Neutral Citation Number: [2019] EWHC 1581 (Ch)

Case No: CH-2018-000338 & CH-2018-000339

**IN THE HIGH COURT OF JUSTICE**
**CHANCERY DIVISION**

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 20/06/2019

**Before** :

**THE HONOURABLE MR JUSTICE ZACAROLI**

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**Between :**

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| **Promontoria (Chestnut) Limited** | **Appellant** |
| **- and –** | |
| **(1) Charles Phelan Bell**<br>**(2) Angela Bell** | **Respondents** |

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**Jamie Riley QC** (instructed by **Addleshaw Goddard LLP**) for the **Appellant**
**Simon Hill** (instructed by **Direct Access**) for the **Respondents**

Hearing dates: 16 May 2019

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# Approved Judgment

I direct that pursuant to CPR PD 39A para 6.1 no official shorthand note shall be taken of this Judgment and that copies of this version as handed down may be treated as authentic.

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MR JUSTICE ZACAROLI

**Mr Justice Zacaroli:**

1. This is an appeal brought with the permission of Arnold J dated 18 January 2019 against the orders of Deputy Insolvency and Companies Court Judge Prentis (as he then was) dated 3 December 2018. By those orders the deputy judge set aside statutory demands served under s.268 Insolvency Act 1986 ("IA 1986") by the appellant, Promontoria (Chestnut) Limited (the "Creditor") against the respondents, Mr Charles Bell and Mrs Angela Bell ("Mr and Mrs Bell").

2. It is common ground that the Insolvency Rules 1986 ("IR 1986") continue to apply to this matter, notwithstanding the enactment of the Insolvency Rules 2016.

# The facts

3. Mr and Mrs Bell were directors and shareholders of a company called 34 Julian Road Dev Limited (the "Company"). Pursuant to a facility letter dated 22 December 2011, Clydesdale bank (the "Bank") advanced facilities to the Company (being a refinancing of earlier lending) in a sum not exceeding £783,000. The loans were due to be repaid in full on or before the final maturity date of 5 January 2014.

4. Mr and Mrs Bell had entered into a personal guarantee, dated 6 April 2009, in respect of the Company's present and future borrowing from the Bank, up to a limit of £170,000. The guarantee imposed secondary liability for the debts of the Company, although it included an indemnity if the Company's liabilities could not be recovered for any reason from Mr and Mrs Bell as guarantors. The guarantee contained standard provisions to the effect that the Bank could release or deal with any security or guarantee held by it without affecting the guarantors' liability, and that the guarantee was in addition to and was not affected by any other security held by the Bank in relation to the Company's liabilities.

5. In addition, on 29 July 2009 Mr Bell executed a third-party mortgage over a property owned by him, and Mr and Mrs Bell executed a third-party mortgage over a property owned jointly by them, in both cases to secure the Company's lending to the Bank. Each of the mortgages contained a clause negating any personal liability on the part of the mortgagor to pay to the Bank any of the Company's liabilities. The Bank's lending to the Company was also secured over property of the Company.

6. By a deed of assignment dated 28 November 2014 the Creditor acquired the Bank's rights under the facility, the guarantee and the mortgages.

7. The Company had not repaid the facilities by 5 January 2014. On 19 March 2015 the Creditor demanded repayment from the Company in the sum of £597,699.77. The Company failed to pay and on 8 April 2015 the Creditor sent letters of demand to each of Mr and Mrs Bell under the guarantee.

8. On 24 March 2015 the Creditor appointed receivers over the Company's property. On 14 April 2015 the Creditor appointed receivers over the properties owned by Mr and Mrs Bell. By December 2016 the receivers had realised assets of the Company so as to reduce the outstanding balance on the facilities to £185,000 odd.

9. On 5 January 2017 the Creditor issued demand letters to Mr and Mrs Bell demanding payment of £170,000 under the guarantee. In the absence of payment, the Creditor served the statutory demands against Mr and Mrs Bell dated 10 February 2017.

