RECENT DEVELOPMENTS UPDATE

MS Fashions v Bank of Commerce & Credit International Ltd (Guarantees, Principal Obligation Clauses)

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The courts today rely increasingly on policy and what are seen as desired outcomes, and less on purely technical reasoning. This paper considers the policy issues which arise when a principal debtor clause is claimed to give a right to set-off which would otherwise not exist. The advantages and risks of such clauses are considered. The conclusion is that principal debtor clauses can bring unforeseen complications with them, and that those minded to use them need to be clear about just what they aim to achieve.

INTRODUCTION

One of the interesting things about the law is the way in which it, like so many aspects of human activity, can be affected by currents of opinion.

It seems to me that over the last decade there have been signs of change in the way in which the courts develop the common law and apply statute law.

Australian courts, led by the High Court, have demonstrated a new willingness to reconsider long standing principles and authorities.[1] There is an increased willingness to formulate and apply legal principles in terms which are clearly value related or based on value judgments.[2] In interpreting statutes the courts are moving away from a technical and literal approach to a more purposive approach, with greater emphasis on a meaning consistent with the policy and purpose of an Act rather than a meaning resulting from a literal application of the words used.

One could say that the courts have become more activist, more concerned to achieve results which can be justified as substantively just or equitable or consistent with fundamental common law principles. Conversely, they are less inclined to accept a result which seems technically correct, the result of the strict application of precedent, if that result conflicts with what is seen as the just or equitable or principled outcome. This is something on which I have written before.[3] On that occasion I focussed on developments in the field of Constitutional

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1 I mention just two examples. *Cole v Whitfield* (1988) 165 CLR 360 and *Trident v McNiece* (1988) 165 CLR 107.

2 See Finn, "Commerce, The Common Law and Morality" (1988) 17 *MULR* 87.

3 See Doyle "At the Eye of the Storm" (1993) 23 *UWALR* 15.

Law. I referred to a move away from legalism to a technique which involves more open and greater reliance on community values.

The change of approach to which I referred is not confined to Constitutional Law. We see it in many areas of the law.

I do not suggest that in the past courts were not concerned with justice. What I refer to is a change of emphasis. Less emphasis on certainty and logical or technical reasoning, more emphasis on change in the law when required in the light of contemporary circumstances and more emphasis on just or sensible outcomes.

The relevance of these rather general remarks to the subject of this paper is twofold. First, this paper is concerned with guarantees and bankruptcy (or liquidation). Anyone who has worked in this area will be aware of the difficulty of adhering to principle but at the same time getting the balance right between competing interests. Guarantors have long been treated with solicitude by the courts. When Shylock said:

> "The pound of flesh which I demand of him is dearly bought, t'is mine and I shall have it. If you deny me, fie upon your law!"[4]

he expressed the sentiment of many a creditor suing on a guarantee. Like many such creditors, he left the courtroom disappointed. The rules of law which protect guarantors have been criticised as being unduly protective, and as unfair to creditors. In bankruptcy getting the right balance between the interests of the general body of creditors of the bankrupt and the individual (be it a secured creditor or a debtor to the bankrupt) has also been troublesome.

The decision in *MS Fashions v Bank of Credit and Commerce International SA*[5] ("*MS Fashions*") involves both of these difficult areas. It will not be surprising if views differ on the outcome as a matter of policy. In addition, and here is the link to these general remarks, *MS Fashions* and recent Australian cases seem to me to reflect this new drive to get a commercially sensible and fair result, and not to be trapped in technical reasoning. The difficulty of achieving the right result (technically and substantively) in this area adds to the interest. Will the new approach produce better results, or in areas like this would the courts be better to opt for certainty, to stick to technical reasoning without striving for a particular outcome?

My purpose in this paper is to consider the reasoning and outcome in *MS Fashions*, and in some Australian decision relating to set-offs, then to consider the implication of these decisions, and finally to return to the issue of whether, when the courts are more result oriented, they produce better outcomes.

THE FACTS

Three actions which raised common points of principle were before the court. The facts, and the common points, were as follows.

Bank of Credit and Commercial International SA ("BCCI") was banker to three companies. Each company was indebted to BCCI. BCCI took from a director of each company a guarantee in BCCI's standard form. Each director also had accounts with BCCI which were in credit. Each director signed a standard BCCI form (although not the same form in each case) by which he charged the deposit in any such account as security for the repayment of the relevant company liability to BCCI.

