SECOND DIVISION, INNER HOUSE, COURT OF SESSION

[2019] CSIH 56
XA17/17

Lord Justice Clerk
Lord Menzies
Lord Glennie

OPINION OF THE COURT

delivered by LORD GLENNIE

in the Appeal

by

THE ROYAL BANK OF SCOTLAND PLC

Appellant (Defender)

against

MRS ALISON DONNELLY

Respondent (Pursuer)

Appellant: Sellar QC, Thomson QC; Pinsent Masons LLP
Respondent: Upton; Friels, Solicitors

21 November 2019

Introduction

[1] This appeal is said to raise an important and novel question of law relating to the scope of "insolvency set off" and its continued applicability after the insolvency has terminated and the debtor has been released from his outstanding debts. It arises against a factual background indistinguishable in any material respect from that considered by the Supreme Court in *Dooneen Ltd* v *Mond* [2018] UKSC 54, 2018 SLT 1255 (hereafter simply

"*Dooneen*"), affirming the decision of the Inner House in that case ([2016] CSIH 59, 2017 SCLR 199). But it is argued that the issue in *Dooneen* arose in a different way, with the result that the question whether insolvency set-off could apply between the parties to this appeal post termination of the insolvency and release of the debtor did not fall to be decided in that case.

Factual background

[2] Between 1997 and 2003, the respondent, Mrs Donnelly, borrowed money from the appellant ("the bank"). At the same time, the bank sold Mrs Donnelly payment protection insurance ("PPI") in respect of those loans.

[3] On 29 August 2006 Mrs Donnelly became insolvent. She entered into a trust deed for behoof of her creditors in terms of the Bankruptcy (Scotland) Act 1985. That Act ("the Act") has now been repealed (by the Bankruptcy (Scotland) Act 2016), but it is the relevant statutory provision for present purposes. In October 2006, the trust deed became a "protected trust deed" under para 5 of Schedule 5 to the Act. In practical terms, that meant that creditors who had received notice from the trustee and had not objected were treated as if they were acceding creditors. The bank was one such creditor. It submitted claims to the trustee in respect of the sums owed to it under the loans. The insolvency took its course. The trustee gathered in Mrs Donnelly's estate so far as was known to him, and made payments to the creditors in respect of their claims. The amount of Mrs Donnelly's estate ingathered by the trustee was insufficient to pay the creditors' claims in full. Like other creditors, the bank received a dividend of about 22 pence in the pound. That left unpaid, so far as the bank was concerned, a balance of £21,617.42. The final dividend was paid to creditors in December 2013; and thereupon, in terms of the provisions of the trust deed, the

trust deed terminated (clause 11) and Mrs Donnelly was discharged from all her debts (clause 10).

[4] In January 2014 Mrs Donnelly complained that the PPI had been mis-sold to her by the bank at the time of her taking out the loans. She presented her claims to the Financial Ombudsman Service. Her claims were upheld in February and March 2014. A settlement agreement between Mrs Donnelly and the bank was entered into, providing for payment to Mrs Donnelly of sums totalling £11,927.39 in respect of the PPI mis-selling claims. The bank made a payment to Mrs Donnelly of £1,111.63 in respect of the sums which it agreed to pay under the settlement agreement, but has not paid any more than that. As regards the unpaid balance of £10,815 odd, the bank argues that it can set off against it the amount which it contends remains due from Mrs Donnelly under the loan agreements (the sum of £21,617.42 referred to above); so that no further sum is due to her.

[5] It should be noted, though it does not affect the disposal of this appeal, that it is a matter of agreement that at no time either before or during Mrs Donnelly's bankruptcy was Mrs Donnelly or the trustee aware that Mrs Donnelly had a claim against the bank for mis-selling PPI.

Proceedings to date

[6] Mrs Donnelly raised an action against the bank in the sheriff court for payment of the balance due under the settlement agreement. The bank sought to defend the claim on the basis that, after setting off against Mrs Donnelly's claim the unpaid balance due to it under the loan agreements, nothing further was due to Mrs Donnelly. As the matter was formulated in the bank's third plea-in-law in the sheriff court action: "balancing of accounts in bankruptcy operates to discharge the defender [the bank] from any obligation to make

further payment to the pursuer". That principle has been referred to in this appeal as "insolvency set off".

[7] After debate on Mrs Donnelly's plea to the relevancy, the sheriff excluded certain averments but otherwise allowed a proof on the bank's defence of insolvency set-off. The Sheriff Appeal Court ("SAC"), having had the benefit of the decision of the Inner House in *Dooneen*, which they regarded as indistinguishable, allowed the appeal, held that the defence of insolvency set off could not succeed, and granted decree in favour of Mrs Donnelly. This is an appeal by the bank against that decision.

[8] Before summarising the arguments and giving our decision in this appeal, it is convenient first to set out the relevant terms of the trust deed and then to explain the basis of the decision in *Dooneen*.

