1-02-01

Privy Council Appeal No. 5 of 2000

(1) G.J. Cleaver and *Appellants*
(2) Naul Bodden
(the joint liquidators of the Transnational Insurance Company Limited)

v.

Delta American Reinsurance Company *Respondent*
(a Company incorporated under the laws of Kentucky in liquidation)

FROM

THE COURT OF APPEAL OF THE CAYMAN ISLANDS

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JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL

Delivered the 1st of February 2001

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Present at the hearing:-

Lord Steyn
Lord Lloyd of Berwick
Lord Cooke of Thorndon
Lord Scott of Foscote
Sir Patrick Russell

*[Delivered by **Lord Scott of Foscote**]*

1. This is an appeal from the Court of Appeal of the Cayman Islands. There are three issues for decision. The first issue is whether and how the principle of hotchpot, derived from such cases as *Banco de Portugal v. Waddell* (1880) 5 App. Cas. 161, *Selkrig v. Davis* (1814) 2 Rose 291 and *Ex parte Wilson* (1872) L.R. 7 Ch. App. 490, should be applied to the proof of debt submitted by Delta American Reinsurance Company ("Delta Re") in the liquidation of Transnational Insurance Co. Ltd. ("Transnational"). The second issue is one of construction of the Retrocession Agreement between Transnational and Delta Re entered into in March 1984. The third issue relates to Delta Re's entitlement to interest under Rule 4.93 of the Insolvency

Rules 1986. The second and third of these issues are, of course, of some importance to the parties. But the first raises an important point of general principle in the winding up of companies.

The history

2. Transnational is an insurance company incorporated and licensed under the laws of the Cayman Islands. It carried on business as a retrocessionaire. Delta Re is a re-insurance company incorporated under the laws of Kentucky and licensed to do business in Kentucky and New York. In March 1984 Delta Re and Transnational entered into the Retrocession Agreement to which I have referred. It was a one year agreement but was renewed for the period 1st January 1985 to 31st December 1985. It is common ground that New York law is the proper law of the Retrocession Agreement.

3. Under the Retrocession Agreement Delta Re ceded and Transnational, as retrocessionaire, accepted a percentage of Delta Re's liability under certain contracts of insurance and treaty re-insurance.

4. On 15th September 1985 Delta Re was placed in liquidation by the Franklin Circuit Court in Kentucky. The Commissioner of Insurance of the Commonwealth of Kentucky was appointed liquidator. On 2nd May 1989 the Commissioner, as liquidator of Delta Re, commenced proceedings in the U.S. District Court in New York against Transnational and several other retrocessionaires. Some, like Transnational, were foreign companies and carried on business outside the U.S. It was alleged by Delta Re that the defendant retrocessionaires had failed to pay current balances due to Delta Re and had indicated their refusal to pay sums that might become due in the future under the respective retrocession agreements they had entered into with Delta Re. The relief sought against Transnational included a declaration as to Delta Re's rights, and payment of all sums due under the Retrocession Agreement.

5. For the purposes of the New York Insurance Law, section 1213, Transnational was an "unauthorised foreign or alien insurer". Paragraph (c)(1) of section 1213 provides as follows:-

> "Before any unauthorised foreign or alien insurer files any pleading in any proceeding against it, it shall either:
>
> (A) deposit with the clerk of the court in which the proceeding is pending, cash or securities or file with such clerk a bond with good and sufficient securities, to be approved by the court, in an amount to be fixed by the court sufficient to secure payment of any final judgment which may be rendered in the proceeding, but the court may in its discretion make an order dispensing with such deposit or bond if the superintendent certifies to it that such insurer maintains within this state funds or securities in trust or otherwise sufficient and available to satisfy any final judgment which may be entered in the proceeding, or
>
> (B) procure a license to do an insurance business in this state."

6. On 20th July 1990 the Magistrate of the U.S. District Court ordered each of the foreign retrocessionaire defendants to provide security pursuant to section 1213. The order was made following the hearing of a motion by the retrocessionaires to be relieved of the requirement of providing security. In her judgment, the Magistrate described section 1213 as:-

> "primarily a long-arm statute ... [which] addresses the concern that many residents of this state hold policies of insurance issued or delivered in this state by insurers while not authorized to do business in this state, thus presenting to such residents the often insuperable obstacle of resorting to distant forums for the purpose of asserting legal rights under such policies."

7. She ordered Transnational to give security equal in amount to Transnational's proportion of the amount of the claims which had been actually paid by Delta Re's ceding companies. She gave Delta Re liberty to apply for an increase in the amount of the security as the amount of Delta Re's paid losses increased. The initial amount of the security to be given was agreed by Delta Re and Transnational to be U.S. $380,000.

