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Client briefing
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The Kaupthing Case – Playing by the Rules: A Supreme Court win for Bondholders in Icelandic Bank administrations

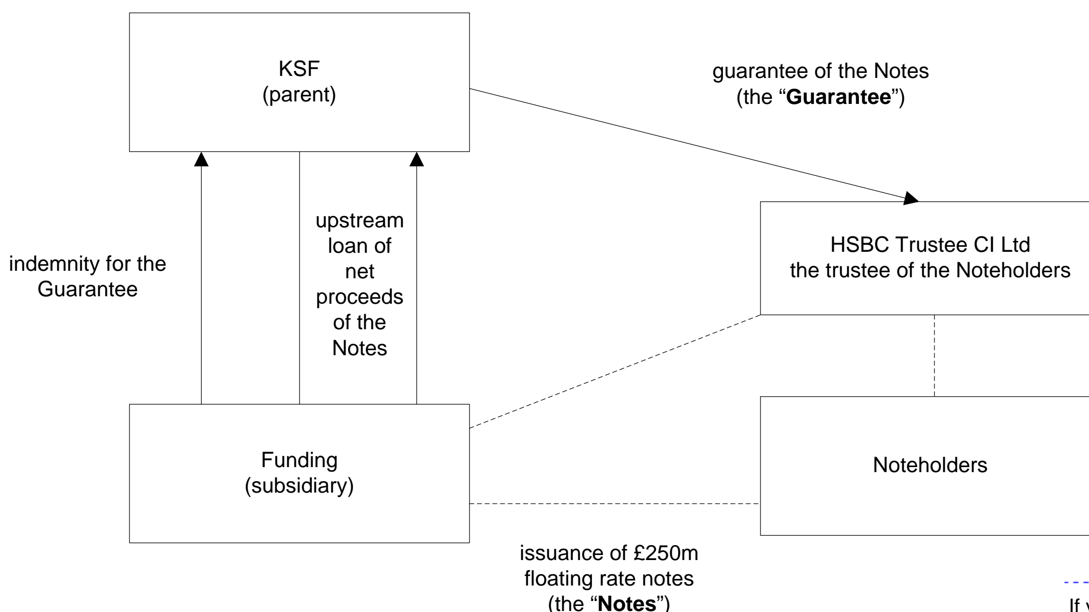
On 19 October the Supreme Court handed down its judgment in the case of Re *Kaupthing Singer and Friedlander Limited (in administration)[2011]* UKSC 48. The appeal was concerned with a long standing principle of insolvency law known as the rule against double proof and has been eagerly awaited since it deals with an important issue in the context of guarantees and recourse to those guarantees when a party becomes insolvent. In this case the guarantor, Kaupthing Singer & Friedlander Limited (KSF) and the principal debtor, Kaupthing & Singer Funding plc (Funding) were both in administration.

Key Issues

Bondholders win!

Guarantees and insolvency

Double proof trumps *Cherry v Boultbee*



If you would like to know more about the subjects covered in this publication or our services, please contact:

Philip Hertz +44 (0)20 7006 1666

Kate Gibbons +44 (0)20 7006 2544

Gabrielle Ruiz +44 (0)20 7006 1615

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

Double or twist?

The rule against double proof prevents a guarantor from proving a claim in relation to its right of indemnity against the principal debtor (in the liquidation of the principal debtor) when the beneficiary of the guarantee is also proving for its primary claim against the principal debtor. This is because it would lead to the payment of a double dividend out of one estate in relation to the same debt. The rule is extended to administration proceedings where the administrators elect to make a distribution. The effect of this rule was critical for the level of potential recoveries to be made by the bondholders in the administration proceedings of KSF and Funding.

Guess who?

The case involved a typical capital markets transaction. KSF formed a wholly owned subsidiary, Funding, which it used as means of raising finance for its operations. Funding had issued £250m of bonds. KSF had guaranteed the notes and in turn it had an indemnity from Funding for the obligations arising under the guarantee. Funding had used the proceeds of the notes to make an unsecured upstream loan to KSF. When KSF went into administration it owed Funding approximately £242m. When Funding went into administration, £240m was due on the bonds and the obligations of Funding (as principal debtor) and KSF (as guarantor) came into immediate effect. The bondholder trustee submitted proofs of debts to the administrators of KSF and Funding in respect of the notes in the sum of £248m. Funding submitted a proof of debt to the administrator of KSF in the sum of £242m in respect of the unsecured loan. KSF's administrators applied to the court for directions as to how to apply distributions in the administration.