The trust deed

[9] The function of the trust deed in a case such as this was explained by Lord Reed in the Supreme Court in *Dooneen* at para 1. As an alternative to being sequestrated, a person facing insolvency may enter into a voluntary arrangement with his creditors. In Scotland this usually takes the form of a deed granted by the debtor transferring his estate to a trustee for the benefit of his creditors. The trustee is given power to collect and realise assets, to rank claims, and to distribute the estate among the creditors according to their respective rights and preferences. The trust deed will usually contain provisions relating to the discharge of the debtor from his debts, the restoration to him of any surplus, and the discharge of the trustee. At common law the trust deed is binding on creditors who accede to it but, as happened in this case, it has the potential to become a protected trust deed binding on all creditors whether they accede to it or not.

[10] A trust deed becomes a protected trust deed in terms of the Act if, within four weeks after the trustee has taken up his appointment, published a notice in the Edinburgh Gazette and sent to every creditor known to him a notice in the required terms, a majority in number of the creditors amounting to not less than two-thirds in value accede to the trust deed: para 5(c) of Schedule 5 to the Act. A non-acceding creditor has a short period within which to present a petition for sequestration of the debtor (para 7(1)(a)), but if he does not do that then he has no higher right to recover his debt than an acceding creditor has (para 6(a)). As noted by the Inner House in *Dooneen* at para [16], what creditors are getting by voting for the matter to proceed in this way is a simplified procedure which allows them to obtain some payment with the minimum of fuss, as against the greater protection given to them in formal bankruptcy proceedings.

[11] The trust deed in this case is dated 29 August 2006. It is signed by Mrs Donnelly as truster. In the deed she transferred to Graham Cameron Tough, an insolvency practitioner, as trustee for her creditors as at that date, the rights and assets which would vest in a permanent trustee in terms of sections 31-33 of the Act. In terms of clause 5 of the trust deed Mrs Donnelly undertook to co-operate fully with the trustee at all times and to give him such information as he might require relating to her estate, her dealings with her estate, her conduct in relation to any business carried on by her, and her financial affairs. In terms of clause 6, the trustee was given power, among other things, to take possession of her estate, to recover debts due to her, and to compound and compromise claims enforceable by or against her or her estate. Clause 7 makes it clear that the trust deed was granted for the benefit of her creditors; and stipulates that, after payment of the expenses of the trust deed and the trustee's remuneration, the estate was to be distributed in payment of debts due by her to her creditors as at the date of the trust deed, all in accordance with the order of

priority in distribution as provided for by section 51 of the Act. The trustee was given the power to determine as he thought fit when payment should be made and whether payment should be made by way of interim or final dividend.

[12] Clauses 10 and 11 deal with discharge of debts and termination of the trust deed. They are important and are set out in full below:

> "Discharge of Debts
>
> (10) This Trust Deed is granted by me on condition that the creditors acceding to the Trust Deed shall discharge me of all my debts due to them on the termination of this Trust Deed unless:-
>
> (i) My Trustee reports that in his opinion I have not made full and fair surrender of my Estate or;
>
> (ii) The Trust Deed terminates on an award of sequestration of my Estate being made.
>
> Termination of Trust Deed
>
> (11) This Trust Deed shall terminate on the earliest of the following events:-
>
> (i) An award of sequestration of my Estate …
>
> (ii) The final distribution of my Estate (which for the avoidance of doubt shall include a nil distribution) by my Trustee in accordance with this Trust Deed.
>
> (iii) The acceptance by my creditors of any composition by me."

[13] As the Inner House pointed out in *Dooneen* at paras 8-9, at common law a discharge of the debtor does not affect the estate, which continues to be subject to the trust until all claims have been settled in full; but the effect of a composition with creditors in terms such as these is to grant an absolute discharge to the debtor in return for payment of a proportion of his debts. That has the effect of terminating the trust and removing any remaining estate from the trust as at the date of discharge.

The decision in *Dooneen Ltd* v *Mond*

[14] The essential facts in *Dooneen* were similar to those in the present case. In 2006 the debtor granted a trust deed for creditors in identical terms to the trust deed in the present case. In 2010 the trustee made a final distribution of something over 20 pence in the pound. In 2014 the (former) debtor brought a claim against a bank for mis-selling PPI. Compensation was agreed and paid in 2015. When he made the final distribution the trustee was unaware of the mis-selling claim; but it was agreed by all parties that the claim, albeit then unknown, formed part of the estate vesting in the trustee under the trust deed. The question before the court was whether, in terms of the trust deed, the making by the trustee of a final distribution to creditors brought the trust to an end with the result that the agreed compensation for PPI mis-selling went to the pursuer (the former debtor), with neither the trustee nor the creditors having any claim to it. The Lord Ordinary found in favour of the pursuer and held that neither the trustee nor the creditors had any claim to the compensation. That decision was upheld in the Inner House and by the Supreme Court.

