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# 'UNEQUALLY EQUAL' —CIRCUMVENTING THE PARI PASSU RULE

*Giselle Romain*

With the current economic climate hosting a less than positive outlook for at least over the next three to five year period, companies in financial difficulty are being forced to weather the storm. To accomplish this some are availing themselves of rehabilitation avenues via recently proclaimed bankruptcy and insolvency legislation while others, seemingly left with no other alternative, are winding down and closing up. In either case, the creditors of these companies are the ones who pay the ultimate price in an unhealthy economy which can no longer support many businesses in which they have invested time, money, goods and services.

These creditors find themselves in a winner takes all game that may leave some fully satisfied and others barely fed or, in some cases, with nothing at all. Against this backdrop, the sharing or distribution of a company's assets (when it files for bankruptcy or commences a liquidation) equally and rateably amongst all its creditors is viewed as most equitable or fair. The essence of this rule of equal distribution, commonly known as the *pari passu* rule, is reflected in Section 426 of the Companies Act.[1] Many commentators and courts hold the view that this rule is one of the (if not the most) fundamental principles of the law of liquidation (and of insolvency in general).[2] So important is the pari passu principle that the both the Companies Act ('CA') and the Bankruptcy and Insolvency Act ('BIA') contain provisions which guard against creditors obtaining preferences just prior to winding up.[3] Finally, other than in certain limited exceptions, the common law supports the pari passu rule by making contracts or provisions of contracts which seek to contract out of the pari passu rule void.

Despite the above, both the evolution and application of insolvency law, as well as the operation of common commercial principles have led to a number of situations where creditors can either side step the pari passu rule altogether or, at the very least turn it on its head. So whittled down has the pari passu rule become that it was stated by Professor Riz Mokal that *'pari passu is not a rule or a restriction or a standard. It neither imposes a requirement which insolvency must fulfil nor does it shape that law in any way'.*[4]

Under bankruptcy and or winding up/liquidation proceedings, there now exists a hierarchy, created partly by statute and partly due to commercial practice, which has led to various levels of priority being created amongst creditors. These priorities create exceptions to the pari passu rule and ultimately impact upon the distribution of assets and the settlement of debts in an insolvency/liquidation.

Three categories of exceptions to the pari passu rule have been identified:

1. False exceptions[5] so deemed because the inapplicability of the pari passu rule turns not on the rule itself but on the question of title to the assets to be distributed. These include secured and quasi-secured creditors and assets which are subject to trusts.

2. Exceptions created by contracting out of the rule, as it is believed that to not allow such exceptions may impinge upon commercial viability. These include subordination agreements and direct payment clauses in certain contracts.

1 *Subject to the provisions of this Act as to preferential payments, the property of a company shall, on its winding up, be applied in satisfaction of its liabilities pari passu……….."*
2 *Mc Pherson's Law of Company Liquidation p. 831 quoting R. Goode from Principles of Corporate Insolvency Law.*
3 *Sections 436 and 84 of the CA and BIA respectively.*
4 *Mc Pherson's Law of Company Liquidation, p. 835*
5 *As described by R. Goode—Principles of Corporate Insolvency Law, p. 189*

*(cont'd on page 2)*

## C O N T E N T S

3. True exceptions enshrined in statute and/or upheld by the courts such as rights of set off, liquidation expenses, statutory preferences, deferred claims by statute and other special cases of market contracts and contracts with environmental liability.

The above examples in each of the categories are not meant to represent an exhaustive list of exceptions to the pari passu rule. This article explores the more common examples under the false exceptions and exceptions created by contracting out of the rule.

**False exceptions to the rule**

Secured creditors: It is a trite principle of law that secured creditors are not prevented from realizing on their security during bankruptcy and/or liquidation proceedings. These creditors operate completely outside of the pari passu rule because they have certain proprietary rights (charges) over the assets of the debtor. These rights, referred to as rights in rem, allow the creditor to exercise certain powers of seizure and sale over the assets and to use the proceeds of such sale towards the settlement of any claims they may have against the insolvent company. The proprietary right over the assets is also complimented by a personal right against the company. Liquidation does not extinguish the rights of a secured creditor and as such secured creditors can have their claims and/or debts settled ahead of other creditors.

