross-default clause, and accelerated the $100M owed to it under the working capital facility.

The security trustee agreed to the subsidiaries A Co and B Co selling land and factories and using the net proceeds to pay down the syndicate debt, rather than taking enforcement action under its securities.

A Co realised $220M in net sale proceeds.

B Co realised $60M in net sale proceeds.

The security trustee collected all proceeds ($280M). This was sufficient to discharge all of the debts owed to the syndicate lenders.

The security trustee held a surplus from the proceeds of $30M.

In April 2010, the security trustee released the Securities, remitted the surplus to Merbank and provided it with ASIC forms 312 (notification of discharge or release of property from a charge), and, under a deed of release, released all security granted in its favour by AHL and the AHL subsidiaries.

Merbank lodged the forms and applied the surplus against the debt owing under the working capital facility.

Merbank is left with $70M owing to it by AHL._ It retained its security in respect of the outstanding debt owed to it by AHL and that security became a first ranking security upon discharge of the security trustee's ~~security~~Securities.

AHL, CFL, A Co and B Co are now all in liquidation.

The liquidators of A Co and B Co have now brought an action against Merbank. _They claim that A Co and B Co were subrogated to the rights of the syndicate lenders and the security trustee under the guarantees and Ssecurities and are entitled to the surplus. _They claim Merbank holds the $30M as constructive trustee.

1.2 SUBROGATION GENERALLY

Subrogation is the equitable principle whereby a surety who pays in whole or in part the debt owed by a principal debtor to a creditor, may stand in the shoes of the creditor once the debt has been completely discharged. _The surety enjoys all of the rights of the

creditor, including any security and remedies to which the creditor would be entitled, not only against the debtor but against all who claim under it. In one sense, the surety may be regarded as the equivalent of an equitable assignee with respect to those securities and rights. In most jurisdictions, this equitable rule has been embodied in statutory form (discussed below).

It is a remedy rather than a "right" or a cause of action.[1] (See *Lerinda Pty Ltd v Laertes Investment Pty Ltd atf AP-Pack Deveney Unit Trust* [2009] QSC 251; *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269, at [6]; *Adams v Zen 28 Pty Ltd* [2010] QSC 36).

Millett LJ in *Boscawen v Bajwa*[2] [1996] 1 WLR 328, at 355, said:

> *"Subrogation, therefore, is a remedy not a cause of action ... It is available in a wide variety of different factual situations in which it is required in order to reverse the defendant's unjust enrichment. Equity lawyers speak of a right of subrogation or of an equity of subrogation, but this merely reflects the fact that it is not a remedy which the court has a general discretion to impose whenever it thinks it just to do so. The equity arises from the conduct of the parties on well-settled principles and in defined circumstances which make it unconscionable for the defendant to deny the proprietary interest claimed by the plaintiff."*

The creditor is bound to hold and preserve the securities for the benefit of the surety. The creditor cannot apply the security in payment of any other debt than that for which the surety was liable: *Pearl v Deacon* (1857) 24 Beav 186.[3]

The rationale behind the principle is that the surety should be able to resort to the security held by the creditor to enforce its right of indemnity as against the debtor: *Orakpo v Manson Investments Pty Ltd* [1977] 1 All ER 666 at 676.[4] More recently, it has also been observed that the surety should not have to bear the whole of the burden of the debt simply because the creditor has chosen not to resort to its other remedies such as the security given by the debtor.[5]

Subrogation is related to that other right which is available to a surety who has paid the primary obligor's debt: the right of counter-indemnity, also an equitable remedy. Subrogation

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[1] *Lerinda Pty Ltd v Laertes Investment Pty Ltd atf AP-Pack Deveney Unit Trust* [2009] QSC 251; *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269, at [6]; *Adams v Zen 28 Pty Ltd* [2010] QSC 36.

[2] [1996] 1 WLR 328, at 355.

[3] *Pearl v Deacon* (1857) 24 Beav 186.

[4] *Orakpo v Manson Investments Pty Ltd* [1977] 1 All ER 666 at 676.

[5] *McColl's Wholesale Pty ltd v State Bank of New South Wales* [1984] 3 NSWLR 365.

may be seen to operate as providing security for that counter-indemnity. The High Court has stated:[6]

> *"This notion of the ultimate liability of the principal provides a foundation for the application of subrogation in aid of the surety. Thus, where a claim to the benefit of securities held by the creditor is made by a surety, it was said by Turner V-C [Yonge v Reynell [1852] EngR 655] that the equity for subrogation is derived from the obligation of the principal debtor to indemnify the surety. There is "nothing hard" in the act of a court of equity in placing the surety in exactly the situation of the creditor with respect to those securities, because it would be unconscientious for the debtor to recover back the securities from the creditor while the debtor was obliged to indemnify the surety." (Bofinger v Kingsway Group Ltd [2009] 239 CLR 269, at [8]).*

As a matter of legal theory, in England, it is now accepted that the right is founded on the principle of unjust enrichment. In *Banque Financière De La Cité v Parc (Battersea) Ltd*[7] [1999] AC 221, Lord Hoffmann described subrogation as a word "*to describe an equitable remedy to reverse or prevent unjust enrichment which is not based upon any agreement or common intention of the party enriched and the party deprived*".

In Australia however, the High Court in *Bofinger v Kingsway Group Ltd*[8] *(2009) 239 CLR 269 ("**Bofinger**")* has rejected the use of unjust enrichment as anything more than a conceptual tool and affirmed that the right of subrogation rests on equitable principles and unconscionability. _Unjust enrichment is not a "unifying legal concept"[9] (at [86]). It is therefore said that the equity is explained in terms of the obligations in conscience of the principal creditor, who is not to let the guarantor go without the benefit of the remedies available to the principal creditor while himself collecting the guarantor's money: *Mitchell v Crane* [2009] NSWSC 489 at [28].[10]

As Diccon Loxton has pointed out (see 2010 3 JIBFL 184),[11] the High Court has very firmly stated that the Australian courts are bound by this interpretation which is consistent with the Australian focus on the traditional doctrines and remedies of equity, with their emphasis on the conscience of the defendant rather than all-embracing theories which may conflict in a fundamental way with well settled doctrines and remedies.

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[6] *Bofinger v Kingsway Group Ltd* (2009) 239 CLR 269, at [8]

[7] [1999] AC 221.

[8] (2009) 239 CLR 269.

[9] (2009) 239 CLR 269 at [86].

[10] *Mitchell v Crane* [2009] NSWSC 489 at [28].

[11] Diccon Loxton 'Subrogation: Australian High Court gives guarantors priority over mortgage debts they guaranteed' (2010) 3 *Butterworths Journal of International Banking and Finance Law* 184.

As can be seen, this is yet another area, where as Diccon Loxton has said "... there is a slow drift apart of Australian and English jurisprudence ...". (2010) 3 JIBFL at 186).[12]

There is no requirement that the surety be compelled or called on to pay the debt before the right of subrogation can arise. In this case, the syndicate agent had accelerated the loan but has not taken possession of the property under the security, for example by appointing a receiver. The security trustee agreed to A Co and B Co selling the land and factories - but did not enforce the securities, for example, by appointing a receiver. Nevertheless, the payment of the proceeds of sale by A Co and B Co to discharge AHL's debt is sufficient for the equitable principle to apply. By making that payment as sureties, they acquired, in equity, an ability to seek counter-indemnification from AHL and, in support, an ability to subrogate to the security trustee's security as against AHL.

The main precondition is that the debt is wholly satisfied.[13] *Duncan, Fox & Co* (1880) LR 6 App Cas 1; *Austin v Royal* (1999) 47 NSWLR 27. But while the debt the subject of the guarantee must be paid in full before subrogation is available, it need not be met in its entirety by the claiming surety.[14] *Equity Trustees Executors & Agency Co Ltd v New Zealand Loan & Mercantile Agency Co Ltd* [1940] VLR 201 at 207; *AE Goodwin Ltd v AG Healing Ltd* (1979) 7 ACLR 481 at 487. The reasons why the principal creditor has an obligation in conscience towards a surety are just as strong whether the surety has paid all of the debt or only a small part of it: *Mitchell v Crane* [2009] NSWSC 489 at [33].[15] But this is also so where the statutory right is relied on: *Clout v Klein* [2003] QSC 152 at [19].[16]

Co-sureties are just as entitled to be subrogated as each other, even if some may have contributed more than others to reduce the debt, subject to any agreement to the contrary: *AE Goodwin Ltd v AG Healing Ltd* (1979) 7 ACLR 481.[17]

In terms of priorities, because the doctrine entitles the surety to stand in the shoes of the creditor, they are entitled to the same priority afforded to the creditor under the security: *Drew v Lockett* (1863) 32 Beav 499 at 505.[18]

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[12] Diccon Loxton 'Subrogation: Australian High Court gives guarantors priority over mortgage debts they guaranteed' (2010) 3 *Butterworths Journal of International Banking and Finance Law* 184, 186.

[13] *Duncan, Fox & Co* (1880) LR 6 App Cas 1; *Austin v Royal* (1999) 47 NSWLR 27.

[14] *Equity Trustees Executors & Agency Co Ltd v New Zealand Loan & Mercantile Agency Co Ltd* [1940] VLR 201 at 207; *AE Goodwin Ltd v AG Healing Ltd* (1979) 7 ACLR 481 at 487.

[15] *Mitchell v Crane* [2009] NSWSC 489 at [33].

[16] *Clout v Klein* [2003] QSC 152 at [19].

[17] *AE Goodwin Ltd v AG Healing Ltd* (1979) 7 ACLR 481.

The remedy of subrogation is a creature of equity, and does not rest on contract. It can be excluded or modified by agreement.[19] (*O'Day v Commercial Bank of Australia Ltd* (1933) 50 CLR 200. This is despite being embodied in statute - see below.) However, as shall be seen, this requires express and clear language to achieve the desired result.

Further, being a rule of equity, other equitable principles may operate to disentitle the surety from its right of subrogation, such as the equitable defences of laches and unclean hands.

In most jurisdictions, the equitable rule is enshrined in statute: see *Mercantile Law Amendment Act 1856* (UK) s 5, *Law Reform (Miscellaneous Provisions) Act 1965* (NSW) and s 3, *Supreme Court Act 1986* (Vic) s 52.[20] (These provisions were discussed in *D&J Fowler (Australia) Ltd v Bank of New South Wales* [1982] NSWLR 879 and by the Privy Council in *Scholefield Goodman & Sons v Zyngier* [1986] AC 562.)

The Victorian legislation, for example, provides that:

> "*(1) A person who is—*
>
> *(a) surety for the debt or duty of another; or*
>
> *(b liable with another for a debt or duty—*
>
> *and who pays that debt or performs that duty, is entitled to have assigned to that person or to a trustee for that person every judgment specialty or other security held by the creditor in respect of that debt or duty.*
>
> *(2) Subsection (1) applies whether or not the judgment specialty or other security is taken at law to have been satisfied by the payment of the debt or the performance of the duty.*
>
> *(3)* ***A person who pays a debt or performs a duty as referred to in subsection (1) is entitled—***
>
> ***(a to stand in the place of the creditor; and***
>
> ***(b) to use all the remedies of the creditor; and***
>
> ***(c) if necessary and on a proper indemnity, to use the name of the creditor—***
>
> *in any proceeding* ***to obtain*** *from the principal debtor or any co-surety, co-contractor or co-debtor (as the case requires)* ***indemnity for the advances***

[18] *Drew v Lockett* (1863) 32 Beav 499 at 505.