8. Transnational provided the security by arranging for a letter of credit to be issued by Barclays Bank Plc to the Kentucky Commissioner of Insurance. The letter of credit was duly issued on 30th November 1990. Under it the bank agreed to pay the stipulated sum, $380,000, upon receipt (a) of a certified copy of a judgment of the U.S. District Court in favour of the Commissioner and against Transnational and (b) of an affidavit by the Commissioner confirming that the judgment was final, with no rights of appeal outstanding, and that the $380,000 was due from Transnational to the Commissioner.

9. In consideration of Barclays Bank issuing the letter of credit, Transnational agreed (i) that Barclays should have a charge over Transnational's credit balances as security for Transnational's contingent obligation to indemnify Barclays against any payment made by Barclays under the letter of credit and (ii) to maintain with Barclays a credit balance at least equal to the amount payable under the letter of credit.

10. Having procured the letter of credit in favour of the Commissioner to be issued by Barclays Bank, and thereby having complied with the order of the U.S. District Court to give security, Transnational was free to contest Delta Re's claims and filed pleadings in the New York court alleging that the Retrocession Agreement was void for misrepresentation.

11. As Delta Re's paid losses increased, Transnational was called upon from time to time to provide additional security. It did so by arranging with Barclays for the sum specified in the letter of credit to be increased, and by maintaining with Barclays correspondingly increased credit balances. By July 1992 the amount of the security had increased to U.S. $735,393. Following the July 1992 increase, further increases were ordered by the U.S. District Court. But Transnational was unable to provide them and on 15th January 1993 went into creditors, voluntary liquidation. On 8th March 1993 the liquidation was ordered to continue under the supervision of the Grand Court of the Cayman Islands.

12. On 23rd March 1993 Delta Re applied to the U.S. court for an order striking out Transnational's Answer and Counterclaim and for default judgment to be entered against Transnational. The ground of the application was Transnational's failure to provide the increased security that had been ordered.

13. On 8th April 1993 the Grand Court, on the application of the liquidators, directed that Transnational take no further part in the New York action. And on 5th May 1993 the New York court gave judgment in default against Transnational. Transnational was held liable to Delta Re in the sum of U.S. $988,680.56.

14. The default judgment was followed, not surprisingly, by a claim on Barclays Bank under the letter of credit. Barclays duly paid the Commissioner U.S. $735,393 and deducted that sum from Transnational's credit balances with the Bank at its Grand Cayman branch.

15. The receipt by Delta Re of the $735,393 left a balance still outstanding and on 6th December 1995 Delta Re submitted a proof in Transnational's liquidation. The proof was based upon the default judgment that had been obtained from the U.S. court. The liquidators of Transnational did not renew the claim that the Retrocession Agreement was void. The misrepresentation allegations did not reappear. On the contrary, the liquidator accepted some of the items in Delta Re's proof but rejected others. Delta Re then applied to the Grand Court for a review of the liquidator's decision. The issues before the Grand Court, and later before the Court of Appeal of the Cayman Islands, were those three issues to which brief reference has already been made.

The Hotchpot Issue

16. The liquidators of Transnational contend that before receiving any dividend Delta Re should be required to bring into hotchpot the $735,393 obtained, via the letter of credit, from Barclays Bank. The acts of the Commissioner in seeking default judgment against Transnational at a time when Transnational was already in liquidation in the Cayman Islands, and then claiming against Barclays Bank under the letter of credit, had the result that Barclays, having honoured the letter of credit, indemnified itself out of Transnational's credit balances over which it had a charge. These credit balances would otherwise have formed part of Transnational's assets in the liquidation, available for distribution among the unsecured creditors, including Delta Re, *pari passu*. Delta Re, by availing itself of New York law and the procedures of the New York court had obtained an inequitable advantage over the other unsecured creditors of Transnational and, as a condition of being allowed to prove in

the liquidation and share in the liquidation assets, ought to be required to bring that advantage, i.e. the $735,393, into hotchpot. So it was argued.

17. Smellie J. (as he then was), in the Grand Court, agreed with the liquidator. But the Court of Appeal (Zacca P. and Kerr and Collett JJ.A) disagreed. Their Lordships must now resolve the issue.

The hotchpot authorities

18. The authorities establish the principle that if a company is being wound up in an English liquidation and also in a liquidation in a foreign country, a creditor who has proved and received a dividend in the foreign liquidation may not receive a dividend in the English liquidation without bringing into hotchpot his foreign dividend. The question is whether the authorities establish anything further. It is convenient to take them in chronological order.