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4 "*The Merchant of Venice*", Act IV Scene I.

5 [1993] 3 All ER 769.

In each case either the charging instrument or the guarantee contained an agreement that the liability of the director to BCCI should be that of a principal debtor.

In two of the cases the obligation as principal debtor was expressed as a covenant to pay on demand in writing.

BCCI became insolvent and was put into liquidation.

When BCCI was ordered to be wound up each company was indebted to BCCI in a substantial amount.

Each director at that time had a substantial amount on deposit with BCCI. (In one case the amount on deposit exceeded the amount owed by the company to BCCI).

In each case BCCI claimed that the company should pay to BCCI's liquidator the full amount of the company's debt, and that the director should prove in BCCI's liquidation for the amount of his deposit.

Each director, on the other hand, claimed that BCCI was obliged to set-off the deposit against the company's indebtedness or the director's liability to BCCI, and then BCCI could claim only the balance.

The different outcomes can be illustrated quite simply. Assume that at the time of the winding up order the company owes BCCI one million dollars, the director has on deposit $400,000, and the dividend to creditors in BCCI's liquidation is 50 cents in the dollar.

On BCCI's approach, the company will pay to BCCI $1,000,000, the director will regain a dividend of $200,000 (or half his deposit). Treating the company and the director as one entity, instead of a net payment to BCCI of $600,000 (the net amount due if there were no insolvency), there has been a net payment to BCCI of $800,000. On the other side, the company pays $1,000,000, but the director loses $200,000 of his $400,000.

On the directors' approach the company will pay to BCCI $600,000 (after the set-off), and the director has a claim against his company for $400,000 (by subrogation). There has again been a net payment to BCCI of $600,000 (the same as if no insolvency), now paid by the director as to $400,000 and by the company as to $600,000. If the company is solvent the director can recoup his $400,000. The end result will be that the company pays $1,000,000 to BCCI, and the director still has his $400,000 (as would have happened if there was no insolvency).

THE ISSUES

The difference in the outcome is significant. BCCI's approach produces an extra $200,000 available for the creditors of BCCI. It means that the director loses $200,000 (the company will never pay more than its debt to BCCI).

The odd feature of the situation is this. If BCCI had never taken a guarantee and charge from the directors, its preferred outcome would be the result. That is, it could claim the debt from the company and the director would have to prove for his deposit, recovering half only.

The directors, however, agreed to undertake a secured liability to BCCI, to give BCCI added protection (by agreeing to be a principal debtor). It is ironic, is it not, that the result of BCCI having sought and obtained added security is that through principles of set-off the creditors of BCCI are worse off than they would be if the added security had not been obtained?

Set-off gives protection to a particular category of creditor of a bankrupt — one who has had mutual dealings with the bankrupt. Such a creditor is protected from the ordinary rules of bankruptcy. Is it right, BCCI could ask, that the directors get this protection as a result of having undertaken an added liability to BCCI?

We must remember that on the directors' approach the ultimate benefit (assuming the debtor company is solvent) does flow to the director. The company will pay its $1,000,000 come what may and the director will still have his deposit of $400,000 (recouped from the company). If there is no set-off the company will pay its $1,000,000 to BCCI, and the director will lose half of his deposit.

Furthermore, BCCI could argue that what it took was essentially security from each director against the inability of the company to pay its debt, and that it is odd if BCCI's insolvency means that the directors are better off than they would have been if the security were not taken.

To this the directors could respond that had BCCI been content with a guarantee supported by the security of a charge over the deposit, BCCI would have achieved its desired outcome. This would occur because the liability of the director would be contingent upon a demand under the guarantee. Unless and until demand was made by BCCI, there would be nothing due by the directors to BCCI, and so no basis for a set-off.[6] But, BCCI wanted more. It wanted to avoid the operation of the principles which protect a guarantor against certain dealings between creditor and principal debtor (and against any legal defect in the dealings between BCCI and the debtor company). BCCI also wanted the ability to resort to the director if that was more convenient. The consequence was that it elevated the directors from guarantors to principal debtors, and now BCCI (or its creditors) must take the consequences that flowed from that. The directors could argue that BCCI wants to have its cake and eat it — treat the directors as principal debtors in relation to advances by BCCI to the companies, but ignore that status in relation to advances by the directors to BCCI (the deposits).