[19] *O'Day v Commercial Bank of Australia Ltd* (1933) 50 CLR 200.

[20] These provisions were discussed in *D&J Fowler (Australia) Ltd v Bank of New South Wales* [1982] NSWLR 879 and by the Privy Council in *Scholefield Goodman & Sons v Zyngier* [1986] AC 562.

made *and loss sustained by the person who paid the debt or performed the duty.*

(4) The payment of the debt or the performance of the duty by a surety is not a defence to any proceeding referred to in subsection (3).

(5) A co-surety, co-contractor or co-debtor is not entitled to recover from another co-surety, co-contractor or co-debtor more than the proportion to which, as between those parties themselves, that person is justly liable."

It is important not to confuse the surety's ability to have recourse to the security property, with the existence of the security itself. Naturally, once the debt is discharged, the creditor's security ceases to exist at law. Practically speaking, this usually occurs where the creditor discharges the security (eg notifying discharge or release by ASIC Form 312, as in the case study). However, equity treats the security as if it is still available so that the surety can recover the amount it paid toward reducing the debt. The surety ranks ahead of subsequent mortgagees in relation to the recovery of this amount, and in this sense is treated as a secured creditor of its principal debtor with respect to this amount.

1.3 SURPLUS PROCEEDS

A mortgagee who exercises his power of sale holds the surplus moneys after satisfying his costs, expenses and the loan, for any person interested therein under any subsequent encumbrance.

Surplus proceeds after sale by a mortgagee/chargee are to be disbursed in accordance with general law as codified in statute: see eg section 58(3), *Real Property Act 1900* (NSW), section 77(3), *Transfer of Land Act 1958* (Vic).[21]

The statutory provisions are read consistently with the equitable duties imposed on the mortgagee/chargee to account as a trustee: *Adams v Bank of New South Wales* [1984] 1 NSWLR 285 at 299, 302.[22] (See in Victoria, Robson J's discussion of the principles in *Re S & D International Pty Ltd (in liq) (rec & mgr apptd)* [2009] VSC 225 at [99]ff).

The position in equity was described by Kay J in *Charles v Jones* (1887) 35 Ch D 544 at 549-550 as follows:[23]

[21] see eg section 58(3), *Real Property Act 1900* (NSW), section 77(3), *Transfer of Land Act 1958* (Vic).

[22] *Adams v Bank of New South Wales* [1984] 1 NSWLR 285 at 299, 302. See also, Victoria, Robson J's discussion of the principles in *Re S & D International Pty Ltd (in liq) (rec & mgr apptd)* [2009] VSC 225 at [99ff].

[23] (1887) 35 Ch D 544 at 549-550.

> *"I have never heard it doubted that where a mortgagee sells, and has a balance in his hands, he is a trustee of that balance for the persons beneficially interested. He takes his mortgage as a security for his debt, but, so soon as he has paid himself what is due, he has no right to be in possession of the estate, or of the balance of the purchase-money. He then holds them, to say the least, for the benefit of somebody else, of a second mortgagee, if there be one, or, if not, of the mortgagor. What, then, is he to do? Surely he has a duty cast upon him. His duty is to say, 'I have paid my debt: this property which is pledged to me, and in respect of which I now hold this surplus in my hands, is not my property. I desire to get rid of this surplus, and hand it back to the person to whom it belongs.' ... The duty of this mortgagee was at least to set this money apart in such a way as to be fruitful for the benefit of the persons beneficially entitled to it. To that extent and in that manner he was, according to my understanding of the law, in a fiduciary relation to the persons entitled to the money."*

The above principles were cited with approval in *Bofinger* ~~at [35]~~.[24]

The principles apply also when the security has been discharged as a result of the mortgagor selling the property with the consent of the mortgagee and applying the net proceeds against the debt.

1.4 *BOFINGER V KINGSWAY GROUP LIMITED* (2009) 239 CLR 269

(a) Facts:

In that case, the appellants (Mr and Mrs Bofinger) gave guarantees to the First, Second and Third Mortgagees of borrowings by a company (B & B Holdings Pty Ltd), of which Mr Bofinger was a director.

The company carried on business as a real estate developer. It borrowed monies ($7.062M later increased to $8.288M) from the First Mortgagee (Kingsway Group Limited) to finance the purchase of land (the ***Enmore Land***) and the construction of the buildings thereon. _As the development proceeded, the company borrowed further monies from Rekley Pty Limited, the Second Mortgagee ($1.4M) and from Mr John Edward Skehan, the Third Mortgagee ($350K). _The First, Second and Third M~~m~~ortgages were registered and dated 31 January 2003, 14 March 2003 and 28 April 2005 respectively.

The indebtedness under each of these mortgages was secured by a registered mortgage against the title to the Enmore Land and another property of B & B Holdings.

In addition, the Bofingers had guaranteed to each mortgagee (by an instrument of guarantee) repayment of the amount owing from time to time under the mortgages given by B & B Holdings.

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[24] (2009) 239 CLR 269 at [35]

The guarantees from Mr and Mrs Bofinger were each supported by mortgages over residential properties owned by them.

B & B Holdings defaulted under all three mortgagees.

In July and October 2005, the Bofingers sold their mortgaged properties. These sales were initiated by them as there had been no call by the First Mortgagee upon the guarantees. From the proceeds they paid a total of $1,519,234.40 to the Ffirst Mmortgagee in reduction of the amount which was then owing to the Ffirst Mmortgagee by B & B Holdings and secured by the Ffirst Mmortgage.

It is important to note that following the sales of the pProperties owned by Mr and Mrs Bofinger there were discharges of the mortgages over those properties which the Bofingers had given, not only to the First but also to the Second and Third Mortgagees. Thereafter the guarantees given by the Bofingers remained in force but were unsecured.

In November 2005, the First Mortgagee went into possession of the Enmore Land. It exercised its power of sale over one parcel of the Enmore Land (Lot 13) so that, by 8 February 2006, the indebtedness of B & B Holdings to the First Mortgagee had been satisfied.

However, the company's indebtedness to the Second and Third mortgagees was $1,935,671.23 and $464,267.12 respectively.

After discharging the First Mortgage, on 8 February 2006, the First Mortgagee paid the surplus proceeds of $268,307 into a solicitors' trust account for the purpose of being disbursed to the Second Mortgagee. It also delivered the keys, deeds and discharge of mortgage in relation to Lots 1 and 14, to the solicitors.

By the end, parts of the Enmore Land no longer showed the First Mortgage. The Second Mortgagee had received the surplus proceeds of sale of one Lot ($268,307) and the whole of the proceeds from the sale of another Lot ($432,712.53).

The Bofingers contended that the First Mortgagee should have accounted to them for the surplus so that they might recoup what they had paid off the indebtedness of B & B Holdings and also that the First Mortgagee held on trust for them its remaining interest as first mortgagee over the remaining properties.

They submitted that the First Mortgagee had distributed the surplus in breach of the constructive trust in which the surplus was held for them as sureties. They submitted that their rights took priority over any entitlement of the Second and Third Mortgagees.

The High Court allowed the appeal and stated:[25]

> *"In the absence of prior consent or release by Mr and Mrs Bofinger, ...Kingsway Group Limited was obliged to account to Mr and Mrs Bofinger as a constructive trustee for any dealing by it with the moneys and securities identified in the question for decision in favour of any other party, and to pay equitable compensation to Mr and Mrs Bofinger in respect of the denial or limitation by such dealing of recoupment from those moneys and securities of moneys paid by Mr and Mrs Bofinger to Kingsway Group Limited, in total $1,519,234.40, from the proceeds of sale of their properties....."* ~~*(at [99]).*~~

(b) General Principles stated by the High Court

The decision of the Court, constituted by Gummow, Hayne, Heydon, Keifel and Bell JJ, commenced with a consideration of the general principles, which were not in dispute.

The right of subrogation in favour of a surety recently was described by Sir Andrew Morritt V-C as follows ~~*(Liberty Mutual Insurance Co (UK) Ltd v HSBC Bank plc* [2001] Lloyd's Rep Bank 224 at 225~~):[26]

> "*The right operates so as to confer on the surety who has paid the debt in full the rights against the debtor formerly enjoyed by the creditor* ***or by imposing on the creditor the obligation to account to the surety for any recovery in excess of the full amount of his debt.***" (emphasis added)

That statement is important for this case because the indebtedness to the first mortgagee had been paid in full and the securities held by the first mortgagee discharged. The remedies equity provides must, as will appear, derive from the obligation of the first mortgagee to account. (At [4]).

There is no subrogation "*cause of action*": it is unhelpful (and misleading) to speak of subrogation as if it were a "right" or a "*cause of action*" in the sense recognised at common law. (At [6].)

The right of subrogation is not based on unjust enrichment: As we have already noted, the majority rejected any link between subrogation and the principle of unjust enrichment as has been stated in the more recent English authorities.

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[25] (2009) 239 CLR 269 at [99].

[26] *Liberty Mutual Insurance Co (UK) Ltd v HSBC Bank plc* [2001] Lloyd's Rep Bank 224 at 225.

Ultimate liability is the foundation for subrogation: The notion of the ultimate liability of the principal debtor provides a foundation for the application of subrogation in aid of the surety. Thus, where a claim to the benefit of securities held by the creditor is made by a surety, it was said by Turner V-C that the equity for subrogation is derived from the obligation of the principal debtor to indemnify the surety. (At [8].)

The authorities hold that a **second mortgagee cannot complain where the surety utilises by subrogation the security held by the first mortgagee**. (At [9].) The authorities vary as to the basis for this.

In *Drew v Lockett*[27] (1863) 32 Beav 499 [55 ER 196], this was put on the basis that the second mortgagee took its interest with notice and by grant from the equity of redemption enjoyed by the principal debtor in its state remaining after giving full effect to the first mortgage. In that case, Sir John Romilly MR said:[28]

> *"I am of opinion that a surety who pays off the debt for which he became surety must be entitled to all the equities which the creditor, whose debts he paid off, could have enforced, not merely against the principal debtor, but also as against all persons claiming under him. It is to be observed that the second and any subsequent mortgagee is in no respect prejudiced by the enforcement of this equity;* ***when he advances his money he knows perfectly well that there is a prior charge on the property, and if he thinks fit to advance his money on such security, it is his own affair, and he cannot afterwards with justice complain****. The amount being limited, it is a matter of indifference to him whether the first mortgagee or the surety is the prior claimant for that amount, and it would be, in my opinion, a violation of all principle if, when the surety pays off the debt, he were not to be* entitled, as against the principal debtor and those who claim under him, *to be paid the full amount due to him."*

The general principle relating to surplus proceeds of sale is that the mortgagee's distribution is subject to the rules of equity: where a mortgagee sells, and has a balance in his hands, he is a "trustee" of that balance for the persons beneficially interested. He then holds them, to say the least, for the benefit of somebody else, of a second mortgagee, if there be one, or, if not, of the mortgagor.[29] See above (*Charles v Jones*, *Adams v Bank of New South Wales*). Accordingly, the mortgagee is in a fiduciary relationship with respect to the persons entitled to the money.