19. *Selkrig v. Davis* (1814) 2 Rose 291 was a case involving an English bankruptcy of an individual who had been trading in Scotland and whose creditors in Scotland had sequestrated personal property in Scotland belonging to the bankrupt. The question was whether the assets in Scotland formed part of the estate in bankruptcy available for the general benefit of all the creditors or whether the sequestration in Scotland prevailed. Lord Chancellor Eldon, L.C. after discussing the difficulties involved in deciding who was an English creditor and who was a Scottish creditor said at page 318: "Yet I think there is no Difficulty, if the Scottish Creditor thinks proper to come in under the English Commission. Then, he is to all Intents and Purposes an English Creditor". Lord Eldon L.C. then continued as follows:

> "It has been decided, that a Person cannot come in under an English Commission without bringing into the common Fund what he has received abroad. The Reason of that cannot be, merely that all the Creditors under a Commission are to be put on an equal Footing. If, my Lords, he has got Property which did not pass under the Commission before he came in, whatever Chancellors may have said on the Subject, they had no more Right to call into the common Fund, that which he had got by Law, and

> which was kept out of the common Fund, than any other Part of his Property. It could only be therefore because the Law did not pass the Property of the Individual coming within your Jurisdiction, that you say to him, if you claim any Thing under this Commission, you shall not hold in your Hands the Property which you have got by Force of the Law of another Country. If a Man chuses to say, I will not bring into the common Fund that Sum which I have received, then let him retire."

20. It appears from the above passage that the hotchpot requirement, the "bringing into the common Fund what he has received abroad", would not apply to assets which had never formed part of the "common Fund." Assets, or an interest in assets, which had been acquired before the commencement of the bankruptcy would fall into that category.

21. *Ex parte Wilson* (1871-1872) L.R. 7 Ch. App. 490 involved an English bankruptcy of an individual who had carried on business both in England and in Brazil. The bankrupt's Brazilian assets were administered under Brazilian law which gave priority to Brazilian creditors. The Brazilian creditors proved in the English liquidation for the balance of the debts owing to them. It was held that they were not entitled to a dividend in the English liquidation until all creditors had received a dividend equal to that which the Brazilian creditors had received out of the Brazilian assets. There was no question in this case of the Brazilian creditors having acquired an interest in the assets of the estate which pre-dated the commencement of the English bankruptcy. In the eyes of the English law, the Brazilian assets formed part of the bankrupt's estate. James L.J. at page 493 cited *Selkrig v. Davis* as establishing that "if a particular creditor who is able to lay hold of assets of the bankrupt abroad comes here to share with the other creditors, he must bring into the estate here that which the law of the foreign country has given him over the other creditors." Mellish L.J. expressed the same opinion.

22. These dicta do not help the liquidators in the present case. First, the sum received by Delta Re from Barclays had, plainly, never been part of Transnational's assets in the winding-up. Second, Delta Re's interest in the letter of credit, and Barclay's

interest in the charged credit balances, pre-dated the commencement of the winding-up of Transnational.

23. Next comes the leading case of *Banco de Portugal v. Waddell* (1880) 5 App. Cas. 161. In this case, too, there was an English insolvency and a foreign insolvency. Two individuals had carried on business in England and in Portugal as wine merchants. They presented a petition for their adjudication in bankruptcy in England in December 1877. Insolvency proceedings were taken in Portugal after the English petition had already been presented. The Portuguese court took possession of the insolvents' assets in Portugal, realised them and paid a dividend to the Portuguese creditors. These creditors then proved in the English bankruptcy. They were not allowed any dividend in the English bankruptcy until they had accounted for the dividend they had received in Portugal. The House of Lords regarded the case as so clear that the respondents were not called on. Lord Chancellor Cairns L.C. referred to *Selkrig v. Davis* and *Ex parte Wilson* and expressed the applicable principle in the following passage at page 168:-

> "... the Appellants are perfectly entitled to prove under the English bankruptcy; but if they elect do so they must, as was said in the case of Selkrig v. Davis, bring into the common fund what they have received abroad."

24. Lord Selborne noted, at p. 169, that the "Portuguese assets were, by the Law of England, ... subject to and bound by the English liquidation, except so far as the local law of Portugal might have intercepted any portion of them while within its jurisdiction" and continued at pages 169-170:-

> "Every creditor coming in to prove under, and to take the benefit of, the English liquidation, must do so on the terms of the English law of bankruptcy; he cannot be permitted to approbate and reprobate, to claim the benefit of that law, and at the same time insist on retaining, as against it, any preferential right inconsistent with the equality of distribution intended by that law, which he may have obtained either by the use of legal process in a foreign country, or otherwise. As against the Appellants .... it is unimportant that the presentation of the petition in December 1877 was not per se a cessio

> bonorum; because ... the Act makes the title of the trustee relate back to the time when the petition was presented, which was before the time when the title of the Portuguese Court to administer the Portuguese assets is said to have accrued. The Appellants cannot come in and prove and take dividends out of the English assets, with the full benefit of the relation back of the title of the trustee to the date of the petition, and at the same time set up against that title a later act of a Portuguese Court, for the purpose of enabling themselves to refuse credit for property belonging to the estate, received by them in Portugal after the date of the petition, through the action of that Court. I must not, however, be supposed to think that it would really have made any difference if the action of the Portuguese Court had been earlier, nothing having been received by the Appellants till long after the title of the English trustee had accrued."