I will return to these issues later. Suffice it to say that what I aim to show here is that there is a real issue of policy underlying the legal technicalities, and its resolution is not simple. I have tried to draw out the policy issues as I see them.

Another point which emerges is the need to think through the implications (if any) of taking added security, and the manner in which it is done. BCCI's difficulties arose because it used the concept of principal debtor, to improve its protection under the guarantees.

The case illustrates the danger of using a concept to achieve a desired outcome, rather than specific agreement on the matters on which a variation or change is wanted (ie in the present case, certain specific rules relating to the liability of guarantors).

The other thing which I find intriguing about this case is that it was through the law relating to guarantees that BCCI found itself enmeshed in the law relating to set-offs. The case neatly illustrates how one can get into difficulty by focussing on one facet of a situation (improving the recoverability of the debt owed to BCCI) and consequently failing to see that one may have potentially attracted an unrelated set of legal principles (relevant to the administration of the assets of BCCI).

THE LEGAL REASONING

I now turn to the manner in which the legal issues were dealt with by the court. I propose to refer mainly to the judgment of the Court of Appeal, although on occasions I will refer to the judgment of Hoffman LJ which was upheld on appeal. There seems to be no difference of substance between the two judgments.

I will approach the issues in an order which differs from the order of the judgments.

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6 *MS Fashions* at 778e, Hoffman LJ.

Existing liability to BCCI available to be set-off against deposit

BCCI argued that the liability of the directors to BCCI was contingent upon a demand being made (and the instruments did provide for a demand in writing), that no demand had been made on the directors, and accordingly there was no liability by the directors to BCCI available to be set-off against BCCI's liability to the directors.[7]

The answer to this argument was that in the case of a primary obligation as opposed to a secondary obligation such as a guarantee, a provision for a demand in writing is not regarded as creating a contingency.[8] While the matter is ultimately one of construction of the particular contract, this basic rule is well established. It followed that the reference to the directors as "principal debtor", and the power of BCCI to appropriate deposited monies without notice, meant that there was an existing liability, despite the provision for a demand in writing.

A separate argument, rejected by Hoffman LJ, was that there could be no set-off unless and until BCCI sued the directors and they elected to plead set-off by way of defence.[9] The answer to this was what he called the hindsight principle — the courts will have regard to events which have occurred since winding up, as long as at winding up there are mutual dealings capable of giving rise to cross claims. I suggest that the way in which Dixon J put it in *Hiley's* case (cited by Dillon LJ) is simpler and clearer:

> "It is enough that at the commencement of the winding up mutual dealings exist which involve rights and obligations whether absolute or contingent of such a nature that afterwards in the events that happen they mature or develop into pecuniary demands capable of set-off".[10]

The approach of Dixon J in *Hiley's* case has been supported by the High Court in *Day & Dent*.[11] Indeed, it is worth noting that the High Court judgments in *Day & Dent* are open to the construction that a guarantor who after bankruptcy elects to pay on a guarantee may improve the guarantor's position by thereby establishing a right of set-off. Such a guarantor could, if the principal debtor is solvent, by making payment put himself or herself in the same position as the directors in *MS Fashions*.[12]

It follows that the directors had brought themselves within the scope of the set-off rules.

Automatic operation of rules

It is perhaps just another way of putting what has been said, but as Dillon LJ pointed out, the statutory set-off was "not something which BCCI can, as it were, place in a suspense

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7 In one case a demand had been made, and there was no appeal from Hoffman LJ in that case.

8 *MS Fashions* at 785b Dillon LJ; at 778 Hoffman LJ.

9 *Ibid* at 777h Hoffman LJ.

10 *Hiley v People's Prudential Assurance Co Ltd (in liq)* (1938) 60 CLR 468 at 496-497.

11 *Day & Dent Constructions Pty Ltd v North Australian Properties Pty Ltd* (1981-1982) 150 CLR 85 at 497.

12 *Ibid* at 91-92 Gibbs CJ; at 100 Mason J.

account".[13] The rules of set-off operate of their own force, and so the creditor (BCCI) cannot sue for an amount the subject of set-off.

