THE DUTY TO MAINTAIN EQUALITY IN COLLECTIVE CREDITOR ACTIONS

It is argued in this article that creditors who act collectively to deal with the insolvency of their common debtor, whether in formal insolvency proceedings or in a private debt restructuring exercise, owe each other a duty to refrain from receiving any additional and undisclosed benefit, from the debtor or from a third party, in consideration for taking a particular position in relation to the debtor's insolvency. The duty is based on a line of old English authorities which, from the beginning of the last century, appeared to have lapsed into obscurity. Although more recent cases have confirmed that the duty continues to apply in contemporary insolvency regimes, new issues are likely to be encountered which may require some reformulation and refinement of the duty.

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I. Introduction

1 When a creditor[1] exercises his individual rights against an insolvent debtor, he is at liberty to take such steps as may be available to him to maximise the recovery of his debt. He does not owe any duty to refrain from receiving more than his proportionate entitlement of the debtor's assets; in fact, he will probably try his level best to achieve the highest level of repayment amongst all the creditors of the same debtor. In contrast, in insolvency proceedings such as liquidation and bankruptcy, the so-called *pari passu* principle of insolvency law reigns supreme. In these collective proceedings against an insolvent debtor, an unsecured creditor is compelled, by a myriad of statutory provisions and judge-made law, to share in the debtor's assets on an equal basis with his fellow creditors. The *pari passu* principle also strikes down contracts which seek to give a creditor an advantage, in the liquidation or bankruptcy of the debtor, over the other creditors.

2 It is suggested that, between the two extremes, there is a duty, in both common law and equity, to maintain equality amongst creditors in

1 All references to creditors in this article, except where otherwise indicated, refer to unsecured creditors. The concept of equality is generally alien to secured creditors.

a number of situations. This duty is not quite the same as the *pari passu* principle, and a few key differences can be highlighted. First, the duty is triggered only where two or more creditors collectively agree, share their views or vote on a plan or a course of action to deal with the insolvency of their common debtor, upon a common understanding or legitimate assumption that they would be doing so on the basis of equality. As such, while the scope of application of the duty is perhaps more limited than that of the *pari passu* principle, its operation cuts across formal insolvency proceedings such as liquidation or bankruptcy and into private or informal efforts by creditor groups. Secondly, it does not apply only to prevent a creditor from obtaining preferential treatment in relation to the distribution of the debtor's assets, but goes further to prohibit the creditor's receipt of undisclosed benefits from a third party. In particular, the use of third party funds to pay a creditor or to acquire the creditor's debt, which results in the creditor getting a more advantageous deal than the other creditors with whom he is acting collectively. Thirdly, the duty applies not only as between a debtor and his creditors, but also between the creditors *inter se*. This has an impact on the nature and range of legal remedies which a breach of the duty will attract.

3 The foundation for this duty is not new and has been recognised by the courts for well over two centuries. However, much of the law is found in very early cases dealing with proposals for compositions made by individual creditors to their creditors in order to avert bankruptcy, and there is a relative dearth of case law on the subject in more recent times. The principles established in these cases have been rarely invoked in the modern commercial context where corporate debtors in financial difficulty often seek to work together with their creditors collectively towards the approval and implementation of a debt restructuring plan or a scheme of arrangement. Neither have they been often thought to be relevant to voting and decision-making by creditors under the statutory insolvency regimes in relation to the administration of the debtor's assets and affairs.

4 In truth, the duty to maintain equality is in full accord with current notions of fair dealing, commercial morality and procedural transparency, and the principles established by the old cases remain relevant, perhaps even more so, in the present day. It has become orthodoxy in both insolvency law and practice that, in the insolvency of a debtor, the majority interests, views and decisions of the body of creditors are to be accorded critical, if not decisive, weight in determining the fate of the debtor, working out the terms of a debt restructuring or compromise plan, and fixing the level of recovery that can be enjoyed by the creditors. The courts have also declared that, as

the insolvency of a company deepens, its creditors displace its shareholders as the primary stakeholders.[2] It is critical to this regime that a body of creditors has the legal assurance that, in its collective actions *vis-à-vis* the debtor, each creditor is duty bound to stand on an equal footing and to refrain from receiving any undisclosed benefit which has compromised the objectivity of his judgment, decision or view in relation to the collective action.

5 However, some evolution may be necessary so that the application of the relevant principles is sufficiently sophisticated and agile to deal with contemporary issues. With the increasing size and structural complexity of commercial enterprises and financial institutions, it is not surprising to find that a creditor may have different levels and types of exposure to different entities within a corporate group, just as a single debtor may find itself indebted to several creditors which are part of the same financial conglomerate, or a combination of both. The purchase of debts by parties friendly or related to the debtor, so as to be in a position to exert influence or control over the debtor's debt restructuring proposal, is also frequently encountered. These developments may make it easier to disguise an objectionable transaction in which a creditor receives or is promised additional benefits which are not extended to his fellow creditors, in exchange for his vote or influence in respect of any proposal in relation to the debtor's debts or assets.

II. The basic principles

6 It has been the law since the 18th century that, if a debtor makes a proposal to his creditors for a composition or arrangement of his debts, any undisclosed arrangement entered into with a particular creditor to receive more than the other creditors, for the purpose of securing that creditor's approval of the proposal or removing that creditor's opposition to the proposal, is void for illegality.[3] The earliest English cases struck down such secret arrangements between a debtor and one of his creditors as a fraud on the other creditors. In one of the

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2 This doctrine became firmly established only in the recent past few decades: see the leading decisions of *Nicholson v Permakraft (NZ) Ltd* [1985] 1 NZLR 242; *Kinsela v Russell Kinsela Pty Ltd* (1986) 10 ACLR 395; *West Mercia Safetywear Ltd v Dodd* [1988] BCLC 250. It was first accepted as part of Singapore law in *Tong Tien See Construction Pte Ltd v Tong Tien See* [2002] 3 SLR 76, appeal allowed in part in *Caltong (Australia) Pty Ltd (fka Tong Tien See Holding (Australia) Pty Ltd) v Tong Tien See Construction Pte Ltd* [2002] 3 SLR 241. See also *Chip Thye Enterprises Pte Ltd v Phay Gi Mo* [2004] 1 SLR 434; *W&P Piling Pte Ltd v Chew Yin What* [2007] 4 SLR 218.

3 In both law and equity: see, for example, *Cockshott v Bennett* (1788) 2 TR 763; *Mare v Sandford* (1859) 1 Giff 288.

earliest reported cases, *Cockshott v Bennett*,[4] a debtor made a proposal to pay 11 shillings in the pound to his creditors, but one of the creditors refused to execute the deed of composition until the debtor issued a promissory note to him for the payment of the remaining nine shillings in the pound. The court held that the issue of the promissory note was a fraud on the creditors, and that it was absolutely void.

7 It was also settled early in the day that it is not essential that the illicit benefit be given by the debtor himself to the creditor concerned. A payment by a third person is just as much a fraud on the general body of creditors as a payment or an agreement to pay by the insolvent debtor itself.[5] The undisclosed additional benefit can, therefore, be provided by the debtor's brother,[6] brother-in-law,[7] friend[8] or "family sources".[9] Further, the funds or assets that are transferred or promised to be transferred to the creditor need not come from the debtor's assets;[10] the bribery does not have to be at the expense of the debtor.[11] As such, there is no necessity that the conferring of the secret benefit on a creditor be at the expense of the other creditors. A secret benefit given to a creditor may be impugned by the other creditors even though they have no legal right to insist that the secret benefit be included in the debtor's composition for sharing amongst all the creditors. It is not necessary to show that the preference of one creditor comes from the debtor's assets or that all the creditors will not receive an equal distribution of the debtor's assets.[12]

8 It was further settled that the secret benefit need not be given to the creditor to secure the creditor's agreement to vote in favour of the debtor's proposal; it may be given to secure some other form of assistance from the creditor in relation to the proposal. Thus, the additional benefit may be given to the creditor to persuade him to

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4 (1788) 2 TR 763. See also *Jackson v Lomas* (1791) 4 TR 166; *Cecil v Plaistow* (1793) 1 Anst 201; *Eastabrook v Scott* (1797) 3 Ves Jun 456; *Wells v Girling* (1819) 1 Brod 447; *Murray v Reeves* (1828) 8 B & C 422; *Hall v Dyson* (1852) 17 QB 785; *Mare v Sandford* (1859) 1 Giff 288; *Wood v Barker* (1865) LR 1 Eq 139; *Dauglish v Tennent* (1866) LR 2 QB 49. The equitable aspect of the rule goes back even earlier at least to 1721: see Ormiston JA's judgment in *Scuderi v Morris* (2001) 30 ACSR 592.