25. This passage from the speech of Lord Selborne makes it clear that had the Portuguese creditors received their dividend before the commencement of the English liquidation, they would not have been required to bring it into hotchpot as a condition of proving in England.

26. The three cases to which reference has been made demonstrate that the hotchpot requirement applies only to assets that, under English law, are regarded as forming part of the estate in liquidation. This is the reason why a secured creditor, who has obtained his security before the commencement of the liquidation, is entitled to realise his security, apply the proceeds towards discharging his debt, and prove in the liquidation for any balance still owing (see rule 4.88 of the Insolvency Rules 1986). He is not required to bring into hotchpot the proceeds of his security. The asset constituting the security never formed part of the liquidation estate. The equity of redemption would, theoretically, have been an asset of the estate but, in a case where the secured debt exceeded the value of the security, would be worthless.

27. In the present case, Mr. Robert Hildyard Q.C., counsel for the liquidators, described rule 4.88 of the Insolvency Rules 1986, under which a secured creditor may realise his security

and prove for the balance of the debt owing to him, as an exception to the hotchpot rule. It is nothing of the sort. Rule 4.88 is entirely consistent with the hotchpot rule. In realising his security and applying the proceeds towards discharge of his debt, a secured creditor is not setting up an adverse title against the title of the insolvent company. The insolvent company has no title to the security. Nor does the liquidator.

28. The proposition that a security granted before the commencement of the liquidation is not part of the liquidation estate is demonstrated by *Moor v. Anglo-Italian Bank* (1879) 10 Ch. 681. The defendant bank had a mortgage over land in Florence belonging to a company in liquidation. The liquidator of the company applied to the court to restrain the bank from realising its security. The application failed. Jessel M.R. summed up the options of a secured creditor at pages 689-690:-

> "In bankruptcy, if a secured creditor wants to prove, he must do one of three things: he may give up his security altogether and prove for the full amount, or he may get his security valued and prove for the difference, or he may sell and realise his security and then prove for the difference."

29. It is only if the secured creditor elects to give up his security and prove for the full amount that the secured asset becomes part of the liquidation estate. The bank had made no such election and was entitled to realise its security and prove in the liquidation for any balance still due.

Does the hotchpot rule apply to Delta Re?

30. The proposition that Rule 4.88 constitutes an exception to the hotchpot rule led, in the courts below and before the Board, to arguments as to whether or not Delta Re should be regarded, vis à vis Transnational, as a secured creditor so as to be able to take advantage of the Rule 4.88 "exception". Unless it could claim the status of a secured creditor, so the argument ran, it could not claim the benefit of Rule 4.88, would not come within the secured creditor "exception" and should be required to bring into hotchpot the $735,393 it had received under the letter of credit.

31. These arguments are, in their Lordships' view, founded upon a fallacy and a fundamental misunderstanding of the

hotchpot rule. The fallacy is that the right of a secured creditor to realise his security and prove for any balance of the debt still owing constitutes an exception to the hotchpot rule. The fallacy derives from the misunderstanding. The wellspring of the hotchpot rule is the need to ensure that the assets of a liquidation are, subject to prior claims such as liquidation expenses, preferential debts etc, divided *pari passu* among the unsecured creditors. If any of them obtains a share of the liquidation assets by participating in a distribution of liquidation assets in a foreign liquidation, that share must be brought into account before a dividend in the English liquidation can be claimed. There is no example to which their Lordships have been referred of any application of the hotchpot rule for any other purpose than that. Nor should that be a surprise. In the present case, Delta Re obtained the $735,393 from Barclays Bank under the letter of credit. The sum was not paid out of assets of Transnational. Transnational had arranged for the letter of credit to be issued and had provided Barclays Bank with security, in the form of the credit balances, for its contingent liability to indemnify Barclays Bank against the Bank's liability under the letter of credit. So Barclays Bank was a secured creditor. But its security had been granted before the commencement of the Transnational liquidation. At the commencement of the liquidation Transnational's interest in the credit balances was limited to an equity of redemption.

32. On this analysis, the payment of $735,393 to Delta Re was not made, either directly or indirectly, out of assets of the liquidation estate. The unencumbered credit balances were never part of the estate. The hotchpot rule as established by *Banco de Portugal v. Waddell* does not come into play.

33. The position was, in their Lordships' view, no different from what it would have been if the section 1213 security required by the New York court had been provided by Transnational by depositing the $735,393 with the court instead of with Barclays Bank. In that event, too, the deposit would have been made before the commencement of the winding-up and would not have been part of the liquidation estate.

