Marshalling, subrogation and Agricultural Credits Act security (McLean v Berry)

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Restructuring & Insolvency analysis: Louis Doyle, barrister at Kings Chambers, explains the background to the case of McLean v Berry and considers the implications of the judgment for insolvency practitioners with regards to the principle of marshalling and the circumstances in which the doctrine of subrogation will not operate.

Original news

McLean and another (as Joint Administrators of Dent Company (a partnership) (in administration)) v Berry and others [2016] EWHC 2650 (Ch), [2016] All ER (D) 18 (Nov)

The Chancery Division ruled on an application by the joint liquidators of a partnership (in administration) for directions, under paragraph 63 of Schedule B1 to the Insolvency Act 1986 (IA 1986). The court held, among other things, that the fourth respondent, who had loaned money to the partnership, was entitled to claim the proceeds of assets subject to an agricultural charge by the application of the principle of 'marshalling' and to prove as an unsecured creditor in the administration for any shortfall, in circumstances where a bank had had the right to resort to two securities in support of its lending to the partnership and where the fourth respondent had had a right to resort to one security in support of her lending to the partnership, a company connected to the partners and to the partners personally. The court further held that the trustees in bankruptcy of the partners did not have a claim based on unjust enrichment and were not entitled to claim in the administration of the partnership by operation of the doctrine of subrogation.

What was the case about?

The case involved an application by the joint administrators of a partnership that engaged in pig farming and haulage for directions under IA 1986, Sch B1, para 63 as to the correct distribution of the partnership's funds. There were four respondents to the application. The first three were the joint trustees of the bankruptcy estates of the three individual partners in the partnership. The fourth respondent (the Junior Creditor) was the daughter and sister of the individual partners who had advanced loans to the partnership during its trading life. Some of the members of the partnership were also shareholders in and directors of a limited company (the Company) which is one of the largest outdoor pig producers in the UK, although the Company was not central to the administrators' application.

The partnership's capital had come from secured lending from Barclays Bank plc (the Bank). The Bank held an 'all-monies' debenture over the assets of the Company and third party charges over two farms which were used for the purpose of conducting the partnership business but did not form part of the partnership assets (the Non-Agricultural Assets).

In early 2007, the Junior Creditor made two unsecured loans to the partnership.

Later that year, in June 2007, three things happened:

- first, the Junior Creditor made a further loan secured partly by legal mortgages over the Non-Agricultural Assets (second ranking after the Bank's security over the same assets)
- second, the partnership created in favour of the Bank an 'agricultural charge' within the meaning of the Agricultural Credits Act 1928 (ACA 1928) which created a fixed charge over the partnership's agricultural assets and a floating charge over those agricultural assets not caught by the fixed charge (the Agricultural Assets)
- Third, the Bank and the Junior Creditor entered into a priorities agreement under the terms of which the Bank held realisations by it on trust for the Junior Creditor in respect of advances made by her to the partnership, after discharge of the Bank's costs and enforcement.

Subsequently, the partnership granted further security and personal guarantees to the Bank, and received further lending from the Junior Creditor, but those were not material to the application.

The partnership went into administration in 2013, and in 2014 the Bank sold the Non-Agricultural Assets. The proceeds of those Non-Agricultural Assets were sufficient to discharge all of the Bank's lending and the majority of the Junior Creditor's lending. Because the Bank had not needed to rely on its security over the Agricultural Assets, the administrators sold those partnership assets and realised approximately £276,000. The principal question arising on the application was whether the proceeds of the Agricultural Assets fell into the general assets of the partnership available to unsecured creditors (including the Junior Creditor) or whether those proceeds should be used, in the first place, to satisfy the Junior Creditor's secured indebtedness, given that the Junior Creditor's security over the Non-Agricultural Assets caught nothing on account of the Bank having sold those assets and met its indebtedness from them in full.

What were the issues raised in the case?

There were two main issues. First, whether the doctrine of marshalling applied in favour of the Junior Creditor as regards the proceeds of the Agricultural Assets in the hands of the administrators. Second, whether the trustees in bankruptcy of the individual partners had a claim on those proceeds by operation of the doctrine of subrogation.