10. Mr and Mrs Bell applied to set aside the statutory demands. Numerous grounds of objection were advanced, but at the hearing before the deputy Judge only one was pursued, namely that the Creditor held security over their property.

# The Statutory provisions

11. The rights of secured creditors in the bankruptcy of a debtor are relevant at, at least, three stages: the statutory demand, the petition and the proof of debt.

## Statutory demand

12. Rule 6.5(4)(c) of IR 1986 entitles the court to set aside a statutory demand if "it appears that the creditor holds some security in respect of the debt claimed in the demand, and either rule 6.1(5) is not complied with in respect of it, or the court is satisfied that the value of the security equals or exceeds the full amount of the debt".

13. Rule 6.1(5) provides that if a creditor holds security for the debt then there shall be specified in the statutory demand the nature of the security and the value which the creditor puts upon it as at the date of the demand. The amount which may be claimed is then the full amount of the debt less the amount specified as the value of the security.

## Bankruptcy petition

14. By s.267(2)(b) of the Insolvency Act 1986 ("IA 1986"), subject to s.269, a creditor's petition can be presented in respect of a debt only if the debt is unsecured.

15. By s.269 IA 1986, a debt upon which a bankruptcy petition is presented need not be unsecured only if the petition contains a statement that the petitioner is willing, if a bankruptcy order is made, to give up the security for the benefit of the bankrupt's estate or the petition is expressed not to be made in respect of the secured part of the debt and contains a statement by the person of the estimated value as at the date of the petition of the security for the secured part of the debt.

16. By s.383, a debt is secured "to the extent that the person to whom the debt is owed holds any security for the debt (whether a mortgage, charge, lien or other security) over any property of the person by whom the debt is owed." By s.385(1), "secured" and related expressions are to be construed in accordance with s.383.

## Proof of debt

17. A secured creditor is entitled to prove only in respect of the unsecured part (if any) of the debt. By Rule 6.98 of IR 1986, the proof of debt must give particulars of any security held, and the value which the creditor puts upon it. Failure to do so will result in the security being surrendered for the general benefit of creditors (Rule 6.116) unless the court grants relief from the effect of the rule.

## The underlying principle

18. Those Rules reflect a long-standing principle in bankruptcy that secured creditors can only participate in the bankruptcy to the extent of any unsecured part of their debt unless they are willing to give up their security for the benefit of the general body of creditors: see *White v Davenham Trust Ltd* [2011] EWCA Civ 747 where, at [36], Lloyd LJ referred to the following authorities which explain the rationale for this principle.

19. First, in *Re Plummer* (1841) 1 Ph 56, 59, Lord Lyndurst said:

> "For the principle of the bankrupt laws is, that all creditors are to be put on an equal footing, and, therefore, if a creditor chooses to prove under the commission, he must sell or surrender whatever property he holds belonging to the bankrupt."

20. Second, in *Ex p West Riding Union Banking Co* (1881) 19 Ch D 105, Jessel MR said:

> "The principles of the bankruptcy law are plain enough. A man is not allowed to prove against a bankrupt's estate and to retain a security which, if given up, would go to augment the estate against which he proves. That is the principle of the whole thing. The only question is whether, if the security were given up, it would augment the estate?"

21. In *Davenham v White* itself, Lloyd LJ said, at [9] (having referred to the statutory prohibitions on a secured creditor presenting a petition for bankruptcy, and the two exceptions contained in s.269 IA 1986):

> "Lying behind these arrangements is the fact that bankruptcy proceedings are not intended as a means for a single creditor to enforce his debt against the debtor but rather as a method of collective realisation of the assets of a debtor who cannot pay his debts, to be distributed for the benefit of all creditors with claims on those assets. A creditor who is fully secured over assets of that debtor does not need to take bankruptcy proceedings, and should not do so, unless he is willing to give up the security, because the asset over which the security exists will not be part of the estate divisible for the benefit of the creditors generally. That is why a secured creditor cannot present a bankruptcy petition under section 267(2)(b) unless either he is willing to give up the security or his security is not adequate to cover the whole debt, in which case he ranks with the other unsecured creditors but only so far as the shortfall is concerned."