34. Mr. Hildyard pointed out that Delta Re's right to call for payment under the letter of credit, like its right, if sums had been deposited with the New York court, to obtain those sums, was conditional on its obtaining a final judgment. He pointed

out that, once Transnational had gone into liquidation, the leave of the Grand Court to the institution or continuance of proceedings against Transnational would have been necessary. He submitted that Delta Re, by obtaining a default judgment in New York, and thereby making the letter of credit unconditional, had obtained an unfair advantage, vis à vis the other unsecured creditors, and ought, in equity, to be required to bring the fruits of that unfair advantage into hotchpot.

35. Acceptance of this submission would be to extend the hotchpot rule to assets which had never formed part of the liquidation estate. It would result in Rule 4.88 and the position of secured creditors constituting a genuine exception to the hotchpot rule. An extension of the hotchpot rule in order to cater for all cases of "unfair advantage" would be to introduce inherent uncertainty into what ought to be, and at present is, a rule easy to understand and to apply. Moreover, in their Lordships view, whatever may be the theoretical arguments in favour of such an extension, the facts of the present case would not bring it within an "unfair advantage" category.

36. First, Delta Re, although not a secured creditor in the rule 4.88 sense – in that it did not hold a charge over any asset of Transnational – was in substance a secured creditor. The order made by the New York court had ordered Transnational to provide security pursuant to section 1213. Section 1213 requires the "foreign or alien" insurer to "deposit ... cash or securities or file ... a bond ... sufficient to secure payment of any final judgment ...." The letter of credit in favour of Delta Re was procured by Transnational in order to discharge its obligation under section 1213. The purpose was, plainly "to secure" payment to Delta Re of the amount awarded in any final judgment. If the security had taken the form of a deposit of cash, or of share certificates or bonds, or the like, Delta Re would have been a secured creditor in the rule 4.88 sense. It would, subject to the final judgment condition, have been entitled under rule 4.88 to realise its security, apply the proceeds towards its judgment debt and prove in the liquidation for any balance. It would not have been required to bring the proceeds of the realisation into hotchpot. Why should the circumstance that the security took the form of a Bank letter of credit, with cash being deposited with the Bank instead of with the New York court, put Delta Re in a worse position? The result would be highly anomalous and, in their Lordships' view, unfair.

Rules of equity, prayed in aid by Mr. Hildyard in advocating the extension of the hotchpot rule, are intended to produce fair results, not anomalous and unfair ones.

37. Nor, in their Lordships' view, does the fact that Delta Re, in order to render the letter of credit unconditional, obtained a default judgment in New York after the commencement of Transnational's liquidation make the application of the hotchpot rule in this case any more acceptable. Mr. Hildyard submitted that it was inequitable for Delta Re to have done so and, by implication, that, if Delta Re had applied to the Grand Court for leave to proceed to judgment in the New York proceedings, the application would have been refused.

38. However, there are two authorities which, in their Lordships' view, suggest the contrary. In *In re West Cumberland Iron and Steel Co.* [1893] 1 Ch. 713 the question for decision was whether the creditors of a company in liquidation in England should be restrained from continuing an action against the company in Scotland. The creditors had arrested property of the company in Scotland and had commenced in Scotland an action against the company for a liquidated sum in respect of goods supplied and damages for breach of contract. Under the law of Scotland the arrested property would, if the creditors succeeded in obtaining judgment, become security for the judgment debt. After the arrest had taken place and the action had been commenced, but before judgment had been obtained, the company went into liquidation in England. The liquidator applied for an injunction restraining the creditors from proceeding with the Scottish action. The creditors responded by applying for leave to continue the action. The position, in short, at the commencement of the liquidation was that the creditors' security was contingent on obtaining judgment but, under Scottish law, if judgment were obtained, would date back to the date of the arrest. Counsel for the liquidator argued at page 719 that "... this court will not allow [the creditors] to avail themselves of such a device in order to obtain a priority over the other creditors of the company, which they would not otherwise have possessed." The argument matches that which Mr. Hildyard addressed to their Lordships. It was rejected by Vaughan Williams J. He declined to restrain the creditors from pursuing their Scottish action to judgment and granted them leave to do so.