Issue 1—did the doctrine of marshalling apply in favour of the Junior Creditor as regards the Bank's agricultural charge, and if so, why?

At para [17], Norris J referred to the summary of the equitable doctrine of marshalling by Lewison LJ in *Highbury Pension Fund Management Co and another v Zirfin Investments Ltd and others* [2014] Ch 359 at para [1] in the following terms:

'In its classic form it applies where two creditors are owed debts by the same debtor, one of whom can enforce his claim against more than one security but the other can resort to only one. In those circumstances, the principle gives the second creditor a right in equity to require that the first creditor be treated as having satisfied itself as far as possible out of the security to which the latter has no claim.'

As Lewison LJ had pointed out in *Highbury* at para [18], 'It is the fact that [the doubly secured creditor] has the choice which fund to resort to and the power at law to disappoint the singly secured creditor which brings the equity into play'. By reference to Lewison LJ's characterisation, Norris J observed at para [18] that the principle of marshalling would apply to the circumstances as between the Bank and the Junior Creditor because the Bank had chosen to look to the Non-Agricultural Assets exclusively without resort to the assets secured by the agricultural charge.

The objection raised by the trustees in bankruptcy was that the nature of an agricultural charge under ACA 1928 is such that it cannot be the subject of the doctrine of marshalling. Although the trustees accepted that there is nothing in ACA 1928 (at least in express terms) which forbids the application of the doctrine of marshalling, they argued two points. First, an agricultural charge can only be created by 'a bank' (as defined) such that, because the Junior Creditor was not a bank and could not have created such a security, she was not entitled to benefit from it under the principle of marshalling. Second, an agricultural charge is a special sort of security where the identity of the party entitled to enforce it (ie a bank, as defined) is of particular importance, such that the Junior Creditor should not be treated as if she were able to enforce it. Norris J rejected both points on four grounds. First, although the ACA 1928 authorises the creation of a security in favour of a 'bank', it does not provide that such a security is not assignable by a bank to a person or entity that is not a bank. There was no basis for reading in such a limitation. On the contrary, Norris J observed that clause 12 of the agricultural charge actually provided that the term 'the Bank' included 'persons deriving title under the Bank'. As the judge put it at para [24], 'If the security is assignable why cannot it be marshalled?'

Second, given that the principle of marshalling fastens on the conduct and conscience of the doubly-secured creditor (as identified by Lewison LJ in *Highbury*), and the equity it creates arises between the two creditors (not between the creditor and the debtor), there was nothing in the relationship between the Bank and the Junior Creditor that militated against marshalling. On the contrary, the priority agreement between the Bank and the Junior Creditor was entirely consistent with marshalling in that the Bank had agreed to hold realisations on trust to distribute them in a particular way, and for the benefit of the Junior Creditor.

Third, the principle of marshalling is not identical with the doctrine of subrogation. Although Lewison LJ had explained in *Highbury* that the principle of marshalling is that the second mortgagee 'is entitled to stand pro tanto in the place of the first mortgagee', his lordship had gone on to identify that, 'It is in this sense that we say that the second mortgagee is in effect subrogated to the rights of the first mortgagee'. But this is a useful turn of phrase, and no more; the language does not dictate that the principle of marshalling and the doctrine of subrogation are identical. As Norris J put it at para [26], 'The imagery must not distort the reality'.

Fourth, although the trustees had argued that the ACA 1928 was intended to protect against the risks of unscrupulous lenders, the theoretical risk postulated by the trustees did not in fact exist in the present case. Perhaps more importantly, the Junior Creditor was not enforcing or seeking to enforce the agricultural charge. Rather, she was simply saying that because of an equity that existed between herself and the Bank, she was entitled to claim the surplus proceeds receivable by the Bank from the sales effected by the administrators of the partnership. Properly analysed, that amounted to no more than an accounting exercise, and not enforcement. As a consequence, the Junior Creditor was entitled to claim the proceeds of the assets subject to the agricultural charge by the application of the principle of marshalling, and was entitled to prove as an unsecured creditor in the administration for any shortfall.

Issue 2—were the trustees in bankruptcy of the individual partners entitled to claim in the administration of the partnership by operation of the doctrine of subrogation?