22. In interpreting the Insolvency Rules referred to above, it is necessary to have regard to the fact that their purpose is to give effect to that underlying principle.

# The judgment of the deputy Judge

23. The Creditor argued before the deputy judge that the security, in the form of third-party charges, was held in respect of the Company's indebtedness and not that of Mr and Mrs Bell. There was therefore no security for the debt claimed in the statutory demands. Moreover by reason of the terms of the guarantee there was no obligation on the Creditor to enforce the legal charges first as opposed to pursuing Mr and Mrs Bell under the guarantee.

24. The deputy Judge rejected that submission, holding that the Creditor had "some security in respect of the debt claimed by the demand" within Rule 6.5(4)(c) IR 1986. Accordingly, he set aside the statutory demand on the basis that Rule 6.1(5) had not been complied with.

25. He reasoned that the underlying purpose of the provisions precluding secured creditors from initiating bankruptcy proceedings in reliance on a secured debt was to prevent the process being initiated by creditors who have no interest in the outcome, citing *White v Davenham*, above. He noted that the exclusion of secured creditors permeated the scheme of the bankruptcy legislation. Moreover, he noted that if the Creditor's argument was correct, then it would mean that the Creditor could prove in the bankruptcy of Mr and Mrs Bell and in the liquidation of the Company in full, without its security over Mr and Mrs Bells' property being taken into account in either.

# A preliminary issue

26. A preliminary question is whether "security in respect of the debt" in Rule 6.1(5) and Rule 6.5(4)(c) is to be given a different meaning to the phrase "security for the debt" in s.383 IA 1986.

27. Mr Riley QC, who appeared for the Creditor, submitted that the two phrases have the same meaning, the point having been determined by Knox J in *Re a Debtor (No. 310 of 1988)* [1989] 1 WLR 452. In that case, the debtor had entered into a guarantee in favour of the creditor in respect of the debts of a company. The company had assigned to the bank by way of security claims against the Export Credit Guarantee Department. The debtor argued that the creditor had security in respect of the debt within the meaning of Rule 6.1(5), although it was accepted that it was not security for the purposes of the provisions relating to the bankruptcy petition (because it was security over the property of a third party). Knox J rejected the argument. At p.455D-G he said:

> "It seems to me that one has to read the Insolvency Rules 1986 in the context of the requirements of the Insolvency Act 1986, and it does seem to me to follow that the word "security" and the conception of an "unsecured" debt all hold together, and that the requirement that value should be placed upon a security, and that the amount to be claimed shall be the amount less the amount specified as the value of the security, is closely tied to the way in which the grounds for a creditor's petition are set out in section 267(2). It seems to me, therefore, that

> although the turn of phrase is not exactly the same, and although the definition is in the Act and not in the rules, the two ought to be read so that they mesh together and operate hand in hand."

28. While that was said in the context of an argument that security provided by a third party fell outside Rule 6.5(4)(c) (as opposed to whether security provided by a debtor/guarantor, but in respect of a debt owed to the creditor by the principal debtor fell outside the Rule), Knox J's reasoning is in my judgment of general application. Since the service of a statutory demand is a precursor to a bankruptcy petition, and the bankruptcy petition is intended to lead to a regime where creditors can prove their debts, it is logical that the definition of secured creditors should be the same at each stage.

## The arguments on this appeal

29. Mr Riley QC submitted that the deputy judge failed to distinguish between two different debts: the Company's debt to the creditor (for which the third-part charges were provided as security) and the debt owed by Mr and Mrs Bell under the guarantee. He contended that security only comes within the definition in s.383 IA 1986 if it is security over the property of the debtor *and in respect of the debt owed by the debtor*. He relied on the provisions of the guarantee which demonstrate that the guarantee is additional to and independent of other security (for example the third-party charges) provided to the Bank for the Company's debt. He also relied on the principle (found in, for example, *China and South Seas Bank v Tan* [1990] 1 AC 536) that a creditor can choose the order in which it enforces its different security rights.