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[27] (1863) 32 Beav 499; 55 ER 196.

[28] (1863) 32 Beav 499; 55 ER 196 at 198

[29] See above; *Charles v Jones* (1887) 35 Ch D 544 at 549; *Adams v Bank of New South Wales* [1984] 1 NSWLR 285 at 299.

The respondents in *Bofinger* did not challenge the above statements of principle. But by their notices of contention they submitted that the statements did not apply to the circumstances of the litigation:

(1) First, they submitted that the debt secured by the Ffirst Mmortgage had been paid in full at the date when the entitlement of the appellant sureties was to be assessed and the Ffirst Mmortgage had been displaced on the register upon exercise of the power of sale of some of the lots and upon registration of discharges with respect to other lots.

(2) Second, they submitted that surplus proceeds and assets had been distributed to the Ssecond Mmortgagee and thus had left the control of the Ffirst Mmortgagee.

(3) Third, they submitted that as the sureties had also guaranteed the subsequent mortgages, for that reason any entitlement they had in equity to the surplus would prejudice impermissibly the Ssecond and Tthird Mmortgagees.

(c) The appropriate remedy

The Court stated that the "*essential task*" for the Court is to identify the scope of equitable relief which, in the circumstances of this case, adequately protects the position of the appellants that obtained when the indebtedness toof the Ffirst Mmortgagee had been satisfied (at [45]).[30]

The Court seemed to take the view that the constructive trust is imposed as a remedial trust. That is: the term "*constructive trust*" can be used not with respect to the creation or *recognition* of a proprietary interest but to identify the imposition of a personal liability to account upon a defaulting fiduciary (see at [47]).[31] Thus, their Honours held at [49]:[32]

> "*... the first mortgagee was obliged in good conscience both to account to the appellants for surplus moneys and securities it held and not to undertake or perform any competing engagement in that respect without prior release by the appellants. These obligations were fiduciary in character... the first mortgagee entered into and performed a conflicting engagement with the second mortgagee. The result was to cause loss to the appellants by denial of enjoyment of their entitlement to recoupment from the surplus moneys with respect to the sale of [the relevant] Lots ...*"

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[30] (2009) 239 CLR 269 at [45].

[31] See (2009) 239 CLR 269 at [47].

[32] (2009) 239 CLR 269 at [49].

In respect of its misapplication of the surplus moneys and securities and the consequent loss to the appellants, the Ffirst Mmortgagee wais **to be treated as a constructive trustee to the extent that it must account to the appellants as a defaulting fiduciary**. It was found to be unnecessary to seek to determine upon the agreed facts whether the Ffirst Mmortgagee was a trustee in a fuller sense which would afforded the appellants a beneficial interest in the assets in question.

In many respects to describe this personal liability as a "*constructive trust*" is perhaps stretching the usual understood meaning of a trust.

Crennan J in *Jones v Southall & Bourke Pty Ltd*[33] (2004) 3 ABC (NS) 1, 17 said that a constructive trust may give rise to either an equitable proprietary remedy based on tracing or "*... an equitable personal remedy to redress unconscionable conduct ...*". The High Court agreed with this analysis (*Bofinger* at [47 and 48]).[34]

As noted later, notwithstanding the description of this personal remedy as a constructive trust, it is not at all clear that the Court intended to impress upon this remedy the normal incidences attaching to a trust.

Given that the same result could have been achieved by another monetary equitable remedy such as account, describing the relationship as a constructive trust may not strictly be necessary, especially in circumstances where the property attached to the remedial constructive trust is money, as in the case study and *Bofinger*. However, it is probably convenient to use the same analysis as when property (other than money) is involved.[35] (see generally on remedial constructive trusts G E Dal Pont "*Timing, insolvency and the constructive trust*" 2004 24 Aust Bar Rev 262).

(d) Comments regarding the possibility of *Barnes v Addy* liability

The Court remarked that breach by the Ffirst Mmortgagee of its fiduciary obligation to the appellants would suffice to engage the principles associated with the "*second limb*" in *Barnes v Addy*[36] (1874) 9 Ch App 244 (namely, knowing assistance or accessory liability), if at any further hearing the necessary further facts were established against other respondents. This has the potential for wider ramifications where, for example, the first mortgagee is found to

[33] (2004) 3 ABC (NS) 1 at 17.

[34] (2009) 239 CLR 269 at [48].

[35] See generally on remedial constructive trusts G E Dal Pont "*Timing, insolvency and the constructive trust*" (2004) 24 *Australian Bar Review* 262.

[36] (1874) 9 Ch App 244.

be insolvent or the surplus proceeds are otherwise lost. A surety may turn to the subsequent mortgagee or lawyers to make good as constructive trustees the loss of the trust assets provided they had sufficient knowledge of the breach of fiduciary duty.

Barnes v Addy: shortly stated, the *Barnes v Addy* principle stems from the notion that a person who has been knowingly concerned in a breach of trust, or who receives trust property transferred in breach of trust, may be personally liable to the beneficiaries of the trust.

The "*second limb*": the second limb makes a defendant liable if that defendant assists a trustee or fiduciary with knowledge of a dishonest and fraudulent design on the part of the trustee or fiduciary.

To test whether this element is established a key is whether there is requisite "knowledge". *Baden v Societe Generale pour Favoriser le Development de Commerce et de l'Industrie en France*[37] (***Baden***)[1992] 2 All ER 161. It is customary to analyse this requirement by the five categories set out in *Baden* [at 235].[38]

The breach must be dishonest and fraudulent: "*any breach of trust or breach of fiduciary duty relied on must be dishonest and fraudulent*": *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* (2007) 230 CLR 89 at [179].[39]

In Australia, the High Court in *Farah Constructions* has confirmed that circumstances falling within any of the first four categories set out in *Baden* are sufficient to establish requisite knowledge for the purposes of the second limb in *Barnes v Addy*.

There are: (i) actual knowledge; (ii) wilfully shutting ones eyes to the obvious; (iii) wilfully and recklessly failing to make such inquiries as an honest and reasonable man would make; and (iv) knowledge of circumstances which would indicate facts to an honest and reasonable man. In relation to constructive trusts, the High Court has said that whilst the assessment of whether there is requisite knowledge is to be made by reference to these four tests, at least in relation to constructive trusts, the relevant breach must always be, that liability can attach to a breach of fiduciary duty but any such breach must be "....dishonest and fraudulent".

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[37] [1992] 2 All ER 161.

[38] [1992] 2 All ER 161 at 235.

[39] (2007) 230 CLR 89 at [179]

(e) Comments regarding whether the right of subrogation was excluded

In *Equity Trustees Executors & Agency Co Ltd v New Zealand Loan & Mercantile Agency Co Ltd* [1940] VLR 205 Lowe J said:[40]

> *"When a guaranteed debt is paid by the surety he is entitled, unless the right is excluded by agreement or his conduct makes it inequitable to enforce it, in respect of the amount he has paid under his guarantee to the securities which the creditor holds for the debt guaranteed. This right arises not from any agreement between the surety and the creditor, though it may be excluded by agreement between them. It rests on equitable principles."* (emphasis added)

In *Bofinger*, the majority Court said that this statement of principle was "*plainly correct*" (at [52], see also at [82]).[41] Thus, the right of subrogation is subject to contrary agreement or inequitable conduct.

Parties can agree to prioritisation but must do so expressly and jointly: the majority's Court's conclusions rested heavily on the finding that there was no inconsistency between the Bofingers asserting their rights of subrogation and their obligations as guarantors under a guarantee to the Ssecond (and Tthird) Mmortgagee. A corollary of this was the finding that the second mortgageeguarantee instrument did not manifest a "*plain intention*" that the Ssecond Mmortgagee was to have resort to its security after the First Mortgagee in priority to any entitlement which the Bofingers as guarantors might have in respect of that property. Their Honours concluded that the terms of the second guarantee manifested no such intention. Nor did the giving of a consecutive guarantee produce any such inconsistency. Each guarantee operated in accordance with its terms. Consequently, there was nothing in the circumstances rendering it inequitable for the appellants to enjoy the rights of subrogation.[42] See at [71].

The Ssecond Mmortgagee sought to rely on the terms of the guarantee given to it by deed, in particular clause 3 by which the Bofingers guaranteed to the second mortgagee the performance of all the obligations of the B & B Holdings under the second mortgage and immediate payment of the amount payable to the second mortgagee if the Borrower did not pay any amount payable to the Lender. The majority held that, *taken by itself*, clause 3 did not contain a covenant by the guarantor to ensure that B & B Holdings meets its obligations to the second mortgagee in priority to those owed to the first mortgagee (at [56]).[43] The

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[40] [1940] VLR 201 at 205

[41] (2009) 239 CLR 269 at [52], and see also at [82].

[42] (2009) 239 CLR 269 at [70]-[71].

[43] (2009) 239 CLR 269 at [56]

~~majority~~ Court observed that such a priority structure "*would have been at odds with the sequence of the registered mortgages and the circumstances of the borrowings to finance the development of the Enmoro land*".[44] Their Honours further observed that this "*would have required clear terms in a multi-party priority agreement*".[45]

It must also be remembered that any ambiguity in a guarantee will be construed in favour of the surety, ie "strictissimi juris"[46]: *Andar Transport Pty Ltd v Brambles Ltd* [2004] ~~HCA~~ 28.

Waiver clauses may not be sufficient: The Ssecond Mmortgagee also sought to rely on a clause in the guarantee which provided as follows:

> "*Each Guarantor waives the Guarantor's rights as surety whether legal, equitable, statutory or otherwise which may be inconsistent with the provisions of this deed or in any way restrict the Lender's rights, remedies or recourse.*"

The majority held that this waiver was a waiver of such of the Bofingers' rights as sureties under the guarantee to the Ssecond Mmortgagee as may be inconsistent with the provisions of that guarantee. It was *not*, however, a waiver of any of the Bofingers' rights under the guarantee to the Ffirst Mmortgagee. ~~The contractual exclusion or waiver by the guarantors in its second mortgagee's document was not effective because it was made with respect to rights against the "wrong" person, ie the first mortgagee not the second.~~ The contractual exclusion or waiver by the guarantors in its second guarantee was not effective because it restrained the exercise of rights only against the Second Mortgagee and the restraint did not extend to rights arising against another person - namely the First Mortgagee.

Nor was clause 7.1 (headed "*Guarantors Not To Claim Benefits Or Enforce Rights*") found to be sufficient. That clause provided that:

> "*Until the Guaranteed Money is paid in full and all obligations of the Borrower under the Mortgage are fully and finally discharged or released, a Guarantor must not in any way:*
>
> *(1) claim the benefit or seek the transfer (in whole or in part) of any other guarantee, indemnity or security held or taken by the Lender [the Second Mortgagee];*
>
> *(2) make a claim or enforce a right against any other Obligated Person or against the estate or any of the property of any of them (except for the benefit of the Lender); or*

[44] (2009) 239 CLR 269 at [56].