5 *Brigham v La Banque Jacques-Cartier* (1900) 30 SCR 429. See also *Wells v Girling* (1819) 1 Brod 447.

6 *Knight v Hunt* (1829) 5 Bing 432; *McKewan v Sanderson* (1875) 20 Eq 65; *Ex parte Milner* (1889) 15 QBD 605.

7 *Hochberger v Rittenberg* (1916) SCR 480.

8 *Somji v Cadbury Schweppes plc* [2001] 1 BCLC 498, affirmed [2001] 1 WLR 615.

9 *NZI Capital Corporation Ltd v Lancaster* (1991) 30 FCR 441.

10 *Hall v Dyson* (1852) 17 QB 785.

11 *Ex parte Milner* (1889) 15 QBD 605 at 613.

12 See *Dauglish v Tennent* (1866) LR 2 QB 49 at 53–54. See also *Paton v Campbell Capital Ltd* (1993) 46 FCR 30 at [27].

withdraw his opposition to the debtor's proposal[13] or even to become surety for the amounts to be paid under the debtor's proposal.[14] In fact, there need not be a successful composition at all. In *Wells v Girling*,[15] a promissory note was signed by a debtor and the defendant and given to the plaintiff, one of the debtor's creditors, pursuant to a secret agreement by the plaintiff that he would induce the other creditors to accept a composition of their debts on certain terms. However, the plaintiff ultimately failed to persuade the other creditors to accept the composition. The court disallowed the plaintiff's claim against the defendant on the promissory note, which it held was a fraudulent transaction and therefore void.

9 By 1875, the legal position in England was already well established, at least in relation to debtors' proposals for the composition or arrangement of their debts. The following leading statement of the law was given by Malins VC in *McKewan v Sanderson*:[16]

> Now I take it to be thoroughly settled, both in Courts of Law and Equity, that where there is a bankruptcy, or an arrangement with creditors by composition or insolvency, when insolvency exists as contradistinguished from bankruptcy, it is the duty of all creditors who have once taken part in the proceedings of bankruptcy or composition to stand to share and share alike. Equality is the only principle that can be applied, and if one creditor, unknown to the other creditors – not unknown to one or two, but to the general body – enters into an arrangement by which he gets for himself from the debtor, or from any one on behalf of the debtor, any collateral advantage whatsoever, that is a fraud upon the other creditors; and, although the money has been paid, the Court will enforce its repayment. … That principle cannot be too well understood. I am sorry to find that it is not better understood; and I hope this will be a lesson to bankers, whether joint stock or private bankers, that where there is once a bankruptcy of a customer, they are not to stipulate for a private advantage to themselves, but must stand with the other creditors and participate equally with them.

10 The learned Vice-Chancellor also held that a creditor owes a duty to his fellow creditors to disclose any arrangement under which that creditor receives a benefit which is not equally given to the other creditors under the debtor's composition. The non-disclosure of such an arrangement amounts to concealment, and such concealment is "a total misapprehension of the rights of creditors *inter se*".

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13 *Hall v Dyson* (1852) 17 QB 785.
14 *Wood v Barker* (1865) LR 1 Eq 139.
15 (1819) 1 Brod 447.
16 (1875) 20 Eq 65.

11 The *McKewan v Sanderson* line of authority, which must include the subsequent leading case of *Ex parte Milner*,[17] though accepted by the Canadian[18] and Australian[19] courts, became obscure after the early part of the last century, as there was a dearth of significant cases.[20] After the relevant principles were worked out between 1788 and 1915, there were remarkably few cases.[21] The cases seemed to have dropped out of sight, and faded from the consciousness of practitioners, judges and textbook writers.[22]

12 However, since the 1980s, the old English cases have begun to resurface in decisions in many of the major Commonwealth jurisdictions. Despite the fact that insolvency law and practice have progressed considerably since the Victorian times when most of these cases were decided, they are obviously thought to be still relevant. Developments such as the widespread use of statutory "cram-down" procedures for compositions of debt, the conferment of wide statutory rights of challenge, and the general acceptance of the validity and commercial utility of assignments of distressed debt do not appear to have undermined the fundamental principle of these cases. The principle in *McKewan v Sanderson* was applied in Canada[23] to what some might view to be an innocuous assignment of distressed debt. In Australia[24] and New Zealand,[25] the principle was held to be applicable in relation to compositions of debt attempted to be effected by way of modern "cram-down" procedures under bankruptcy legislation. The

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17 But which, rather curiously, does not refer to *McKewan v Sanderson*.

18 *Brigham v La Banque Jacques-Cartier* (1900) 30 SCR 429; *Hochberger v Rittenberg* (1916) 54 SCR 480. See also *Clarke v Ritchey* (1865) 11 Grant Ch 499; *Lawrence v Anderson* (1890) 17 SCR 349; *Langley v Van Allen and Co* (1902) 32 SCR 174.

19 *E T Fisher and Co Pty Ltd v English Scottish and Australian Bank Ltd* (1940) 64 CLR 84.

20 The only reported English case on the subject between the early part of the 20th century and the current century appears to be the criminal case of *R v Potter* [1953] 1 All ER 296.

21 See Ormiston JA's judgment in *Scuderi v Morris* (2001) 30 ACSR 592 at [2]. This writer must express one minor point of disagreement with this statement. Ormiston JA cited the House of Lords decision in *Farmers' Mart Limited v Milne* [1915] AC 106 as the basis for the reference to 1915. It is submitted, however, that the decision was not one dealing with the principle in *McKewan v Sanderson* at all. The more appropriate year would be 1917, being the year in which *Re Shaw* [1917] 2 KB 734 was decided.

22 *Somji v Cadbury Schweppes plc* [2001] 1 BCLC 498 at [28].

23 *Newlands Textiles, Inc v Carrier* (1983) 21 ACWS (2d) 69. See also *Anderson v Canadian Imperial Bank of Commerce* (1999) ACWS (3d) 8.

24 *Re Jacobs* (1984) 53 ALR 93; *NZI Capital Corporation Ltd v Lancaster* (1991) 30 FCR 441; *Paton v Campbell Capital Ltd* (1993) 46 FCR 30; *Scuderi v Morris* (2001) 30 ACSR 592. See also *Deputy Commissioner of Taxation v Woodings* (1995) 13 WAR 189; *Wood v Laser Holdings Ltd* (1996) 19 ACSR 245; *Young v Sherman* [2002] NSWCA 281 (judgment of Davies AJA); *Bidald Consulting Pty Ltd v Miles Special Builders Pty Ltd* (2005) 226 ALR 510.