Creditors with rights of title: The creditors in this category are often regarded as having a 'quasi security' over the assets of the debtor. Quasi security differs from actual security such as the charges held by secured creditors (created pursuant to debentures, mortgages and other security instruments) in that it arises under certain contractual clauses found in commercial agreements.

The operation of these clauses however imitate the security offered by fixed charges. An example would include retention of title clauses in contracts for the sale of goods and services. These clauses, referred to as Romalpa[6] clauses, make it clear that title in the asset does not pass or vest in the company until payment in full. Therefore, if the company goes into liquidation prior to making full payment on the goods or services in question, no title will pass and the goods will not form part of the asset base of the debtor. The owner of the goods may also have other rights of retention and sale which may arise by virtue of the operation of other legislation[7]. Other assets which may also fall outside the asset pool of an insolvent company would be assets held on trust.

**Exceptions created by contracting out of the rule**

Debt Subordination**:** P. Wood, in his work on *International Finance: the Law of Subordinated Debt,* explained debt subordination as a transaction where one subordinated or junior creditor agrees not to be paid by a common borrower or debtor until another creditor of the common debtor has been paid. Debt subordination may be achieved via many ways and one common way is where creditors agree to arrange the ranking order themselves thus contracting out of the pari passu rule.

In many instances, case law has opined that debt subordination should be disallowed on the grounds of being against the public interest and unfair on the general body of creditors. Debt subordination may occur when creditors, who provide monies or goods to the company just prior to the filing of liquidation proceedings, (where the company is deemed to be under financial distress) and want to safeguard receipt of their monies for these goods and services, implement arrangements to ensure that such debt is paid prior to other unsecured debts. These creditors rely on the fact that, without their injection of cash or provision of goods and/or services, the company will almost inevitably be wound up. As such, they use this as leverage to negotiate a side stepping of the pari passu rule via debt subordination. It therefore becomes a balancing act where the courts have to decide whether the commercial benefits of these arrangements far outweigh the legal importance of upholding the pari passu rule.

Eventually, two distinct positions were outlined: one in which an unsecured creditor would seek to gain a preference over other unsecured creditors without obtaining their consent, and such arrangement would not be supported by the courts. The other scenario involved an agreement between the company, a named unsecured creditor, and other unsecured creditors whereby the debt of the other unsecured creditors is subordinated to that of the named unsecured creditor.

The courts were more willing to honour such arrangements on the grounds that creditors who were not party to the agreement would remain unaffected and have their claims/debts settled in accordance with the pari passu principle. The end position seems to be that as held in the New South Wales case of *United States Trust Co. of New York v ANZ Banking Group Limited (1995)* where the judge stated:

> *'there is no public policy or good sense which prohibits one creditor deferring payment of its debt in favour of the payment of the debt of another creditor if the rights or entitlements of other creditors to payment remain unaffected'* .

Although the courts in recent cases have mentioned these agreements being contrary to public policy, the ultimate decision seems to turn on the express words of the agreement and how they are construed and implemented.

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[6] *Coming out of the case of Aluminium Industrie Vaassen BV v. Romalpa Aluminium (1976) 1 W.L.R. 676*

[7] *Sale of Goods Act Ch. 82:30*

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# NAVIGATING UNCHARTED TERRITORY IN GUAVA SEASON: SECURED CREDITORS' RIGHTS ON INSOLVENCY

*Melissa Inglefield*

As indicated in our May and August 2016 issues of the Forum, the Bankruptcy and Insolvency Act Chapter 9:70 (the 'BIA') overhauled and replaced the bankruptcy regime in Trinidad and Tobago. Some of the major changes include the introduction of certain protections for bankrupt persons, including but not limited to provisions allowing for a bankrupt person to stay bankruptcy proceedings for the purpose of rehabilitating itself. With the introduction of such provisions, secured creditors may now find themselves in a position where a borrower is in clear default of the conditions of a loan provided by a secured creditor (e.g. a bank), but the secured creditor cannot enforce its collateral.