[15] The reasoning can be taken from the judgment of Lord Reed in the Supreme Court with which the other members of the court agreed. There was no difference between a dividend (the word used in clause 7 of the trust deed) and a distribution (the word used in clause 11(ii)). Where the trustee stated that a dividend or distribution made by him was final, that had to be regarded as the final distribution for the purpose of clause 11(ii) of the trust deed. In consequence, the trust came to an end on the date of that distribution (clause 11(ii)); the debtor was discharged of all debts due by him to his creditors in accordance with cl.10; and the former trustee had no entitlement to the asset discovered (in 2015) after the termination of the trust. Any other construction would lead to uncertainty. If there was no certainty that any distribution was final, the trust would be of indeterminate

duration. If there was no certainty that the trust had terminated on payment of the final distribution, the debtor could not be certain that he had been discharged of his debts under cl.10, which could have serious consequences both for him and for anyone else doing business with him. If the discovery of previously unknown assets signified that there had not been a final distribution, even though the certificate required by para. 9 of Schedule 5 to the 1985 Act had already been registered, it followed that reliance could not be placed on the accuracy of the Public Register of Insolvencies. It was inherently unlikely that the trust deed was intended to have that result.

The decision of the Sheriff Appeal Court

16] In the present case the SAC had before it the decision of the Inner House in *Dooneen*. It held that *Dooneen* was indistinguishable. Applying the reasoning in *Dooneen*, the trust deed in this case had come to an end in December 2013 and the debtor, Mrs Donnelly, had thereupon been discharged of all debts due to her creditors, including the outstanding balance of the debt previously owed to the bank. Since her liability to the bank in respect of the sums otherwise due under the loan agreements had been discharged, there was nothing for the bank to use as a set off against her claim to the sums agreed to be due to her in respect of the PPI mis-selling claim.

Submissions

[17] Both parties lodged written Notes of Argument for which we are grateful. They developed those arguments before us as summarised below.

The bank (appellant)

[18] For the bank, Mr Sellar QC submitted that the only thing decided by *Dooneen* was that the trust must be regarded as having been brought to an end by the payment of the final distribution and that any assets which had initially vested in the trust estate would revert to the truster. In *Dooneen* the contest was between the truster and the trustee and the only issue was whether the newly discovered asset (the PPI mis-selling claim) should be regarded as belonging to the former trustee, for the benefit of (former) creditors of the (former) debtor, or as belonging to the former debtor in his own right. There was no claim by a creditor to enforce his debt against the new fund, still less was there any claim by a creditor who had a right of set-off against that new fund. It followed that nothing said in *Dooneen* was intended to decide the issue before the court in the present case.

[19] "Insolvency set-off" was a modern term for what was traditionally known as "balancing of accounts in bankruptcy": McBryde, *The Law of Contract in Scotland* (3rd Ed. 2007), para 25.35-25.36. It applied to trust deeds as part of the common law as much as it applied in a statutory sequestration or liquidation: *Mill* v *Paul* (1825) 4 S 219, 220, *Highland Engineering* v *Thomson* 1972 SC 87, 91, Bell, *Commentaries*, (7th Ed.), ii, 122. Two important principles were to be borne in mind. The first was that insolvency set-off was "not merely an arrangement of convenience, but … an equitable adjustment of mutual debts and credits, to avoid manifest injustice" (Bell, *ibid*, ii, 119, as explained by Lord Hope in *Heritable Bank Plc* v *Landsbanki Islands HF* 2013 SC (UKSC) 201 at para [39]). The second was that, though the law of insolvency is often highly technical, to achieve a just result "rigid logic must [sometimes] give way to practical sense" (per Lord Drummond Young in *Liquidator of The Ben Line Steamers Ltd, Noter* 2011 SLT 535, at para [23]).

[20] The basic rule of Scots insolvency law, both personal and corporate, is that the legal position of creditors is to be determined at the date of insolvency: see e.g. *Ben Line* at para 21. In this case, the date of insolvency is the date of the trust deed: *Mill* v *Paul* (1825) 4 S 220, Goudy, *Treatise on the Law of Bankruptcy* (4th Ed. 1914) at p.555. One application of this, though sometimes described as an exception, is the "hindsight principle", which allows a subsequent valuation to be used; but it is only used to determine the net value of the indebtedness at the date of insolvency: *Ben Line* at para 23. Another is the rule that insolvency "operates *retro* when pleaded and sustained" (Bell, *ibid*, ii, 124); so that, when the claim is made in the insolvency process – and in insolvency it is not necessary first to have raised legal proceedings and pursued the claim to judgment, since it is the function of the trustee to adjudicate on claims made in the insolvency (McBryde, *ibid*, para 25.70) – the set-off is deemed to have taken effect at the date of the insolvency.

