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In Practice

Author Adam Pierce

Guarantors' indemnity claims in insolvency following *Re Kaupthing*

KEY POINTS

- *Re Kaupthing* overturns the *Re SSSL* decision on how the rule against double proof interacts with the rule in *Cherry v Boultbee*.
- Where insolvent corporate groups have cross-guarantees in place, this will often change the basis on which insolvency practitioners determine distributions to creditors.
- Where a guarantor owes a debt to a principal debtor and both have entered insolvency proceedings, the question of whether the rule in *Cherry v Boultbee* affects the recovery of that debt is now less likely to be determined by the drafting of the non-competition clause in the relevant guarantee.

INTRODUCTION

In *Re Kaupthing Singer and Friedlander Ltd (in administration)* [2011] UKSC 48 (*Re Kaupthing*), the Supreme Court overturned the Court of Appeal decision in *Re SSSL Realisations (2002) Ltd* [2006] EWCA Civ 7 (*Re SSSL*) on how the rule against double proof interacts with the rule in *Cherry v Boultbee*. The ruling is likely to be particularly relevant in the context of group insolvencies: where one company guarantees another company's obligations, and both later become insolvent, the ruling will often affect the recoveries of those companies' creditors.

BACKGROUND – KEY LEGAL PRINCIPLES

A guarantor's indemnity

Both *Re SSSL* and *Re Kaupthing* were cases about the extent to which a guarantor can take advantage of its indemnity rights in insolvency. A guarantor is entitled to an indemnity from the principal debtor in respect of any amount of the guaranteed debt the guarantor has paid. Until the guarantor pays any of the guaranteed debt, it has a contingent indemnity right against the principal debtor in the amount of the outstanding guaranteed debt.

The key question in both *Re SSSL* and *Re Kaupthing* was the extent to which the rule against double proof prevented the guarantor from exercising, or otherwise taking advantage of, these indemnity rights (the Surety Rights) before the creditor had been paid in full.

The rule against double proof

The rule against double proof is a long-established principle of English insolvency law (both corporate and individual). Under the rule, it is not possible for more than one person to make a claim on an insolvent estate in relation to the same debt. The rule is most commonly relevant in surety situations, where the principal debtor has become subject to an English insolvency procedure. This was the case in both *Re SSSL* and *Re Kaupthing*. Take the situation where a guarantor of an insolvent borrower has made a partial payment to the creditor. The creditor will still have a claim against the borrower for the full amount of the debt, and the guarantor will have an indemnity claim against the borrower for the amount the guarantor has paid to the creditor. The rule prevents both creditor and guarantor from proving against the borrower at the same time for these claims, which would distort the amount of the distributions available to other creditors generally.

The key second limb of the rule is that, in surety situations, the creditor has the superior right of proof. So a guarantor cannot prove against a principal debtor on account of its indemnity until the creditor has been paid in full (which of course may never happen).

It is also settled law that, where the rule against double proof prevents a guarantor from proving on account of its indemnity, no account will be taken of that indemnity for the purposes of insolvency set-off in the principal debtor's insolvency.

The rule in *Cherry v Boultbee*

Under the English law equitable principle known as "the rule in *Cherry v Boultbee*" (*C v B*) (from *Cherry v Boultbee* (1839) 4 My & Cr 442), a person cannot share in a fund of which he is also a debtor without first contributing to the fund by paying his debt. The rule originates in probate law, and has applied in that context where beneficiaries under a will separately owed money to the deceased. But it has also become relevant where, as in *Re SSSL* and *Re Kaupthing*:

- a guarantor and a principal debtor are both insolvent;
- the guaranteed obligation is outstanding; and
- the guarantor owes money to the principal debtor on account of a loan made pre-insolvency.

For the purposes of *C v B*, the "fund" in this situation is the insolvent guarantor, the person seeking to share in the fund is the insolvent principal debtor, and its "debt" to be contributed to the fund is its (contingent) counter-indemnity obligation to the guarantor.

C v B and the rule against double proof collided in *Re SSSL* and *Re Kaupthing* because in each case there was both:

- a "fund" subject to English law equitable principles (a guarantor in an English insolvency procedure), making C v B relevant; and
- a principal debtor in an English insolvency procedure, making the rule against double proof relevant.

RE KAUPTHING

Facts

In 2005, Singer & Friedlander Funding plc (Funding) issued £250m of floating rate guaranteed bearer notes, with Funding's parent company, Kaupthing Singer & Friedlander Ltd (KSF), as guarantor. HSBC Trustee (CI) Ltd (the Trustee) held the notes as trustee for the noteholders. Funding lent the proceeds from the notes to KSF.

In 2008, both KSF and Funding went into administration.

In April 2009, the Trustee lodged proof of debt for £240.3m plus interest in the administration of both Funding and KSF (in the case of the latter, under the guarantee). In May 2009, Funding lodged a proof of debt in the administration of KSF for £242.6m due in respect of the intra-group loan it had provided to KSF.

The question at the heart of the case was whether the administrators of KSF should:

- apply *C v B*, and so adjust the amount of Funding's proof to take account of Funding's contingent counter-indemnity obligation to KSF; or
- not apply *C v B* (either because to do so would offend the rule against double proof, or because KSF had agreed not to in its guarantee) and so admit Funding's proof in full.

Arguments and the courts' decisions

In a similar (though not identical) situation in *Re SSSL*, the Court of Appeal had held that the liquidators of the surety could apply *C v B* without breaching the rule against double proof. It considered the opposite conclusion would result in the rule against double proof artificially swelling the assets of the principal debtor.