The trustees' case was that the Non-Agricultural Assets—which belonged to the partners personally and should, therefore, have been available to satisfy the claims of the partners' personal unsecured creditors—were used to satisfy the claims of creditors of the partnership. Whose claims, the trustees argue, ought to have satisfied out of the assets of the partnership, and the partnership only, with the consequence that the creditors of the partnership were unjustly enriched at the expense of the creditors of the partners—an injustice that was capable of correction, the trustees argue, through the operation of the doctrine of subrogation.

Norris J rejected the trustees' submissions (which relied only on subrogation, and not on the principle of marshalling, in seeking what was labelled 'restitutionary subrogation by operation of law'). In asserting that the creditors of the individual partners could be subrogated to the Bank's rights under the personal covenant for repayment of the Bank's debt, the trustees were, in substance, arguing that the partners themselves could compete with the creditors of the insolvent partnership.

By reference to the judgments of both Romer J at first instance (*Re Ritson* [1898] 1 Ch 667 at para [670]) and Lindley MR on appeal (*Re Ritson* [1899] 1 Ch 128 at para [131]) that argument went against established principles because the proposition relied upon by the trustees—that joint debts are payable out of joint assets if sufficient even though secured on the separate property of one partner—could not arise where the joint assets were not sufficient (as in the present case) to pay joint debts. Norris J pointed to the rules for distribution in the Insolvent Partnerships Order 1994, SI 1994/2142 and their application. That is, where a partnership's joint estate is insufficient to pay its joint debts, the deficiency is to be claimed from the estate of each of the partners. It was not open to the trustees to argue that the partnership's unsecured creditors had been 'enriched' by the Bank's reliance on its security over the Non-Agricultural Assets, rather than the partnership assets secured by the agricultural charge, because any such enrichment could not have been at the expense of the partners, or the trustees claiming through them. The point is analysed at paras [35] and [36].

Furthermore, neither could any enrichment at the expense of the partners properly be described as 'unjust'. As Norris J put it at para [38]:

'The Partners covenanted to pay the Bank and secure their promise by charges over the [Non-Agricultural Assets]. The Bank called on that security when the partners did not perform their promise to pay. There is no injustice to the partners in that. The partners simply cannot say: "You satisfied your claim against us out of some of our assets rather than others; so we want to be subrogated to your claim against ourselves under our personal covenant to pay".'

Further, at para [39]:

'Nor can there be any injustice to persons claiming through the partners, such as creditors. Such creditors can be in no better a position than the Partners themselves, whose entire assets were always available to satisfy creditors of the partnership…The exercise by the Bank of the rights so granted [by way of the security over the Non-Agricultural Assets] cannot constitute unjust enrichment at the expense of the Partners or those claiming through them.'

Costs

In dealing with the costs of the application, perhaps unsurprisingly the administrators were allowed their costs of the application as an expense of the administration of the partnership. Norris J was not, however, prepared to allow the trustees their costs as an expense in the administration. Having regard to the analysis of the proper incidence of costs in adversarial insolvency litigation undertaken by Briggs J (as he then was) in *Re Lehman Brothers International (Europe) (in administration)* [2010] EWHC 3044 (Ch), [2010] All ER (D) 278 (Nov) which considered the views expressed by Henderson J (as he then was) in *Kostic v Chaplin and others* [2007] EWHC 2909 (Ch), Norris J took the view that the administrators' application had involved, in substance, a fight between the Junior Creditor, on the one hand and, on the other, the trustees in bankruptcy of the individual partners. Whatever light had been brought to bear on the legal position, there was no justification from detracting from the general rule in CPR r 44.3(2) that the unsuccessful party pays the costs of the successful party. Neither was there any supposed general principle that the partnership estate should bear the costs of that fight. Accordingly, the trustees were ordered to pay personally (subject to their entitlement to recoup such liability from the bankruptcy estates) the Junior Creditor's costs of the application

Why is the case important?

Norris J's judgment provides for a better understanding of the principle of marshalling, as analysed most recently in the Court of Appeal in *Highbury*, and in understanding the nature and negotiability of security created under ACA 1928. The approach to costs through the application of the approach espoused by Briggs J in *Lehman Bros* is also instructive.

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Interviewed by Alex Heshmaty.

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