[21] Applying these principles to this case, it was submitted that the SAC erred in concluding that the termination of the trust had the effect of preventing the *retro* application of insolvency set-off (as at the date of the trust deed). There was nothing that the bank could have done differently to enforce its claim under the loan agreements standing the grant of the trust deed. It had submitted a valid claim to the trustee. It could not have pled set-off against a claim by Mrs Donnelly in respect of the PPI mis-selling during the currency of the trust deed, since she had not made any such claim; and the trustee himself had made no such claim on behalf of the estate against which set-off could have been asserted. The decision by the SAC was counter-intuitive and unjust. Its effect was that insolvency process, the very arrangement which gave rise to the right of insolvency set-off in the first place, must be taken to have destroyed that right in a way which was fundamentally at odds with

the whole point of insolvency set-off. The decision was wrong in law and should be reversed.

[22] Mr Sellar recognised that there was unlikely to be any dispute about the general principles outlined in his submissions thus far. The point made against him was that insolvency set-off only applied during the course of the insolvency process. This was wrong. The termination of the trust did not have the effect of preventing the bank from exercising an accrued right of insolvency set-off, which would operate *retro*, as at the date of the grant of the trust deed. For this he relied on Burton, *The Law of Bankruptcy, Insolvency and Mercantile Sequestration*, (1845), pages 22-23 and *Baillie* v *Young* (1837) 16 S 294. He recognised that Burton was not generally regarded as an authority, and that the passage in Burton on which he relied looked to derive more support from *Baillie* v *Young* than that case justified, since *Baillie* v *Young* expressly proceeded on the basis that the discharge of the debtor was reduced before the set-off could be operated. Nevertheless, he submitted that there were two legal bases for his argument.

[23] First, it could be argued that the discharge given to Mrs Donnelly was not absolute and did not preclude the exercise of insolvency set-off which had already accrued but could not have been exercised. Thus, it did not have the effect of discharging a co-obligant or, in some circumstances, a guarantor. Nor did it have the same effect as the extinction of a debt by prescription (cf Goudy, at p. 554, who referred only to prescription). *Kinmond, Luke, & Co* v *James Finlay &Co* (1904) 6 F 564, cited with approval by the Supreme Court in *Dooneen* at paragraph 11, showed that while a discharge under a trust deed clearly prevented a secured creditor from suing the debtor, it did not affect the creditor's right in security: per the Lord Ordinary (Low) at 568, and per Lord Trayner at 570. A right of set-off had been equiparated with a right in security: *Borthwick* v *Scottish Widows Fund and Life Assurance Society* (1864) 2 M

595. On that basis it was argued that, while the discharge prevented the bank from commencing proceedings against Mrs Donnelly, it did not prevent it from exercising its right of set-off if sued by her. If a security right continued after discharge, why does a right of insolvency set-off not similarly continue after discharge?

[24] The second basis for the argument was that the lodging of a claim in the insolvency process should be treated as an assertion of all legal rights as a creditor of the trust, including any right to insolvency set-off. The trustee's function in the present case was to apply insolvency set-off. His failure to do so was the result of the debt, which was owed to the trust, not being known about. The plea in the sheriff court action was merely a permissible reassertion of that right. While that basis might be seen as artificial, insolvency law permits such artificiality.

[25] Mr Sellar was at pains to emphasise that the aims and outcomes of insolvency set-off in Scots law were no different in any material respect from those of insolvency set-off in England, though the English rules had always been statutory: see per Lord Blackburn in *Hannay & Sons' Tr* v *Armstrong Brothers & Co* (1877) 4 R (HL) 43, 45; and see also per Lord Hope in *Secretary of State for Trade and Industry* v *Frid, Re West End Networks Ltd (in liquidation)* [2004] 2 AC 506 at paras [32]-[34]. It was not surprising, therefore, that the continuing right to exercise insolvency set-off after termination of the insolvency, which the bank submits exists here, reflects the result which would until recently have been produced in England (changes to the Insolvency Rules 2016 have now removed the need for that). More to the point, there was assistance to be found in remarks of Hoffman LJ, as he then was, in *MS Fashions Ltd and Ors* v *Bank of Credit and Commerce International SA* [1993] Ch 425 in support of the proposition that insolvency set-off could continue to be exercised even

after the termination of the insolvency process and the termination of the creditor's claim on the company's dissolution. He said this (at p.435):

> "Until the contingency occurs, the liquidator or trustee will not be able to use the claim as either a cause of action or a set-off. If the other party has a cross-claim, he will be able to prove for the full amount. I suppose it may happen that the contingency occurs long after the winding up has been completed and the company is then restored to the register and brings an action. The defendant may have proved for his cross-claim and received a small dividend. Can he still rely on the full claim as a set-off, giving credit for the dividend? For my part, I do not see why not."

