

# Insolvency Set-Off, Discharged Debts and Protected Trust

## Deeds: *Royal Bank of Scotland Plc v Donnelly*

### A. INTRODUCTION

For the second time in recent years, a significant case on payment protection insurance (“PPI”) and protected trust deeds has come before the courts.<sup>1</sup> In *Dooneen Ltd v Mond* (“*Dooneen*”),<sup>2</sup> the UK Supreme Court held that a discharged debtor, rather than the trustee, was entitled to receive PPI compensation that was due to the debtor but unknown to the trustee when a “final distribution” of the estate was made.<sup>3</sup> *Royal Bank of Scotland Plc v Donnelly* (“*Donnelly*”)<sup>4</sup> involves similar facts, but focuses on the different question of whether insolvency set-off<sup>5</sup> can be utilised by a bank to resist or limit a PPI claim by a discharged debtor. The Inner House’s refusal to allow insolvency set-off may be correct, but there are scenarios not too far removed from that in *Donnelly* in which the result could be different, and it might be asked whether, like the outcome in *Dooneen* itself, the outcome is “scarcely...satisfactory”.<sup>6</sup> In addition, related litigation involving the potential reduction of the debtor’s discharge raises further issues of interest.

---

<sup>1</sup> More broadly, protected trust deeds are, and have been for some time, controversial: the Scottish Parliament’s Economy, Energy and Fair Work Committee are currently carrying out a short inquiry on such deeds – see <https://www.parliament.scot/parliamentarybusiness/CurrentCommittees/113650.aspx>.

<sup>2</sup> [2018] UKSC 54.

<sup>3</sup> Affirming the decision of the Inner House ([2016] CSIH 59).

<sup>4</sup> [2019] CSIH 56.

<sup>5</sup> The traditional term in this context is “balancing of accounts in bankruptcy”. However, the English term “set-off” is often used, including in *Donnelly*.

<sup>6</sup> See Lord Reed in *Dooneen*, para [22].

## B. THE FACTS

Mrs Donnelly obtained loans from RBS between 1997 and 2003 and at the same time was mis-sold PPI. In August 2006 Mrs Donnelly became insolvent and entered into a trust deed for her creditors under the Bankruptcy (Scotland) Act 1985. The trust deed became a protected trust deed in October 2006, under Sch 5, para 5 of the 1985 Act, meaning creditors were treated as acceding creditors, whether or not they had objected.<sup>7</sup> The trustee distributed sums to creditors, and RBS received a dividend of around 22 pence in the pound. The final dividend was paid to creditors in December 2013 and, under the trust deed's provisions, this caused the deed to terminate and Mrs Donnelly to be discharged from her debts. The shortfall to RBS was £21,617.42.

A short time later, in January 2014, Mrs Donnelly complained about having been mis-sold PPI by RBS. The Financial Ombudsman Service upheld her claims and it was agreed between Mrs Donnelly and RBS that she was due £11,927.39 in compensation. An initial payment of £1,111.63 was made and then RBS stopped payments, arguing that it could set-off the £21,617.42 it asserted was still due by Mrs Donnelly against the PPI claim.

Mrs Donnelly raised an action for payment against RBS in the sheriff court and RBS argued nothing further was payable due to the operation of balancing of accounts in bankruptcy (insolvency set-off). The sheriff allowed a proof on the bank's defence but the Sheriff Appeal Court, which by the time the appeal was heard had the benefit of the decision of the Inner House in *Dooneen*, considered the matter to be indistinguishable from that decision and held that insolvency set-off could not operate. RBS appealed to the Inner House.

---

<sup>7</sup> Now see Bankruptcy (Scotland) Act 2016, Part 14. For further discussion of protected trust deeds, see *Donnelly* paras [9]-[10] and DW McKenzie Skene, *Bankruptcy* (2018), 560ff.

### C. THE DECISION

The Second Division in *Donnelly* relied heavily on the UK Supreme Court's decision in *Dooneen*.<sup>8</sup> In fact, *Dooneen* was one of the few sources to which reference was made by the court. Lord Glennie, delivering the court's opinion, held that for RBS to succeed it had to demonstrate that it was owed a debt by Mrs Donnelly and that the debt existed when RBS put forward its plea of set-off. It should be noted that set-off does not operate *ipso jure* in Scots law and requires to be pleaded, albeit that if it is successfully pleaded it will have retrospective effect.<sup>9</sup>