In this Article, we highlight both the steps with which secured creditors must now be familiar prior to taking any enforcement action in respect of collateral security, and also circumstances in which a secured creditor may find itself restricted from enforcing its security interest.

**Know the steps to be taken prior to enforcement**

Prior to the introduction of the BIA, a secured creditor was able to take possession of property secured by a security interest (or appoint a receiver in respect thereof) immediately upon the occurrence of an event of default by a debtor. Such rights were only limited by the terms and conditions of the loan or security documents and, in respect of certain enforcement actions, certain provisions in the Conveyance and Law of Property Act Chap 56:01.

The BIA changes this landscape by requiring secured creditors to provide ten (10) days prior notice to a debtor of its intent to enforce security interests granted in its favour where the security interest covers all or substantially all of the borrower's inventory, accounts receivable, or other property. In such circumstances, a secured creditor is restricted from enforcing its security interest until the expiry of ten (10) days after the notice is sent (unless the debtor consents to an earlier enforcement of the security). It is not possible to contract out of the requirement to issue such notice or to obtain prior consent from a borrower in respect of an earlier enforcement of the security.

Notably, such requirement of prior notice does not apply in certain prescribed circumstances. It is therefore critical for secured creditors to take early pre-emptive steps where the financial soundness of a debtor is called into question. A secured creditor should take the time to verify the rights and powers available to it in respect of the enforcement of its security. Failure to do so may result in any enforcement steps taken being deemed invalid, which may accordingly jeopardize the ability of the secured creditor to swiftly take possession of the secured assets.

**How a stay in bankruptcy proceedings might affect a secured creditor**

As mentioned, the BIA now provides certain rights to insolvent persons under which such insolvent persons may seek to rehabilitate themselves.

Under the provisions of the BIA, an insolvent person may seek to trigger such relief by filing either a notice of intention to file a proposal (a 'NOI') or a proposal (a 'Proposal') with a view to staying insolvency proceedings. Notably, a person against whom bankruptcy proceedings have already been initiated still has the option of filing a Proposal in order to stay such proceedings.

A NOI provides an insolvent person with the opportunity to prepare its proposal and affords such a person a maximum aggregate period of five (5) months (inclusive of extensions of time which may be granted under the BIA) within which a Proposal must be filed. While a stay of proceedings is effected by the filing of a NOI, such stay will not affect a secured creditor where:

- the secured creditor took possession of the relevant secured assets of the insolvent person for the purpose of realization before an NOI was filed;
- the secured creditor notified the insolvent person that it intended to enforce its security against the insolvent person more than ten (10) days before:
  - (i) a NOI was filed by the insolvent person; or
  - (ii) a Proposal was filed (in circumstances where no NOI was filed by the insolvent person); or
- the secured creditor notified the insolvent person that it intended to enforce its security against the insolvent person and the insolvent person consented to the enforcement action.

The filing of a Proposal with the trustee in bankruptcy either continues the stay (where a NOI was filed) or effects a stay (where no NOI was filed).

Importantly, a NOI or a Proposal will affect the rights of secured creditors only where it is addressed to secured creditors holding the same class of secured claims. The BIA prescribed the circumstances in which secured claims may be included in the same class. Under the BIA, a class of secured claims exists only where the interests of the creditors holding such claims are sufficiently similar to give them a commonality of interest, taking into account:

(a) the nature of the debts giving rise to the claims;
(b) the nature and priority of the security in respect of the claims;
(c) the remedies available to the creditors in the absence of the proposal, and the extent to which the creditors would recover their claims by exercising those remedies;
(d) the treatment of the claims under the proposal, and the extent to which the claims would be paid under the proposal; and