Those remarks were entirely consistent with principles of the Scots law of insolvency set-off. The completion of the winding up in *MS Fashions* was the functional equivalent of the termination of the trust in the present case. The conclusion that a creditor, who has received only a small dividend, may later rely on its full claim for the purposes of set-off is exactly the solution which the law requires in order to avoid manifest injustice to the creditor. In the present case, the SAC sought to distinguish *MS Fashions* on the ground that the trust deed here precluded the bank from relying on its claim as a set off after termination of the insolvency. But that reasoning was circular. It simply assumed the effect of the termination of the trust and the discharge of the truster, whereas that was the very issue to be decided.

[26] Mr Sellar concluded by noting that the Supreme Court in *Dooneen* described the decision on the interpretation of the trust deed as "scarcely a satisfactory outcome": para 27. Such a description would apply all the more so if the bank did not continue to have even the purely negative right to exercise insolvency set-off.

Mrs Donnelly (respondent)

[27] For Mrs Donnelly, Mr Upton emphasised the terms and effect of the trust deed as explained by the Inner House and the Supreme Court in *Dooneen*. On a final distribution by the trustee, which had happened here, the trust came to an end and the debtor was

discharged of all her pre-insolvency debts, including sums formerly due under the loan agreements with the bank. That occurred as a matter of agreement in accordance with the terms of the trust deed. That discharge had not been reduced (set aside) as in *Baillie* v *Young*. The debt previously owing by Mrs Donnelly to the bank under the loan agreements had been extinguished and therefore could not form the basis of any set-off against claims by Mrs Donnelly against the bank. The insolvency had come to an end with the termination of the trust deed and the discharge of the debtor from all her debts. To re-open the question of debts and cross-debts after the termination of the trust deed would be conducive of great uncertainty as indicated by Lord Reed. There was no basis for the contention that insolvency set-off should be available to one of her (former) creditors post insolvency.

[28] At the beginning of his submissions, Mr Upton identified four elements of common ground and used these headings to develop some of his arguments.

[29] The first point was that Mrs Donnelly had claimed PPI compensation in January 2014, after the trust had terminated. Settlement of Mrs Donnelly's claims was achieved in February and March 2014. The bank paid the sum of £1,111.63 pursuant to that settlement. It was only after it had made that initial payment that the bank raised the question of set-off. This action was raised in light of the bank's refusal to pay the balance due from it under the settlement agreement.

[30] The second point was that for set-off to operate, the debt by the pursuer to the defender must exist at the time the plea comes before the court. It is insufficient that it may have existed at some time prior to that. Set-off does not operate automatically so as to extinguish a debt *ipso iure* – it must be pled: Bell, *ibid*, ii, 124, Wilson, *Debt* (2nd Ed), para 13.6. The relevancy of the plea of set-off depends on whether the debt sought to be set-off against the claim by the other party exists when the court is asked to give effect to the plea. In this

case the debt owed by Mrs Donnelly to the bank had already been extinguished not only before the plea was first stated by the bank on record in this action but before conclusion of the settlement agreement on which the present action was based. It is well established that a debt which has been extinguished by prescription at the time the issue is raised cannot thereafter be used by way of set-off: *Carmichael* v *Carmichael* (1719) Mor 2677, *Baillie* v *M'Intosh* (1753) Mor 2680, *Galloway* v *Galloway* (1799) Mor 11122, Erskine, III, iv, 12, Bell, *ibid*, ii, 123. The issue between the parties was as to whether that same conclusion should follow where, as here, the debt had been extinguished not by prescription but by agreement. There was no reason why the same result should not follow. The proper construction of clause 10 of the trust deed was that on payment of the final dividend and termination of the trust deed the acceding creditors discharged Mrs Donnelly of all her debts due to them. The ordinary meaning of that term ("discharge") was that those debts were extinguished for all time. The argument that the settlement operates *retro* begs the question, because it ignores the prior issue of whether there remains outstanding a debt owed to the bank capable of being set off against Mrs Donnelly's claim under the settlement agreement. Otherwise any express bilateral discharge of a debt could simply be ignored.

[31] Third, it was common ground that the trust deed had to be construed as a contract between the debtor and the acceding creditors: see *Kinmond* at p.570, *Dooneen*, Inner House, para 8.

[32] Fourth, at the moment when the trust terminated, there had already been a "PPI event" (i.e. the mis-selling) and therefore a debt owed by the bank to Mrs Donnelly. The mis-selling was in respect of the loans taken out under the loan agreements on which the bank presently relies for its set-off claim. Accordingly, at all material times the facts giving rise to the claim for PPI compensation were within the actual or imputed knowledge of the

bank. The bank knew Mrs Donnelly's details and the manner in which she had been sold the PPI. The PPI debt was not latent or contingent. Steps needed to be taken to enforce it, but that did not alter the status of the obligation.