[45] (2009) 239 CLR 269 at [56].

[46] *Andar Transport Pty Ltd v Brambles Ltd* (2004) 217 CLR 424.

(3) *raise or claim any set-off, counterclaim or defence available to any other Obligated Person in reduction of the Guarantor's liability under this deed."*

It was accepted that neither (1) nor (3) above could apply to constrain the exercise of rights under a guarantee of the Ffirst Mmortgage. However, their Honours also rejected the submission that paragraph (2) manifested an intention that the Ssecond Mmortgagee would take priority in relation to property of B & B Holdings over what otherwise might be prior claims by the Bofingers in reliance upon subrogation to the rights of the Ffirst Mmortgagee.

"*Obligated Person*" was defined in the deed guarantee to mean any of the Borrower, Guarantor, and any other person who was liable to the Lender for payment of the "*Guaranteed Money*", being the subject of the guarantee and indemnity in cl 3 and cl 5 respectively.

Their Honours held that in asserting subrogation to the rights of the Ffirst Mmortgagee against B & B Holdings as borrower, the Bofingers were not making a claim "*against any other Obligated Person*" within the meaning of paragraph (2). What was restricted under clause 7.1 were rights otherwise available by a guarantor against any Obligated Person with respect to the moneys owing to the Ssecond Mmortgagee. The rights of subrogation which the Bofingers had against the borrower and its properties arose with respect to the debt owing to the Ffirst Mmortgagee not the "Guaranteed Moneys" (being namely the debt owing to the second mortgagee

The Courts below were overruled: Young CJ (in Equity) held that the clauses set out above "*clearly show that the sureties are not to claim their rights of subrogation to prejudice the secured rights of the second and third mortgages from B & B which the Bofingers have guaranteed*" *Bofinger v Rekley Pty Ltd* [2007] NSWSC 1138 at [43].[47] On one view this can be seen as a fair and available construction of the words and intentions of the parties. The Court of Appeal also agreed that the arrangements between the parties envisaged that the Second Mortgagee would take priority over the Bofingers. Neither Court took theis view, as the High Court did, that on a very strict analysis of the words, the restriction was limited to claims relating to debts owed to the Ssecond Mmortgagee and did not extend to claims arising from debts owing to a different creditor (ie the Ffirst Mmortgagee).

Estoppel by convention: In the Court of Appeal, it was held that the Bofingers were estopped from claiming priority over the Second Mortgagee by their guarantee contract with the Second Mortgagee. Handley AJA held (at [52]-[53]):[48]

[47] *Bofinger v Rekley Pty Ltd* [2007] NSWSC 1138 at [43].

[48] [2007] NSWSC 1138 at [52]-[53].

> *"The personal liability of the guarantors to both mortgagees, and the agreed order of priorities, prevents the guarantors both by contract and estoppel from setting up a title in themselves in priority to that of the second mortgagee. Thus the priority of the second mortgagee was the conventional basis of the transaction between the guarantors and the second mortgagee, and they are estopped from claiming priority."*

In that regard, the High Court emphasised the need for an agreed or assumed state of facts to found an estoppel by convention.[49] The Court held that the agreed facts fell "far short of what would be necessary to establish that the priority of the second mortgagee which is now asserted was the conventional basis of the transaction between it and the appellants as guarantors, so that the appellants had been estopped from asserting their right of subrogation".[50]

Ultimately, given the High Court's reasons, the best solution to avoid any doubt (and litigation), is to draft carefully such clauses and reinforce any prioritisation with a multi-party priority intercreditor agreement with the surety and any mortgagees.

This is reinforced by the Court's observation in paragraph [80] that *"the second and third mortgagees had not, for example, protected their position by obtaining an agreement with the appellants and the first mortgagee expressly to deny to the appellants what otherwise would be their subrogation rights to the first mortgage over the assets of B & B Holdings"*.[51]

In the absence of a priority deed or other intercreditor document, the waiver / suspension of rights clause in a guarantee secured by subsequent security ought expressly to include reference to any and every prior ranking security so that it can be enforced by the subsequent mortgagee/chargee.

(f) A few things remain unclear after *Bofinger*

Will a mortgagee holding a surplus be a trustee with attendant obligations? The First Mortgagee was held to be, first, a fiduciary. It was only upon the First Mortgagee's breach of its fiduciary duty by entering into and performing arrangements with the Second Mortgagee which conflicted with its duty to account to the guarantors, that the breach gave rise to an equitable duty to account personally for the surplus, as a constructive trustee would. But of course, while every trustee is a fiduciary, not every fiduciary is a trustee. The Court found it unnecessary to decide whether that obligation supported a trust or equitable

[49] (2009) 239 CLR 269 at [75].

[50] (2009) 239 CLR 269 at [75].

[51] (2009) 239 CLR 269 at [80].

lien with proprietary characteristics enforceable against third parties, or was really only a personal obligation even though described as a "constructive trust".

Young CJ in Eq below, said that the predominant view is that the surety's right is only a charge and it is not appropriate to impose a trust (at [46]).[52] He also noted that it would be quite unclear what obligations would be imposed on the trustee if there were such a trust and *"there are particular commercial difficulties in subjecting the creditor to the responsibilities of a trustee in the state of knowledge that he may have"* (at [49]).[53]

Related to this is the question whether a surety obtains a proprietary interest at the moment the mortgagee retains a surplus: if the First Mortgagee had been insolvent, or had paid away the surplus, could the Bofingers have claimed in the liquidation as an unsecured creditor or claimed a lien or trust over an asset (presuming it they could trace the proceeds into such an asset)? If the First Mortgagee had not breached its duty to account, but simply held the proceeds, there is little in *Bofinger* which would compel the conclusion that the proceeds are held on trust for the surety.

What are the duties of the a first mortgagee in respect of the surplus? *Bofinger* leaves untouched the question whether the mortgagee's fiduciary obligation to account might also include administrative and investment duties such as trustees often owe. Again, in view of the above reasoning, if the First first mMortgagee is not a trustee, it seems unlikely that there is an obligation to invest the money, keep it separate and not comingled etc.

How will PPSA affect Bofinger: The *Personal Property Securities Act 2009* (C'lth), is expected to come into operation in May 2011. Currently, the drafting of the new Act is being digested by us all. The definition of a "security interest" (section 12) is very wide and a "grantor" (section 10) of a security interest does not seem to need actively to take any steps to grant a security interest (it is sufficient that the person has the interest in the relevant personal property).

However section 8(1)(c) states that the PPSA Act does not apply to a "...a lien, charge, or other interest in personal property, that is created, arises or is provided for by operation of this general law...".

[52] *Bofinger v Rekley Pty Ltd* [2007] NSWSC 1138 at [46].

[53] *Bofinger v Rekley Pty Ltd* [2007] NSWSC 1138 at [49].

Whilst it might be arguable that the constructive trust which arises in cases such as *Bofinger*, may create a security interest granted by the creditor, as it arises by operation of equity, it would seem to be covered by section 8.

Accordingly, there would not be any obligation to register either the subrogation or the constructive trust as a security interest. The constructive trust which attaches to the proceeds in the facts of the case study would oblige Merbank to account to A Co and B Co notwithstanding Merbank's registered security interest as mortgagee.

1.5 APPLICATION OF THE LAW TO THE CASE STUDY

At the date the security trustee transferred the surplus of $30M to Merbank, the debt owed to the syndicate lenders by AHL had been discharged and A Co and B Co were entitled to be subrogated to the syndicate lenders' rights as creditors.

In a case such as this, the right clearly arises as the giving of the guarantee by B Co is almost certainly at the request of AHL, and indeed it is most likely that the loan from AHL was funded from the debts borrowed by AHL. If it could be established that AHL did not request the guarantee, there may still be a right of reimbursement based on a restitutionary claim.[54] (*Moule v Garrett* (1872) L.R. 5 Ex 132; Ex 101; O'Donovan, J and Phillips, JC, *Modern Contract of Guarantee* (Law Book Co, subscription service), at [12-100] - [12.200]. See too Andrews GM and Millet R, *Law of Guarantees* (5 ed, Sweet & Maxwell, London, 2008), at [10-002] and [10-008].)

As persons beneficially interested in the surplus, A Co and B Co were entitled to the surplus.

It is interesting to consider whether a Quistclose trust could be established. Arguably the realisation proceeds were paid by A Co and B Co with the mutual intention that they were to be used only to discharge AHL's debt to the sSyndicate lLenders. This creates a trust if any of the proceeds are not used for that purpose.[55] (See *Barclays Bank Ltd v Quistclose Investments Ltd* (1970) AC 567; *Re Australian Elizabethan Theatre Trust* (1991) 30 FCR 491.) If a Quistclose trust can be established, this may well be a more "robust" constructive trust (which carries attendant obligations upon the trustee) than the remedial constructive trust outlined by the High Court in *Bofinger*.

[54] *Moule v Garrett* (1872) L.R. 5 Ex 132; Ex 101; Law Book Co, O'Donovan, J and Phillips, JC, *Modern Contract of Guarantee*, at [12.100] - [12.200]. See too Andrews GM and Millet R, *Law of Guarantees* (5th ed, 2008), at [10-002] and [10-008].

[55] See *Barclays Bank Ltd v Quistclose Investments Ltd* (1970) AC 567; *Re Australian Elizabethan Theatre Trust* (1991) 30 FCR 491.

By virtue of their rights of subrogation (both in equity and under statute), A Co and B Co were also entitled to an assignment of the security held by the security trustee.

When, in April 2010, the security trustee remitted the surplus to Merbank and released the property it held under its charges, it acted in breach of the rights of subrogation of A Co and B Co.

As stated in *Bofinger*, the security trustee was obliged to account to A Co and B Co as a constructive trustee for the dealing by it with the moneys and securities in favour of Merbank, and to pay equitable compensation to A Co and B Co.

If Merbank was aware of the breach of duty (as it seems it was), it is liable to account for the surplus as a constructive trustee.

Merbank may also be liable for any loss of the surplus pursuant to *Barnes v Addy*, if the elements of the limbs of that test can be met.

The above is subject to any agreement by A Co and B Co which would postpone or waive their rights as sureties.

In accordance with *Bofinger*, it is not sufficient simply that the companies also gave guarantees and fixed and floating charges to Merbank.

We do not have evidence from the facts of the case study to mount an argument that it would be unconscionable for A Co and B Co to assert their rights as sureties.

The question raised by Part 2 of the case study (see below) is how to reconcile the claim of B Co by way of counter indemnity/subrogation against AHL against the claim by AHL against B Co under the $80M intercompany loan.

In Part 2, we analyse the question on the basis that AHL and B Co are each unsecured creditors of each other. However, on the basis of the law as confirmed by High Court's analysis *Bofinger*, the remedy of subrogation available to B Co which, as we have seen, survives the discharge of the security held by the security trustee, results in both A Co and B Co being treated as a secured creditor of AHL standing in the place of the security trustee and indeed ranking ahead of Merbank for the full amount of its claim (subject as between A Co and B Co, to the rights A Co has against B Co by way of contribution). This means that B Co is not an unsecured creditor of AHL.