The later decision of Vinelott J in *Re Maxwell Communications Corp plc (No 2)* ([1994] 1 All ER 737) makes the point that although the set-off rules are mandatory and automatic, there is nothing to stop a creditor agreeing with a debtor to postpone or subordinate the creditor's claim to the claim of other unsecured creditors. As Vinelott J said, if a creditor can waive his claim or decline to prove, it seems logical that he can subordinate his claim.

This suggests that BCCI might have protected itself by securing an agreement from the directors (as part of the charges) that any claim which they had against BCCI for repayment of their deposits should be subordinated to the claims of the general creditors of BCCI in the event of a winding up. Whether such an agreement could be secured from a depositor is another matter.

Were there mutual dealings?

Central to the operation of rule 4.90 of the English Insolvency Rules, and to the operation of section 86 of the Australian *Bankruptcy Act*, is the notion of "...mutual credits, mutual debts or other mutual dealings..."

It is clear that the reference to "other mutual dealings" was added to these provisions:

> "...both to give a more extended right of set-off and to ensure that the intended scope of such provisions was not frustrated by a narrow or technical approach to what constituted 'credits' or 'debts'."[14]

Despite this, it is established that situations may exist in which, despite the existence of cross claims of a monetary kind, the necessary element of mutuality is lacking. To begin with, the demands must obviously be between the same parties, and between those parties in the same capacities. A person who is personally indebted to a bankrupt cannot set-off a debt due by the bankrupt to him in his capacity as a trustee. But apart from those clear cases, there are cases in which money has been paid for a special purpose and is then said to be outside the scope of mutual dealings.

The cases on this point were reviewed by the House of Lords in *National Westminster Bank v Halesowen Presswork*[15] where the point was stated thus by Lord Simon:

> "Every payment of money is for a special or specific purpose in the ordinary sense of those words: something more is required to take the transaction out of the concept of 'mutual dealings'...money is paid for a special (or specific) purpose so as to exclude mutuality of dealing within section 31 if the money is paid in such circumstances that it would be a misappropriation to use it for any other purpose than that for which it is paid."[16]

This indicates that this exception to a limit on the notion of mutuality is a narrow one. The same notion was expressed by Lord Hanworth MR in *Re City Equitable Life Fire Insurance Co Ltd (No 2)*[17] as follows:

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13 *MS Fashions* at 785j.

14 *Gye v McIntyre* (1990-1991) 171 CLR 609 at 623.

15 [1972] AC 785.

16 *Ibid* at 808C-E.

17 [1930] 2 Ch 293

> "Different considerations apply where money has been handed over for a specific purpose and not treated as a mere item in accounts kept between the bankrupt and his creditors..."[18]

BCCI argued that the monies charged by each director were monies paid to or held by BCCI for a special purpose — security for the company indebtedness to BCCI, and so the necessary element of mutuality was lacking.

Both Hoffman LJ and Dillon LJ dealt with this argument very shortly, the former in a few lines,[19] the latter after a discussion of the cases but then simply on the basis "...there is nothing in the charge point...".[20] One gets the feeling that each judge found the answer clear, but not so easy to explain. They seem to me to be quite right. There was debt on each side. The charge did not deprive the directors of their beneficial interest in the money on deposit. The charge seems, if anything, to emphasise the mutuality, because it links the deposit with BCCI with the debt owed to BCCI. That said, I must say that the passages just cited are not easy to apply, but I leave it at that, this not being our main concern.

The result

It followed from all this that the deposit account and the liability of each director for the amount advanced by BCCI constituted or arose out of mutual dealings, that the existence of the charge did not affect this conclusion, and that the amount payable by each director being at all times presently due (because they were principal debtors) there existed amounts capable of set-off and necessarily so treated. The directors succeeded.

The position of the directors in relation to the companies

Only Hoffman LJ touched on this. He said that "for some purposes" the courts will look to the underlying reality of the suretyship relationship, but:

> "...this is only for the purpose of protecting the surety's rights against the principal debtor..."[21]

I take him to mean, as I assumed when analysing the monetary outcome, that as between each director and the relevant company, the director would be treated as surety for a principal debtor, and so entitled to recover from the company any amount subject to set-off (this amount being treated for this purpose as a payment by the director to BCCI in reduction of the company's indebtedness). This points up the irony of the fact that as a principal debtor to BCCI the directors benefit from the set-off only because they can recover any amount set-off from the debtor company because **for that purpose** they are regarded as sureties. A happy paradoxical state!