25 *Re Paterson* [1997] 1 NZLR 371.

principle was also reconciled with the contemporary notion of debt subordination, when it was held in Australia that the creditors are not prevented from openly agreeing between themselves, as a means of obtaining acceptance of the debtor's proposal, that one or more of them should receive priority in the time or amount of payment.[26]

13 Further, the issue of disclosure in relation to "cram-down" procedures was clarified. It has been recognised from the earliest times that, if an arrangement to give a particular creditor an additional benefit is properly disclosed to all his fellow creditors, who nevertheless proceed to approve the debtor's proposal, the arrangement would be lawful.[27] However, where the proposal is not accepted by all the creditors but becomes binding or may become binding by virtue of a statutory "cram-down" procedure, such disclosure may not be sufficient, and the court may refuse to sanction a proposal or may set it aside if an additional benefit has been given to a particular creditor to induce his support for the proposal, even if this is fully disclosed to the creditors prior to the conduct of the voting for the proposal. In *Paton v Campbell Capital Limited*,[28] a debtor's deed of arrangement with his creditors was terminated by the court because the debtor entered into another arrangement with one of the creditors in consideration of extending its support to the deed of arrangement. Essentially, the debtor and the creditor were shareholders in another company and the debtor agreed to transfer his shareholdings in that company to the creditor as well as to take all necessary steps to stave off the winding up of that company. This arrangement was made known to all the creditors. However, the court held that this did not save the debtor's deed of arrangement. Secrecy of itself is not an essential ingredient in treating an arrangement or composition as being void where any inducement is given to a particular creditor to secure his vote, that inducement being over and above the other benefits which accrue to all creditors under the arrangement or composition.[29]

26 *Re Jacobs* (1984) 53 ALR 93; *Paton v Campbell Capital Ltd* (1993) 46 FCR 30 at [33]–[35]. See also the judgment of Davies AJA in *Khoury v Zambena Pty Ltd* [1999] NSWCA 402.

27 See the unreported case referred to by the Lord Chancellor in *Jackman v Mitchell* (1807) 13 Ves Jun 581.

28 (1993) 4 FCR 30. See also *Deputy Commissioner of Taxation v Woodings* (1995) 13 WAR 189; *Bidald Consulting Pty Ltd v Miles Special Builders Pty Ltd* (2005) 226 ALR 510 at [241]–[242]. See further the judgment of Davies AJA in *Young v Sherman* [2002] NSWCA 281.

29 *Ibid*, at [35]. See also *Somji v Cadbury Schweppes plc* [2001] 1 BCLC 498, especially at [38], where the court proceeded to make a bankruptcy order against the debtor despite noting that, at the time of voting on the debtor's individual voluntary arrangement, the petitioning creditor had "strong suspicions" that two of the other creditors had entered into illicit secret arrangements.

14 The revival of *McKewan v Sanderson* reached a high point when, in England itself, it received a new lease of life in the English Court of Appeal's decision in *Somji v Cadbury Schweppes plc*.[30] In this case, the debtor's individual voluntary arrangement was not approved by the requisite majority of creditors, and the meeting was then adjourned. A friend of the debtor then approached two of the bank creditors, whose votes would enable the arrangement to be approved. The debtor's friend, with the knowledge of the debtor, acquired the debts of the two bank creditors for a sum which was about five times what they could expect to receive under the arrangement. When the meeting of creditors resumed, the two bank creditors voted in favour of the arrangement, and the arrangement was, therefore, approved by the requisite majority of the creditors. Subsequently, one of the creditors filed a bankruptcy petition against the debtor on the ground that there was a material omission in the information which had been given to the creditors in relation to the arrangement.

15 Deputy Judge Anthony Boswood QC examined the early cases, including *McKewan v Sanderson*, and stated six propositions which reflected the law as it stood at the end of the 19th century:

> … (1) any secret deal made in connection with a composition or arrangement for the settlement of debts, whereby a creditor was to receive more than the other creditors in return for supporting (or not opposing) the composition or arrangement, was illegal and void; (2) the existence of such a deal rendered the composition or arrangement voidable at the instance of an aggrieved creditor; (3) moreover, such a deal was wholly unenforceable as between the parties to it; (4) the principle was of entirely general application, and covered all forms of composition or arrangement, whether statutory or otherwise; (5) the principle was based on the fundamental rule that there should be complete good faith between the debtor and his creditors, and between the creditors inter se. It was therefore irrelevant that the inducement to the creditor came from a third party and not out of the debtor's estate; (6) if the secret deal was not made by the debtor himself, all that was required was that it should have been made to his knowledge, and therefore with his concurrence, since concurrence must obviously be inferred where the debtor knows of the deal and does nothing either to stop it, or to inform the creditors of it.

16 The learned Deputy Judge held that these principles continue to apply to the "cram-down" procedure for individual voluntary arrangements under the Insolvency Act 1986. Further, the principles applied to the transaction in question; it was not an ordinary debt purchase transaction but one whose principal aim and object was to procure the bank creditors to vote in favour of the arrangement. In the

30 [2001] 1 BCLC 498.

circumstances, the Deputy Judge held that there was a material omission in the information made available to the creditors in connection with the arrangement, in that the arrangement with the two bank creditors was not disclosed. A bankruptcy order was made against the debtor.

17 The Court of Appeal upheld this decision.[31] Robert Walker LJ, with whom the other two judges agreed, observed that the Deputy Judge's impressive survey of the old law shows that in relation to composition and arrangements with creditors the court did impose a strict requirement of good faith as between competing unsecured creditors and prohibited any secret inducement to one creditor even if that inducement did not come from the debtor's own estate.[32] The learned Lord Justice also shared the view of the Deputy Judge that a similar principle applies to individual voluntary arrangements under the Insolvency Act 1986.

18 *Somji v Cadbury Schweppes plc* must now be regarded as the leading authority on the subject. It has been accepted as good law in Australia[33] and Hong Kong,[34] and there is no reason to think it will not be endorsed in Singapore. However, it leaves a number of questions unanswered. While it confirms that the principle in *McKewan v Sanderson* still has force in current insolvency regimes, it does little to rationalise and update its scope and content. Several major areas of uncertainty still have to be resolved.

III. Formulation of the duty

19 There is little doubt that the law should condemn a creditor who knowingly accepts a secret benefit as consideration for his support or the withdrawal of his opposition to his debtor's proposal for composition or arrangement of his debts. Such an act is morally wrong, not just in the eyes of commercial men who are disposed to entertain high notions of credit and of character in their dealings, but those of any man of common sense with the ordinary instincts of morality.[35] However, it is not entirely clear *why* it is wrong. A number of different thoughts interact in the cases: the need of creditors to be treated equally, the agreement of a creditor being obtained by some inducement or reward special to him, and the secrecy of the bargain between the debtor

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31 *Somji v Cadbury Schweppes plc* [2001] 1 WLR 615. For the sequel, see *Cooper v Official Receiver* [2003] BPIR 55.

32 At [24].

33 *Scuderi v Morris* (2001) 39 ACSR 592. See also *Bidald Consulting Pty Ltd v Miles Special Builders Pty Ltd* (2005) 226 ALR 510.

34 *Ampang Jaya Sdn Bhd v Zhu Feng Chang* [2005] HKCU 1123.

35 See *Somji v Cadbury Schweppes plc* [2001] 1 BCLC 498 at [39].

and that creditor, though later cases have tended to focus on the inequalities among creditors or the secrecy of the arrangement.[36]

20 Broadly, three distinct bases have been advanced by the courts. The first is that the acceptance or agreement by a creditor to accept a secret benefit as consideration for taking a certain course of conduct with respect to the debtor's proposal for a composition or arrangement of his debts constitutes the perpetuation of a fraud by a debtor and a creditor on the other creditors.[37] The secret and preferential bargain which one creditor negotiates with the debtor is a fraud on the other creditors, the fraud being that the others are misled into signing on the false basis that all are being treated equally.[38] Implicit in this analysis is that the undisclosed additional benefit must have been given, or the agreement to give it must have been struck, at the time that the creditors agree on the composition with the debtor. It is the pretending to accept the same terms as the other creditors, and so encouraging them to come into the arrangement, when the party so pretending has at the time secured to himself some advantage, of which the others are not to partake, which constitutes the fraud on the other creditors.[39]

21 It is submitted that this basis should not be accepted. The language of fraud in this context, found in many of the early cases, is simply archaic; it is not apt to be employed nowadays where fraud has acquired a technical and well-defined meaning. More importantly, a fraud analysis is too restrictive and does not sit well with the cases. It seems clear that the conferring of an undisclosed additional benefit on a creditor, even *after* the composition has been entered into, can be impugned. This is illustrated by *Ex parte Milner*,[40] where it was only after a creditor had executed a deed of arrangement with his debtor that several other of the other creditors were induced by additional payments from the debtor's brother to execute the same deed. The deed was held to be voidable at the instance of the creditor. Further, even after the creditors of a debtor have agreed on a composition, an agreement entered into by a debtor with one of his creditors for the full payment of his debt is invalid, if the agreement undermines the debtor's ability to meet his obligations under the composition and is inconsistent with the

