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Précis Paper

Subrogation in light of recent judgements

A discussion about the law surrounding subrogation and in particular partial subrogation in light of the recent judgements of *Re Fellmane Pty Ltd (in liq)* [2020] NSWSC 595 and *Gandel Metals Pty Ltd, in the matter of Centennial Mining Limited (Subject to Deed of Company Arrangement) v Centennial Mining Limited (No 2)* [2020] FCA 633.

Discussion Includes

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Subrogation in light of recent judgements

In this edition of BenchTV, Daniel Krochmalik (Barrister, 3 St James Hall Chambers, Sydney) and Thomas Russell (Partner, Piper Alderman, Sydney) discuss the law surrounding subrogation and in particular partial subrogation in light of the recent judgements of *Fellmane Pty Ltd (in liq)* [2020] NSWSC 595 and *Gandel Metals Pty Ltd, in the matter of Centennial Mining Limited (Subject to Deed of Company Arrangement) v Centennial Mining Limited (No 2)* [2020] FCA 633.

What is subrogation?

1. Subrogation is the term given to somebody stepping into somebody else's shoes for legal reasons. It ordinarily occurs in the context of a secured creditor having been paid out or somebody holding particular rights no longer requires them and somebody else is able to step into those rights without the existence of any formal legal agreement between the parties.
2. It often arises in the context of equity. Equity presupposes the right of a party to stand in the shoes of another in a particular context
3. In the matter of *Bofinger v Kingsway Group Limited* (2009) 239 CLR 269, the Court tried to explain that the doctrine of subrogation cannot be understood through the rubric of one particular lens like unjust enrichment for example. Rather, the High Court explained that it really is based on principles of equity.

Species of subrogation

4. One species of subrogation are the subrogation rights that insurers have. If an insurer pays out a claim, that insurer is automatically given the rights of the rights of the person given the funds to claim any relief that person could otherwise have claimed from the other party.
5. There is also statutory subrogation where, under the Fair Entitlements Guarantee (FEG) scheme, the government will pay out employee entitlements in certain circumstances if a company becomes insolvent and cannot pay its employees. Under this scheme, the Commonwealth is able to subrogate the employee's right to be paid in priority to other creditors.
6. Another area is where a third party comes in and pays out monies owing by a debtor to a creditor and particularly in the context of where a creditor has security over the debtor's assets. Subrogation can arise where that security is discharged by the third party repaying the debtor's debt and there is a question of whether the third party is able to be subrogated to the existing creditor's securities.

Facts of Gandel

7. The matter of *Gandel Metals Pty Ltd, in the matter of Centennial Mining Limited (Subject to Deed of Company Arrangement) v Centennial Mining Limited (No 2)* [2020] FCA 633 concerned a mining company by the name of Centennial which was operating a gold mine in Victoria.
8. In the course of conducting its operations Centennial borrowed $2.5 million from a company called Squadron. Centennial came into discussions with Gandel, another lender to refinance the debt owing to Squadron.
9. In this case Centennial was an ASX listed company and Gandel was a related party secured creditor. As such, it was impossible, without a resolution of shareholders approving the loan by the related party, for Centennial to offer security to its related party. Gandel did not have the option of agreeing with Squadron for Squadron to assign it the security because the requisite steps needed to be followed first.
10. Instead what was agreed was that the debt would be paid out by Gandel and the (then) unsecured loan by Gandel that was used to pay out Squadron would become secured subject to the relevant procedures being complied with.
11. Gandel paid out the vast majority, but not all, of the Squadron debt and the rest was paid out by a Centennial subsidiary. Before arrangements could be put in place for Gandel to take the security, Centennial was placed into voluntary administration and, at that point, it was seemingly unsecured.
12. By then, Squadron had been paid out in full and it had discharged its security over all of Centennial's property. Gandel had lent the $2.17 million but it was completely unsecured at that point; it did not have any security.
13. There then developed a fight between Gandel on one hand and some otherwise unsecured creditors of Centennial and Centennial itself on the other hand as to whether or not Gandel had effectively subrogated or had the right to subrogate to Squadron's securities.

Fellmane case facts

14. The case of *Re Fellmane Pty Ltd (in liq)* [2020] NSWSC 595 also concerned the question of partial subrogation. Fellmane had gone into liquidation and was the trustee of a family trust known as the Battaglia Family Trust.
15. The liquidator of that company, Mr Copeland, had also been appointed as the receiver and manager of the assets of the trust. The only substantial asset in the liquidation of Fellmane, which it held as trustee of this particular trust, was a property on the South Coast of NSW.