The charge

A credit in a deposit account with a bank represents, in law, a debt owed by the bank to the depositor. How does one charge such a chose in action to the person by whom it is owed? If BCCI owes the director $400,000, how does he charge that same debt in favour of BCCI?

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18 *Ibid* at 312.

19 *MS Fashions* at 780j-781a.

20 *Ibid* at 788j-g.

21 *Ibid* at 779f-g.

The relevance of this point is that if the charge was ineffective, then the argument that it eliminated the required mutuality was without a basis.

In *Re Charge Card Services Ltd*[22] Millett J said that:

> "...a charge in favour of a debtor of his own indebtedness to the chargor is conceptually impossible."[23]

The reason was that a debt is the right to sue the debtor. Such a right can be assigned or made available to a third party, but not to the debtor, who cannot sue himself. That seems logical. But a charge appears to involve two elements. The right to recover, and priority over other claimants. If I charge in favour of my bank book debts owed to me by another, the bank gets the ability to recover the book debt **and** priority over my general creditors. Might it not be that the charge which BCCI took gave it the latter benefit, the former (right of recovery) being irrelevant?

The point is of some significance, but unfortunately Dillon LJ said nothing about it, and Hoffman LJ merely alluded to it without any comment.[24]

AN AUSTRALIAN PERSPECTIVE

I am unaware of any Australian cases on point, but I suspect that the same result would be reached by an Australian court.

The decision that the principal debtor clause meant just what it said seems fairly straightforward. Once one gets to there, the remaining issue is the application of section 86 of the *Bankruptcy Act*.

In *Dent & Dent* the High Court held that the section applied if at the date of the liquidation there existed some liability, albeit only contingent, or a transaction which would naturally result in a debt which by the time when the issue of set-off arose had become fixed or had crystallised in the anticipated manner.[25] The High Court showed no inclination to give section 86 a narrow or technical operation. Indeed, Mason J said that the section, being protective, was to be given "the widest possible scope."[26]

In the later decision in *Gye v McIntyre*[27] this view was expressed by the whole court.[28] The court went on to emphasise the width of "dealings", which word was to be read in a non-technical sense.[29]

This suggests that an Australian court would favour a set-off, and would not be anxious to read section 86 in a manner which would prevent one arising. This is consistent with the

22 [1987] Ch 150.

23 *Ibid* at 175C.

24 *MS Fashions* at 780j.

25 (1981-1982) 150 CLR 85 at 91 Gibbs CJ, at 103-104 Mason J.

26 *Ibid* at 108.

27 (1990-1991) 171 CLR 609.

28 *Ibid* at 619, 623.

29 *Ibid* at 625.

outcome in *Gye v McIntyre*. The facts are rather complex, and I propose to simplify them. In effect the court held that a person who had a judgment for money due under a loan (used to purchase a business) could set-off against that the lender's liability to the borrower for damages for deceit in connection with the sale of the business. The court said that protection (for the creditors of the bankrupt) lies, in the main, in the requirement of mutuality, but apart from that eschewed a "narrow and technical meaning" and called in aid "considerations of 'substantial justice'".[30] All parties had been involved in negotiations leading up to the sale and purchase of the business and the loan in connection with it. Those dealings were mutual although other parties may have been involved, although the creditor or bankrupt may have been involved in more than one capacity and although those dealings gave rise to different claims between other parties.

None of this offers any encouragement to a banker seeking to avoid the operation of section 86.

This flexible approach in Australia to the operation of section 86 with an eye to preferred outcomes, is consistent with the decision of the Court of Appeal in *Stein v Blake*.[31] There it was held that a trustee in bankruptcy could assign a claim by a bankrupt, despite a counterclaim by the defendant to the claim which would (if both claims were valid) be set-off against the claim. Although the set-off rules have been described as mandatory, automatic or self-executing, the court was influenced towards its conclusion by the fact that the counterclaiming defendant would not suffer. He could still prove in the bankruptcy or still use his counterclaim as a set-off against the claim.[32]

PURPOSE OF SET-OFF

If the courts are going to be more responsive to policy, to substantial justice, to the purpose lying behind the law of set-off, it follows that we must be clear what the underlying principles are. One has to understand a policy or principle to apply it.