36 See *Paton v Campbell Capital Limited* (1993) 4 FCR 30 at [32]–[33].
37 See *Cockshott v Bennett* (1788) 2 TR 763 and the other cases cited *supra* n 4.
38 *Cockshott v Bennett* (1788) 2 TR 763 as explained in *Clarion Ltd v National Provident Institution* [2000] 1 WLR 1888 at 1907.
39 *Took v Tuck* (1827) 4 Bing 224 at 228–229, affirmed on appeal *sub nom Tuck v Tooke* (1829) 9 B & C 437; *E T Fisher & Company Proprietary Limited v The English Scottish and Australian Bank Limited* (1940) 64 CLR 84 at 92–93, 104–105. See also *Mcintyre v G D Galastaun* [1843] Ky 2; *Carey v Barrett* (1889) 4 CPD 379 at 382.
40 (1885) 15 QBD 605.

duty of good faith to the other creditors.[41] It would be artificial to explain the setting aside of the secret benefits or arrangements in such cases as being based on fraud, at least in the sense which we now understand the term. The creditors would not have been the victims of any fraudulent inducement or misrepresentation at the time of the entering into the composition or arrangement with the debtor.

22 Another reason why the fraud analysis must be rejected for modern-day purposes is that, in relation to compositions or arrangements which are implemented with the assistance of statutory "cram-down" procedures, it has been held that full disclosure of the additional benefit given or agreed to be given to a certain creditor or certain creditors, at the time of entering into the composition or arrangement with the debtor, does not prevent the composition or arrangement from being challenged. As discussed earlier, *Paton v Campbell Capital Limited*[42] has made clear that secrecy of itself is not an essential ingredient in treating an arrangement or composition as being void where any inducement is given to a particular creditor to secure his vote, that inducement being over and above the other benefits which accrue to all creditors under the arrangement or composition. It is difficult to see how there can be fraud (as opposed to oppression) where the alleged fraudulent arrangement has been fully disclosed at the time of the composition or arrangement.

23 The second basis is that a creditor breaches a duty of good faith when he accepts an additional benefit as consideration for his support for the debtor's proposal for a composition or arrangement of his debts. Agreements for composition with creditors have been said to require the strictest[43] or most perfect[44] good faith and are contracts *uberrimei fidei.*[45] Thus, where an inducement is given to a creditor, the necessary good faith between the debtor and the whole of the creditors would be missing.[46]

24 The use of the notion of good faith in this context is wholly unsatisfactory. It is one of the most slippery legal concepts. Putting aside the lack of precision in meaning, there is uncertainty as to whether one is speaking of good faith or *utmost* good faith, a distinction which has

41 *Ex parte Barrow, In re Andrews* (1881) 18 Ch D 464; *E T Fisher & Company Proprietary Limited v The English Scottish and Australian Bank Limited* (1940) 64 CLR 84 at 92–95. See also *Wild v Tucker* [1914] 3 KB 36.

42 (1993) 4 FCR 30.

43 *Knight v Hunt* (1829) 5 Bing 432.

44 *Dauglish v Tennent* (1866) LR 2 QB 49.

45 *E T Fisher & Company Proprietary Limited v The English Scottish and Australian Bank Limited* (1940) 64 CLR 84 at 103. See also Ormiston JA's judgment in *Scuderi v Morris* (2001) 30 ACSR 592.

46 *Paton v Campbell Capital Ltd* (1993) 46 FCR 30 at [35].

grown to be significant. Good faith *simpliciter* is generally taken to mean a lawful and proper motive, while utmost good faith imports more onerous duties relating to full disclosure and the avoidance of conflicts of interest. Neither sense works well in the present context. In any case, it is very problematic to assign a sensible definition to such a duty of good faith or utmost good faith, other than to say, with circularity, that the duty requires a creditor to refrain from receiving any additional benefit as consideration for voting for or withdrawing his objection to the debtor's proposal for composition or arrangement of his debts.

25 The third and final basis is a breach of the basis of equality upon which a composition or arrangement of debts between a debtor and his creditors is fundamentally premised. As emphasised in *Ex parte Milner*,[47] it is the very essence of a composition that the creditors who come under it assume an obligation between themselves to be on a footing of equality and that there is no private bargain with any of the creditors which will destroy this equality; this equality is implied by law from the very nature of the transaction. Secrecy and the lack of good faith are not the essence of the rule; the underlying principle of equality and fairness is the crucial point and factors such as secrecy and lack of good faith are indicators that the principle has been breached.[48] Put simply, a creditor who enters into a composition or arrangement with his debtor is legally entitled to assume and expect that the views of his fellow creditors are objective and have not been swayed by the receipt or promise of an additional benefit. There may be cases in which a man might not be capable of deciding for himself whether he would accept the composition or arrangement and would rather trust the judgment of the body of creditors than his own, and he is entitled by the agreement into which he enters to insist that the concurrence of the other creditors has been obtained by fair means.[49] Thus, when a debtor enters into a composition or arrangement with his creditors, the duty to maintain equality is imposed by law on the debtor for the benefit of each of his creditors, and by each creditor for the benefit of each of his fellow creditors.

26 It is contended that this is the true basis of the principle. It strikes at the heart of the mischief, unites all the cases and provides a

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47 *Ex parte Milner* (1885) 15 QBD 605 at 613–616. See also *Dauglish v Tennent* (1866) LR 2 QB 49 at 54; *E T Fisher & Company Proprietary Limited v The English Scottish and Australian Bank Limited* (1940) 64 CLR 84 at 91; *Re Jacobs* (1984) 29 ALR 93; *Paton v Campbell Capital Ltd* (1993) 46 FCR 30 at [27]–[31]; *Young v Sherman* [2002] NSWCA 281 (judgment of Davies AJA); *Clarion Ltd v National Provident Institution* [2000] 1 WLR 1888 at 1908; *International Air Transport Association v Ansett Australia Holdings Ltd* 2008 HCA 3 at [170].

48 See judgment of Davies AJA in *Young v Sherman* [2002] NSWCA 281.

49 *Dauglish v Tennent* (1867) 2 LR QB 49 at 53–54; *Paton v Campbell Capital Ltd* (1993) 46 FCR 30 at [27].

platform for its application and further development in modern insolvency regimes. It explains why full disclosure does not necessarily cure the wrong, and why it is not necessary that the additional inducement has to come from the debtor's assets or detract from the assets to be distributed to the creditors under the composition or arrangement. It explains why no active deception is required, and why the wrong can be committed even after the composition or arrangement has been entered into. It also explains, as discussed in the next section, why the principle has been and can be applied outside the context of a debtor's proposal for the composition or arrangement of his debts, to any situation where creditors come together as a body to express a collective view or make a collective decision as to a course of action in relation to their debtor.

IV. Beyond compositions and arrangements for settlement of debts

27 It is clear that the duty to maintain equality applies where a debtor presents a proposal to his creditors for the composition or arrangement of his debts, whether to be implemented as a private contract or a modern statutory scheme with "cram-down" features.[50] The duty prohibits a creditor from receiving or agreeing to receive an additional benefit as consideration for voting in favour of, or withdrawing his objection to, the proposal for the composition or arrangement.

28 However, there is no compelling reason why the duty to maintain equality should not apply in other situations where a body of creditors act collectively to make a decision or take a step in relation to their debtor's insolvency. The critical inquiry is whether the decision is being made, or the step is being taken, in a creditors' forum premised on a fundamental basis of equality. If the creditors are operating in such a collective forum, the duty to maintain equality should be imposed on all the creditors *inter se*, as there is no justification for a creditor receiving or agreeing to receive an undisclosed and additional benefit in consideration of taking a certain position or exercising his vote in a particular manner in the forum. All the considerations which apply in the traditional forum of creditors agreeing to enter into or voting on a proposal for composition or arrangement of debts would similarly be applicable. Put simply, if no duty to maintain equality is imposed, the integrity, fairness and transparency of the creditors' forum breaks down.