[33] In response to Mr Sellar's reliance on *dicta* of Lord Trayner in *Kinmond* in support of his argument, by analogy with rights in security, that the discharge of the truster did not preclude the exercise of insolvency set-off, Mr Upton pointed out that that case was concerned with the effect of insolvency on a creditor's real right in security; and the court had, in effect, done no more than apply the terms of section 65 of the Bankruptcy (Scotland) Act 1856, which expressly provided for a trustee to "reserve to such creditor the full benefit of such security". That had no bearing on the fact that at common law a discharge, including a discharge by contract, extinguishes a debt. Indeed it might be said that the statutory provision in the 1856 Act was only necessary because of the common law position. There was no authority to support the proposition that a debt which had been extinguished by prescription or agreement has some continued existence, albeit only as a shield, to be used by way of set-off.

[34] Hoffman LJ's remarks in *MS Fashions Ltd* were clearly *obiter*. They concerned a mere possibility ("I suppose it may happen …") on which he clearly had not been addressed. His conclusion was tentative and unreasoned ("For my part, I do not see why not."). He was sitting at first instance and there was no reference to this point in the judgments of the Court of Appeal. The discussion was about contingent obligations, whereas in this case the obligation to pay PPI compensation was not contingent for the reasons already mentioned. The case raised issues arising under the English Insolvency Rules. Further, the discussion was about liquidation, where neither the debtor not the creditor has any control over the process. In those circumstances it is a natural reaction to suppose that one way or another

the unpaid claim could be used as a set off against the new claim. But the circumstances here were quite different. In the present case the trust deed process was essentially contractual in nature. The bank could have refused to participate as an acceding creditor except on terms safeguarding its position in respect of its potential liability for PPI mis-selling. The bank could have made its consent to termination of the trust deed similarly conditional. And, even after the trust deed was terminated, the bank could have raised before the Ombudsman its claim to set off the unpaid balance against the PPI compensation; and the Ombudsman could have taken that into account in making his decision on liability.

[35] Finally Mr Upton referred to the submission on behalf of the bank that refusing set-off in this case would create an injustice, since the bank had never had the ability to exercise insolvency set off in the insolvency process. This submission was incorrect. The bank knew or ought to have known about its potential liability for mis-selling PPI. This was true as a matter of principle, but also as it was a member of the British Bankers' Association, which was party to the principal litigation concerning obligations to compensate customers to whom PPI policies had been sold: *R (British Bankers' Association)* v *Financial Services Authority* [2011] EWHC 999 (Admin). That case was decided during the course of the insolvency. The set-off could have been exercised during Mrs Donnelly's insolvency by her trustee on behalf of her estate granting the bank a discharge. The bank could have prompted the trustee to do so by intimating its indebtedness to the estate – if the trustee's own diligence had not identified the PPI claim as a potential asset. The trust could not be terminated and the trustee discharged without prior notice inviting the creditors, including the bank, to a meeting in order to approve those steps. The bank did not object to the respondent's discharge. If the bank considered that termination of the trust without set off being given effect (by a discharge) would result in gross and manifest injustice then it had only to raise

the matter at the creditors' meeting and make its approval conditional thereon. It had not done so. There was no manifest injustice in leaving the bank to take the consequences of its inaction. Indeed, it would run counter to the intention behind the resolution of affairs in this way by use of a trust deed if a creditor in the position of the bank could keep quiet about its potential liability to the debtor, receive a dividend along with other creditors in proportion to its claims lodged in the process, and then, after the termination of the insolvency, seek to recover more by setting off its liability against the unpaid balance of its claims.

Discussion

[36] The issue before this court in this appeal is as to the relevancy of the bank's plea of set-off in answer to the action brought by Mrs Donnelly to enforce payment by the bank of sums agreed to be owing to her in respect of PPI mis-selling. The set-off relates to sums advanced by the bank to Mrs Donnelly under loan agreements in the period from 1997 and 2003. No other defence to Mrs Donnelly's claim is put forward by the bank.

[37] For its plea of set-off to succeed, the bank must demonstrate that there is a debt owing to it by Mrs Donnelly and that that debt existed when it put forward its plea of set-off in this action: see eg Wilson, *The Scottish Law of Debt*, (2nd Ed), para 13.6. The question is whether it can do so. That depends in this case on the circumstances in which the bank's claim was advanced against Mrs Donnelly's estate in the insolvency proceedings constituted by the trust deed; and on the terms upon which those insolvency proceedings were brought to an end.

[38] The trust deed was entered into by Mrs Donnelly in August 2006. It became a protected trust deed in October of that year. It is not in dispute that the bank became, or is to be treated as, an acceding creditor and bound by the terms of the trust deed, subject to its

rights to apply to the court in circumstances set out in Schedule 5 to the 1985 Act (that being the Act with which we are here concerned, notwithstanding its repeal by the 2016 Act). The bank duly submitted its claims to the trustee. There was insufficient in the trust estate to enable Mrs Donnelly's creditors to be paid in full. In December 2013 the trustee paid a final dividend or distribution. Along with other creditors, the bank was paid a dividend in respect of its claims of about 22 pence in the pound. This left a balance of over £20,000 unpaid in respect of the bank's claims under the loan agreements.