Oddly enough, in *MS Fashions*[33] there was no discussion relating policy or principle to outcome.

In *Stein v Blake*[34] the purpose of set-off in bankruptcy was said to be not to avoid cross-actions (the purpose of set-off between solvent persons) but "to do substantial justice between the parties." This was a reference to the injustice of the solvent party having to discharge his debt to the bankrupt in full, and having to prove for a dividend in respect of his claim against the bankrupt.

In *Re Maxwell Communications Corp plc (No 2)*[35] the policy was seen in part as being the avoidance of expense and inconvenience in the bankruptcy or winding up if a creditor could elect not to set-off, but prove for his claim leaving it to the trustee or liquidator to sue to recover the debt due to the estate. With respect, it seems to me that while minimising delay and expense is relevant, the policy behind set-offs is more accurately stated in *Stein v Blake* — substantial justice (and minimising cost and delay) between the creditors of the insolvent

30 *Ibid* at 621, 625.

31 [1993] 4 All ER 225.

32 *Ibid* at 234j Balcombe LJ; cf at 236d Staughton LJ.

33 [1993] 3 All ER 769.

34 [1993] 4 All ER 225.

35 [1994] 1 All ER 736 at 746.

and the debtor/creditor of the insolvent estate. That is how it has been seen in the Australian cases referred to.[36]

There are two points which I want to make about this.

First, that this notion of justice gives no more than a rough guide. It supports a fairly generous approach to the application of set-off, but when we get to a hard case what guidance does it really supply? If mutuality of established claims (ie claims which have matured or crystallised) is the key, does the notion of substantial justice really help to draw the line? I suspect that there will be cases in which it is of little help.

Secondly, *MS Fashions* suggests, if my speculation about the issues is correct, that the hard cases can throw up factors beyond those just identified, which leave one quite unsure about the sensible outcome. Perhaps the answer to that is that in *MS Fashions* the difficulties of policy really arose independently of the law of set-offs, and in the law of guarantees and principal debt obligations.

HINDSIGHT

Looking back, what could BCCI have done (and what could a lender do today) to avoid the same outcome?

One answer is — why worry? If BCCI had remained solvent, the problem would never have arisen. It was a problem only for the liquidator. Perhaps a lender should not worry if the pursuit of extra security could have adverse consequences should the lender become insolvent.

If that answer is not sufficient, Alan Berg[37] has suggested that avoidance of a principal debtor clause and the use of a provision which excludes the rules relating to the discharge of sureties, excludes the rules by which the release of a co-obligor discharges others, and which provides that if for specified reasons the borrower's obligations are or become invalid, then the guarantor becomes liable as an independent obligor.

I have reservations about this. First, a provision excluding the usual protections available to a surety may be rather lengthy, and difficult to draft satisfactorily. Secondly, there is a risk that a court would hold that such an arrangement was not in substance a guarantee but just what it tried not to be — an independent primary obligation to the lender. That risk is lessened by merely providing for an independent obligation, as principal debtor, to pay to the lender any sums not recoverable from the principle debtor. In *MS Fashions* Hoffman LJ accepted that such a liability was contingent on the guarantee having been enforced without success, and so would not have resulted in a set-off, unless a claim had been made under the independent obligation. This approach has been taken in some documents which I have examined, ie a guarantee coupled with an independent obligation as principal debtor to indemnify against any loss. It seems to me to be a safer approach.

Either way, it might also be wise to make liability expressly dependant upon a demand in writing. In this way the lender will have the chance to decide whether or not to crystallise the liability and attract the rules relating to set-off.

Another possibility, to which I alluded earlier, is a clause by which the "guarantor" agrees to subordinate any claims to repayment of monies deposited to the claims of the general

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36 *Day & Dent* (1981-1982) 150 CLR 85 at 95 Gibbs CJ, at 107 Mason J. *Gye v McIntyre* (1990-1991) 171 CLR 609 at 618-619.

37 "BCCI In the Court of Appeal", *Butterworth's Journal of International Banking and Finance Law* — June 1993 at 289.

creditors of the lender (to the principal debtor). This was held to be effective in *Re Maxwell Communications Corp plc (No 2)*.