39. *W.A. Sherratt Ltd v. John Bromley (Church Stretton) Ltd.* [1985] QB 1038 is a decision of the Court of Appeal in England. The plaintiffs had commenced an action and the defendant company had paid £13,000 into court in satisfaction of the plaintiffs' claim. The company later went into liquidation with an estimated large deficiency for unsecured creditors. The question at issue was what should happen to the £13,000 in court. The company applied to withdraw it on the ground that the plaintiffs should not be allowed to obtain an unfair preference over the other unsecured creditors. The plaintiffs cross-applied for payment out to themselves. The leading judgment in the Court of Appeal was given by Oliver L.J. He reviewed the earlier authorities in which the effect of a payment into court by a party who had subsequently become bankrupt had been considered (see, in particular *In* re Gordon *Ex parte Navalchand* [1897] 2 Q.B. 516 and *In re Ford Ex parte The Trustee* [1900] 2 Q.B. 211) and held at page 1049A that they established the principle that a payment by a defendant into court resulted in the plaintiff becoming a secured creditor in the subsequent bankruptcy of the defendant (p. 222F). Oliver L.J. commented at page 1056 "... I am not clear why it should be thought desirable that a creditor who has a valid claim but is kept out of his money by a defence which ultimately fails should be deprived of the advantage which he gains by a payment into court" and, expressed his conclusion at page 1057 as follows:-

> "In my judgment the principles emerging from the *In re Gordon* line of cases are still applicable to money paid in under the current rules. The plaintiffs are therefore secured creditors to the extent of that money in the defendants' liquidation ..."

40. In their Lordships' opinion these authorities establish that, *prima facie,* a creditor such as Delta Re, who has obtained before the commencement of the liquidation a form of security conditional on establishing the validity of its claim is entitled to retain the benefit of that security notwithstanding the intervening liquidation. It follows, also, that if Delta Re had applied to the Grand Court for leave to pursue the New York action to judgment, that leave should have been granted.

41. The situation that has arisen in the present case might arise in every case in which a guarantor, A, guarantees payment to C

of B's indebtedness to C and takes security over assets of B to secure re-imbursement by B of any sums A may be called upon to pay C. Let it be supposed that, after these arrangements have been made, B becomes bankrupt or, if corporate, goes into insolvent liquidation. If B's debt to C exceeds the amount of the guarantee, C will claim against A the amount guaranteed and prove in the liquidation for the balance. A, having paid C, will re-imburse himself out of the secured assets. This must be a state of affairs which has come about on many occasions. No one would suggest that C could not prove in the liquidation for the balance owing to him without bringing into hotchpot the sum he had recovered from A under the guarantee. Yet that, in their Lordships' view, is what Transnational's claim in the present litigation amounts to. In their Lordships' opinion the claim is contrary to principle, the Court of Appeal reached a correct conclusion on the hotchpot issue and the appeal on this issue should be dismissed.

The Construction Issue

42. The liabilities of an insurance company at any particular date will include a figure for claims "incurred but not reported" (ie. "IBNR"). This is because there will always be some delay between the happening of an insured event which gives rise to a claim against the company and the actual notification of the claim to the company. During the period between the happening of the event and the notification of the claim, the company's liability on the claim will have accrued although the company will not yet know about the claim. The company's liability will, in a sense, be contingent on the claim being made. In order for an insurance company's accounts to show a true and fair view of the company's financial state as at the account date, some figure must be included to reflect IBNR. The figure to be included will be actuarially calculated and based upon past claims experience in the insurance field in question. The IBNR figure does not constitute a liability that is currently due for payment. It constitutes an estimate of a liability that statistics and experience show to exist in respect of claims not yet put forward.

43. The normal contractual obligation of a retrocessionaire, like that of a re-insurer or an insurer, is to make due payment in respect of claims that are made and verified. The claims made by Delta Re in the New York action were for payment by

Transnational of Transnational's share of claims made on Delta Re that Delta Re had paid.

44. The proof of debt that Delta Re submitted in Transnational's liquidation included US$797,695.82 on account of paid losses. The liquidator accepted the amount, but deducted from it the recovery that Delta Re had made from the letter of credit. This gave rise to the hotchpot issue that has already been addressed in this judgment. But, in addition, the proof of debt included a sum in respect of IBNR. The liquidators rejected this claim, in toto. They did so on the ground that Transnational's contractual obligation under the Retrocession Agreement, being an obligation to indemnify, was to pay its due proportion of claims paid out by Delta Re. The IBNR figure did not represent sums paid out by Delta Re. So the proof of debt was premature. As and when the IBNR claims were actually notified and Delta Re's liability to pay had been established, a revised proof of debt, reflecting Transnational's proportion of that liability, could be submitted. This contention was fortified by reliance on the effect of a Creditors Dividend Payment Plan, prepared by the liquidator of Delta Re and approved by the Kentucky court. The plan is, in effect, a cut-off scheme. It provided for 31st December 1995 to be a cut-off date for fixing the liquidated claims that, initially, were to rank for a dividend out of Delta Re's assets. Claims that, on the cut-off date, were IBNR would, obviously, not qualify for the initial dividend. And, under clause IV.F.5 of the plan, claims that did not become liquidated claims until after the cut-off date would not receive any dividend until the pre-cut-off date liquidated claims had been met in full. So, as Transnational's liquidators points out, Delta Re is not proposing, at present at least, to make any payment in respect of the IBNR liability on the basis of which its proof of debt has been submitted.