However, under the facts of the case study, AHL has no remaining assets so there is nothing to which B Co's right as a secured creditor can attach.

1.6 CAN SUBROGATION BE CONTRACTED OUT OF?: NON-COMPETE CLAUSES

It is possible, carefully to draft documents which, as stated by Rich J in the High Court in *O'Day v Commercial Bank of Australia Ltd* (1933) 50 CLR 200,[56] will act as "*charted rocks*" foredooming to failure any course of navigation by a surety toward the equitable principle of subrogation. (At [213]). But the charted rocks must be clear.

In *Bofinger* the clause was not sufficient because it only excluded the surety's rights as surety under the guarantee of the second mortgage and not its rights as surety under the first mortgage.

In *O'Day* the surety gave three express declarations that it would not claim the benefit or seek the transfer of any other security the Bank might have in respect of the debtor. First, the surety had given a lien to the Bank in which he agreed that the security constituted by the general lien should be considered in addition to any other security which the Bank had or might thereafter take, and that he would not in any way claim the benefit or seek the transfer of any such other security or any part thereof. Second, he gave the Bank a guarantee in which he also declared that it should be considered in addition to any other guarantee or security, either from the guarantor or any other person or Company which the Bank had or may thereafter take for the debts of the Company, and again declared that the surety would not in any way claim the benefit or seek the transfer of any such other security or any part thereof. Finally, he gave the bank a mortgage, which itself contained a similar provision.

When the debtor company defaulted, the Bank (pursuant to its floating charge over the debtor's property) appointed a receiver and manager who entered and took possession of the property and assets of the Company and sold and realised a considerable proportion of those assets. The surety, Mr O'Day, applied to the Court for a declaration that he was discharged from his liabilities under the lien, the guarantee, and the mortgage.

The Court held inter alia that the surety was not discharged from its obligations and was not entitled to its ordinary rights of subrogation. Dixon J said:[57]

> "*The ordinary rights of a surety in respect of securities given by the principal debtor do not exist in the present case. Each of the instruments of suretyship contains*

[56] (1933) 50 CLR 200 at 213.

[57] (1933) 50 CLR 200 at 219 - 212.

elaborate provisions which effectually disentitle the surety to any interest in and to any rights in respect of the security, whether by way of subrogation or otherwise. It follows that no reliance could be placed upon a contention that the acts of the Bank amounted to a wrongful dealing with securities discharging the surety." ~~(At [219 and [220]).~~

Note the exclusion can operate even in the face of the statutory provisions in relation to subrogation.

In *Bofinger*, however, the High Court found it necessary that more express language be used.

In *Bell Group Ltd (in liq) v Westpac Banking Corporation (No 9)*[58] ~~[2008] WASC 239~~, Owen J considered the effect of a non-competition clause worded as follows:

> *"The clause provides that until all the banks' debts have been paid in full, the guarantor:*
>
> *(a) shall not by virtue of any payment made ... for or on account of the liability of any borrower or the security provider:*
>
> *(i) be subrogated to any rights ... held or received by the security agent or any Finance Party or be entitled to any right ... so as to diminish any distribution or payment which but for that claim or proof the security agent ... would otherwise have been entitled to receive;*
>
> *(ii) except as provided in [other agreements] be entitled to claim or rank as a creditor or prove in competition with the security agent ... if an Insolvency Event occurs in respect of a borrower or any other security provider; or*
>
> *(iii) except as provided in [other agreements], receive ... any payment ... from or on account of any borrower or any security provider or exercise any right of set-off against any borrower [or] security provider ... or claim the benefit of any security or moneys held by or for the security agent ...; and*
>
> *(b) shall forthwith pay ... to the security agent an amount equal to any such set-off in fact exercised by it ... and shall hold in trust for and forthwith pay ... to the Security Agent any such payment."*

His Honour considered what the clause meant and concluded:[59]

> *"Clause 3.7 of the guarantee and indemnities provides that until the secured liabilities have been paid and discharged in full, the guarantor cannot exercise certain of the rights that a guarantor would normally enjoy at law. **The rights that are removed by this agreement are a guarantor's rights of subrogation** and set off. The guarantor forgoes any right of contribution against the debtor that might otherwise reduce the amount of security available to the Security Agent. In addition, the guarantor agrees not to prove or compete in the liquidation in contest with the*

[58] [2008] WASC 239.

[59] [2008] WASC 239 at [9230].

Security Agent. If any payment or security asset is received by the guarantor, there is a contractual obligation to hold it for, or at the direction of, the Security Agent."

His Honour rejected the characterisation of the non-competition clause and a subordination clause as giving rise to a mortgage or charge because the fundamental characteristics of a security arrangement of that nature were not found to be present.

1.7 LESSONS TO BE LEARNT

As we have seen, in order for the guarantors to be prevented from exercising the right to be subrogated to the rights of the security trustee on behalf of the syndicate lenders, the suspension of the guarantee rights clause must very specifically deal with the point.

The clause in the case study in Attachment 2 does not - it is taken from the clause in *Bofinger*.

There needs to be added a specific additional paragraph to the effect:

"The Guarantors cannot claim or exercise any right, whether by way of subrogation or otherwise, to be entitled to the benefit of any Encumbrance in favour of a person other than [Merbank] in connection with any obligations of, and any other amounts payable by the Borrower to, and for the account of that other person."

As noted earlier, it is strongly preferable to ensure that the borrower, the guarantors and all the secured creditors are party to an intercreditor agreement. Under this agreement it should be made perfectly clear that the right of subrogation is waived and that this is for the benefit of all the secured creditors. Under this agreement, all the Obligors should expressly agree that any surplus proceeds are to be paid to the next junior secured creditor.

If, in the circumstances, an all party intercreditor agreement is not able to be entered into, at the very least the terms of the guarantee/charge should require the guarantors, on the financier's request, to inform any prior charge holder of the existence of the subsequent charge and of the guarantors' agreement to suspend its rights of subrogation. The clause should also allow the financier to do this on the guarantors' behalf.

These steps are intended to minimise the risk that the prior ranking security holder may accidentally pay to the guarantor any proceeds it recovers which exceeds the debt owed to it because the prior ranking security holder believes (on the basis of *Bofinger*) that the guarantor is entitled to exercise its subrogation rights in respect of the prior ranking security.

If such a payment were to be made, the financier would not have a proprietary claim against the guarantor in respect of that amount unless they could establish that the guarantor holds the amount as a constructive trustee (for example, under the second limb of the rule in *Barnes v Addy*).

2 PART 2: RULE IN CHERRY V BOULTBEE : AHL LOAN TO B CO.

2.1 THE RELEVANT FACTS FOR THIS PART

B Co owes AHL $80M under an intercompany loan.

The sale of B Co's assets realised $60M which was paid to the security trustee, which, together with the funds realised by the sale of A Co's assets, paid in full the moneys owing to the syndicate lenders.

This application of B Co's assets was made by B Co on the basis of its liability as a guarantor of AHL's debt to the syndicate lenders.

Accordingly, B Co is entitled to be indemnified by AHL for the amount paid - $60m.

The liquidator of AHL has sought to prove in B Co's liquidation for the amount of $80m.

The liquidator of B Co seeks to prove in the liquidation of AHL for the amount of $60m for which it is entitled to be indemnified. Our analysis in this Part assumes AHL and B Co are unsecured creditors of each other. As seen earlier, under the principle of subrogation, B Co may be treated as having priority rights against AHL, which would affect this analysis if AHL had any remaining assets - which we are told it does not.

2.2 THE ISSUE

The question is how these two claims should be treated. There are three possibilities. The first is that each clam is made and the distributions are made in the ordinary course, without reference to any special rules.

The second possibility is that an insolvency set-off applies.

The third possibility is that the rule in *Cherry v Boultbee*[60] (1839) 41 All ER 171 applies.

In this part we will focus on the differences between these three methods of application on the position between AHL and B Co.

For the purposes of illustrating these differences we will in this part not include the possible application of *Bofinger* (dealt with in Part 1) or the Subordination arrangements (which are deal with in Part 3).

[60] (1839) 41 All ER 171.

As we will see, the results achieved under these three scenarios for AHL are dramatically different.

The end result for Merbank (as a secured creditor of AHL as well as offer A Co but an unsecured creditor of B Co) will also be affected by which method is adopted to determine the claims between AHL and B Co.

After we have examined the subordination arrangements, we will put the whole picture together and examine how the ultimate recovery by Merbank as the external secured creditor can be significantly affected by the various scenarios.

2.3 CLAIMS PROVED IN THE ORDINARY COURSE

If the liquidator of AHL is entitled to prove for its intercompany debt of $80M then it would share in the funds available in the liquidation of B Co, which we are told are valued at $50M. The creditors of B Co (ignoring the possible application of *Bofinger's* case and the effect of the subordination provisions) are:

- Merbank which is owned $100M-$30M ie $70M.
- AHL which is owed $80M under the unsecured inter-company loan.
- CFLC which has a claim agent against B Co as a guarantor of the debt owed by AHL to CFL. CFL is entitled to provide for the full amount of this amount ie $30M.

Note, as A Co has contributed more then B Co to the repayment of the debt owed to the syndicate lenders, A Co would normally have a claim against B Co by way of contribution. The amount of the claim would be the relative overpayment by A Co. The total amount paid was $280M and A Co paid $220M of that amount. If A Co and B Co had contributed equally, each would have paid $140M. Accordingly, absent agreement to the contrary, A Co's claim against B Co would normally be $220M - $140M = $80M.

However, the terms of the Merbank Cross Guarantee and Charge (see Attachment 2 paragraph (2)) may prevent A Co claiming that right of contribution. Although the clause, as we have seen, would not be effective under the test in *Bofinger*, it may be effective to prevent a claim of contribution by A Co. On one interpretation of *Bofinger*, the deficiency in this clause which meant it could not be relied upon by Merbank to avoid A Co and B Co claiming rights against AHL as principal creditor would also result in the clause being ineffective to prevent A Co claiming rights of contribution against B Co. In this Part we will assume A Co is

prevented from making a claim of contribution against B Co by the terms of the Merbank cross guarantee and charge.

The liabilities of B Co are therefore:

Merbank ($100M-$30M)	$ 70M
AHL	$ 80M
CFL (Guarantor)	$ 30M
	$180M

Accordingly, the distribution available to creditors is $^{50}/_{180}$ which is 27.8%.

The amount payable to AHL is $80M x 27.8% ie $22.2M.

2.4 ~~SET~~ SET-OFF

The second possibility is that an insolvency set-off under section 553C of the Corporations Act should apply. If set-off were to apply only the net amount of $80M-$60M namely $20m can be claimed by the liquidator of AHL in the liquidation of B Co and the liquidator of B Co has no claim in the liquidation of AHL.

Accordingly under this method of application, in the liquidation of B Co the creditors to share in the $50M of funds available are:

Merbank	$ 70M
AHL	$ 20M
CFL	$ 30M
	$120M

Accordingly, the distribution available to creditors is 41.7%.