## 'Unequally Equal'— Circumventing the Pari Passu Rule *(cont'd)*

*(cont'd from page 2)*

Direct payment clauses: Creditors with direct action are another category of creditors who may gain a preference over other creditors. These creditors usually have contracts with direct payment clauses. Under these contracts, in the event of the insolvency of the company, monies that would usually go to the company can be paid directly to specific creditors, without the consent of or consultation with the general body of creditors by virtue of the contract terms under which they operate. These clauses are usually found in construction contracts where the owner of the property is entitled to pay the sub-contractor directly in the event of the insolvency of the head contractor.[8]

The courts have in the past held these clauses as void being in breach of the pari passu principle because they adversely affect ordinary unsecured creditors as money that would have come to the liquidator of the head contractor, goes to particular creditors of the head contractor, without the consent of or consultation with the general body of creditors. There have been cases however where direct payment clauses have been upheld[9] on the basis that the head contractor did not have an interest in the funds at the beginning of the winding up because it had not been able to satisfy the architect that it had paid the subcontractors which was a requirement under the contract. As such, the validity of direct payment clauses depends upon whether, at the time of liquidation commencement, the insolvent contractor had an interest in the funds that were diverted.[10] If it is established that the insolvent contractor had an interest, then the direct payment clause is unlikely to be upheld.

**Summary**

In summary, creditors with fixed security and quasi security against the company's assets or third parties with rights in rem over the company's assets can make good on their debts free of the pari passu rule. The assets on which they make their claim do not belong to the company and therefore are not caught in the pool of assets from which all creditors can claim. In other cases, parties to commercial agreements may negotiate terms of the agreement which create a preference which they may enjoy if one party were to file for bankruptcy or go into liquidation. The express wording in these contracts is of great importance as, more often than not, it determines whether the preference created would be upheld or disallowed. Statutes which address bankruptcy and liquidation also put time restrictions on when such contracts can be made. In our next issue of the Forum, Part II of this Article will consider the true exceptions to the rule which are more common place in bankruptcy and winding up proceedings.

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[8] *McPherson's Law of Company Liquidation, p. 843*
[9] *Glow Heating Ltd v Eastern Health Board (1988) I.R. 110*
[10] *B. Mullen and Sons (Contractors) v. Ross (McLaughlin and Harvey Plc Re) 1995*

## Navigating Uncharted Territory in Guava Season: Secured Creditors' Rights On Insolvency *(cont'd)*

*(cont'd from page 3)*

(e) such further criteria, consistent with those set out in paragraphs (a) to (d), as may be prescribed by the regulator.

Where a NOI or Proposal is made in respect of a class of secured creditors, it will be binding on such class only where the Proposal (once filed) is accepted by the unsecured creditors and by a majority in number and two-thirds in value of the secured creditors present, in person or by proxy, at the meeting and voting on the resolution to accept the Proposal. In circumstances where there is no quorum of secured creditors in respect of a particular class of secured claims, the secured creditors having claims of that class are deemed to have voted for the refusal of the Proposal. That said, one creditor (or such creditor's representative) constitutes a quorum.

In circumstances where a Proposal is accepted by a class of secured creditors, such class of secured creditors will be subject to the stay. Conversely, where the Proposal is not accepted by a class of secured creditors, such secured creditors may enforce their respective security interests unless the Court orders otherwise in accordance with the provisions of the BIA.

**Navigating uncharted territory**

Prior to the BIA, the enforcement of security by a secured creditor was straightforward and largely unrestricted. Given the rights and options now available to insolvent persons under the BIA, secured creditors may find themselves in uncharted territory. Secured creditors should take the time to familiarise themselves with their rights in respect of collateral they hold, particularly where debtors appear to be approaching financial distress.

Moreover, now more than ever, it is critical that secured creditors pay close attention to the financial health of their debtors in order to ensure that such creditors are primed to take swift, necessary action in circumstances where a debtor defaults on its obligations and the security granted by it becomes enforceable.

