Feature

KEY POINTS

- Suspense accounts can maximise a creditor's recoveries in a liquidation.
- To be effective a creditor should refrain from appropriating sums in such an account towards the outstanding debts until it has exhausted its other remedies.
- A suspense account will not assist a creditor to prove against a principal debtor for the entire amount owed where a surety's obligations extend to part of a debt only and the surety has discharged that part.

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Keeping it in suspense – the use and limits of suspense accounts

Suspense accounts commonly feature in guarantees and security documents. They allow a creditor to credit partial payments from a surety, or from realising assets subject to security from a surety, to a suspense or "securities realisation" account. The account represents a fund to which the creditor can resort, but without any obligation to do so until it has recovered all debts in full. This enables a creditor to prove for the full amount owed in a liquidation of the principal debtor where a shortfall is anticipated, thereby improving the prospects of a full recovery.

In this article we take a closer look at why creditors use suspense accounts, the benefits of doing so and the limitations of such rights by reference to the questions below.

SPECIFIC CONSIDERATIONS

What kind of account is a suspense account?

A suspense account is not necessarily an account at a bank as a layman might expect. Often they are ledger accounts only, with transactions recorded by book entry alone.

While opening a designated account at a bank is not essential to create a suspense account, this is probably the cleanest way to earmark such funds and keep them separate from other recoveries.

In *Commercial Bank of Australia*,[1] the Privy Council considered how monies recovered from guarantors had been credited to a specially named suspense account held in the names of the guarantors who had paid funds in.

Setting aside the monies in this way ensured that, '*down to the time of appropriation by the bank … their Lordships [were] unable to see anything which could discharge the principal debtor*'.[2]

Who can open a suspense account?

Conceivably any creditor can open a suspense account if it has a contractual right to do so. This could include an individual or a corporate creditor. Individual creditors less familiar with accounting practices might be more inclined to open a suspense account at a bank as per the example in *Commercial Bank of Australia*, although that is not necessarily essential.

How can a suspense account benefit a creditor in insolvency?

Sums in a suspense account do not reduce the amount of a creditor's claim against a principal debtor so long as it does not appropriate such amounts to the outstanding debt. The creditor can then prove for the entire debt in a liquidation of the principal debtor rather than part only. Moreover, the surety from whom the amount has been recovered acquires no right to be indemnified by the principal debtor and no provable claim in the liquidation of the debtor in respect of sums in the suspense account.

These advantages can be illustrated by the following example: if a lender that is owed £100 recovers £50 from a guarantor and applies that sum to discharge part of the outstanding debt, the debt is reduced to £50. Thereafter the lender can only prove for £50 in the borrower's liquidation. If the liquidation dividends amount to say 50 pence for each £1 of debt, the lender will receive £25. The lender's total recovery is £75 and it suffers a £25 shortfall.

Conversely, if the lender credits £50 recovered from the guarantor to a suspense account, the lender can prove for £100 in the borrower's liquidation. Assuming the liquidation dividends are still 50 pence for each £1 of debt, the lender will recover £50, meaning a total recovery of £100 once it uses the sum in the suspense account. The lender therefore achieves a full recovery.

Can suspense accounts be used outside insolvency?

Potentially yes, although how useful they are depends upon the wording of the surety instrument. According to Goode, '*the general rule outside insolvency appears to be that a part payment by the surety does not prevent the creditor suing a solvent principal debtor for the whole amount of the debt*'.[3] We could see how a suspense account could be useful in this context. For example, if a claimant credits monies recovered from a surety to a suspense account while suing a solvent defendant for breach of contract, there may be equities that the defendant can assert which mean the claimant is left short.

The claimant may have additional rights against the surety which enable it to resort to monies in the suspense account to recover the additional amounts claimed.

Is there any advantage for a surety when a creditor uses a suspense account?

Since they enable a creditor on liquidation to postpone the appropriation of monies recovered from a surety against outstanding debts, suspense accounts help to delay when a surety might compete with a creditor by, for example, exercising its subrogation or other rights against the principal debtor. They also complement the rule against double proof.[4]

This obviously sounds disadvantageous from the surety's perspective. Some concessions may be afforded to a surety in intercreditor arrangements, for example, an ability to prove in the insolvency of a principal debtor at least to preserve their contingent claims. On the plus side, a suspense account does at least create the possibility (theoretical perhaps) that a surety will get reimbursed some or all of its money, assuming the beneficiary recovers more than expected from the principal debtor in a liquidation or otherwise.

Is it market practice to include a suspense account in a surety instrument?