AHL receives $8.3M. Just over a third of the amount payable under the first methodology. Note in both cases any amount received by AHL would be recovered by Merbank as a secured creditor of AHL.

2.5 WHEN DOES SET OFF APPLY?

An insolvency set set-off applies under sSection 553C which provides:

> *"553C (1) **[Where mutual dealings, balance of account admissible to proof or payable to company]** Subject to subsection (2), where there have been mutual credits, mutual debts or other mutual dealings between an insolvent company that is being wound up and a person who wants to have a debt or claim admitted against the company:*
>
> *(a) an account is to be taken of what is due from the one party to the other in respect of those mutual dealings; and*
>
> *(b) the sum due from the one party is to be set off against any sum due from the other party; and*
>
> *(c) only the balance of the account is admissible to proof against the company, or is payable to the company, as the case may be.*
>
> *553C (2) **[No entitlement to set-off where prior notice of insolvency]** A person is not entitled under this section to claim the benefit of a set-off if, at the time of giving credit to the company, or at the time of receiving credit from the company, the person had notice of the fact that the company was insolvent."*

For the statutory set-off to apply:

1 there must be mutual credits, mutual debts or other mutual dealings;

2 the relevant transactions must have taken place between the parties in the same capacities;

3 at the time of the giving of credit, the person making a claim to be entitled to set-off must not have had notice of the insolvency of the counterparty; and

4 there must not be any disentitling condition (such as the rule against double proof).

In the current circumstances, the loan by AHL to B Co and the indemnity right arising from B Co meeting its surety obligations to the syndicate lenders would be regarded as mutual debts or dealings with the ambit of section 553C.

The transactions have taken place between AHL and B Co in the same capacities.

The relevant time to test whether a party is aware of the insolvency of its counterparty is at the time of "giving credit". In the case of AHL, that was at the time of advancing the intercompany loan.

In the case of B Co, the time of "giving credit" is the time it gave the guarantee, not the time it made payments to the syndicate lenders pursuant to its obligations under the guarantee - which is the event which gave rise to the right of indemnity from AHL.

Accordingly, as long as in that time - in 2007 neither AHL nor B Co were insolvent, then the subsequent insolvency of both companies should not prevent the application of the insolvency set-off for the "credit" given before the insolvency.

Are there any disentitling events? Under the facts of the case study there do not appear to be any disentitling events.

It would be different if the syndicate lenders had not been paid in full. In that case the rule against double proof would disnot entitle B Co fromto provinge in the liquidation of AHL in competition with the syndicate lenders. Set-off requires the ability to prove and if a party is prevented from proving, there can not be a set-off.[61] (*Re Oriental Commercial Bank* [1871] LR7, Ch 99 and Wood "English and International Set-off" (Sweet and Maxwell 1989) p 397.)

2.6 RULE IN *CHERRY V BOULTBEE*

The third possibility is that the liquidator of B Co is entitled to rely on the rule in *Cherry v Boultbee* (1839) 41 All ER 171.[62] The rule in *Cherry v Boultbee* may be stated thus: where a person entitled to participate in a fund is also obliged to make a contribution to that fund, they may not so participate unless and until they have fulfilled their obligation to contribute. Under that rule AHL cannot share in the assets available for distribution (the fund in B Co's liquidation), without first contributing to the fund what that personit owes to the fund.[63] (*Jeffs v Wood* (1923) 2 P Wms 128.)

It should be noted that the rule does not apply at all if there is a set-off. If there is a set-off, there is no room for the rule because the face amounts of the reciprocal claims are simply set-off and there is only one claim for the net amount.

If the rule does apply, effect is given to it, as a matter of accounting by treating the fund as notionally increased by the amount of that contribution; determining the amount of the share to which the claimant is entitled by applying the appropriate proportion to the notionally

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[61] *Re Oriental Commercial Bank* [1871] LR7, Ch 99; and Wood *English and International Set-off* (1st ed, 1989), 397.

[62] (1839) 41 All ER 171.

[63] *Jeffs v Wood* (1923) 2 P Wms 128.

increased fund and then distributing to the claimant the amount of the share less the amount of the contribution.[64] ~~(*Re SSSL Realisations (2002)* [2006] EWCA Civ 7 at [79].)~~

If the rule were to apply in the liquidation of B Co, it would apply as follows.

Recall we are told B Co has funds available for distribution of $50M.

The first step is notionally to increase the value of the fund by the amount AHL owes to B Co by way of indemnity ($60M), so the value of the fund is notionally $110M.

The liabilities of the fund (again ignoring for the moment the possible application of *Bofingers* ~~case~~ and the subordination provisions) are:

Merbank $100m - $30M =	$ 70M
AHL	$ 80M
CFL	$ 30M
	$180M

Accordingly the distribution which is notionally available for creditors is $^{110}/_{180}$ which is 61.1%.

The amount payable to AHL is [61.1% x 80m - $60m] that is $48.9m - $60m, a negative amount.

On this calculation, AHL is not able to claim at all in the liquidation of B Co.

As between AHL and B Co, one can readily see the dramatic difference between the outcome when no special rules apply, (set-off being available) and the application of the rule in Cherry v Boultbee. If no special rules apply, AHL can claim $80M and receives $22.2M. If set-off applies, AHL is able to claim $20m in the liquidation of B Co and B Co has no claim in the liquidation of AHL. AHL would receive $8.3M.

If the rule in Cherry v Boultbee applies, AHL has no claim in the liquation of B Co and B Co has a claim for $60m in the liquation of AHL, although that would not deliver any benefit to B Co as AHL has no assets.

2.7 SOME COMMENTS ON THE RULE

The most recent relevant decisions on the rule in *Cherry v Boultbee* are the English Court of Appeal decision in the *SSSL* Realisations ~~(2002) [2006] EWCA Civ 7~~ (the ***Save Case***)[65],

[64] *Re SSSL Realisations (2002)* [2006] EWCA Civ 7 at [79].

Cattles plc v Welcome Financial Services Ltd (2009) EWHC 3027 (Ch);[66] *Mills (as administrator of Kaupling Singer & Friedlander Ltd v HSBC Trustee* [2009] EWHC 3377 (Ch);[67] and in Australia *Otis Elevator Co Pty Ltd v Guide Rails (In liq)* (2004) 49 ASCR 531.[68] These cases are discussed in an article by Lee Aitken in the Australian Law Journal.[69] "Recent applications of the role in *Cherry v Boultbee* (or *Jeffs v Woods*) 2010 84 ALJ 191.

The decision in *SSSL Realisations* (the "**Save Case**")the Save Case in particular, has received some criticism,[70] see "Understanding Debt Subordination at the rule in Cherry v Boultbee: Re SSSL Realisation" Look Chan Ho [2006] JIBLR p266.

One of the criticisms is that the Court of Appeal determined that the amount the claimant must notionally contribute to the fund in order to determine the amount of its distribution is always the full amount the fund is owed by the claimant. This applies in circumstances where the fund is a surety, on the basis of the full amount for which the surety could be liable, and not the amount the surety has paid and for which it thereby has a right of indemnity against the principal debtor. It is sufficient, said the Court, for there to be a likelihood of a claim on the fund.

In this respect it seems to us (and as noted in the aArticle by Look Chan Ho[71]) that including the full amount for which the surety could be liable is contrary to the established law of guarantees (see [2006] JIBLR at p272). On the basis of the Save Case, AHL is also liable to B Co for the contingent claim B Co has on account of its surety liability to CFL. On this basis AHL is liable to contribute $60M + $30M = $90M, notwithstanding that B Co has not paid any part of the CFL debt.

The Ccourt further held that a notional contribution for the full amount of the debt applies whether or not the claimant or the fund is insolvent.

As pointed out in the aArticle by Look Chan Ho, this can give rise to some very strange results including the principal debtor becoming liable to pay more than 100c in the dollar.

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[66] [2006] EWCA Civ 7.

[66] (2009) EWHC 3027 (Ch).

[67] [2009] EWHC 3377 (Ch).

[68] (2004) 49 ASCR 531.

[69] Lee Aitkin, "Recent applications of the role in *Cherry v Boultbee* (or *Jeffs v Woods*) (2010) 84 *Australian Law Journal* 191.

[70] See Look Chan Ho, "Understanding Debt Subordination at the rule in Cherry v Boultbee: Re SSSL Realisation" Look Chan Ho [2006] *Journal of International Banking Law and Regulation* 266

[71] Look Chan Ho, "Understanding Debt Subordination at the rule in Cherry v Boultbee: Re SSSL Realisation" Look Chan Ho [2006] *Journal of International Banking Law and Regulation* 266, 272.

It can be strongly argued that in the case of an insolvent surety, the principal debtor should only ever be required to contribute notionally the amount the principal creditor would receive in the liquidation of the surety - in the absence of the principal debtor proving in the surety's liquidation.

It can also be argued that if the claimant (ie principal debtor) is also insolvent, the amount the claimant must notionally contribute to the fund is only the amount the fund could receive in the claimant's insolvency and not the full amount of the debt.

2.8 DOES THE RULE APPLY OR HAS IT BEEN EXCLUDED?

The rule in *Cherry v Boultbee* may be excluded by contract.[72] (*Re Abrahams* [1908] 2 Ch 60, at 72.)

Accordingly, if there is a clear contractual agreement between AHL and B Co excluding the application of the rule, then it does not apply.

The intercompany loan in the case study does not have any such provision.

However what is the position as the cross guarantee given by the guarantors including B Co, to Merbank attempts to exclude the application of the rule?

Can AHL rely on this exclusion of the rule as against the liquidator of B Co?

Does this depend upon whether AHL as principal debtor is also party to the cross guarantee?

If the agreement by B Co not to apply the rule is given for the benefit of Merbank can the liquidator of AHL rely on that exclusion?

If the application of the rule were to result in Merbank being adversely affected, because it results in AHL having a smaller distribution from B Co, then we suggest the exclusion may be able to be relied upon by Merbank to prevent the liquidator of B Co relying on the rule.

It would be better if the contract makes it specifically clear that each co-surety and the borrowers all agree, both for the benefit of the principal creditor and each other co-surety, that the rule is excluded at the request of the principal creditor.

(The principal creditor would exercise this right if it is beneficial for the creditor for the rule to be excluded. This may not always be the case.).

[72] *Re Abrahams* [1908] 2 Ch 60, at 72.

The lesson on this point is that the terms of the documents need to provide specific exclusions of the rule at the option of the external creditor. One needs to provide for the maximum flexibility for the external creditor.

The other point is that in order to be effective, the exclusion needs to be quite specific. In the Save Case and also in *Kauplhing Singe*, the relevant clauses were not effective. In the Save Case, the terms were as set out in the extract from the Subordination Deed (see YI (c)).

The Ccourt of Appeal said that clause did not prevent the application of the rule, notwithstanding that the application of the rule does require a notional repayment by AHL to B ~~co~~-Co and a different calculation of the total pie available for distribution to the group of creditors including AHL - which may result in the principal creditor (Merbank) receiving less than it otherwise would receive.