29 This general proposition has not been clearly enunciated in the cases. Nevertheless, it seems clear that the courts have always been

50 See *Ex parte Milner* (1885) 15 QBD 605 and the cases cited *supra* n 47.

prepared to impose the duty to maintain equality outside the paradigm situation of creditors considering their debtor's proposal for the composition or arrangement of his debts. For instance, the duty to maintain equality has been held to apply in relation to a mere proposal for an extension of time to make payment, as there is no distinction between an agreement for an extension of time and an agreement for the creditors to forego parts of their claim.[51] Similarly, the duty applies in relation to a body of creditors deciding whether to allow the discharge of their debtor from bankruptcy or the annulment of his bankruptcy. A secret agreement by a bankrupt to pay a sum of money to one of his creditors, in consideration of the creditor agreeing to assign his debt to another party and thus enabling the bankrupt to obtain an annulment of his bankruptcy, is void for illegality,[52] as is an additional benefit given to a creditor to persuade him to withdraw his opposition to the debtor's application for discharge from bankruptcy.[53] The duty to maintain equality has also been thought to apply where the creditors are collectively considering the proposal of a third party to purchase the assets of their debtor.[54] Further, an agreement by a debtor company to pay a creditor in full, in consideration of that creditor appearing at the hearing of a winding-up application against the debtor company and opposing the making of a winding-up order, has been held to be void for illegality.[55] A winding up is a collective insolvency proceeding, and the expression of creditor support for, or opposition to, a winding-up order in the court must be regarded as taking place in a creditors' collective forum.

30 On the other hand, where there is no creditors' forum for collective action, the courts have refused to recognise a duty to maintain equality. An agreement between an issuer of pension scheme policies and one of its investors in its funds, which gives that investor the right to switch investments from one fund to another on terms which are much more favourable than those applicable to other investors, does not attract the application of the principle and is not void for illegality, as the investors are not party to any common agreement between themselves. [56] By the same token, where the creditors' collective forum has expired, the duty to maintain equality ceases to apply. Thus, after a composition has been fully and finally worked out, a debtor can lawfully make an agreement for valuable consideration to pay in full the original

51 *Hochberger v Rittenberg* (1916) SCR 480 at 491.
52 *Re McHenry, McDermott v Boyd* [1894] 2 Ch 428.
53 *Murray v Reeves* (1828) 8 B & C 422; *Gould v Williams* (1835) 4 Dowl PC 91; *Hall v Dyson* (1852) 17 QB (NS) 785.
54 *Brigham v La Banque Jacques-Cartier* (1900) 30 SCR 429; *Scuderi v Morris* (2001) 30 ACSR 592. The duty was held not be breached in the latter case, because the additional benefit was not given on behalf of the debtor.
55 *Amman Singh v Vasudvevan* [1973] 1 MLJ 210.
56 *Clarion Ltd v National Provident Institution* [2000] 1 WLR 1888.

debt of a particular creditor.[57] An agreement by a debtor to pay one of its creditors in full, in consideration of the creditor advancing moneys to the debtor in order to allow the debtor to discharge its obligations under an earlier composition with its creditors, is also perfectly lawful.[58] It should further be noted that, even where there is collective action by a group of creditors, there may nonetheless be no breach of the duty to maintain equality if additional benefits are given to certain creditors, but not as an inducement to garner their support for a particular course of action to be taken by the creditor group. For example, where the main asset of an insolvent debtor is its membership in a professional football league and such membership can only be preserved by paying certain "football creditors" in full, it is not objectionable for a purchaser of the business to offer to pay such creditors in full, even though the other creditors will receive less than full payment from the proceeds of sale of the business.[59] The reason why the purchaser is making the payments to the "football creditors" is not to satisfy them as such, but to maintain an asset of the company without which its business would effectively have no value.[60]

31 The extension of the duty to maintain equality to all creditors' collective fora is timely given that the importance of collective action and decision-making by creditor groups continues to grow. Current commercial wisdom, with good reason, usually prescribes formal insolvency proceedings only as a last resort. Much of the value in modern business enterprises resides in soft assets, such as marketing and distribution channels, human capital, intellectual property rights, and business and operational continuity, all of which tend to be seriously eroded upon the onset of formal insolvency proceedings. The displacement of management in favour of a court-appointed officer and the absence of efficacious legal mechanisms to deal with cross-border issues add to the unattractiveness of formal insolvency proceedings. Insolvent debtors, and oftentimes their creditors, have therefore developed a strong preference towards private debt restructuring agreements. Of course, such agreements are viable only if consensus can be reached with the creditors collectively. If consensus cannot be achieved, "cram-down" procedures will have to be threatened or used. The law makes provision for the majority creditors of an insolvent company or individual to approve a composition or arrangement for the settlement of debts and, subject to the supervision of the court, to foist the composition or arrangement on the entire body of creditors,

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57 *E T Fisher & Company Proprietary Limited v The English Scottish and Australian Bank Limited* (1940) 64 CLR 84 at 92.

58 *E T Fisher & Company Proprietary Limited v The English Scottish and Australian Bank Limited* (1940) 64 CLR 84.

59 See *IRC v Wimbledon Football Club Ltd* [2005] 1 BCLC 66.

60 See *IRC v Wimbledon Football Club Ltd* [2005] 1 BCLC 66 at [44].

including the creditors who do not agree to it. This right is given to the majority creditors of a company seeking to implement a scheme of arrangement with its creditors,[61] as well as the majority creditors of a company in or about to be in liquidation seeking to enter into an arrangement with its creditors.[62] A similar right is also given to the majority creditors of an insolvent individual who proposes a voluntary arrangement[63] and the majority creditors of a bankrupt individual who offers a composition or scheme.[64] In any case, collective creditor actions are also relevant in formal insolvency proceedings. In the liquidation of a company, it is statutorily provided that the court may, as to all matters relating to the winding up of a company, have regard to the wishes of the creditors and may, for the purpose of ascertaining those wishes, direct meetings of the creditors to be called.[65] This applies, *mutatis mutandis*, to the judicial management of a company[66] and the bankruptcy of an individual.[67] The creditors are given the right to appoint representative committees, vested with powers of supervision, in the liquidation, judicial management or bankruptcy of their debtor.[68] In addition, the majority creditors of a company in judicial management are given the right to decide whether the statement of proposals presented by the judicial manager should be implemented.[69]

32 In all these scenarios, the collective actions of the creditors will have a very significant impact on the debtor as well as on the financial interests of the creditors themselves. It cannot be gainsaid that each of the creditors who participate in these exercises should be legally entitled to assume that all the creditors are in the same boat and that each creditor's decision, view or vote is objective and not dictated or influenced by any secret collateral inducements. The duty to maintain equality should, it is submitted, apply in all these cases.

V. Involvement of the debtor

33 In *Re E A B*,[70] the debtor's brother had, without any knowledge of the debtor, given security to two of the creditors, putting them in a

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61 Companies Act s 210. See also s 227X(*a*) of the Companies Act.
62 Companies Act s 309.
63 Bankruptcy Act (Cap 20, 1996 Rev Ed) ss 51–53.
64 Bankruptcy Act ss 95 and 95A.
65 Companies Act (Cap 50, 2006 Rev Ed) s 325. The majority creditors of an insolvent company are also statutorily accorded the right to choose its liquidator in a voluntary winding up: ss 294 and 295 of the Companies Act.
66 Section 325 read with s 227X(*b*) of the Companies Act.
67 Bankruptcy Act (Cap 20, 1996 Rev Ed) ss 79 and 80.
68 Companies Act ss 298 and 227O and Bankruptcy Act s 80.
69 Companies Act s 227N.
70 [1902] 1 KB 457. See also *Bradshaw v Bradshaw* (1841) 9 M & W 29; *Ex parte Milner* (1889) 15 QBD 605; *Re Pilling, ex parte Board of Trade* [1903] 2 KB 50.

better position than the other creditors, so that they would withdraw from participating in the debtor's scheme of arrangement. The Court of Appeal nevertheless sanctioned the scheme, as the security was not the result of any bargain made by or with the knowledge of the debtor himself. This principle was endorsed in *Somji v Cadbury Schweppes plc*,[71] where the court stated that the secret deal must be made with the "knowledge and concurrence" of the debtor.