16. That property was given as security for a guarantee that Fellmane had given in support of loans that were advanced by the National Australia Bank to the wife of the director of Fellmane, Karen Battaglia.
17. Mr Copeland, as the liquidator of the company and the receiver of the trust assets, looked at ways to sell the property in order to realise monies in the liquidation and the receivership of the trust. The difficulty for Mr Copeland was that the National Australia Bank held the registered mortgage over the property and the amount that Fellmane had guaranteed in respect of Karen Battaglia's debts were substantially greater than the value of the property. That meant that if the property were to be sold, all of the proceeds of the sale would (or at least could theoretically) be paid to the NAB pursuant to the guarantee.
18. This, however, would have given the liquidator a right to bring a claim against Karen Battaglia based on a guarantor's right of indemnity where it pays out the debt of the principal debtor. The issue in the case was not just whether there was a right of indemnity in that situation but whether there would be a right of subrogation to the securities held by NAB (including mortgages over other property owned by Karen Battaglia).
19. In the course of looking to realise the property on the South Coast, the new trustee of the Battaglia Family Trust came up with a proposal whereby it would pay the sum of $850,000.00 to Mr Copeland in order to in effect buy out the company's equity in the property.
20. The effect of that transaction in all likelihood though would have meant that Fellmane and its liquidator would have no claim against Karen based on its right of indemnity.
21. The question in that case was whether it was appropriate to proceed with that particular transaction (whereby the liquidator would receive $850,000.00) but potentially give up its right of indemnity against Karen and also potentially give up a right of subrogation if there was indeed a right of subrogation arising in the circumstances.

<u>Decision of Justice Middleton in Gandel</u>

22. After reviewing the authorities and hearing submissions from the opposing parties, Middleton J came to the view that subrogation is possible where a secured debt has only been paid out in part by a new creditor.
23. The position in Gandel was that there was a 2.5 million debt to Squadron and Squadron had security over Centennial's assets. Gandel paid out 2.17 million of Squadron's debt (with the balance paid out by a wholly owned subsidiary of Centennial) and Gandel was seeking to subrogate in those circumstances. At most, what the case law says that if you have not paid out the whole debt there is a dormant potential right of subrogation which only becomes alive once the rest of the debt is paid out.
24. What the Court said in Gandel is that it is possible to subrogate to a security if you only pay out part of the secured debt and, in those circumstances, you subrogate to the security in the proportion of the amount you paid out the debt

25. The outcome of this decision was that Gandel was permitted to subrogate even though it had only paid out part of the debt and, as a result, it became a secured creditor with first ranking security over Centennial's assets even though there was at least some evidence that might have suggested to a third party that both Centennial and Gandel intended that Gandel's loan would be unsecured.
26. This is an interesting judgement since the ordinary rule is that equitable subrogation to another's security ordinarily applies as a presumption but that presumption can be rebutted if it can be shown that the parties' intention was that subrogation would not occur.
27. The issue with subrogation is whether as a matter of equity, it should be held that the unsecured loan is nevertheless taken to be secured by reason of the keeping alive of the existing security. So even though, as a matter of fact, looking at the contractual documentation between the parties for example, the loan may well be unsecured, the fact that it is being done in a particular context, equity deems it as being unfair to do anything other than treat the incoming financier as being subrogated to the outgoing financier's securities.
28. It does not matter that Squadron's securities had been discharged legally, in equity, and by virtue of the fact that it was not the parties' intention not to subrogate, these securities are kept alive. On that basis, the Judge decided that despite being discharged, it was still possible for Gandel to subrogate to Squadron's securities.

Decision of Justice Gleeson in Fellmane

29. Justice Gleeson looked at one of the same issues that Justice Middleton considered which is whether or not the partial repayment of monies owing to a secured creditor would have the effect of permitting, in that case, the guarantor to be subrogated either in whole or in part to the existing securities.
30. However, Justice Gleeson reached the conclusion that there really was no such thing as the doctrine of partial subrogation.
31. The receiver in that case was coming to the court for directions about a particular transaction and the creditors took the view that the transaction was not in the best interests of the company and opposed it.
32. One of the arguments they raised was whether or not an alternative transaction, which involved the sale of the property, would have the effect of permitting the company as the guarantor of Karen Battaglia's loans to be subrogated to the securities that were held by the NAB and that was in effect the transaction for which the creditors were contending for in that case as an alternative to the transaction that was being promoted by Mr Copeland (which was the transfer of the property to the new trustee for the payment of $850,000.00).
33. The creditors argued that if Mr Copeland paid out the NAB on behalf of Karen Battaglia, he could subrogate to the NAB's securities over Karen's other properties.