3 CONTRACTUAL SUBORDINATION

3.1 CONTRACTUAL SUBORDINATION

Contractual subordination involves creditors agreeing to change their priority in relation to a common debtor. There are two main forms of contractual subordination~~, either~~: (i) that the junior debt is not payable until the senior is paid, and~~or~~ (ii) that one creditor (the "**Junior Creditor**") will not compete with another creditor debt (the "**Senior Creditor**") for payment of the Junior Creditor's debt on insolvency until the Senior Creditor is fully paid.

~~There was a view that subordination was ineffective as being in breach of the *pari passu* rule and could be voidable at the election of the Junior Creditor. That is, all creditors of equal standing shall receive dividends that are reflective of their percentage owed of the total debt.~~

In New Zealand, the validity and effect of subordination arrangements is confirmed by statute. - Section 313(3) of the Companies Act 1993 states that where, before the commencement of liquidation, a creditor agrees to accept a lower priority in respect of a debt than that it would otherwise have, nothing prevents that agreement from having effect according to its terms. Similarly, section 70 of the *Personal Property Securities Act 1999* ("**PPSA (NZ)**") expressly permits a secured party to subordinate its interest to any other interest. It ~~further~~Section 70 stipulates that this subordination can be enforced by a third party if they are a person for whose benefit the agreement is intended. Section 70 also explicitly states that a subordination agreement in respect of security interests does not of itself create a security interest. It merely effects a change in priority.

The Australian equivalent to section 313(3) of the *Companies Act 1993* is section 563C of the *Corporations Act 2001* (C'th), which provides that a subordination agreement is lawful and enforceable as long as it does not disadvantage any creditor who is not a party to the subordination. Similarly, section 61 of the *Personal Property Securities Act 2009* (C'th) ("**Australian PPSA**") permits a secured party to subordinate its interest in the collateral to any other interest and also allows for the enforcement of a subordination agreement by a third party if that third party was intended to benefit from the agreement.

The English Court of Appeal in the Save Case~~*Re SSSL Realisations (2002) Limited (in liquidation)* [2006]~~ EWCA Civ 7 ("**SSSL**") confirmed that the approach is the same under the common law~~.~~ The case emphasised the commercial importance of upholding a binding contract~~.~~ If a party is willing to enter into an agreement while the debtor is solvent, then they should be held to that bargain when the situation for which the agreement was made arises.

Like section 70 of the PPSA, the Save Case~~SSSL~~ holds that contractual subordination can be enforced by not only by those that are a party to it, but also by third parties who benefit from it unless a contrary intention is evident. ~~.~~ This was evidenced in ~~SSSL~~ the Save Case when it was held that the Senior Creditor could not, without the express entitlement to do so, unilaterally waive the subordination since the debtor also enjoyed the benefits of the Junior Creditor's subordination.

Therefore, contractual subordination in New Zealand and Australia is lawful and enforceable.

3.2 DISCLAIMER OF A SUBORDINATION AGREEMENT ON THE BASIS IT IS AN UNPROFITABLE CONTRACT?

Where a company is in liquidation, its liquidator enjoys the statutory power to disclaim onerous property of the company. The definition of onerous property includes, among other things, "unprofitable contracts". Could a liquidator of a Junior Creditor disclaim a subordination agreement as an unprofitable contract?

The issue was raised by the liquidators of the subordinated lenders in the Save Case~~SSSL~~. It was submitted that the nature and cause of the disadvantages imposed on the subordinated lender as a result of the subordination of their debt was such that no sufficient reciprocal benefit was conferred on the subordinated lender. As such, the subordinated lender was prospectively liable, in an onerous and unprofitable way, to the senior lender.

This contention was rejected both at first instance and by the English Court of Appeal. The Courts applied the principles laid down by Chesterman J in the Australian case *Transmetro Corporation Ltd v Real Investments Pty Ltd* (1999) ~~17 ACLC 1314~~.[73] ~~It was held~~The English Court of Appeal held ~~in SSSL~~ that although the subordination arrangement in question was detrimental to the creditors of the subordinated lender, it did not give rise to prospective liabilities as it did not require performance over a substantial period of time or involve expenditure by the liquidator. Accordingly, it did not impede the liquidator from discharging his functions.

The equivalent provisions in New Zealand, section 269 of the *Companies Act 1993*, and in Australia, section 568 of the *Corporations Act 2001* (C'th) are substantially similar to the English provision. Both allow a liquidator to disclaim a contract which is an "unprofitable contract". Unless a subordinated agreement was able to be disclaimed on other grounds, it should be safe from disclaimer in New Zealand and Australia.

[73] (1999) 17 ACLC 1314.

3.3 AUTOMATIC SET-OFF IN RELATION TO JUNIOR CREDITOR DEBT IN LIQUIDATION

An issue which has not been considered directly ~~by the Courts~~in New Zealand and Australia is whether, to the extent that the Junior Creditor is also indebted to the debtor, there will be set-off upon the commencement of liquidation of the debtor. Generally, ~~where~~ Where there have been "mutual credits, mutual debts, or other mutual dealings" between a company and a creditor who seeks or would seek to "have a claim admitted in the liquidation of the company", the amount that is due from one party must be set off against an amount due from another party.[74] Only the balance of the account may be claimed in the liquidation or is payable to the company. In those circumstances, set-off is automatic and mandatory.

If a Junior Creditor is allowed to claim that its debt has been set-off upon commencement of the debtor's liquidation, the economic effect may be that the Junior Creditor ~~has~~ will recover part or ~~ally~~ of its debt from the debtor ahead of the Senior Creditors. Given that the statutory provision is mandatory, the issue is whether ~~the~~ a subordination arrangement can nevertheless prevent set-off in those circumstances. Leading commentators assert that set-off will not occur where there is contractual subordination.[75] Two reasons have been advanced. The first is that the statutory provision refers to "persons who seek... to have a claim admitted" (e.g. s 310(1), *Companies Act 1993*)[76]. To the extent that a Junior Creditor is prohibited from submitting a claim in competition with the Senior Creditor, it falls outside the provision. Secondly, an account must be taken of what is "due" from one party to the other and only amounts "due" may be set off. Under subordination arrangements ~~of the type,~~ which state that the Junior Creditor's debt is not payable until Senior is paid, a Junior Creditor's debt is contingent upon the Senior Creditors having fully recovered. Accordingly, where the assets of the debtor are not sufficient to pay off the Senior Creditor's debt, no amount can ever be "due" to the Junior Creditor which may be ~~set~~ set-off against their indebtedness to the debtor.

3.4 TURNOVER TRUST SUBORDINATION:

~~T~~A turnover trust subordination typically operates so that the Junior Creditor ~~typically~~ agrees to hold dividends and distributions received from the liquidation of the debtor on trust for the Senior Creditor.

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[74] See section 310 of the Companies Act (1993) (NZ) and section 563 of the Corporations Act (C'th).

[75] Derham, *The Law of Set-off*, (3rd~~3rd~~ ed, 2002), [6.74]; Wood, *Project Finance, Securitisations and Subordinated Debt* (2nd ed, 2007) [11-035]-[11-036];

[76] Section 553C(1) of the Companies Act refers to "a person who wants to have a debt or claim admitted".

A turnover trust can be more advantageous to a creditor than a basic subordination agreement, particularly where the Ssenior and Junior Creditors are unsecured. This is because the economic effect of the two different types subordinations are different. In a situation where there are multiple creditors, the Senior Creditor is protected from competition with the Junior Creditor but must still compete on a *pari passu* basis with other creditors not party to the subordination agreement.

If, however, the subordination agreement is by way of a turnover trust, then the Senior Creditor effectively receives a "doubletwo dividends". That is, after all creditors are paid on a *pari passu* basis, the Senior Creditor is able to claim its own dividend, as well as receive the dividend of the Junior Creditor under the obligation to "turnover".

Take the example of a situation where there are three creditors to a common debtor and two of the creditors have a turnover trust subordination agreement. All three creditors will get a *pari passu* distribution. Assuming they are all owed the same amount of money from the debtor they would all receive 33% of the debtor's assets. However, because the Senior Creditor has a turnover trust subordination agreement with the Junior Creditor, the Junior Creditor must now turnover its share (up to the amount of the Senior Creditor's debt) to the Senior Creditor. Therefore, the Senior Creditor could receive 66% of the total dividend.

If, however, only a contractual subordination operated the Junior Creditor would be prohibited from claiming in the debtor's liquidation, the Senior Creditor would have ranked *pari passu* with the third creditor. The Senior Creditor would have only received a 50% dividend from the debtor.

Therefore, in a situation with multiple unsecured creditors, turnover trust subordination is likely to achieve a better recovery for the Senior Creditor than contractual subordination. It also protects against inadvertent payments or payments in breach of the contractual subordination.

3.5 TURNOVER TRUST AS A CHARGE

~~It is well established that clauses~~Provisions under which a company declares that it shall hold certain future proceeds on trust in favour of another do not generally amount to the creation of a charge over the company's book debts.[77] In *Re SSSL Realisations (2002) Limited (in liquidation)*the Save Case[78], the English Court of Appeal expressed the (obiter)

[77] *Associated Alloys Pty Limited v ACN 001 452 106 Pty Limited (in liquidation)* [2000] HCA 25(2000) 202 CLR 588.

[78] [2006] EWCA Civ 7.

view that a turnover trust clause in a subordination arrangement does not give rise to a charge over the Junior Creditor's debts in favour of the Senior Creditor. However, the Court commented that there is a distinction between turnover trust provisions that apply to sums received up to the amount of the senior debt, and those that apply to all receipts. The latter could create a charge.

3.6 TURNOVER TRUST AS A SECURITY INTEREST UNDER THE PERSONAL PROPERTY SECURITIES ACT 1999 (NEW ZEALAND)

(a) New Zealand

The definition of a security interest in section 17 of the PPSA is "*an interest in personal property* created or provided for by a transaction that *in substance secures payment* or performance of an obligation...and includes an interest created or provided for by a transfer of an account receivable..." (emphasis added).

There is an argument that a turnover trust might fit within the definition of a security interest as it involves personal property, provided for by a transaction (being the turnover agreement) which secures the performance of an obligation (either the obligation to turnover funds or the obligation of the debtor to pay the Senior Creditor).

There is a carve out for subordinated turnover trusts from the definition of a security interest in section 17A of the PPSA for situations when the debtor has been put into liquidation. Section 17A reads:

> *For the avoidance of doubt, a beneficial interest in personal property held by a creditor (the senior creditor) of a person who has been adjudged bankrupt or put into liquidation (the insolvent debtor) is not a security interest if -*
>
> *(a) the personal property is property that has been distributed by the Official Assignee under the Insolvency Act 2006 or by a liquidator under the Companies Act 1993 to another creditor of the insolvent debtor (the subordinated creditor); and*
>
> *(b) the beneficial interest was created or provided for under the terms of a security (as defined in section 2D of the Securities Act 1978) that is held by the subordinated creditor; and*
>
> *(c) under those terms, the subordinated creditor must hold the personal property on trust for the senior creditor; and*
>
> *(d) the purpose of those terms is to postpone or subordinate the right of the subordinated creditor to the performance of all or any part of an obligation of the insolvent debtor to the right of the senior creditor to the performance of all or any part of another obligation of the insolvent debtor.*

~~Although application of this section is limited to circumstances where the debtor is insolvent,~~ arguably Arguably this section 17A merely confirms the general rule that trusts are not security interests. A ~~t~~Turnover trust operates (if expressed as such) as an alienation of property, not as security for an obligation.

