

A hierarchy of creditors

Studying trust subordination and trust charge, Peter McMaster QC explains the differences and why they matter



Peter McMaster QC is a barrister at Serle Court

“Trust subordination” or “turnover subordination”, as it is sometimes called, is simply a technique for subordinating debt. Trust subordination is an arrangement whereby the junior creditor agrees to hold on trust for the senior creditor dividends or other payments received in respect of his own debt in an amount up or equal to the unpaid senior debt.’

Welcome to the world of debt subordination. For the uninitiated, a debt is said to be subordinated when arrangements have been made that mean that the creditor to whom the subordinated debt is owed has to permit other creditors to receive payment in full from the debtor before it receives anything. Obviously this has important consequences where the debtor’s assets are insufficient to meet all of its liabilities. Imagine the simplified case of a debtor (D) with two ordinary unsecured creditors (C1 and C2), where D’s total assets are £100,000 and he owes £60,000 to C1 and £60,000 to C2. D’s assets are five-sixths of his liabilities and C1 and C2 will each receive £50,000 from him. If, however, C2 is subordinated to C1 then C1 will be paid in full, leaving only £40,000 available to discharge D’s indebtedness to C2. Lenders and loans are ‘senior’ or ‘junior’ according to their place in the subordination hierarchy.

Significance

Debt subordination plays an important role in modern finance. To take but one example, consider mezzanine finance. This is borrowing that is subordinated to conventional lending. It is often used where a corporate borrower has reached the limit of what it can borrow from senior lenders (such as a bank or finance house) but has a cash flow that will allow it to service further debt. In an appropriate case mezzanine lenders will, in consideration of an enhanced return on the loan, provide lending on a subordinated basis. The enhanced return will take the form of a high rate of interest, to which equity and other enhancements may be added. Because the debt is subordinated it is akin to fresh capital from the perspective

of the senior lender – the lending is unsecured and does not interfere with the repayment of the senior debt.

From one point of view, debt subordination involves displacing the normal *pari passu* distribution of assets on insolvency, making assets that would have been available for all creditors available only to some, infringing the ‘anti-deprivation rule’ (see the House of Lords decision in *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] for the rule). If subordinated debt infringed the anti-deprivation rule, the subordination would be unenforceable, but the courts have consistently upheld subordination arrangements (see *Re British & Commonwealth Holdings plc (no 3)* [1992], *Re Maxwell Communications Corporation plc* [1993] and *Re SSSL Realisations Ltd* [2004]). The modern approach is to confine the anti-deprivation rule, as exemplified in this statement by Lord Neuberger in *Perpetual Trustee Co Ltd & anor v BNY Corporate Trustee Services Ltd & ors; Butters & ors v BBC Worldwide Ltd & ors* [2009]:

Fifthly, it is important that, so far as possible, judicial decisions in the insolvency field ensure that the law is clear and consistent. That has always been true, but the need for consistency and clarity is all the greater now that commercial contracts are becoming increasingly complex both in their underlying nature and in their detailed provisions, as is well demonstrated by the contracts in the instant cases, especially in the *Perpetual* appeal. It is also desirable that, if possible, the courts give effect to contractual terms which parties have agreed. Indeed, there is a particularly strong case for

party autonomy in cases of complex financial instruments such as those involved in the *Perpetual* appeal and in arrangements involving large corporate groups, such as those who signed the

senior debt. *Re SSSL* is an example from the authorities. *Re SSSL* was a case of debt subordination arising from the collapse of the Save group, who were petrol retailers. Three parties

be provided to Customs and Excise to secure the ultimate payment of duty. This was where AIG came in to the picture. AIG provided the bond in exchange for an indemnity on the terms of a deed made with six members of the Save group, including Group and Stations.

The key feature of the deed for present purposes was a subordination and turnover agreement by which the members of the Save group agreed to subordinate intercompany debt to debts owed to AIG under the bond. The purpose was to ensure that in any scramble for assets AIG got paid first and did not have its claim diluted by ranking *pari passu* with intercompany creditors.

The relevant provisions were as follows:

8.2 Until all amounts which may be or become payable by the Indemnitors [the members of the Save group] to the Surety under this deed have been irrevocably paid in full no Indemnitor shall after a claim has been made by the Surety hereunder or by virtue of any payment made by it under this deed:

[...]

- (b) claim rank prove or vote as a creditor of any Indemnitor or its estate in competition with the Surety; or
- (c) receive, claim or have the benefit of any payment distribution or security from or on account of any Indemnitor or exercise any right of set-off as against any Indemnitor.

Thus the group companies agreed with AIG that their resources would be applied to paying AIG what it was owed under the terms of the bond before being applied in satisfaction of their liabilities *inter se*. This was backed by the trust subordination:

8.3 Each Indemnitor shall hold in trust for and forthwith pay or transfer to the Surety:

- (a) any payment distribution benefit or security received by it contrary to clause 8.2.

Clause 8.2 is a contractual subordination, whereas clause 8.3 is a trust subordination, which only

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agreements in the *Butters* appeal; in such cases, the parties are likely to have been commercially sophisticated and expertly advised.

Trust subordination

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were involved in the subordination arrangement: Save Group Plc (Group), Save Service Stations Ltd (Stations) and AIG Europe (UK) Ltd (AIG). Group bought petrol and related products from suppliers, and sold it to Stations, which retailed it. Group was also in charge of bank borrowing for the whole Save group, and lent money to subsidiaries for trading purposes. There was substantial intercompany indebtedness.

