



SHERIFF APPEAL COURT

**[2017] SAC (Civ) 1
GLW-CA115-14**

Sheriff Principal Dunlop QC
Sheriff Morrison QC
Sheriff A MacFadyen

OPINION OF THE COURT

delivered by SHERIFF MORRISON QC

in appeal by

ALISON DONNELLY

Pursuer and Appellant

against

THE ROYAL BANK OF SCOTLAND PLC

Defender and Respondent

**Pursuer/Appellant: Upton; Friels Solicitors Ltd, Uddingston
Defender/Respondent: D Thomson; Pinsent Masons LLP, Edinburgh**

Edinburgh, 13 January 2017

The background and context

[1] Between 1997 and 2003, the pursuer, Mrs Donnelly, borrowed money from the defender (“the Bank”) and the Bank sold to Mrs Donnelly payment protection insurance (“PPI”). On 29 August 2006, Mrs Donnelly became insolvent and executed a trust deed for behoof of her creditors. On 24 October 2006 that deed became a protected trust deed under the Bankruptcy (Scotland) Act 1985. One of the consequences of that is that creditors who

had received notice from the trustee and had not objected are treated as if they were acceding creditors. The Bank was such a creditor. The Bank submitted claims in respect of the loans. Mrs Donnelly was discharged on 11 December 2013 and the trustee paid a final dividend to creditors on 31 December. The Bank was not paid in full; the Bank says, which is not admitted, that a balance of £21,617.42 remained. The trustee was discharged.

[2] In February and March 2014, claims by Mrs Donnelly that she had been mis-sold the PPI were upheld and settlement agreements provided for payment to her of sums totalling £11,927.39, of which £1,111.63 was paid by the Bank. Mrs Donnelly now sues the Bank for payment of the balance of the PPI compensation of some £10,815. The Bank pleads compensation or set-off, by application of the principle of balancing of accounts in bankruptcy, in respect of the debt it claims remains due to it by Mrs Donnelly for the loans. That was the balance of the loans unpaid after the dividends paid to the Bank under the trust deed. It was accepted for Mrs Donnelly before us, though it had not been at the debate before the sheriff, that her PPI claim was a pre-insolvency debt, though not purified at that time because it had not be quantified until the settlement after her discharge.

The issue

[3] A number of issues were debated before the sheriff; the only one that concerns this court being whether the discharge of Mrs Donnelly extinguished any obligation she may have had to pay the balance of the loans to the Bank. The sheriff decided that the obligation had not been extinguished, and that the Bank could plead set-off. He held that Mrs Donnelly sued as constructive trustee to recover the PPI compensation as an asset of her insolvent estate of which the Bank remained a creditor. Mrs Donnelly appealed on that point and did not seek to

challenge the sheriff's decisions in his clear and full judgment on the other points debated before him.

[4] Although that is the sole issue before us, the argument has changed since the decision of the sheriff on 11 February 2016 following the decision of the Second Division of the Inner House of the Court of Session in *Dooneen Ltd v Mond*, [2016] CSIH 59, delivered on 13 July 2016. That decision upheld the opinion of the Lord Ordinary, about the construction and effect of a trust deed in the same terms as the trust deed in this case. Clauses (10) and (11) of the trust deed in *Dooneen* are in identical terms to the relevant un-numbered clauses in the trust deed in this case. The clauses are set out at paragraph [8] of the judgment in *Dooneen*. We were informed that trust deeds in these terms had been widely used, although they are no longer in use. It was also brought to our attention that leave to appeal by the defender in that case to the UK Supreme Court had been refused by the Inner House but it was also understood that an application was to be made directly to the UK Supreme Court for leave to appeal to that court. Counsel for Mrs Donnelly accepted that her appeal could not succeed if *Dooneen* was wrongly decided.

[5] In *Dooneen* the issue was whether the trust deed had come to an end on the making of a distribution by the trustee with the result that neither the trustee nor the creditors had a claim to the PPI compensation subsequently sought and received by the debtor. After the final distribution by the trustee of 22.41 pence in the pound and the discharge of the second pursuer, the first pursuer made a claim as agent for the second pursuer for the mis-selling of PPI to the second pursuer by a bank (not the Bank in this case) from which the second pursuer had borrowed money. The PPI compensation awarded was paid to the trustee, the defender, as it was accepted that the PPI claim vested in the trustee at the date of execution of the trust deed. The Second Division held, on a construction of the trust deed, that the

final distribution was in effect a composition which brought the trust to an end, the trustee and the creditors had no claim on the PPI compensation and the second pursuer was re-invested with the remaining trust estate including the PPI compensation.

[6] Although the Bank contended in a supplementary note of argument that *Dooneen* had been wrongly decided, it was recognised that it was binding on this court and the argument was not, therefore, made to us.

The arguments in brief

[7] For Mrs Donnelly, it was argued that *Dooneen* was determinative of the issue in this case and Mrs Donnelly's obligation to pay the balance of the loan debt to the Bank had been extinguished by her discharge and payment of the final dividend according to the particular terms of the trust deed. Any property left in the insolvent estate was re-invested in her, she sued in her personal capacity, and not as a constructive trustee, for the unpaid PPI compensation and the Bank could not plead set-off of the balance of the loan debt owed to it.

[8] For the Bank, there was an ingenious argument to circumvent the decision in *Dooneen*. In that case, there was a surplus that came into being after the trust had terminated; in this case, there was not because the Bank's claim for the loan debt was larger than Mrs Donnelly's PPI claim. When compensation or a balancing of accounts in bankruptcy is pleaded, it operates *retro*, that is to say, at the date of insolvency: Bell, *Commentaries*, ii. 124. At that date, Mrs Donnelly's PPI claim, which was now accepted for Mrs Donnelly to be a pre-insolvency debt although not then purified, was "extinguished" by the larger claim the Bank had. The Bank could plead a balancing of accounts or set-off in this action.