What this highlights, to my mind, is the need to be clear on the main objective. Is it to improve the prospect of recovery (in which event there is no harm in a principal debtor clause), or is it to avoid set-off arising on the insolvency of the lender (in which event an unqualified principal debtor is unwise)? Mr Berg's suggestion may achieve both objectives, but there is a risk that the courts will be resistant.

Finally, I should mention some other points made by Mr Berg in his thorough article. If the "guarantor" is a company, one needs to consider whether a power in the objects clause to guarantee extends to a principal debtor obligation. Secondly, it may be more difficult for a director to satisfy himself that it is in the interests of a company to enter into a principal debtor arrangement to support a related company. Thirdly, as an obligation under a principal debtor clause is not contingent, it will be for accounting purposes (ie in the obligor's accounts) need to be properly treated. Fourthly, and most importantly, authority indicates that knowledge by a creditor that as between two of his debtors one of them is guarantor only, means that the rules as to discharge of guarantors will apply. It is knowledge by the creditor of the status of guarantor which is decisive. If that is correct, then the principal debtor clause has lost its value, unless the relevant rights which attach to the status of surety are in fact excluded. In other words, describing a person as "principal debtor" may make the obligation a primary and non-contingent obligation, but fail to include protective rules favouring the surety.

PRINCIPAL DEBTOR CLAUSES

A brief review of the function and utility of such clauses seems warranted, although a full review is beyond the scope of this paper.

The first and most obvious effect of such a clause is to remove the need for a demand. That means that time may begin to run when the advance is made, but that problem can be dealt with by drafting the guarantee as a continuing guarantee.

The second effect (which flows from the first) is to convert the liability of the putative guarantor from a contingent liability into a fixed or definite liability. That means, as *MS Fashions* illustrates, that there is a liability in existence which may attract the rules relating to set-off. That is, however, assuming that the substantive obligation is not itself a contingent one for other reasons, eg a liability to pay such sum as may not be recoverable on the footing of the guarantee.

The third effect may be, depending upon the wording (and it would require additional provisions) to eliminate rights which the putative guarantor would otherwise have as a result of dealings between the creditor and principal debtor or as a result of the liability of the principal debtor being void or becoming unenforceable. The two things are distinct, although it seems common to deal with both.

The intent behind the last feature is to transform the arrangement in those respects from one which is or has elements of a guarantee to one in which what is given is an indemnity. (The right to the creditor's securities by subrogation might survive even that, and require separate treatment).

In the face of explicit provisions to this effect it seems to me that it would be contradictory for a court to hold that the creditor had notice of dealings between the putative guarantor and principal debtor indicating that the liability of the former was secondary, and that therefore the putative guarantor had, as against the creditor, the usual rights of a guarantor.

In other words, as long as the principal debtor clause makes it clear that the third effect is intended, the clause should be effective. Mere description of the obligation as that of principal debtor is unlikely to eliminate the protection that a substantive guarantor would otherwise get.

In cases like this it seems safer not to ask whether the arrangement is one of guarantee or indemnity, but rather to consider whether, assuming that as between the debtors one is principal debtor (and the creditor has notice of that) any and which of the rights and remedies of a guarantor are available consistently with the terms of the instrument. In short, it is not all or nothing — the arrangement may exhibit features of a guarantee and of an indemnity.

CONCLUSION

The decision in *MS Fashions*, on analysis, opens up a Pandora's box of problems. It seems that the attempt to turn a guarantor into a principal debtor is more difficult than at first appears, and that to do so brings with it new problems of set-off. One view is that they should not concern the lender, who should focus on protecting his position, not on the position of his creditors in the event of insolvency. The other view is, I suppose, that the attempt to transform the guarantor into principal debtor is on balance unwise — like Shylock, such a lender may find that he is taking blood with his pound of flesh and so loses his bargain.

Perhaps the real lesson is that one has to be clear, in structuring legal relationships, on the real objectives. Trying to achieve too much may lead to unforeseen consequences.

Finally, it seems to me that in each case discussed above, the court has reached a satisfactory outcome. It is noticeable that in several of them some awkward precedents are pushed aside. It does appear that the courts are paying more attention to policy or principle, but as *MS Fashions* itself illustrates, there is still scope for the sometimes intricate legal rules to produce unforeseen results.