In *Donnelly*, clause 11 of the trust deed specified that on a final distribution by the trustee the deed terminated and under clause 10 this would cause Mrs Donnelly to be discharged of all debts payable to acceding creditors. Lord Glennie used *Dooneen* to affirm that these results would arise even if it was later discovered that the trustee had been unaware of part of the estate and therefore that property had not been distributed.<sup>10</sup> In *Dooneen*, Lord Reed explained the negative implications of adopting an alternative view that the debtor is not discharged in such circumstances: the debtor and anyone dealing with them could not be certain whether they were an undischarged bankrupt and this could have serious results.<sup>11</sup> The court in *Donnelly* was therefore able to reach the satisfyingly simple conclusion that because the debt due by Mrs Donnelly to RBS had been discharged when the claim for PPI compensation was made and RBS pleaded set-off in answer, there was no debt owed to the bank that could be the subject of set-off and therefore the plea was irrelevant.<sup>12</sup>

---

<sup>8</sup> See paras [14]-[15], [39], [42]-[46] and [50].

<sup>9</sup> At one time, Scots law (apparently like Roman law) may have allowed for *ipso jure* operation of set-off (compensation) – see Stair, *Inst* 1.18.6. However, this has long been departed from – see Erskine, *Inst* 3.4.12; Bell, *Comm* II, 124; H Goudy, *Bankruptcy*, 4<sup>th</sup> edn by TA Fyfe (1914), 551; WW McBryde, *The Law of Contract in Scotland*, 3<sup>rd</sup> edn (2007), para 25-53.

<sup>10</sup> Para [39] referring to para [12] in *Dooneen*.

<sup>11</sup> See *Dooneen* paras [13]-[15], referred to in *Donnelly*, para [39] per Lord Glennie.

<sup>12</sup> Para [40].

The assertion by counsel for RBS that the discharge in clause 10 did not entirely extinguish RBS's claim and could be relied upon by RBS as "a shield to defend itself against claims" by Mrs Donnelly was rejected, due to the term "discharge" being given its ordinary meaning and because it was used in an unqualified way in the trust deed (which bound RBS and other creditors).<sup>13</sup> Lord Glennie identified three practical points supporting this view. Firstly, if the debtor was not fully discharged, they would be placed in "a state of uncertainty" and claims made by them after the general discharge would be "fraught with uncertainty", as they might be defeated by creditors' claims that had appeared to be discharged in earlier insolvency proceedings.<sup>14</sup> Secondly, if set-off could operate, it would affect the validity of the trustee's final distribution. RBS would receive a windfall, as their dividend should only have been paid on the basis of the net balance remaining after deduction of the PPI claim.<sup>15</sup> This would mean that other creditors should have received a marginally greater dividend payment. Thirdly, and related to the latter point, the court considered that an approach requiring the court to make the operation of set-off conditional upon RBS paying other creditors the amount to which they had been disadvantaged was "virtually unworkable" and, even if not, would amount to a re-opening of the trust deed and require a further final distribution.<sup>16</sup> It would cause insolvency set-off to move to the realm of judicial discretion necessitating court oversight.<sup>17</sup> Identifying relevant creditors and the relevant sums requiring to be paid would be problematic and the assistance of the former trustee would be necessary. Furthermore, the trustee would already have been remunerated so further payment would need to be

---

<sup>13</sup> Paras [40]-[42].

<sup>14</sup> Para [44].

<sup>15</sup> Para [45].

<sup>16</sup> Which was noted at para [46] to be at odds with the practical considerations referred to in *Dooneen*, paras [13]-[15], per Lord Reed.

<sup>17</sup> Para [46].

authorised. All of these difficulties supported the court's decision to reject the operation of set-off.

#### **D. ALTERNATIVE FACTS...**

In spite of the general absence of authority relied upon by the court, its decision involved a straightforward application of the consequences of the debtor being discharged and is supported by the authority referred to in the section below. However, it is worthwhile to ponder the legal position if the facts of the case were to be adjusted in different ways.

To some extent, the operation of set-off can appear arbitrary. If the PPI claim had come to light a few months earlier, it is likely that Mrs Donnelly would not have been discharged and set-off could have operated. Yet the fact that set-off needs to be pleaded shows there is an onus upon a party seeking to utilise it and as counsel for Mrs Donnelly argued, RBS were aware, or ought to have been aware, of the potential PPI claim and could have brought it to the attention of the trustee. They could also have refused to agree to the discharge.<sup>18</sup>

The possibility of information regarding the PPI claim being fraudulently withheld by Mrs Donnelly is discussed below; however, it was a matter of agreement for this action that neither Mrs Donnelly nor the trustee had any knowledge of the claim before or during the operation of the protected trust deed. If, instead, the trustee did have such knowledge, then he would almost certainly not have made the "final distribution" of the estate until the claim for PPI compensation had been decided and the compensation received. This may have delayed the distribution but not alarmingly so. Were the trustee considered to have knowledge of the claim (either actual or constructive) and nevertheless made a final distribution without receiving payment of the PPI claim, he could be sued for breach of his duties by creditors