At the first instance hearing, the focus was on the whether certain terms in the trust deed between KSF and Funding operated to exclude another equitable rule, the rule in *Cherry v Boultbee*. This is a technique for netting-off reciprocal monetary obligations, even where there is no room for set-off. That rule provides that a person cannot share in an estate if he is also a debtor of that estate without first paying the debt he owes to the estate. Here KSF owed Funding repayment on the original upstream loan but KSF had an indemnity claim against Funding under the trust deed. However, the trust deed contained a non competition clause which expressly provided that KSF could not exercise any rights of subrogation or contribution or remedy or claim any payment from Funding (including in its liquidation) and, in the event that notwithstanding these non competition provisions, payments or distributions were made to KSF, those payments were to be held on trust for the bondholders. If the rule in *Cherry v Boultbee* applied, KSF could utilize its indemnity claim to prevent a claim under the upstream loan – i.e. it could claim that equity prevented Funding claiming from a fund where it owed a contribution – via the indemnity – to that fund. At first instance, it was held that following a binding decision in the Court of Appeal *In Re SSSL Realisations (2002) Ltd [2006] Ch 610*, ("*SSSL*") the rule in *Cherry v Boultbee* was not excluded by the particular terms of the trust deed with the result that the administrators of KSF were able to rely on it and refuse payment on Funding's claim in KSF's administration unless and until KSF's right of indemnity (as a surety) had been satisfied in full.

In other words, although the bondholders could make a claim against both Funding and KSF, Funding would have no funds to pay the claim of the bondholders because – as a result of the rule in *Cherry v Boultbee* – unless and until Funding had satisfied KSF's indemnity claim in full. Funding could not make a claim for the repayment of the original loan made to KSF. As a result, bondholders would be prevented from an effective "double dip" – once under the guarantee and once under the original bonds via Funding's indemnity claim against KSF.

Go directly to Go, and collect £248m!

It was recognized that the first instance case concerned a point of law which was of general public significance, as such, the case was allowed to leapfrog the Court of Appeal and go straight to the Supreme Court.

Interestingly the Supreme Court, did not need to consider whether the non-competition clause contained within the trust deed excluded the rule *Cherry v Boultbee*. Instead it focused upon KSF's right to claim under the indemnity provided by Funding in the context of the rule against double proof in competition with the bondholders' primary claim against Funding. In previous authorities, the rule in *Cherry v Boultbee* suggested a result that would permit (a) KSF's claim against Funding under the indemnity preventing (b) Funding's claim under the original upstream loan in circumstances where the rule against double proof would have prevented KSF making any claim under the indemnity in the first place in competition with the bondholders' claims against Funding. It unanimously held that that the rule in *Cherry v Boultbee* is ousted by the rule against double proof, thereby effectively overruling the comments by the Court of Appeal decision in this respect in SSSL and bringing the application of this rule in line with statutory set-off.

In this case it meant that KSF was prevented from seeking to utilise the indemnity claim under the guarantee to block Funding's claim under the original upstream loan with the result that Funding could claim in full from KSF and the bondholders could benefit from (1) assets coming into the Funding estate as a result of that claim (because, apart from a very small HM Revenue and Customs claim, the bondholders were the major creditor of Funding) and (2) their direct claim against KSF under the guarantee. In other words, bondholders now had a double dip, and could submit proofs of debt to both Funding as principal debtor and KSF as guarantor but could only recover £248m in aggregate. Therefore, bondholders now had the likelihood of 100% recovery rather than 84% recovery.

Hitting the jackpot!

The judgment is good news for the bondholders and provides a good example of how claims arising between co-obligors of the same debt such as guarantors' rights of contribution and indemnity operate in an insolvency. It clarifies the primacy of the rule against double proof over the application of the rule in *Cherry v Boultbee* in these types of situation.

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Two Rules

1. The rule against double proof prevents a paying guarantor from proving a claim in relation to his right of indemnity against the principal debtor in the liquidation of the principal debtor when the beneficiary of the guarantee is also proving for its primary claim.
2. The rule in *Cherry v Boultbee (1839) 4 My & Cr 442* is an equitable rule that a person cannot share in a fund if he is also a debtor of that fund without first contributing to the fund by paying the debt he owes to the fund.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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