The leading Canadian case of *Re Skybridge Holidays Inc*[79] on the distinction between trusts and security interests focuses on circumstance and substance. An emphasis is placed on looking behind a transaction and assessing whether or not it has been structured in order to avoid the workings of the PPSA. If this is the case then a trust may be considered to be a security interest. If, however, the transaction was not purposefully avoiding the workings of the PPSA then *in substance* it is probably not a security interest.

In any event, sSection 17A will prevent turnover trusts from being security interests as long as they are created or provided for in a ~~debt~~ security, under the *Securities Act 1978* which includes the very broad definition of debt security. That will include, for example, subordinated bonds but would also extent to any agreement under which the debt from the debtor to the Jjunior Ccreditor is created (~~see definition of "debt security" in the Securities Act~~).

~~The leading Canadian case of *Re Skybridge Holidays Inc*[80] on trusts and security interests focuses on circumstance and substance. An emphasis is placed on looking behind a transaction and assessing whether or not it has been structured in this way in order to avoid the workings of the PPSA. If this is the case then a trust will be considered to be a security interest. If, however, the transaction was not purposefully avoiding the workings of the PPSA then *in substance* it is probably not a security interest.~~

The status of turnover trusts under the PPSA has yet to be considered directly in New Zealand. The leading commentaries in New Zealand emphasise that whether a trust (in a subordination arrangement or otherwise) is to be classified as a security interest or not should be decided by looking at the public policy and substance behind it and not simply at its characterisation.[81]

Widdup and Mayne suggests that, in order to escape classification as a security interest, the subordination agreement must not require the Junior Creditor to hold the monies from the common debtor on trust, but rather to account to the Senior Creditor for any monies received

[79] (1998) 13 PPSAC (2d) 387.

[80] (1998) 13 PPSAC (2d) 387.

[81] M Gedye, R Cuming, and R Wood, *Personal Property Securities in New Zealand*, Brookers ~~Limited~~, Wellington, (1st, 2002), section 17.5.

from the common debtor. This duty to account does not create an interest for the Senior Creditor in the money that the Junior Creditor receives from the common debtor, only a personal right against the Junior Creditor.[82]

(b) Australia

The Australian position is similar. Section 12 of the Australian PPSA has a similar definition of security interest and s 12(b) expressly acknowledges that a security interest is not created only by a contractual subordination. However, there is no equivilant to section 17A of the PPSA (NZ). Therefore, if a turnover trust falls within the definition of security interest, the consequences of registration (or non-registration) must be considered.

3.7 IMPLICATIONS CONSEQUENCES OF TURNOVER TRUST BEING A SECURITY INTEREST UNDER PPSA

(a) New Zealand

If a turnover trust is a deemed security interest and it is not excluded by s 17A, the Senior Creditor runs the risk that if the security interest is not registered, the Senior Creditor will lose priority to a general security agreement in favour of a secured creditor over the Junior Creditor which has perfected its security interest by registration at an earlier point in time (s 66(a) and (b) of PPSA (NZ) and s55 of PPSA (Australia)).

Registration of a financing statement alone would not afford protection against a prior registered general security agreement and a deed of priority may be necessary.

In New Zealand, failure to register a security interest and therefore perfect that interest will not render that interest defective as against the liquidators of the Junior Creditor (s 40, PPSA).

(b) Australia

In Australia, unperfected security interests generally vests back to the grantor upon the grantor's insolvency (s 267 of the Australian PPSA (Australia)). However, tThere is a carve-out in respect of security interests which arises out of certain turnover trust subordination arrangements under s 268(2), if the rather onerous (and cumulative) conditions set out in that section are met. Care must be taken to comply when drafting to ensure coverage by 268(2).

[82] L Widdup and L Mayne, *Personal Property Securities Act: A Conceptual Approach, Revised Edition*, LexisNexis Butterworths, Wellington, (Revised ed, 2002), paragraphs [19.15]-[19.16].

Even if sub-section 268(2) is satisfied priority may still be lost to a perfected security interest over the same collateral.

3.8 TURNOVER TRUST AND SET-OFF

It is unresolved ~~whether~~ doubtfull that turnover trust provisions will be effective to require the Junior Creditor to remit ~~hold~~ the economic benefit it receives in the event of a set-off of mutual debts between itself and the debtor. ~~-~~ Where the language of the turnover trust provision only cover payment, distribution or receipt, it would seem that such provisions will not (and cannot) capture the "benefit" that the Junior Creditor gains as a result of set-off, as set-off does not involve the transfer or receipt of any property. As such, the Senior Creditor's interest is not protected from the debtor exercising ~~their~~ a right of set-off, or statutory set-off applying. Even where there is a contractual subordination arrangement in place which will prohibit the Junior Creditor (or debtor) from exercising any right of set-off, in case of breach the Senior Creditor's remedy might only be an unsecured judgment debt for losses as a result of breach of contract, as it cannot rely on the turnover trust provision to require the Junior Creditor to account for the benefit. Contractual subordination would seem to provide the ~~best~~better protection in these circumstances, as longas the Junior Creditor is not insolvent.

3.9 APPLICATION OF LAW TO FACTUAL POSITION IN CASE STUDY

Merbank and CFL are parties to the Subordination Deed. The Subordination Deed has both contractual subordination provisions and turnover trust provisions:

(a) **Contractual subordination**: Clause Y1 provides that until all amounts payable to Merbank have been paid in full, CFL shall not claim, rank or prove as a creditor of any Obligor (which includes B Co) in competition with Merbank. Therefore, CFL could not prove in B Co's liquidation while Merbank's debt is still outstanding.

B Co's liquidator would be entitled to reject CFL's proof of debt on the basis of the Subordination Deed. *SSSL Realisations* ~~provides authority for the view that a~~The contractual subordination provision is enforceable by the debtor as well as the Senior Creditor (see the Save Case). There is no provision for Merbank unilaterally to waive the subordination provision.

In New Zealand, s70(2) provides that the agreement could be enforced by a third party if the third party is the person or one of the class of persons for whose benefit the agreement is intended. It is not clear from the drafting whether the agreement is intended to benefit B Co. A prudent draftsperson (for ~~the~~ Merbank) may have

excluded B Co (and AHL) from being a person for whom the agreement was intended.

Therefore, the Subordination Deed should be enforceable and will allow B Co's liquidator to reject CFL's proof of debt.

(b) CFL's liquidator would not be entitled to disclaim the Subordination Deed. The subordination provisions do not of themselves render the Subordination Deed an unprofitable contract: see ~~*SSSL Realisations*~~the Save Case.

The result would be the same whether in New Zealand (s 269 of the Companies Act) or Australia (s 568 of the Corporations Act).

(c) **Turnover Trust Subordination**: Unfortunately for Merbank, CFL is prevented from proving in the ~~L~~liquidation of B Co. Had Merbank been entitled to waive the contractual subordination provisions, Merbank could have enforced the turnover trust subordination against CFL's liquidator. Any distribution received by CFL's liquidator would have been trust property which is required to be delivered to Merbank.

(d) The outcome for Merbank would have been significantly better had CFL been able to prove in B Co's liquidation. The outcome would have been as follows:

• B Co : assets for distribution		$ 50 million
• Creditors:	A Co (contribution)	$ 0
	AHL (after set-off)	$ 20 million
	Merbank (guarantee)	$ 70 million
	CFL (guarantee)	$ 30 million
		$120 million
• Distribution %	41.7%	
• AHL receives	$8 million	
• Merbank receives	$29 million	
• CFL receives	$13 million : turnover trust to Merbank	

- Merbank total distribution is $42 million (plus $8 million from AHL)

(e) The outcome from B Co's liquidation due to CFL non-proof ~~instead~~ is as follows:

- B Co : assets for distribution $ 50 million
- Creditors : A Co (contribution) $ 0
  AHL (post set off) $ 20 million
  Merbank $ 70 million
  ~~$150~~ 90 million
- Distribution % 55%
- AHL receives $11.1 million
- Merbank receives $38.9 million (plus $11.1 million from AHL)

(f) We have assumed that:

(i) AHL can prove in B Co's liquidation, because we have not seen the original loan documents. AHL is not prevented by the Merbank guarantee from proving in B Co's liquidation.

(ii) A Co is prevented from asserting its contribution claim against B Co by the Merbank guarantee, although that might be possible on a *Bofinger* analysis.

(iii) Merbank has retained the surplus and does not either have a set-off or have to contribute a share of the surplus of $30 million to B Co before it can prove (likely on a *Cherry v Boultbee* basis). Query whether B Co's claim against Merbank would be subject to set-off against Merbank's guarantee claim against B Co?

(g) Turnover trust: is Merbank's turnover trust a charge or a security interest?

The declaration of trust is stated to apply to the full amount of any payment or distribution received by CFL. The English Court of Appeal stated in *SSSL ~~Realisations~~* the Save Case that a turnover trust provision which applies only to an amount necessary to discharge the Senior Creditor debt will not amount to a charge. This provision goes further and is probably therefore a charge. In Australia, if it is not registered, it would be void as against CFL's liquidator (s 266 of the Corporations Act).

Whether or not the turnover trust amounts to a charge, the provision might amount to a security interest under s 17 of the PPSA (NZ) or under s 12 of the Australian PPSA ~~(Australia)~~. It would not on its face fall within the exception in s17A of the PPSA (NZ)

as the subordination was not created or provided for under the terms of a security. The Subordination Deed may not be a debt security in and of itself unless it was provided for under the CFL - B Co facility agreement. ~~The position would have been different had CFL been a subordinated bondholder of B Co.~~

The consequence of being a security interest might not be material for Merbank in New Zealand. The turnover trust will be enforceable in CFL's liquidation and, if there is no other security interest registered, Merbank will not lose priority.

In Australia, the outcome would not be the same: see s 12 and s 268(2) of the Australian PPSA ~~(Australia)~~. The conditions in s 268(2)(c) could not be met because the obligation to transfer money to Merbank exceeds the value of the amount owed to Merbank. The security interest would therefore vest in CFL (if it is security interest).

3.10 TIPS AND LESSONS LEARNT FROM CASE STUDY ON SUBORDINATION

- Subordination arrangements benefit from having both contractual and turnover trust subordination.
- Contractual subordination provisions should provide expressly that the Senior Creditor may waive the subordination, particularly if a turnover trust is also present.
- Turnover trust provisions should limit the trust to an amount equivalent to the Senior Creditor's debt.
- Consider other options to a turnover trust where an existing GSA exists (unless a deed of priority can be negotiated with the GSA holder) such as the irrevocable direction to pay, but consider whether such a mechanism is enforceable by the Senior Creditor in all relevant circumstances.
- Consider whether turnover trust arrangements should be registered on the PPSR.
- In Australia, ensure that subordination agreements comply with sub-section 268(2) to avoid re-vesting on liquidation if not registered.