---

<sup>18</sup> See para [35].

who were entitled to a portion of the claim (although if the trustee had already obtained a discharge from the creditors,<sup>19</sup> a successful claim would seem to be precluded unless perhaps fraud could be proved).<sup>20</sup>

A key point in *Donnelly* was that RBS had contractually agreed to the discharge of the debtor by acceding to the terms of trust deed. Given that the discharge and RBS's agreement were critical to the decision, it raises the issue of what the outcome would have been if the discharge had been conditional.<sup>21</sup> It is easy to imagine, especially in light of *Donnelly*, that major creditors could request a clause in a trust deed providing that any discharge is conditional upon no further assets being discovered after the purported discharge, or that the discharge does not apply to such assets. The efficacy of such a condition is uncertain for protected trust deeds and would lead to some of the complicated practical consequences outlined by Lord Glennie. Nevertheless, for non-protected trust deeds such a route would appear to be available and unless the statutory overlay for protected trust deeds provides contrary authority then such deeds would fall to be treated in the same way. The Bankruptcy (Scotland) Act 2016 section 184 makes provision for the discharge of the debtor in relation to protected trust deeds: if certain conditions are met, the debtor will, under section 184(1)(a), be "discharged from all debts and obligations" in terms of the protected trust deed or for which the debtor was liable when the trust deed was granted and the exceptions regarding discharge (in section 184(6)) give little scope for further exceptions being separately agreed.

---

<sup>19</sup> See now Bankruptcy (Scotland) Act 2016, section 186.

<sup>20</sup> In contrast to the position in sequestration, where the effect of the trustee's discharge is spelt out by the legislation and expressly excludes discharge from liability for fraud (see Bankruptcy (Scotland) Act 2016, ss 148(7) (trustee other than the Accountant in Bankruptcy) and 151(10) (trustee Accountant in Bankruptcy)), the effect of the trustee's discharge in the case of a protected trust deed is not outlined in the legislation and the cases on the discharge of a trustee under a trust deed at common law are silent on the point. It is thought, however, that as a matter of principle, either any liability of the trustee for fraud would not be discharged by the discharge or that the discharge would be reducible on the grounds of fraud.

<sup>21</sup> See para [34].

*Donnelly* (and *Dooneen*) arose because PPI claims involve conduct that took place sometimes decades ago but which was not known to give rise to valid compensation claims until relatively recently. Although such circumstances are likely to arise relatively rarely, the ways in which these cases have been decided set precedents for other types of claim that arise in a similar way, from the mis-selling of other financial products (eg swaps) to delictual claims stemming from historical abuse allegations or industrial disease.<sup>22</sup>

### E. REDUCTION OF DISCHARGE

The operation of insolvency set-off was rejected in the circumstances of *Donnelly* as the insolvency process had concluded and the debtor had been discharged. Set-off was therefore inoperable unless the insolvency process was re-opened, which would seem to require reduction of the relevant discharge.<sup>23</sup> (A potential contrast was drawn with corporate insolvency insofar as earlier debts are not discharged in the corporate context, even if a company has been dissolved.)<sup>24</sup> The court in fact noted<sup>25</sup> that there is another action in this matter, wherein RBS is now seeking to obtain reduction of the discharge in respect of Mrs Donnelly.<sup>26</sup>

The authorities appear to support the view that reduction is necessary to give creditors an entitlement to an asset that was unknown during the insolvency process *and*, where that

---

<sup>22</sup> These latter examples may be particularly emotive and difficult to handle in bankruptcy scenarios and indeed the treatment of claims for personal injury generally is not uncontroversial: see McKenzie Skene, *Bankruptcy* (n7), paras 11-102-11-104.

<sup>23</sup> If set-off is to operate, it may be on the basis of compensation simpliciter rather than balancing of accounts in bankruptcy, as the sums in question by that stage will both be liquid.

<sup>24</sup> See para [49] and the reference to obiter comments of Hoffman LJ in *MS Fashions Ltd v Bank of Credit and Commerce International SA* [1993] Ch 425.

<sup>25</sup> Para [50] (and see para [39]).