Yes, and equally it is unusual for a surety to delete it. An example of a suspense account can be found within the guarantee and indemnity language of the Loan Market Association's template loan documentation.[5] Surety requests for suspense accounts to be interest bearing are usually accepted.

Does a creditor need a suspense account to prove for the entire amount of its debt in the insolvency of a principal debtor?

This question has attracted some debate and the use or not of a suspense account does not seem conclusive; rather, the answer appears to turn on the scope of a surety's obligations.

Goode refers to the general rule of English law that partial recoveries from a surety do not have to be deducted by a creditor from his proof whether before or after bankruptcy so long as the creditor does not receive in total more than 100 pence in the pound.[6]

There have been examples of exceptions to this rule in other jurisdictions[7] and some doubt has been cast by Dillon L.J.'s comments in *MS Fashions (No 2)*[8] that *'A creditor cannot sue the principal debtor for an amount of the debt which the creditor has already received from a guarantor.'*

What appears to be crucial is the extent to which the surety's obligations extend to all of the outstanding intendedness or part only.

These risks were considered by Vaughan Williams J. in *Re Sass*,[9] in which the bank, having recovered part of the indebtedness owing by the bankrupt borrower from its guarantor, sought to credit that amount to a suspense account and prove in the bankrupt's estate for the entire debt. The trustee rejected the proof on the basis that the bank's claim should have been reduced by the amount recovered from the guarantor. Vaughan Williams J disagreed with the trustee since the guarantee extended to the whole indebtedness, albeit the amount recoverable was limited by amount. Contrasting the position with a guarantee in respect of part of a debt only, Vaughan Williams J noted that *'if the surety is a surety for part of the debt, and the surety has paid that part, then by virtue of that payment the right of proof, which would have been the right of proof of the principal creditor, becomes pro tanto the right of proof by the surety'*.[10]

In summary, Goode concludes that so long as the surety's obligations extend to the entire amount of the indebtedness, then suspense accounts merely confer upon a beneficiary a right to use a procedure that is *'sensible as a matter of accounting practice [but] not essential to enable [a] creditor to maintain his proof for the full sum owing to him'*.[11]

When is it too late to use a suspense account?

Once sums recovered from or in respect of a surety have been appropriated towards the debt in question, a creditor cannot thereafter attempt to credit those amounts to a suspense account. For example, if a bank credits monies on a suspense account towards a principal debtor's overdraft balance, it cannot later elect to move those monies back into the suspense account when it learns that the principal debtor is on the brink of insolvency.

This is consistent with the view expressed by the Privy Counsel in Commercial Bank of Australia, in which the then Lord Chancellor concluded that: *'The bank no doubt had power when it thought it prudent to do so to appropriate that sum to the payment of the principal debt pro tanto, and as soon as they made such appropriation it would undoubtedly operate as payment.'*[12]

How can appropriation occur?

Appropriation of monies in a suspense account usually occurs when the creditor elects to apply such funds towards the discharge of the indebtedness. However, appropriation can also happen automatically by mandatory set-off.

This is illustrated by *MS Fashions (No 2)*,[13] in which Mr Sarwar, a director of M.S. Fashions Limited, put funds on deposit with BCCI as security for his guarantee of the company's loan obligations to BCCI. BCCI subsequently entered liquidation and its liquidators sought to enforce the security from the company in favour of BCCI. Mr Sarwar contended that BCCI should use its deposit to partially satisfy the debt and offered to repay the balance.

Lord Hoffman rejected the submission made by BCCI's counsel that the bank was entitled to transfer Mr Sarwar's deposit to a suspense account rather than applying it to discharge the company's debt. Hoffman concluded that: *'In my judgment this clause cannot survive the winding up of B.C.C.I. and the application of the mandatory principle.'*[14]

The mandatory statutory set-off rules are now set out at Rule 14.25 of the Insolvency Rules[15] and apply in a winding up where, before a company enters liquidation, there have been mutual dealings between the company and a creditor of the company proving or claiming to prove for a debt in the liquidation. The application of such rules in *MS Fashions (No 2)* seems counterintuitive at first blush since Mr Sarwar was not the borrower; however, the Court of Appeal bypassed this issue based on the "principal debtor" wording in his guarantee.

Lord Hoffman concluded that once the winding-up order or resolution is passed, mandatory set-off occurs and the suspense account ceases to have any further effect. This suggests that a suspense account cannot be used to revive a debt that has been discharged by such set-off.

Feature

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The decision also implies that a suspense account may be ineffective against an insolvent guarantor.

Can a creditor use proceeds in a suspense account?

Yes, although any application of such funds will be deemed to represent an appropriation against the relevant debts for which the sums were recovered.