30. In *White v Davenham* (above) the debtor was the director of a company whose debts he guaranteed to the creditor. The creditor had security, for the debtor's guarantee liability, over the assets of the company. The debtor argued that the statutory demand served by the creditor should be set aside under Rule 6.5(4)(c), relying on the "co-extensiveness" principle as applied in *Octagon Assets Ltd v Remblance* [2010] Bus LR 119 (CA). In that case, it had been held that where the principal debtor had an arguable cross-claim against the creditor such that a statutory demand against the principal debtor would have been set aside under Rule 6.5(4)(a), then the surety debtor was also entitled to have a statutory demand against him set aside by analogy because his liability should be regarded as co-extensive with that of the principal debtor.

31. The Court of Appeal in *Davenham v White* rejected the argument based on the co-extensiveness principle. Lloyd LJ explained (at [33]-[34]) the justification for sub-paragraph (b) of Rule 6.5(4), which applies where the debt is disputed on substantial grounds, as follows: "if the debt is disputed on apparently substantial grounds the creditor may not use bankruptcy proceedings but must issue civil proceedings in which the dispute as to the debt may be resolved in the proper manner. This would apply whether the debtor's liability is primary or secondary, on the basis that the guarantor of a disputed debt cannot be made liable any more than can the principal debtor until the dispute is resolved." A similar justification lay behind sub-paragraph (a) of Rule 6.5(4), which applies where there is a counterclaim which equals or

exceeds the debt. At [35], Lloyd LJ explained why the justification did not extend to paragraph (c) of Rule 5(4):

> "35. The position under rule 6.5(4)(c) seems to me to be different. It is concerned with regulating the position as regards the debtor's assets and liabilities. The debtor may have no possible defence to a claim on the personal covenant to pay but in terms of bankruptcy proceedings the creditor is not to claim on a personal debt without bringing into account the security or releasing it: see rule 6.1(5) to which I have referred and also rules 6.09 and 6.115 – 119. If however the security which the creditor holds is given not by the particular debtor but by a third party, whoever that third party may be, that security is not over an asset which can have any effect on the bankrupt estate of the particular debtor and it is accordingly irrelevant for the purposes of rule 6.1(5) and correspondingly for the purposes of rule 6.5(4)(c). The case of third-party security is similar to that of security given by the debtor in one respect since the existence of the security is no answer to a personal claim for payment. On the other hand it is different from the case of security given by the debtor because security by a third party is of no relevance to the debtor's estate as such since the asset over which the security exists can never form part of the assets of the particular debtor divisible between his creditors."

32. Mr Riley QC relied on *White v Davenham* to contend that, in the same way that a debtor who owes a secondary liability cannot rely upon security provided by the primary obligor to the creditor in order to invoke Rule 6.5(4)(c), a debtor who owed an unsecured secondary liability cannot rely upon security which he has provided for the primary liabilities owed by the primary obligor.

33. Mr Hill, appearing for Mr and Mrs Bell, contended that the deputy judge was correct, largely for the reasons given in the judgment. He submitted that the personal security (the guarantee) and the real security (the third-party charge) both secured the same thing, each falling due if the primary liability owed by the Company is unpaid.

34. The only authorities cited by the parties which dealt at all with the issue raised by this appeal were *Sofaer v Anglo Irish Asset Finance PLC* [2011] BPIR 1736, a decision of Lewison J, and *Fagg v Rushton* [2007] EWHC 657 (Ch), a decision of Evans-Lombe J.

35. In *Sofaer*, the debtor was guarantor of loans made by the bank to a company of which the debtor was a director. The debtor proposed an individual voluntary arrangement. At the date of the creditors' meeting, the bank held security, for the company's indebtedness, over certain properties owned by the company. Some three months later, the company assigned the equity of redemption in those properties to the debtor. The debtor argued that the bank had security for its claim against him, as a result of the assignment of the equity of redemption in the properties.