The supply of petrol entailed a liability to pay duty to HM Customs and Excise, which had been deferred. The deferral was on terms that a bond

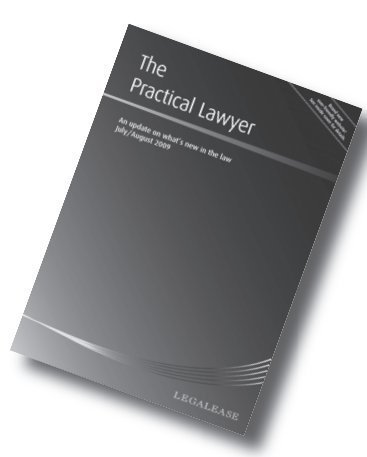
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comes into play where the contractual subordination has not been respected.

Trust charges

A trust charge is an equitable charge created when a person declares that they hold particular assets in trust for a creditor as security for payment of a particular debt. The dual nature of the legal arrangement as both a trust and a charge was explained by Slade J (as he then was) in *Re Bond Worth Ltd* [1980]:

Thus in my judgment, in principle, subject to the provisions of the Bills of Sale Acts, a person may create an effective equitable charge over chattels by declaring that he holds them in trust for a creditor by way of security for the payment of a specified debt. Likewise he can for good consideration create an effective equitable charge over chattels of a specified category to be acquired by him in the future, or over future book debts, in such manner that the charge will attach to chattels when acquired, or to the book debts when they arise. All these things can in my judgment be done by the chargor declaring himself a trustee of the relevant assets for the purposes of the security: compare *In re Yorkshire Woolcombers Association Ltd* [1903] per Farwell J.

Re Bond Worth was about a retention of title clause and Slade J concluded that:

... the effect, if any, of the retention of title clause when properly construed... is a declaration of trust by Bond Worth in respect of the relevant assets by way of equitable charge to secure repayment of the moneys from time to time owing in respect of the relevant order.

As is well known, charges over book debts present potential problems of registration under s860 of the Companies Act 2006. Although a trust subordination arrangement has some of the features of a charge – in particular it is designed to create a fund out of which the senior creditor's debt can be paid – trust subordination and trust charges are distinct and, provided that the trust subordination clause is properly drafted, s860 of the Companies Act 2006 can be avoided.

Distinction between trust subordination and trust charge

The distinguishing feature of a charge is that it is a right to have recourse to property by way of security. The person with the benefit of the charge has no beneficial interest in the property charged, merely rights to have it applied in a certain way. Thus it is a commonplace that what distinguishes a mortgage from a charge is that whereas

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a mortgage is a conveyance of property subject to a right of redemption, a charge merely gives the chargee certain rights over the charged property as security for the loan.

Trust subordination involves the junior debtor undertaking to hold on trust for the senior debtor payments received in respect of the junior debt. Provided that the trust attaches only to payments up to the amount of the senior debt, all of the relevant sums will be beneficially owned by the senior debtor. This means that the trust is not by way of security for the senior debt, but simply gives effect to the agreement that payments are applied first to discharging the senior debt. If the trust is not limited to the amount of the senior debt, it risks becoming a trust by way of charge. This is because where the sums subject to the trust can exceed the senior debt, the senior debtor is not beneficially interested in the whole fund, but is merely entitled to insist on its being applied in a certain way.

This issue was considered by Lloyd J in *Re SSSL*. The first submission addressed to him was that the contractual subordination at clause 8.2 created a charge, which he rejected because it clearly did not create any proprietary right (paragraph 50), pointing out:

The fact that it achieves a result which is, in some respects, similar to that which would be achieved by a charge is of course relevant, but it cannot be characterised as a charge merely because the effects are in some ways similar. The document must be examined

and analysed and its true legal nature ascertained: see *Re Bond Worth Ltd* [1980], *Welsh Development Agency v Export Finance Co Ltd* [1992].

Regarding clause 8.3, which did create a proprietary right in favour of AIG, it was common ground that it would only constitute a charge if applied to all receipts rather than being confined, as a matter of construction, to

sums up to what was owed to AIG. The judge construed the clause as applying only to receipts up to the amount owed to AIG, so it did not create a charge.

Summary

Trust subordination is a tool for ensuring that sums that the parties have agreed should be applied to discharge senior debt are held on trust for the senior debtor. A trust charge is a trust of an asset by way of security for a particular debt.

Trust subordination clauses can and should be drafted so that it is clear that the sums held on trust are only those amounts necessary to discharge the senior debt. ■

Re Bond Worth Ltd
[1980] 1 Ch 228

Re British & Commonwealth Holdings plc (no 3)
[1992] 1 WLR 672

British Eagle International Airlines Ltd v Compagnie Nationale Air France
[1975] 1 WLR 758

Re Maxwell Communications Corporation plc
[1993] 1 WLR 1402

Perpetual Trustee Co Ltd & anor v BNY Corporate Trustee Services Ltd & ors; Butters & ors v BBC Worldwide Ltd & ors
[2009] EWCA Civ 1160

Re SSSL Realisations Ltd
[2004] EWHC 1760 (Ch)

Welsh Development Agency v Export Finance Co Ltd
[1992] BCLC 148

In re Yorkshire Woolcombers Association Ltd
[1903] 2 Ch 284