For example, if a creditor spends monies sitting in a suspense account by depositing them in a high-earning interest account with an offshore bank which subsequently goes insolvent, that is to be regarded as an appropriation and any resulting loss is the creditor's problem rather than the surety's. This is consistent with the views expressed by the Privy Council in *Commercial Bank of Australia*.

How long can a creditor hold monies in a suspense account?

Monies can usually be kept in a suspense account until such time as the guaranteed or secured obligations have been discharged in full. It follows that if a creditor recovers more than the amount due, he holds the surplus on trust for the surety.[16]

Of course it is entirely possible that a creditor may still suffer a shortfall following the liquidation of the principal debtor and any appropriation of partial recoveries sitting in a suspense account. In that instance, the creditor can continue to pursue the surety for any remaining shortfall depending upon the scope of the surety's obligations.

If a creditor is over-compensated as a result of using a suspense account, can it choose how to use the surplus?

This possibility can be illustrated by the following example: supposing a creditor owed £100, recovers £80 from a surety and credits that sum to a suspense account. The creditor then recovers 50 pence in the pound in the insolvency of the borrower so it realises £130 in total. Can the creditor choose whether it reimburses £30 to the surety or applies the £80 recovered from the surety in order to generate a £30 surplus that can be turned over for the benefit of other creditors? This might be helpful if other affiliates of the creditor (secured or unsecured) also have claims against the borrower.

In our view, creditors enjoy no such rights and based on the outcome of cases such as *Westpac Banking Corp*[17] it seems to us that surplus recoveries need to be turned over to sureties from whom partial payments have been recovered and cannot be used to put others in a better position than they might otherwise have been.

SUMMARY

Suspense accounts are a useful tool for creditors taking guarantees or security. However, they should not be included in surety instruments in isolation. Care needs to be taken to ensure the scope of guaranteed or secured obligations reflects the parties' true intention. Suspense accounts also risk being rendered redundant by the application of statutory set-off as illustrated by *MS Fashions (No 2)*. ■

1 *Commercial Bank of Australia Limited v Official Assignee of the Estate of John Wilson & Company* [1893] AC 181.
2 [1893] AC 181, 185.
3 *Goode on Legal Problems of Credit and Security*, 5th edn, paragraph 8-18.
4 See *Re Oriental Commercial Bank* (1871–72) LR 7 Ch App 99 for the common law rule against double proof.
5 For example, see Clause 17.6 (Appropriations) of the Loan Market Association Single Currency Term Facility Agreement dated 18 July 2017 which reads as follows: '*Until all amounts which may be or become payable by the Obligors under or in connection with the Finance Documents have been irrevocably paid in full, each Finance Party (or any trustee or agent on its behalf) may (a) refrain from applying or enforcing any other moneys, security or rights held or received by that Finance Party (or any trustee or agent on its behalf) in respect of those amounts, or apply and enforce the same in such manner and order as it sees fit (whether against those amounts or otherwise) and no Guarantor shall be entitled to the benefit of the same and (b) hold in an interest-bearing suspense account any moneys received from any Guarantor or on account of any Guarantor's liability under this Clause.*'
6 This is based on various case law including *Ellis v Emmanuel* (1876) 1 Ex. D. 157; *Re Sass* [1896] 2 QB 12; *Ulster Bank Ltd v Lambe* [1968] NI 161; *Re An Arranging Debtor No.A 1076* [1971] NI 96.
7 See, for example, the Scottish case of *MacKinnon's Trustee v Bank of Scotland* [1915] S.C. 411 and the New Zealand case of *Stotter v Equiticorp Australia Ltd (In Liquidation)* [2002] 2 NZLR 686.
8 [1993] 1 Ch 425, 448.
9 [1896] 2 QB 12.
10 [1896] 2 QB 12, 15.
11 *Goode on Legal Problems of Credit and Security*, 5th edn, paragraph 8-18.
12 *Commercial Bank of Australia v Official Assignee of the Estate of Wilson* [1893] AC 181, 185.
13 [1993] 1 Ch 425.
14 [1993] 1 Ch 425, 438.
15 Insolvency Rules (England and Wales) 2016 (SI 2016/1024).
16 *Westpac Banking Corp v Gollin & Co Ltd* [1988] VR 397.
17 *Westpac Banking Corp v Gollin & Co Ltd* [1988] VR 397.

Further Reading:

- The strength of a bank guarantee: a credit risk? [2009] 8 JIBFL 488.
- The insolvent bank and security over deposits [1996] 4 JIBFL 185.
- LexisPSL: Banking & Finance: Guarantees of Loans and Bonds