45. Delta Re's proof of debt must be based on the contractual liability assumed by Transnational under the Retrocession Agreement.

46. The relevant provisions of the Retrocession Agreement are the following:-

> "Coverage: Article I
>
> On the terms and conditions hereinafter contained, and for the consideration hereinafter appearing, the

Company [ie. Delta Re] shall cede and the Retrocessionaire shall accept a 6.5% share in respect of liability assumed under all contracts of insurance and treaty reinsurance, hereinafter referred to as 'Acceptances', assumed or renewed by the Company on or after the effective date of this Agreement."

"Original Conditions: Article VII

This Reinsurance shall be subject to the same terms, rates, conditions and waivers, and to the same modifications, alterations and cancellations as those underlying Acceptances, forming the subject matter of this Agreement. In all things coming within the scope of this Agreement, the Retrocessionaire shall follow to the extent of its interest, the fortunes of the Company."

"Quarterly Accounts and Settlements: Article VIII

Within 45 days of the end of each calendar quarter the Company shall render an account, showing for its respective share, for each underwriting year, the Retrocessionaire has participated hereon, the following information relating to the said quarter:

Section A

1. Gross written premium, less returns and cancellations.

2. Commission, Taxes and Expenses.

3. ....

4. ....

5. Loss and loss adjustment expense payments, less salvage recoveries.

6. Funds withheld and released, and any interest earned thereon.

Any balance due by either party shall be paid as soon as possible, but not less than 60 days after the close of the quarter for which the account is rendered.

The Retrocessionaire shall also be advised of the following:

1. Outstanding Loss Reserves reported.

2. Unearned Premium Reserves.

3. Reserves for Incurred but Not Reported Losses."

"Loss Settlements: Article XI

The Retrocessionaire shall pay its proportionate share of all loss settlements and loss adjustment expenses falling within the scope of this Agreement."

"Insolvency: Article XVI

1. In the event of the insolvency of the Company, this reinsurance shall be payable directly to the Company, or to its liquidator, receiver, conservator or statutory successor on the basis of the liability of the Company without diminution because of the insolvency of the Company or because the liquidator, receiver, conservator or statutory successor of the Company has failed to pay all or a portion of any claim. It is agreed, however, that the liquidator, receiver, conservator or statutory successor of the Company shall give written notice to the Retrocessionaires of the pendency of a claim against the Company indicating the policy reinsured which claim would involve a possible liability on the part of the Retrocessionaire within a reasonable time after such claim is filed in the conservation or liquidation proceeding or in the receivership, and that during the pendency of such claim the Retrocessionaires may investigate such claims and interpose, at their own expense, in the proceeding where such claim is to be adjudicated any defense or defenses that they may deem available to the Company or its liquidator, receiver, conservator, or statutory successor."

47. It is common ground that the Agreement is to be construed in accordance with its proper law, the law of New York. Two experts on New York law gave evidence at the trial, one on each

side. The issue between them related to the inter-action between the final sentence in the "Original Conditions" clause, the "follow the fortunes" provision, and the first sentence of the "insolvency" clause. On behalf of Delta Re it was contended that the effect, under New York law, of the insolvency sentence was to transform Transnational's contractual obligation from the normal obligation under an insurance contract, namely, to indemnify the insurer – in which case the obligation would be based on the payments Delta had actually made to its insured – to an obligation based on the liability of Delta Re to its insured. It was argued by Transnational that that would be to deprive the "follow the fortunes" sentence of any real effect. Smellie J., having heard the evidence of the experts, found in favour of Delta Re and the Court of Appeal upheld him. Their Lordships agree that, once Delta Re had become insolvent, the Insolvency provision became the contractual provision governing the obligations of Transnational to Delta Re and that the liability of Transnational to Delta Re fell to be assessed by reference to the liability of Delta Re to its insured rather than to the actual payments made by Delta Re to its insured. Accordingly, in their Lordships' view, the terms of the plan, which postpone, perhaps indefinitely, the time when Delta Re will have to make any payment in respect of the claims that were IBNR on 31st December 1995, do not reduce Transnational's contractual liability to Delta Re.

48. For the same reason, the more general contention that Delta Re is not entitled to prove in respect of a liability that is based on IBNR claims cannot be accepted. The figure given for IBNR claims represents an estimate of an actual liability. The insured events justifying claims will have happened. Transnational's liability to pay the appropriate proportion of the sums payable by Delta Re under the relevant policies will have accrued. Transnational's liability is contingent only on the specific claims being notified to Delta Re and verified. Both Smellie J. and the Court of Appeal accepted Delta Re's contention that Delta Re, being in insolvent liquidation, was entitled to claim, and prove in Transnational's liquidation for, an amount equal to the provision it had made in its accounts in respect of IBNR. Their Lordships agree that the objections of principle put forward by Transnational for opposing this conclusion fail. There has been no argument before your Lordships on the actual figures.