Can the Bank set off its debt?

[9] Unless *Dooneen* can be distinguished on the ground argued by the Bank, the appeal by Mrs Donnelly must succeed.

[10] The first point made by counsel for the Bank was that *Dooneen* can be distinguished because that case involved a surplus and that it did not deal with compensation or balancing of accounts in bankruptcy. It is, of course, true that *Doonen* did not deal with the issues of compensation or balancing of accounts because the dispute was between the truster and his trustee about the effect of the trust deed and was not a dispute between the truster (debtor) and a creditor, but we do not think that whether there was a surplus or not makes any difference to the legal effect of a trust deed which extinguishes a debt.

[11] The second aspect of this point for the Bank was that there was not, in this case, a surplus to revert to Mrs Donnelly because, on a balancing of accounts in bankruptcy at the date of insolvency, the Bank's claim for its loan debt was larger than her PPI claim. That would be true at common law, for the principle of balancing of accounts in bankruptcy is an extension of the law of compensation, which allows for compensation of liquid claims, by allowing set-off of an illiquid claim against a liquid claim. Is it also the case where the effect of the trust deed on discharge of the debtor is to extinguish the creditor's debt?

[12] At common law, the discharge of a debtor does not affect the estate which continues to be subject to the trust until claims have been settled in full unless there is a composition or abandonment. That makes sense: why should a creditor, who has not had his debt paid in full, not claim for the balance when further funds are found or why should the creditor be met subsequently with a claim from the debtor and not be able to plead compensation for his debt? If he has contracted otherwise, such as by a composition, however, he cannot do so.

[13] The argument for the Bank is that when compensation, or a balancing of accounts in bankruptcy, is pleaded, it operates *retro* as stated by Bell in his *Commentaries on the Law of Scotland*, 7th edition, ii. 124. The important date, therefore, is the date of insolvency. The principle of balancing of accounts, it was argued, could be pleaded and sustained, in this action, and applied at the date of insolvency. At that date, the Bank could set-off Mrs Donnelly's PPI claim against its claim. The importance of the date of insolvency, it was submitted, was illustrated in *Liquidators of the Ben Line Steamers Ltd, Noter*, 2011 SLT 535, which even the hindsight principle recognised.

[14] Counsel for Mrs Donnelly pointed out that the Bank's argument overlooked the fact that the bankruptcy was at an end and there could be no balancing of accounts, which was a principle devised to resolve issues in insolvency. Compensation, or the balancing of accounts, had to be pleaded and did not operate automatically: Bell, *Commentaries*, ii.124; and Wilson, *The Scottish Law of Debt*, 2nd edition, paragraph 13.6. The relevant date was the date when compensation or set-off was pleaded and not the date of insolvency, and the question was whether the debt existed at that date (which it did not). Furthermore, both debts must be due (Wilson, para 13.3) and, if one of them has prescribed or has otherwise been extinguished, both are not due and set-off cannot be successfully pleaded.

[15] A critical point, in our opinion, is the rule that a debt which has prescribed cannot be pleaded in compensation: Bell, *Commentaries*, ii.123; Wilson, paragraph 13.6. If compensation does not operate in that situation, why should it operate after a composition or its equivalent? The answer for the Bank was simply that prescription was about stale claims and the Bank's claim was not stale. We do not consider that that adequately answers the question. The reason why prescription prevents compensation is because at the time of the plea of set-off the debt has been extinguished and this is the case even if concurrence has

occurred before prescription has run. If that is so, that reason must apply equally to a situation where creditor and debtor have contractually agreed, as by composition, or, as in this case, are bound by the terms of the trust deed, that one of the debts has been extinguished. By the time the plea is made, the debt has been extinguished. Compensation cannot operate *retro* to revive an extinguished debt. That is so even though the debt is extinguished after the date of insolvency or the making of the trust deed.

[16] Counsel for the Bank submitted that the situation here was exactly the same as in the example given, *obiter*, by Hoffmann, LJ (sitting in the Chancery Division), in *M S Fashions Ltd v Bank of Credit and Commercial International SA*, [1993] Ch. 425, 435:

“it may happen that the contingency [of a debt] 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 set-off, giving credit for the dividend? For my part, I do not see why not.”

The answer to that, in this case, must be that the creditor, the Bank, cannot do so because of the effect of the trust deed.

[17] In light of the decision of the Inner House in *Dooneen*, it must follow that, in this case, the Bank cannot plead compensation or set-off of its extinguished debt against Mrs Donnelly’s claim. Accordingly, we shall allow Mrs Donnelly’s appeal on the issue raised in this court with the result that we shall recall the sheriff’s interlocutors of 11 February and 7 March 2016 insofar as they (a) sustain the defender’s first plea-in-law and exclude from probation as irrelevant averments of the pursuer anent the effect of the discharge of the pursuer from her trust deed and the non-application of the principle of the balancing of accounts in bankruptcy and (b) repel the pursuer’s first plea-in-law. The only matter outstanding in the case is quantification of Mrs Donnelly’s claim against the bank. That matter will proceed, if necessary, in the court below. Accordingly, we shall sustain the pursuer’s first plea-in-law to

the extent of repelling the defender's third plea-in-law and remit to the sheriff to proceed as accords.

Expenses

[18] In view of the fact that the appeal was advanced on an entirely different basis to that presented to the sheriff, the appellant did not seek to alter the finding of expenses in the court below. Parties were agreed that the expenses of the appeal should follow success. Accordingly, we find Mrs Donnelly entitled to the expenses of the appeal.