[39] Thus far there is no dispute between the parties. Nor is there any dispute about the immediate consequences of all that. These are spelled out in the trust deed, which takes effect as a matter of contract between the debtor and her creditors: see the judgments in the Inner House and the Supreme Court in *Dooneen*. On a final distribution (or dividend) by the trustee the trust deed terminated: clause (11). Subject to certain contingencies which are not relevant here, on termination of the trust deed the debtor (Mrs Donnelly) was discharged of all debts due to acceding creditors: clause 10. These consequences all follow even if it later transpires that there was a part of the trust estate of which the trustee was unaware and which had therefore not been distributed in payment of the debts: *Dooneen*, Supreme Court, para 12. The problems with the alternative view are explained by Lord Reed at paras 13-15. Of particular relevance here is the problem referred to by Lord Reed at para 14: if one cannot be certain that at this point the trust has terminated, then the debtor cannot be certain whether or not he has been discharged of all his debts, which would have

> "serious practical consequences not only for the debtor but also for anyone else doing business with him after his apparent discharge and the apparent termination of the trust, since he might nevertheless prove to be an undischarged bankrupt."

So, subject to the possibility of reduction (which we come back to at the end of this Opinion), the trust terminates on payment of the final dividend; and the debtor is discharged from debts due to his acceding creditors.

[40] It follows from the above that Mrs Donnelly's debts to the bank under the loan agreements were discharged on termination of the trust, before Mrs Donnelly brought her claim in the sheriff court for payment of the agreed PPI compensation and before the bank sought to plead set-off in answer to that claim. Since any claim by the bank against Mrs Donnelly under the loan agreements had been discharged by the time the bank raised its plea of set-off, there was no longer any debt owing from her to the bank which could be made the subject of that set-off. The plea of set-off is therefore irrelevant.

[41] In an attempt to resist this conclusion, Mr Sellar sought to argue that the discharge of the indebtedness under clause 10 of the trust deed did not wholly extinguish the bank's claim against Mrs Donnelly. While it prevented the bank from bringing a claim against Mrs Donnelly in respect of the unpaid balance of the loans, it did not prevent the bank from using it as a shield to defend itself against claims by Mrs Donnelly. In this respect it differed from prescription, which extinguished a claim, and operated more like limitation, which simply prevented a claim being made. He sought to strengthen this argument by suggesting, under reference to *Kinmond*, that set-off operated like a right in security, which might continue to exist despite the underlying debt being discharged under a trust.

[42] In our view this argument must fail, simply as a matter of construction of clause (10) of the trust deed and the word "discharge" as used in it. As is made clear in *Dooneen*, the trust deed takes effect as a contract between the debtor and the acceding creditors. The ordinary meaning of the word "discharge" in that context is that the debts due to the creditors are extinguished upon payment by the trustee of the final dividend and

termination of the trust. That is the deal which the parties have agreed. Nothing in the surrounding circumstances supports any different construction. In our opinion the meaning of clause (10) is clear: debts due to creditors are discharged or extinguished upon termination of the trust deed.

[43] There are practical considerations supporting this interpretation of the trust deed. We mention three in particular.

[44] First, if at the moment the trust deed terminated the debtor was not fully discharged from all his debts due to his creditors, in the sense of his liability for those debts being extinguished, that would leave him in a state of uncertainty; and, although there would be no risk of him proving at a later date to be an undischarged bankrupt (as envisaged by Lord Reed at para 14 of *Dooneen*), the extent of his assets, in so far as consisting of claims made by him after his discharge, would be fraught with uncertainty if those claims might be defeated by reference to claims raised (and apparently discharged) in the insolvency proceedings;

[45] Second, if it were open to a creditor to rely by way of set-off upon a debt due from the debtor but discharged only in the limited sense contended for by the bank, it would have consequences for the validity of the final distribution by the trustee under the trust. In this case the bank was paid a dividend on a claim presented by it to the trustee of the whole amount of the sums then outstanding under the loan agreements. If it is now permitted to set off its claim for such sums against its liability to Mrs Donnelly for the PPI mis-selling, then its claim against the trust estate for re-payment of sums advanced under the loan agreements should have been correspondingly reduced. On that basis, it should only have been paid a dividend on the net balance of its claim, after deduction of the PPI settlement amount. It stands to make a windfall (albeit in this case probably a small one) at the expense of other creditors, having been paid a dividend on the full amount of its claim rather than

only on the net balance. The claim presented against the trust estate having been, on this basis, greater than, with hindsight, it ought to have been, the dividend paid by the trustee on all claims was correspondingly smaller (in terms of pence in the pound) than it should have been. It is unclear how much difference in the amount of the dividend there would be in the present case, but it is not difficult to envisage cases where the amount of the difference is significant.