34 The basis for this rule is not immediately evident. The duty to maintain equality is owed not only by a debtor to each of his creditors, but also by the creditors *inter se*. It should follow that it is not necessary to show that a breach of the duty to maintain equality has been committed with the "knowledge and concurrence" of the debtor. Certainly, the basic footing of equality which each creditor is legally entitled to expect from his fellow creditors in a creditors' collective forum can be violated without any involvement of the debtor. However, the lack of any involvement of the debtor *does* mean that the debtor himself has not breached the duty to maintain equality to his creditors and, accordingly, any composition or arrangement which is entered into between the debtor and his creditors, or which is "crammed down" on the creditors, should not be liable to be impugned. On this analysis, the decision in *Re E A B* was correct;[72] it would have been quite unfair for the court to reject the debtor's scheme of arrangement simply because a third party had, officiously and without any knowledge or concurrence of the debtor, decided to confer benefits on certain creditors so that they would withdraw from participating in the debtor's scheme of arrangement. However, *Re E A B* did not decide on the position between the creditors *inter se*; certainly, it did not suggest that the absence of involvement on the part of the debtor should absolve an errant creditor from the consequences of his breach of the duty to maintain equality. Since the duty to maintain equality applies between creditors *inter se*, a creditor may, quite independently of the position of the debtor, be liable to his fellow creditors for a breach of the duty. On the facts of *Re E A B*, the two creditors who had taken security from the debtor's brother and withdrawn from participating in the debtor's scheme of arrangement should have been liable to their fellow creditors for the additional benefits they had received. Such liability would have posed no hindrance to the sanction by the court of the debtor's scheme of arrangement.

35 The issue becomes somewhat more complex where a body of creditors is voting, not on a proposal for composition or arrangement presented by the debtor, but on a proposal put forward by a third party to acquire or enter into some other transaction with respect to the

71 [2001] 1 BCLC 498 at para 23.

72 As was its endorsement in *Somji v Cadbury Schweppes plc*, another case dealing with the issue of whether a debtor's arrangement ought to be upheld by the court.

debtor's assets. This is, of course, a common scenario where an insolvent debtor's assets include or comprise a business which is more valuable as a going concern than on a break-up basis. There seems to be little doubt that the duty to maintain equality should apply between the creditors *inter se* in this situation, so as to prohibit a creditor from receiving an additional and undisclosed benefit as consideration for extending his support for or withdrawing his objection to the proposal. This is supported by the early Canadian Supreme Court decision of *Brigham v La Banque Jacques-Cartier*.[73] A third party had proposed to a debtor's creditors to purchase the debtor's assets for a sum which would be sufficient to pay preferential creditors in full and general creditors a 30% dividend. The plaintiff, one of the creditors, wanted at least a 40% dividend. The third party then procured his brother-in-law, the defendant, to undertake to pay the additional sum to the plaintiff by issuing a promissory note to the plaintiff for the full amount of a 40% dividend. The plaintiff withdrew its opposition to the proposal for the purchase of the debtor's assets, and the proposal was subsequently approved by the creditors and the court without disclosure of the agreement between the plaintiff and the defendant. The 30% dividend was accordingly paid to the debtor's general creditors, including the plaintiff. The plaintiff's suit against the defendant on his promissory note for the additional 10% dividend was dismissed. It was held, following English cases such as *McKewan v Sanderson*, that the promissory note was "wholly void, as having been given in furtherance of a fraudulent and corrupt agreement".

36 However, more recently, the Court of Appeal of the Supreme Court of Victoria came to a different conclusion in *Scuderi v Morris*.[74] In this case, the respondent was the largest creditor of the debtor company and the appellant was a third party who wanted to purchase the debtor company's assets. The appellant agreed to pay him a sum of money by monthly instalments over ten years, in consideration of the respondent agreeing, as a term of the appellant's bid for the assets, that he would not prove his debt and would pay a debt due to the debtor company's bank. As a result, the appellant's bid for the debtor company's assets was successful. However, the appellant later ceased to continue making the promised payments to the respondent. Applying the reasoning in *Re E A B*, the court held that the contract between the appellant and the respondent was not void for illegality and that the appellant was liable for breach of contract to the respondent. The court was of the view that the appellant was not acting on behalf of the debtor company and the debtor company did not acquiesce in the transaction between the appellant and the debtor.

73 (1900) 30 SCR 429.

74 (2001) 30 ACSR 592.

37 It is submitted, with respect, that the court fell into error in applying the reasoning in *Re E A B*. None of the three judgments of the court proffered a convincing explanation of the rationale of what it viewed as an absolute qualification on the duty to maintain equality. The court also did not seriously question whether the rule in *Re E A B* should apply where the creditors of a debtor were voting on a proposal by a third party to acquire the assets of the debtor. Further, as pointed out above, *Re E A B* decided that, if a secret benefit had been given by a third party to certain creditors to remove their objection to the debtor's scheme of arrangement, but this had been done without the knowledge and concurrence of the debtor, there would be no reason for the court to refuse to sanction the debtor's scheme of arrangement. It did not decide that the transaction between the third party and the creditors receiving the benefit was lawful, and, therefore, it did not decide the very issue that was before the court in *Scuderi v Morris*.

38 It should be made clear that this writer is not suggesting that the ultimate decision in *Scuderi v Morris*, that is, that the contract between the appellant and the respondent was valid and enforceable, was wrong. The contention is merely that the decision should not have been based on the perceived rule in *Re E A B*. Instead, the decision could have been justified on the basis that the contract between the appellant and the respondent was not kept secret from the creditors. On the facts, two offers for the debtor's assets had been received. The first offer openly stated the respondent was one of the parties putting up the offer and that one of its terms was that the respondent would withdraw his claim against the debtor. The second offer was made by a third party and did not involve the respondent withdrawing his claim against the debtor. However, the first offer promised a higher recovery for the creditors than the second offer. Further, the respondent urged the creditors to accept the first offer (under which he would have had to forego his claim against the debtor), instead of the second offer (under which he would receive some recovery of his claim against the debtor). In the circumstances, it would have been obvious to the creditors that the respondent was receiving some other collateral benefit under the first offer. However, apparently none of the creditors requested for particulars of any additional benefit which the respondent would have received or contracted to receive; they were content to proceed to vote for the first offer.

39 On a more general note, quite apart from the point that the duty to maintain equality is owed between creditors *inter se*, any requirement that the duty can only be breached with the knowledge and concurrence of the debtor is surely unsupportable and would create a serious deficiency in the law. There are many situations in which third parties may, whether consciously or otherwise, interfere with the integrity of a creditors' collective forum, without having to involve the

debtor itself. For instance, parties such as the shareholders of the debtor, the guarantors of the debtor's debts, major creditors, assignees of distressed debt, and potential investors, financiers or purchasers in relation to the debtor's assets or business and debt traders may, conceivably, offer secret incentives to selected creditors in exchange for their support for the debtor's proposal. The motive will be to secure a private commercial benefit from the success of the debtor's proposal, and this motive can be pursued without any involvement of the debtor. It would be wholly anomalous if the duty to maintain equality is disapplied in this situation, when the objectionable conduct and the prejudice caused to the integrity of the creditors' collective forum are no different in nature and gravity from that which is attendant in the more stereotypical case of a debtor itself being involved in the breach of the duty.