36. Lewison J rejected that submission for three reasons. The first was that events subsequent to the meeting could not affect the bank's entitlement to vote. The second

was that the subject matter of the transfer was the equity of redemption in the properties, which is in effect the residual rights of the mortgagor in the mortgaged property after the mortgage has been satisfied. Accordingly, it is not something which is subject to the bank's security at all. He stated the third reason (at [26]) as follows:

> "The further flaw is that, in my judgment, the acquisition of the equity of redemption did not alter the nature of the liabilities that were secured on the properties. If the liabilities secured on the properties were the companies' liabilities rather than Mr Sofaer's (as indeed they were), I do not see how a change of ownership of the property had enlarged the scope of the security."

37. The premise behind this third reason appears to be, therefore, that security over the debtor's property is not "security" within the rule if it is security for a third party's debt.

38. Lewison J noted, at [27], that Evans-Lombe J appeared to have come to a different conclusion in *Fagg v Rushton* [2007] EWHC 657 (Ch), but he was unable to discern the principle upon which Evans-Lombe J had reached that conclusion and declined to follow him.

39. The facts in *Fagg v Rushton* were similar, in that a statutory demand had been presented against a debtor, who had guaranteed the company's debts, by a creditor with security over the company's property. The company had assigned its equity of redemption in that property to the debtor. The creditor submitted that because the security was security for the indebtedness of the company it was not security for the purposes of s.383(2) IA 1986, but Evans-Lombe J said (at 10]):

> "I asked counsel for the Appellant whether there was any authority which would lead inevitably to that conclusion. It is a conclusion which seems on the face of it to be counter-intuitive of the purpose of rule 6.5, which is that a debtor is entitled to take advantage of the value of any security over his property in the calculation of the sum for which a statutory demand can be served on him. Undoubtedly, the value of this security, albeit given by the company over a debt which he has guaranteed, would inure to his benefit in the event that he had applied the whole of the £170,000 which he had available to him so that if the entirety of the £200,000 had been paid he would have been entitled to be subrogated to that security as against the company and to have recouped himself from the company's assets pro tanto."

40. Evans-Lombe J's conclusion that the security fell within s.383(2) was therefore based on the fact that the debtor would, in the event that the whole of the company's debt had been repaid, have been subrogated to the security as against the company. It was not part of his reasoning that the security was over the debtor's own property (notwithstanding the assignment of the equity of redemption). His conclusion, however, cannot stand in light of the decision of Knox J in *Re a Debtor* (No. 310 of

1988) and the decision of the Court of Appeal in *White v Davenham* (see above for both).

# Conclusion

41. In my judgment, the deputy judge was correct to conclude that the third-party charges provided by Mr and Mrs Bell for the indebtedness of the Company to the Creditor are security in respect of the debt upon which the statutory demands were based, within the meaning of Rule 6.5(4)(c) of IR 1986 interpreted in accordance with its underlying rationale and purpose. (It follows, as explained above, that they are also security "for" the debt under s.383 IA 1986).

42. In explaining why that is so it is helpful first to consider the case where the liability of the guarantor to the creditor is co-extensive (in terms of amount) with the liability of the principal debtor, before considering whether any different conclusion is mandated by the fact that the guarantor's debt is capped at an amount less than the full amount of the principal debtor's debt to the creditor. (In this case, at the time of the statutory demands the Company's debt exceeded the limit on the guarantee but, by virtue of further realisations having been made from the security over the Company's assets, that is no longer the case.)

43. My conclusion is based mainly upon the fact that the rationale and purpose of the Rules, including Rule 6.5(4)(c), which require a secured creditor to give up its security if it wishes to participate in the bankruptcy apply just as much in the present case as they do in the plain case where a debtor provides security over her assets to the creditor in respect of the debt owed by her to the creditor.