<sup>26</sup> It is understood that this Court of Session action has the reference number CA6/19.

asset is a claim, to allow for set-off to operate in relation to it. In *Baillie v Young*,<sup>27</sup> the jury found that a debtor had obtained a discharge and receipt for a composition contract (following a sequestration) by fraud or fraudulent concealment involving a claim relating to goods provided before bankruptcy by a creditor. The creditor succeeded with reduction, which restored the debt due by the debtor (*in integrum*) and thereby allowed set-off to operate, and caused the debtor to remain liable for the balance. The court considered that the reduction operated only in a question between the particular creditor seeking reduction and the debtor, with the Lord President noting that the reduction “will not cut down the discharge or composition-contract as to the other creditors of the defender”.<sup>28</sup> In *Whyte v Knox*<sup>29</sup> a party executed a trust deed for behoof of his creditors but after discharge of debts and the death of the debtor, the creditors claimed the debtor’s life insurance policy, alleging it had been concealed from them. However, in contrast with *Baillie*, the court rejected the claim, indicating that an averment of fraud would be necessary to reduce the discharge and allow for a successful claim in relation to the policy.

As noted by Goudy, a composition contract and discharge may be set aside “on grounds which infer nullity or fraud in the proceedings” on the basis of “wilful concealment or misrepresentation regarding matters which should have been disclosed to the creditors, and by which they have been materially deceived.”<sup>30</sup> Goudy refers to Bell’s *Commentaries*, where it is stated that concealment of assets can give rise to reduction of a composition.<sup>31</sup>

Thus, if RBS is to succeed with the reduction of the discharge, it will likely need to show that Mrs Donnelly fraudulently concealed the PPI claim or perhaps that she failed to comply with the specific terms of the trust deed. It would be tempting, but not advisable or

---

<sup>27</sup> (1837) 16 S 294.

<sup>28</sup> (1837) 16 S 294, at 297.

<sup>29</sup> (1858) 20 D 970.

<sup>30</sup> Goudy, *Bankruptcy* (n9), 415 and see 416 and 493.

<sup>31</sup> Bell, *Comm II*, 360.

commendable, for a debtor approaching discharge to remain quiet about a possible PPI claim (or an equivalent type of claim) until some point after discharge. Indeed, the short time between the discharge of Mrs Donnelly's debts and her first asserting the PPI claim may raise questions. As regards the trust deed's terms, under clause 5 Mrs Donnelly had undertaken to, *inter alia*, give the trustee 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.<sup>32</sup> This may have obliged her to disclose details of the potential PPI claim, assuming she had an awareness of it. In terms of fraudulent concealment, attention must focus on the state of Mrs Donnelly's knowledge of the claim prior to discharge. This contrasts with the already decided case in which there was instead attention paid to the *bank's* actual or imputed knowledge of the circumstances of the claim<sup>33</sup> – yet it may be queried whether Mrs Donnelly was actually deceiving the bank if they already had (or should have had) knowledge of the potential claim's existence.

If the claim for reduction is successful, the problematic consequences outlined by Lord Glennie in *Donnelly* could arise, at least to some extent. However, by contrast, they will be a natural result of the effect of a successful reduction of discharge, rather than factors to be weighed by the court in determining what the outcome of the case will be. On the basis of *Baillie*, any reduction will only be effective in relation to RBS as the reducing creditor, which may minimise practical difficulties. Any disadvantage suffered by other creditors is likely to be small and they may not consider it economical to seek their own reduction in the circumstances. Nevertheless, the revival of the debt due by Mrs Donnelly to RBS, and the continued discharge of other debts, could lead to unanticipated consequences of which the court would need to be mindful.

---

<sup>32</sup> See para [11].

<sup>33</sup> See eg the argument for Mrs Donnelly at para [32].

## F. CONCLUSION

The rules on insolvency set-off exist to avoid the hardship which would arise if a creditor is forced to pay a debt due to the insolvent debtor in full while receiving only a dividend on his claim.<sup>34</sup> The fact that the debt due to the insolvent debtor (in the form of the PPI compensation) existed before but was identified and quantified only after the insolvency process in question was completed, and the debtor discharged, might suggest that the outcome in *Donnelly* was not satisfactory. On the other hand, there is some merit in the operation of insolvency set-off in these circumstances being dependent upon a reduction of the discharge as a result of fraud or other appropriate circumstances. As such, the decision may strike the correct balance between avoiding hardship to the creditor and the certainty of discharge and the finality of insolvency proceedings for the debtor.<sup>35</sup>

*Alisdair D J MacPherson and Donna McKenzie Skene*

*University of Aberdeen*

---

<sup>34</sup> Although the availability of insolvency set-off and the conditions in which it may operate are certainly not uncontroversial: see, for example, P R Wood *Principles of International Insolvency* 2<sup>nd</sup> edn (2007), para 1-018.

<sup>35</sup> We understand that an appeal to the UK Supreme Court is being sought by RBS. The outcome of this is awaited with interest. We are grateful to Joanne Gillies, Pinsent Masons, for this information.