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# Fair Competition Coming

## *The Fair Trading Act is Expected to Finally be Brought Fully into Force*

*M. Glenn Hamel-Smith & Linnel Pierre*

Word on the ground is that the remaining unproclaimed (and the most substantive) part of the Fair Trading Act (Chap. 81:13 of the laws of Trinidad and Tobago, the **FTA** or the **Act**) is expected to be proclaimed in the very near future, bringing the Act fully into force. This article offers an insight into the impact of the anti-competition measures provided for in the FTA, including those that, among other things, regulate prospective acquisitions of companies or their assets, joint ventures, and mergers.

**Background:** In 2007, certain parts of the FTA were proclaimed to facilitate the appointment of Commissioners of the Fair Trading Commission (the Commission), the Executive Director and other key staff; as well as to provide for the funding of the Commission. In 2014, Part II of the Act was proclaimed establishing the Commission and outlining its powers and functions. When Part III of the FTA is brought into force, specified anti-competitive activities will be considered offences which, when contravened, will attract sanctions.

The FTA restricts or prohibits three main Categories of Anti-Competitive Activity:

**(1) Anti-competitive practices and agreements**

Any concerted practice of an association of enterprises which prevents, restricts or distorts competition is considered an anti-competitive practice and is prohibited under the FTA, along with all anti-competitive agreements. Horizontal and vertical agreements (i.e. agreements between competitors, and agreements between customers and suppliers respectively) may also be captured by the FTA and, in specific circumstances, can be considered anti-competitive.

Any agreement that: fixes prices directly or indirectly (other than where reasonably necessary to protect the interests of the parties concerned and not detrimental to the interests of the public); limits or controls markets, technical development or investment; shares markets or sources of supply; applies dissimilar conditions to equivalent transactions and thus places some trading partners at a disadvantage to others; or makes contracts subject to extraneous conditions, is considered under the FTA to be an anti-competitive agreement.

**(2) Abuse of monopoly power**

An enterprise has monopoly power in a market, if by itself or together with an interconnected body corporate (parent and subsidiary having same parent company), it occupies such a position of economic strength as will enable it to operate in the market without effective constraints from its current competitors and/or potential competitors. An enterprise which has monopoly power abuses that power if it impedes the maintenance or development of effective competition in a particular market.

Where the Commission has reason to believe that an enterprise (which controls 40% or more of the market share) has abused or is abusing monopoly market power, the Commission will issue a notice to the enterprise and investigate the matter. If the enterprise fails to comply with a request from the Commission to cease the abusive practice, the Commission may apply to the High Court for sanctions, including but not limited to an asset divestment order or restrictions on share transfers.

**(3) Anti-competitive Mergers**

The FTA defines a merger as the cessation of two or more enterprises from being distinct whether by purchase or lease of shares or assets, amalgamation, combination, joint venture or any other means through which influence over the policy of another enterprise is acquired.

The FTA seeks to regulate mergers that are 'anti-competitive' - those which restrict or distort competition in a market; and mergers that will result in an entity with too dominant a market position due to total combined assets post-merger. Enterprises with combined assets exceeding 50 million dollars (intending to operate locally post-merger) may not enter into a merger unless they obtain prior permission from the Commission. Any proposed merger that restricts or distorts competition, or which would be detrimental to the consumer or the economy, will not be granted permission. As such, parties seeking to enter into a merger or amalgamation must first seek the approval of the Commission.

Subject to certain threshold conditions, the FTA also provides that where a director serves on the board of two or more competing companies, and the director is viewed as being likely to weld together the policies of those companies in a way that would reduce or eliminate competition between them ('Interlocking Directorships'), the companies in which he serves as director must apply to the Commission for permission to merge.

**Conclusion:** The implications of the FTA are far reaching considering the above prohibited categories of anti-competitive activities. Save for certain excluded industries (such as telecommunications, banks and financial services companies that are already separately regulated), and other specific exceptions, the Commission's jurisdiction with regard to approving mergers is quite broad, potentially including mergers by way of amalgamations, joint ventures as well as asset/share purchases. Companies operating locally and prospective investors should seek advice to ensure that their current practices and potential investments do not run afoul of the soon to be fully in force (and enforced) FTA.

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