49. Their Lordships have accordingly concluded that the appeal on the second issue must fail.

The Interest Issue

50. In its proof of debt, Delta Re claimed interest of $151,953 odd. The interest claimed related to the period up to the commencement of the winding-up. The liquidator rejected the claim *in toto*. Their Lordships are not clear as to the basis on which interest was originally claimed but it appears that, at the opening of the hearing before Smellie J., Delta Re based its claim to interest on Rule 4.93 of the Insolvency Rules 1986.

51. Under Ord 102, rule 17 of the Grand Court Rules, the Insolvency Rules 1986 apply in the Cayman Islands "unless and until any rules are made under section 173 [of the *Companies Law* (1995) Revision"] and "in so far as such rules are not inconsistent with the [Companies] Law or such other rules as may be applied to the proceeding in question."

52. Smellie J. applied Rule 4.93 to Delta Re's interest claim. Rule 4.93 provides, in sub-rule (4), that "The rate of interest to be claimed under paragraphs (3) and (4) is the rate specified in section 17 of the Judgments Act 1838 on the date when the company went into liquidation". On 15th January 1993, the date when Transnational went into liquidation, the rate specified was 15 per cent (see the Judgment Debts (Rate of Interest) Order 1985 - S.I. 1985 No. 437).

53. So Smellie J., having accepted that Delta Re was entitled under Rule 4.93 to prove for interest up to 15th January 1993, allowed interest at the rate of 15 per cent per annum.

54. The Court of Appeal agreed that interest up to 15th January 1993 should be allowed but held that, having regard to recent Cayman Island enactments, namely, the Judicature Law (1995 Revision) and the Judgment Debts (Rate of Interest) Rules 1995, the rate should be $7^3/_8$ per cent per annum.

55. Transnational has contended before their Lordships:

> (i) that the common law does not permit the award of interest by way of general damages for delay (*President of India v. La Pintada Compania Navigacion S.A.* [1985] A.C. 104);

(ii) that the Retrocession Agreement contains no provision for interest;

(iii) that whereas Rule 4.93 has statutory authority in England by virtue of sections 411 to 413 of the *Insolvency Act 1986* and section 189 of that Act makes express provision for interest on debts in insolvency, there is no comparable statutory authority for the award of interest under Cayman Islands law;

(iv) that without appropriate statutory authority subordinate legislation cannot validly confer an entitlement to interest;

(v) that although, pursuant to the Grand Court Rules, Ord 102, rule 17, applies the Insolvency Rules 1986 to Cayman Islands liquidations, the Grand Court Rules themselves derive their validity from section 19(3) of the Grand Court Law which enables rules to be made:-

> "(a) regulating pleading, practice and procedure ... in relation to all matters within the jurisdiction of the Court ..." and
>
> "(g) generally providing for such other matters as may be reasonably necessary for or incidental to the administration of this Law" and

(vi) that, accordingly, the application of Rule 4.93 to the Cayman Islands liquidations was ultra vires and ineffective."

56. There is no indication in Smellie J.'s judgment that the *vires* point was taken before him. It does, however, appear to have been taken in the Court of Appeal. Be that as it may, Kerr J.A. in the Court of Appeal, with whose judgment Zacca P. and Collett J.A. agreed, held in clear terms that Ord 102, rule 17, of the Grand Court Rules applied the whole of rule 4.93, including the sub-rule relating to interest, to Cayman Islands liquidations subject only to the express reservations and limitations contained in rule 17 itself.

57. The boundary between substantive law and practice and procedure is often a difficult one to identify with precision and

their Lordships consider that paragraphs (a) and (j) of section 19(3) of the Grand Court Law do permit the interest provisions of rule 4.93 to be applied to Cayman Islands liquidations and are not disposed to disagree with the local judges on a point such as this.

58. A final point relates to the rate of interest.

59. Delta Re has contended before their Lordships that the rate of interest should be restored to 15 per cent. Leave to raise this point by way of cross appeal on the hearing of Transnational's appeal to the Board was not sought by Delta Re but the point was referred to in the Respondent's Case.

60. Kerr J.A. reduced the rate from 15 per cent to $7^3/_8$ per cent in order to take account of the recent Cayman Islands legislation to which reference has already been made. He regarded this legislation as falling within the express reservation in Ord 102, rule 17 applying the Insolvency Rules 1986 "in so far as such rules are not inconsistent with the [Companies] Law or such other rules as may be applied to the proceeding in question". On this point their Lordships agree with the Court of Appeal.

61. For these reasons their Lordships will humbly advise Her Majesty that Transnational's appeal and Delta Re's cross-appeal should be dismissed. Transnational must pay the costs of the appeal.