VI. Assignments

40 The courts have made clear that ordinary assignments of distressed debt are generally unimpeachable. In *McKewan v Sanderson*[75] itself, Malins VC noted that the bank creditor which had accepted a guarantee from the debtor's brother had been misled by its advisers to think that the transaction amounted only to a sale of the bills of exchange or promissory notes on which the debtor was liable. The learned Vice-Chancellor opined that, if there was indeed a simple transaction to sell the bills of exchange or promissory notes, without communication with the debtor or anybody on his behalf, it might have been lawful. The English High Court in *Somji v Cadbury Schweppes plc* also noted that ordinary assignments of distressed debt are commonplace and do not run foul of the duty to maintain equality.[76] Given the burgeoning popularity and obvious commercial utility of distressed debt trading, it is hardly surprising that the courts have taken this position.

41 However, it is equally clear that an assignment of distressed debt can constitute a breach of the duty to maintain equality. It has been held to be impermissible for a creditor to assign his claim against the debtor for a sum that is larger than what he would receive under the debtor's proposal, so that the assignee can step into his shoes and approve the proposal.[77] A dramatic illustration of this rule can be found in *Somji v Cadbury Schweppes plc*,[78] the facts of which have been set out above. Another notable case is the Canadian decision of *Newlands Textiles, Inc v*

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75 (1875) 20 Eq 65.
76 See [2001] 1 BCLC 498 at para 25.
77 *Mare v Sandford* (1859) 1 Giff 288; *Mare v Warner* (1861) 3 Giff 100.
78 [2001] 1 BCLC 498, affirmed [2001] 1 WLR 615.

Carrier,[79] in which the chairman of the debtor company purchased a creditor's claim by, *inter alia*, issuing a promissory note to the creditor, for the purpose of removing the creditor's opposition to the debtor company's proposal. There was no communication to the other creditors about the reason for the withdrawal of the creditor's opposition. Despite noting that there was nothing clandestine about the matter in which the promissory note was issued and that the parties acted in good faith, the court dismissed the creditor's action on the promissory note on the basis that there was a fraud on the other creditors. Further, there has been judicial criticism of a bankrupt being involved in his brother-in-law's purchase of the debts of the bankrupt's creditors at different prices and without full disclosure of all material facts concerning the bankrupt, and such conduct has been held to be a factor militating against the discharge of the bankrupt.[80]

42 The central challenge, then, is to define the line at which an assignment of debt ceases to be a lawful and routine commercial transaction. In essence, where the principal aim and object of an assignment of debt is to secure approval of a proposal, and the assignment is for a value which exceeds the value which the creditor will receive under the proposal, it may be unlawful.[81] Given that the issue can arise in diverse sets of circumstances, the detailed workings of this rule will have to be worked out gradually through the accretion of judicial decisions. The principal aim and object of an assignment of debt will be a question of fact to be determined by the court in each case. Similarly, the issue of whether the assignment is for a value which exceeds the value which the creditor will receive under the proposal depends on the facts of the case. In this connection, great care has to be taken to protect the sanctity and efficacy of genuine commercial bargains in distressed debt trading. The quantification exercise will be uncomplicated where the benefits under the proposal are easily quantifiable in monetary terms. It will be more difficult and heavily dependent on expert opinion where the proposal envisaged more complex arrangements such as those commonly encountered in debt restructuring agreements, such as the grant of new security, "termed-out" payments, debt-equity swaps, debt-buy-backs, and the continuation of credit facilities for sustainable debt. In such cases, a generous amount of elasticity must be built into the quantification process and the use of the benefit of hindsight must be resisted. A further complexity arises if the assignment takes place when the principal terms of the proposal have not been fixed but are still under discussion. Theoretically, the quantification process will have to take into account the prospects of the terms of the proposal being

79 (1983) 21 ACWS (2d) 69. This decision was thought to be correct in *Anderson v Canadian Imperial Bank of Commerce* (1999) ACWS (3d) 8.
80 *Re Shaw* [1917] 2 KB 734.
81 See *Somji v Cadbury Schweppes plc* [2001] 1 BCLC 498 at [25].

concluded. However, it is felt that this will be such a speculative and imprecise process, and one that may undermine commercial certainty in distressed debt trading, that it should not be attempted save in exceptional circumstances. In other words, the general guide should be that, in order for an assignment to be liable to be challenged as a breach of the duty to maintain equality, it has to take place at a time when the terms of the proposal to be considered are already finalised by the debtor or the party putting forward the proposal.

43 Another situation that the courts may have to grapple with is where a party has taken an assignment of debt, not only for the immediate purpose of securing the success of the debtor's proposal, but also for a larger commercial objective of its own. It has been recognised that it is possible that an assignee may have his own commercial reasons for keeping the debtor out of bankruptcy or insolvency, though such reasons must be clearly explained and vague statements will be insufficient.[82] To the extent that this suggests that an assignment is protected as long as the assignee has acted primarily to serve its own commercial objectives, this writer would have to disagree. There is no reason why a party should be given a licence to selectively purchase debts from a body of creditors for greater than the value they would receive under the debtor's proposal, simply because the success of the debtor's proposal would facilitate its pursuit of its own commercial interests. For instance, the parent company of a corporate debtor should not be able to justify taking an assignment of the debt of one of the debtor's creditors for a value exceeding the value of the benefits to which it would be entitled under the debtor's proposal, merely by claiming that the success of the debtor's proposal will ultimately serve its own commercial interests. A potential investor should also not be able to take such an assignment so as to pave the way for its investment in the debtor. Similarly, a major creditor should not be allowed to purchase the debt of a minority creditor, for a value larger than that of the minority creditor's entitlement under the debtor's proposal, on the ground that the major creditor will, in view of its larger exposure, eventually stand to gain more by facilitating the success of the debtor's proposal. In all these instances, the principal aim and object of the assignment should be the immediate one of securing the success of the debtor's proposal, and not the assignee's own larger commercial objectives which would be served by the success of the debtor's proposal.

82 See *Somji v Cadbury Schweppes plc* [2001] 1 BCLC 498 at [25].

VII. The nature of the benefit

44 All the cases reported so far deal with the conferment of benefits on the errant creditor which are monetary or easily quantified in monetary terms.[83] It is not fanciful to envisage cases where the secret benefit is something which is less tangible. For example, if a creditor is a supplier of the debtor, the debtor could promise that it would increase the volume of orders it would place with the creditor, if the creditor would support the debtor's proposal. Similarly, if the creditor is a customer, the debtor could promise that it would give discounts on future purchases by the creditor. Another example would be where a creditor has some exposure to the debtor but much greater exposure to the parent company or related company of the debtor, all of whom are insolvent. The parent company or related company could promise the creditor that it would present a more favourable set of terms for its debt restructuring plan if the creditor could support the debtor's proposal.

45 It is contended that such benefits cannot be considered as secret benefits for the purpose of determining whether the duty to maintain equality has been violated. Admittedly, such benefits may be of real economic value to the creditor involved, and may place the creditor in a better position than his fellow creditors. But to impugn such benefits would be too much of an incursion into commercial certainty. The benefits would stem from legally separate transactions and would not be applied, both as a matter of accounting and law, towards the reduction of the debt which is owed by the debtor.

VIII. Remedies

46 Part of the law on the remedies for a breach of the duty to maintain equality is quite clear, while the remaining, and unfortunately major, portion is either unsettled or wholly undeveloped. It is beyond the scope of this article to explore in detail the possible remedies which may be invoked in all conceivable scenarios, and this concluding part of the article will only outline the key remedies which are or should be available.