[46] Mr Sellar sought to get around this, and this is the third point, by saying that the court could make it a condition of allowing the set-off in this action that the bank make payment to the other creditors in the amount by which they have been so disadvantaged. This would, we suppose, be possible on a one-off basis, though it would mean that set-off in this case became a matter not of right but of judicial discretion, requiring subsequent policing by the court (since Mrs Donnelly, as the former debtor and with nothing to gain or lose by this, would have no interest in ensuring that the bank complied with any such obligation). But such an arrangement would involve identifying all other creditors who had been paid a dividend and ascertaining the amounts they had been paid and what further sums were due to them. This could not work automatically, so an order of the court would be necessary in any case where set-off was pled in similar circumstances. The assistance of the (former) trustee would be required, to assist in identifying the other creditors and calculating how much should be paid to each. But the trustee's remuneration for administering the trust has already been ascertained and paid, so provision would have to be made for further remuneration to be paid for this additional work. In short, such an approach is virtually unworkable; and, if it could be made to work, it would effectively amount, in substance if not in name, to a re-opening of the trust deed, requiring the trustee

to make a further final distribution, a course which would run entirely counter to the practical considerations outlined by Lord Reed in paras 13-15 of *Dooneen*.

[47] For much the same reasons we do not consider that Mr Sellar's argument based on equiparating rights of set-off with rights in security advances his case. The case of *Borthwick*, on which he relied for the analogy, was entirely different and did not raise any question of the set-off or security surviving the discharge of the claim on which it was based. Nor does *Kinmond* assist his argument, since that case was dealing with a real right in security expressly preserved by statute (s. 65 of the Bankruptcy (Scotland) Act 1865). A right of set-off depends for its effectiveness on the existence of a debt at the time the set-off is claimed. The debt in the present case was discharged or extinguished by agreement when the trust deed was terminated. Thereafter the bank no longer had a debt owing to it which it could use to set off against Mrs Donnelly's claim. The analogy with a right in security adds nothing to the argument.

[48] Much of Mr Sellar's submissions focussed on broad principles of insolvency law, with its emphasis on achieving an equitable solution and the subordination of rigid logic to practical common sense. He relied, in particular, on the hindsight principle and the rule that that insolvency set-off, when properly invoked, operates *retro*. These principles were not in dispute. It is difficult, however, to see how they assist the bank in this case. We are not here concerned with a claim to set-off in the insolvency. The insolvency process is at an end, having been terminated by agreement upon the trustee making his final distribution. The claim to set-off is advanced as a defence in a sheriff court action, quite distinct from the insolvency process. The trust deed is relevant to this sheriff court action only because it is in the trust deed that parties agreed that upon termination of the trust the debtor would be discharged of her indebtedness to acceding creditors. It is the discharge which is important,

not the fact that the discharge in this case was agreed as part of a trust deed. A discharge entered into in a bilateral contract between debtor and creditor would be equally effective to bar the plea of set-off. So the fact that Mrs Donnelly's claim, if known about, could have been set off against the bank's claim for repayment on the loans, leaving the bank in the position of creditor for the net balance due to it, is neither here nor there. The insolvency process has come to an end and unless it is re-opened it will not be possible for the bank to rely on insolvency set-off in respect of its claims.

[49] Much stress was laid by Mr Sellar on the remarks of Hoffman LJ, as he then was, in *MS Fashions*. Those remarks are, of course, entitled to great respect, as is everything coming from that source. But they were clearly *obiter*. They were made in the context of corporate insolvency governed by English insolvency rules. The process of corporate insolvency comes to an end with the dissolution of the company. There is, so far as we know, no contractual discharge of all debts due from the company to its creditors. Accordingly, in the circumstances posited by Hoffman LJ, it is not difficult to understand that, if the company was later restored to the register and brought new claims against one of its former creditors, that creditor might be entitled to meet that claim by setting off the unpaid balance of its own claim in the liquidation. Such a claim by the creditor would not have been discharged. We express no view on whether that would be the position in Scotland. But the difference between such a case and the present case is obvious. In the present case the trust proceedings came to an end with an agreed discharge of all debts due from the debtor to acceding creditors. In those circumstances the bank has no debt owing to it capable of being used by way of set-off to defeat Mrs Donnelly's claim to enforce payment of the sums agreed to be due to her as a result of the PPI mis-selling.

[50] Finally, we should note that there is no claim before the court on this appeal for reduction (setting aside) of the actings of the trustee so as to re-open the trust proceedings and allow the bank to assert its right of set-off in the insolvency. The issue was noted by Lord Reed in *Dooneen*. The discharge of the debtor was reduced in *Baillie* v *Young* so as to allow set-off to be operated. We were told that there is an action on foot at the instance of the bank to achieve that result in this case if it is unsuccessful in its appeal. Nothing we have said in this Opinion should be taken as expressing any view on the merits or otherwise of such a course.

Disposal

[51] For the reasons set out above we shall dismiss the appeal. We reserve all questions of expenses.