In *Re Kaupthing*, the Trustee argued that *C v B* should not apply. When the case was brought before the High Court, the Trustee acknowledged that the court was bound by *Re SSSL* on the interaction of *C v B* and the rule against double proof. The only argument open to it at that stage was that the non-competition clause in KSF's guarantee contractually prevented KSF's administrators from applying *C v B*. The High Court held that the non-competition clause was not wide enough to prevent KSF's administrators from applying *C v B* (*Mills and others v HSBC Trustee (CI) Ltd and another* [2009] EWHC 3377 (Ch)).

The Trustee was allowed to make a leapfrog appeal to the Supreme Court, enabling it to appeal against both:

- the High Court's interpretation of the non-competition clause; and
- the ruling on *C v B* in *Re SSSL*.

The Supreme Court ruled that *Re SSSL* had been wrongly decided. Lord Walker concluded (at para 53) "it would be technical, artificial and wrong to treat the rule against double proof as trumping set-off (as it undoubtedly does) but as not trumping the equitable rule [referring to *C v B*]". Accordingly, there was no need for the court to consider whether the drafting of the non-competition clause contractually prevented KSF from applying *C v B*: *C v B* could not apply anyway.

SIGNIFICANCE OF THE DECISION

Is this decision good for creditors?

The Supreme Court's decision in *Re Kaupthing* meant the creditor (the Trustee) got a better recovery than it would have if *C v B* had applied. But this will not always be the case. Where both guarantor and principal debtor are in insolvency procedures, the creditor will (usually) prove for the full amount of its debt against both. If *C v B* does not apply, this is likely to increase the assets of the principal debtor to be shared among its creditors and decrease those of the guarantor, compared with the position if it had applied. Whether this gives the creditor a better recovery will depend on the extent of the respective assets and liabilities of each debtor entity at the time. It may also make a difference if the creditor has security from one but not the other.

Given this uncertainty, why would a creditor normally want its non-competition clause to be as wide as possible, potentially preventing by contract the operation of *C v B* anyway? A well-drafted non-competition clause will normally prevent a guarantor from exercising the relevant rights "unless [the creditor] otherwise directs" (this is what the guarantee in the Loan Market Association's facility agreements says). This contractual provision provides more flexible protection for a creditor than the legal protection this ruling provides. In the relevant circumstances, *C v B* cannot now operate until the creditor has been paid in full (or has withdrawn its proof), whether the creditor wants it to or not.

Nevertheless, given the problems creditors have had convincing courts that the application of *C v B* falls within the scope of their non-competition clauses, the ruling may in practice be helpful for creditors more often than not.

Is the drafting of non-competition clauses now less important in determining whether *C v B* can apply?

The Supreme Court's decision meant the creditor (the Trustee) did not need to rely on the non-competition clause in its guarantee to prevent *C v B* from operating for the guarantor. This was because the rule against double proof applied. But that may not always be the case, for example in the following situations.

Where the principal debtor is not in an insolvency procedure. The rule against double proof will not apply to a guarantor's exercise of its Surety Rights if the borrower is not in an insolvency procedure. So *C v B* could apply in determining the quantum of the principal debtor's proof in the guarantor's insolvency.

It is also worth remembering that, although *C v B* has most commonly arisen in surety situations where the guarantor is insolvent, it is a principle that applies to "funds", not just insolvent companies. So if an individual guarantor dies, *C v B* could apply in determining the extent of the principal debtor's claim on the guarantor's estate, unless the principal debtor is subject to an English insolvency procedure.

Where the principal debtor is in a foreign insolvency procedure. In both *Re SSSL* and *Re Kaupthing*, the English insolvency law rule against double proof was relevant

In Practice

Biog box

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because the principal debtor was in an English insolvency procedure. But what if the principal debtor enters a foreign insolvency procedure, while the surety enters an English insolvency procedure? In those circumstances, the relevant foreign insolvency law would determine whether the insolvent guarantor could exercise its Surety Rights against the principal debtor in those foreign proceedings. This could be relevant, for example, where an English parent company has guaranteed obligations of a foreign subsidiary (although, of course, the jurisdiction of incorporation will not necessarily determine the insolvency forum). Some other jurisdictions do have their own versions of the English rule against double proof: local law advice will be essential.

Where the guarantor has guaranteed only part of the debt owed to the creditor. Broadly, the rule against double proof does not apply once the guarantor has discharged the guaranteed obligations in full. This may be before the creditor has made a full recovery if the guarantee is of part only of the principal debtor's obligations. To avoid competition from the guarantor, "limited" guarantees are normally drafted as guarantees of the whole of the principal debtor's debt, but with a cap on the amount recoverable from the guarantor. In an English insolvency of the principal debtor, this should ensure the rule against double proof will prevent competition from the guarantor until the creditor has made a full recovery.

But limited guarantees are not always drafted in that way. If the guaranteed obligations themselves form only part of the creditor's debt, the creditor may need to rely on contractual restrictions to prevent the guarantor exercising its Surety Rights once the guaranteed obligations have been satisfied.

Will *C v B* be less relevant in insolvencies?

There will no longer be situations where (contractual restrictions aside) the guarantor is prevented from proving or setting off by the rule against double proof but is still able to apply *C v B*. However, the examples above show that the rule against double proof will not always prevent a guarantor from competing with a creditor. Where that is the case, the creditor may still have to rely on contractual protections to prevent the guarantor from exercising its Surety Rights (whether by applying *C v B*, proving, setting off or otherwise).

In those situations, arguing that the non-competition clause does not cover *C v B* may be the guarantor's best (or only) hope. Most non-competition clauses are likely to expressly prevent the guarantor from proving, claiming and/or setting off until the creditor has made a full recovery. But as the High Court decision in *Re Kaupthing* showed, a court may not always be convinced that a non-competition clause is wide enough on its own to prevent a guarantor from applying *C v B*. ■

Re Kaupthing **– summary of obligations**