47 What is certain is that a secret agreement to give an additional benefit in breach of the duty to maintain equality is void. If the additional benefit given to the creditor is in the form of a promissory note, bill of exchange or other instrument, whether by the debtor

83 See, for example, *Knight v Hunt* (1829) 5 Bing 432 where the secret incentive was in the form of coal.

himself or a third party, it would be wholly void and ineffective.[84] Similarly, an agreement between the debtor and the creditor that the latter be paid in full, or a sum additional to what the creditors received or would receive, is void.[85]

48 Where the secret agreement has been performed, the position is convoluted. The case of *Turner v Hoole*[86] decided that, where a debtor has made an additional payment to one of his creditors in order to induce that creditor to approve the debtor's proposal, the sum received by the creditor in excess of the sum he would have received under the proposal can be recovered by the debtor on an action for money had and received. This case was discredited in *Wilson v Ray*,[87] which held that such a payment cannot be recovered by the debtor as it had been made voluntarily by him, and this position was accepted by subsequent cases.[88] However, it appears that recovery is allowed against the creditor if he negotiates the promissory note to a third party, and the debtor is then compelled to make payment under the promissory note to the third party.[89] On the other hand, Malins VC in *McKewan v Sanderson*,[90] after referring to the prohibition against secret arrangements to pay money to particular creditors, stated as follows: "… and, although the money may have been paid, this Court will enforce its repayment".[91] In *Re Lenzberg's Policy*,[92] a debtor had made a secret agreement with one of his creditors to claim for a smaller sum than what he was owed under the debtor's composition deed, and payments were made by the debtor to the creditor under the secret agreement. The court ruled that all such payments could be recovered by the debtor. Yet another judicial approach is that the errant creditor cannot enforce the secret agreement,

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84 *Cockshott v Bennett* (1788) 2 TR 763; *Jackman v Mitchell* (1807) 13 Ves Jun 581; *Murray v Reeves* (1828) 8 B & C 422; *Knight v Hunt* (1829) 5 Bing 432; *Gould v Williams* (1835) 4 Dowl PC 91; *Mare v Sandford* (1859) 1 Giff 288; *Mare v Warner* (1861) 3 Giff 100; *Geere v Mare* (1863) 2 H & C 339. However, if the creditor agrees, in consideration of notes issued by the debtor, to participate in the debtor's proposal for an amount which is less than his real claim against the debtor, he may, after the proposal has been fully implemented, retain such part of the benefit of the notes as to entitle him to receive what he would have received under the proposal if he had participate to the extent of his real claim: *Eastabrook v Scott* (1797) 3 Ves Jun 456.

85 *Murray v Reeves* (1828) 8 B & C 422; *Wood v Barker* (1865) LR 1 Eq 139.

86 (1822) Dowl & Ry NP 27.

87 (1839) 10 Ad & Ell 82, 2 P & D 253.

88 *Bradshaw v Bradshaw* (1841) 9 M & W 29; *Langley v Van Allen and Co* (1902) SCR 174.

89 *Smith v Cuff* (1817) 6 M & Sel 160; *Bradshaw v Bradshaw* (1841) 9 M & W 29.

90 (1875) 20 Eq 65.

91 Note that this particular statement was left out by the court in *Somji v Cadbury Schweppes plc* when citing the key passages from *McKewan v Sanderson*.

92 (1877) 7 Ch D 650.

retain any benefits received under the secret agreement or recover his original debt or his share of the composition.[93]

49 Rather than attempt the probably impossible task of reconciling the authorities, it is tentatively suggested that the position should be as follows: since the secret agreement is void for illegality and also constitutes a breach of duty to the other creditors, neither party should be able to sue on it, whether to enforce it or to recover benefits transferred under it. However, to the extent that benefits have been conferred on the creditor which places him in a better position than his fellow creditors, they would have claims against him for their *pro rata* shares of the benefits received. Admittedly, such claims would be novel.[94] However, it seems clear that to allow such claims would be to strike squarely at the mischief which the duty to maintain equality seeks to address, as well as to provide the most appropriate relief for the aggrieved creditors. The alternative of allowing a party to recover payments made under the void contract is not only unpalatable; it would allow a party to recover the benefits which it had willingly parted with to induce another party to secure an unlawful objective.

50 Another area of uncertainty relates to the status of the debtor's proposal for composition or arrangement of his debts. There is authority that, where secret benefits are given to certain creditors to induce them to agree to the proposal, the proposal is void.[95] In contrast, in *Ex parte Milner*,[96] a creditor who had executed a deed of arrangement with his debtor discovered that, subsequent to the execution, several other of his fellow creditors were induced by additional payments from the debtor's brother to execute the deed. It was held that the deed was *voidable*, and the creditor could treat the deed as void. In the opinion of this writer, this latter view is to be preferred, particularly since, as discussed above, the duty to maintain equality should be regarded as not based on fraud but on the need to protect the fundamental premise of equality in collective creditor actions. It should be noted, however, that, as contended above, the composition or arrangement will not be

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93 *E T Fisher & Company Proprietary Limited v The English Scottish and Australian Bank Limited* (1940) 64 CLR 84 at 103.

94 Such claims would, presumably, not be founded in contract or restitution, but would be *sui generis* and based on the breach of the duty that both law and equity have imposed on creditors acting collectively.

95 *Dauglish v Tennent* (1866) LR 2 QB 49. In *Somji v Cadbury Schweppes plc* [2001] 1 BCLC 498, the High Court took the view that the position under the old cases was that the composition or arrangement was void and ruled that the debtor's voluntary arrangement in that case was, therefore, also void. This order was set aside by the Court of Appeal, but on the basis that it would undermine legal certainty and be inconsistent with the terms and policy of the Insolvency Act 1986.

96 (1885) 15 QBD 605 at 613–616.

voidable unless the debtor has knowledge of and has concurred in the illicit transaction.

51 It should also be remembered that, where a composition or arrangement is effected by way of scheme under a statutory "cram-down" procedure, it will likely not be rendered void or voidable on account of a breach of the duty to maintain equality, even if such breach took place with the knowledge and concurrence of the debtor. To declare the scheme void or voidable may be inconsistent with modern statutory regimes which provide expressly for court supervision or intervention.[97] If the breach of the duty to maintain equality is discovered before the scheme has taken effect, the court may decline to grant its sanction or exercise its jurisdiction to set it aside or terminate it, as the case may be. Thus, it has been said that if a debtor, for the purpose of getting a scheme approved, had in secret offered a creditor, in consideration of that creditor withdrawing his claim, terms which are better than those submitted to the other creditors, and if the creditor accepted those terms and withdrew his claim, that would be a very good reason why the court should refuse to sanction the scheme.[98] However, if the breach of the duty to maintain equality is discovered only after the court has sanctioned the scheme, it is unlikely that the court has the jurisdiction to set aside the scheme. A breach of the duty to maintain equality does not constitute fraud, or the type of fraud, which is sufficient to persuade a court to set aside its order sanctioning a scheme.[99] The aggrieved creditors would, therefore, have to be content with pursuing claims against their fellow creditors who have received secret additional benefits.

IX. Conclusion

52 The duty to maintain equality is more than a rule against fraud or a code of good faith in debtors' proposals for composition or arrangement of debts. Proper conceptualisation and rationalisation show that it is a wider and more general principle designed to protect the integrity, fairness and transparency of collective creditor actions and the fundamental premise of equality on which all creditors participating

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97 See *Somji v Cadbury Schweppes plc* [2001] 1 WLR 615.

98 *Re E A B* [1902] 1 KB 457 at 464. For cases in which the courts have refused to sanction or have terminated a scheme of arrangement on account of a breach of the duty to maintain equality, see *NZI Capital Corporation Ltd v Lancaster* (1991) 30 FCR 441; *Paton v Campbell Capital Ltd* (1993) 46 FCR 30; *Young v Sherman* [2002] NSWCA 281.

99 For the jurisdiction of the court to set aside its order sanctioning a scheme of arrangement, see *Fletcher v Royal Automobile Club Ltd* [1999] 1 BCLC 331, affirmed on appeal in *Fletcher v Royal Automobile Club Ltd* (3 February 2000) (unreported).

in such actions are legally entitled to rely. Put simply, the duty prohibits a creditor from receiving or agreeing to receive undisclosed additional benefits, whether from the debtor or a third party, in consideration for taking a particular position in relation to the creditors' collective action. The application of the duty is not restricted by the legal forum in which the collective creditor action takes place, the nature of the collective creditor action, the proposal or issue which is being considered or addressed by the creditors collectively, the extent of involvement of the debtor or the commercial motivations of the parties. However, it will have to be balanced against the risk of unduly curtailing or undermining distressed debt trading activities and the need to allow a proper measure of flexibility and creativity in the structuring of corporate rescue transactions. The recognition of the duty as a general principle is timely and can serve as an important building block for modern insolvency regimes.