44. As explained in paragraphs 18 to 22 above, the rationale is that all proving creditors stand on an equal footing as regards the assets in the bankruptcy estate, and to allow the secured creditor to prove, whilst retaining its security, would place it in a preferential position. That is because it would be proving for the full amount of its debt in competition with all other creditors against the bankruptcy estate, where that estate was depleted because of the exclusion of the property over which it holds security for the debt. This explains why the sole question (per Jessel MR in *West Riding Union Banking Co*) is whether, if the creditor were to give up the security, it would augment the estate for the benefit of all creditors.

45. In this case, as Mr Riley QC rightly accepted, the receipt by the Creditor of the proceeds of realisation of the charges would result in a discharge, pro rata, of the guarantee liability. Although there are two different debts – one owed by Mr and Mrs Bell and one owed by the Company, both forms of security (in the broad sense) provided by Mr and Mrs Bell are rooted in the same debt: each of them has both guaranteed, and provided a third-party charge for, the Company's debt.

46. It is for this reason that the rationale and purpose referred to above are equally applicable in the circumstances of this case. On the assumption that the guarantee given by Mr and Mrs Bell is of the whole of the Company's debt, then it can clearly be seen, answering the question posed by Jessel MR, that if the security of the Creditor was given up it would augment the bankruptcy estate of Mr and Mrs Bell. For every £1 of value of the secured property released from the security, £1 is available for distribution among unsecured creditors in the bankruptcy estate.

47. Conversely, adopting the language of Lloyd LJ in *Davenham v White*, the asset over which the security exists will not be part of the estate divisible for the benefit of the creditors generally, unless the Creditor gives up its security.

48. The very fact that recourse to the security over Mr and Mrs Bell's property would discharge the personal debt owed by Mr and Mrs Bell is a powerful indication that the third-party charges are security "for" or "in respect of" the debt.

49. Although my conclusion is contrary to the third of the reasons justifying Lewison J's conclusion in *Sofaer*, I do not regard myself as bound by that conclusion in circumstances where (1) it was not necessary for his decision in light of his conclusions on the first two grounds for his decision, (2) no argument was addressed to him on the underlying rationale of the relevant statutory provisions and (3) no authority identifying that rationale was cited to him.

50. As to Mr Riley's arguments that the Creditor is entitled to choose in which order to enforce its securities and that the provisions of the guarantee indicate that it is additional to other securities provided to the Creditor, these factors do not override, in my judgment, the mandatory rule in bankruptcy embodied, among other places, in Rule 6.5(4)(c).

51. Turning to the position where, as existed in this case at the time of the statutory demands, the liability under the guarantee is less than the amount of the Company's debt, the same analysis is appropriate, subject to one change – namely that because the Creditor is free to appropriate its security to the principal debt in such manner as it sees fit, it would be entitled to participate in the bankruptcy of Mr and Mrs Bell to the extent of the shortfall between the debt owed by the Company and the value of the security over the guarantor's property. This is best explained by three worked examples.

52. First, if the Company's debt was £200,000, the guarantee was capped at £100,000 and the property of Mr and Mrs Bell over which the security was granted was worth £100,000, then the Creditor would be entitled to appropriate the entirety of its security to that part of the principal debt which was not covered by the guarantee and thus participate in the bankruptcy in respect of the full amount of the guarantee debt.

53. Second, if the Company's debt was £150,000, the guarantee was capped at £100,000 and the property of Mr and Mrs Bell was worth £100,000, then even if the Creditor appropriated the security first to that part of the Company's debt which was not covered by the guarantee, that would still leave £50,000 worth of security for the remaining (guaranteed) part. Accordingly, the Creditor would be required to value the security in respect of the guarantee debt in an amount equal to half of the debt, being free to prove for the other half.

54. Third, if the Company's debt was £150,000, the guarantee was capped at £100,000, but the property of Mr and Mrs Bell was worth £150,000 or more, then, since however the Creditor applied its security to the principal debt the whole of it was secured, it could only participate in the bankruptcy if it gave up its security.

# Disposition

55. For the above reasons, notwithstanding the attractive argument ably presented by Mr Riley QC, I dismiss this appeal.