34. In response, Mr Copeland put to the court the proposition that he and the company would not be entitled to a right of subrogation in those circumstances because the sale of the property would only realise enough money to partly repay the debt that was owed to the NAB by Karen and, in those circumstances, the NAB would still have its security over the other two properties that she owned and therefore there would be no entitlement to be subrogated to the NAB security.
35. The underlying question was the same: if you are seeking a right of subrogation but, rather than pay out the whole of the debt, only pay out a portion of it, can you subrogate to the creditor's security?
36. In Fellmane, the Court held that, in accordance with existing authority including the High Court's decision in *Bofinger v Kingsway Group Limited* (2009) HCA 44 and *Austin v Royal* (1999) NSWCA 222, it is not possible to have rights of subrogation arise in the hands of a guarantor until the whole of the secured debt is repaid and therefore the whole of the other securities are discharged.
37. Justice Gleeson also referred to the cases of *State Bank of New South Wales v Geeport Developments Pty Ltd* (1991) 5 BPR 11 *and Padovan v MGG Group Pty Ltd (in liq)* [2011] NSWSC 1080 which did seem to support the proposition that there was such a concept as partial subrogation to the extent of the partial payment of the secured debt. Ultimately, however, he said that those cases were either inconsistent with the appellant authorities or, otherwise, they are to be understood as saying no more than partial subrogation does not arise insofar as you are not entitled to subrogate partially to the value of the security, what you have is a right that is not fully formed and only comes into existence when at some later time the balance of the secured debt is paid.

Divergent authorities on partial subrogation

38. These cases leave legal advisers in a difficult position as it appears to differ depending on whether or not the subrogation occurs by virtue of a third party coming in as a new secured lender to pay out an exiting secured lender or whether it is the right of subrogation of a guarantor who is paying out the debt of a principal debtor.
39. Subrogation, like all equitable concepts, exists because it is considered to be against equity not to permit it to occur.
40. Where these cases leave us, is that the key to subrogation is always going to be a fairly detailed analysis of the specific circumstances of the particular case. There does not however seem to be a real principled distinction between the two species of subrogation that should lead to different results.
41. The only real difference is that the guarantor knows from the outset that they are always potentially liable for the whole of the secured debt in respect of which they provided a guarantee. In the second species of subrogation where the party that seeks the subrogation

is an incoming financier the position may well be a little different because they have not in effect undertaken to be liable for the whole of a debtor's secured debt.

42. The law remains unsettled as a result of these two cases and it may indeed warrant, at some point in time, the intervention of an appellate court to try and settle the law in this area.

Other limits to the doctrine of subrogation

43. The first point is the issue that arose in Fellmane, being a contractual provision in the security documents which expressly prevented subrogation. The Court in Fellmane placed a lot of weight on that contractual provision.
44. The same is the case in the guarantor, often when a guarantor agrees to give a guarantee, it is a standard provision of the guarantee that the guarantor is not entitled to compete, subrogate or have any rights of indemnity vis a vis the lender.
45. The other situation where subrogation might not be permitted is where there are competing equities.
46. A third example is where the payment by the party which has the effect of repaying the debt is a voluntary payment such as a gift such as *In the matter of Dalma No 1 Pty Limited (in liquidation) (ACN 111 772 260); Application of Bruce Gleeson and David Shannon in their capacity as joint and several liquidators of Dalma No 1 Pty Limited (in liquidation) and anor* [2013] NSWSC 1335.
47. In this case, a company had become insolvent and appointed an administrator. During the course of the administration, the administrator was without funds to pay employees. The director, without reference to the administrator, went and paid all the wages using his own money. He then lodged a proof of debt in the winding up and claimed that he was entitled to subrogate to the priority position of employees in the winding up.
48. The statutory provision which allows subrogation in those circumstance says that you cannot pay the employees directly and that you must give the money to the company to pay the employees. Therefore, statutory subrogation could not occur as the pre-requisites had not been met.
49. The director fell back on a secondary argument in equity claiming that he should have a right to subrogate as his own money was used to pay out the employee entitlements and therefore, he should be afforded their priority.
50. However, equity does not assist a volunteer and in the Dalma decision, the court said if he had been asked by the administrator to pay the employees or if the administrator had known beforehand and had acquiesced in doing so, he may have had an equitable right of subrogation. However, because he did not take these steps, there was no subrogation.

BIOGRAPHY

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Daniel Krochmalik was admitted as a lawyer in 2008 and called to the NSW Bar in 2013. In the same year he was awarded the Con Varnavas Award for the highest aggregate score in the NSW Bar Examinations. His practice encompasses many different areas but he specialises in corporations law and commercial insolvency.

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