

LANDLORD AND TENANT ISSUES IN THE PROPERTY DOWNTURN

by

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PART 1

RENT DEPOSITS, PRE-PACKS, VARIATIONS, AND SUBTENANTS FOLLOWING DISCLAIMER

by Stephen Jourdan

RENT DEPOSITS

The terms of a rent deposit

The different types of rent deposit

Every rent deposit deed is different. There are at least four types in use:

1. Deposit held by landlord on trust

The tenant pays a sum to the landlord, which the landlord pays into a separate bank account. Legal title to the debt owed by the bank to the landlord is vested in the landlord. The landlord can only draw on the deposit in defined circumstances, and must repay the deposit to the tenant in defined circumstances.

2. Deposit held by landlord absolutely

The tenant pays a sum to the landlord, which the landlord is free to do with as it chooses. The landlord owes a purely contractual obligation to repay a similar amount to the tenant in defined circumstances.

3. Deposit held by tenant, charged to landlord

The tenant places the deposit in an account in the tenant's name, and charges that account to the landlord. Legal title to the debt owed by the bank remains with the tenant, but it is subject to an equitable charge to the landlord.

4. Stakeholder

The rent deposit is paid to a third party, as stakeholder. Neither landlord nor tenant has any proprietary claim in respect of the money; all they have is rights in contract¹ against the stakeholder and each other.

¹ *Hastingwood Property Limited v Saunders Bearman Anselm* [1991] Ch 114, *Manzanilla v Corton Property Ltd* [1996] EWCA Civ 942

The *Financial Collateral Arrangements (No 2) Regulations 2003*

Where the Regulations apply, a number of beneficial consequences for the landlord follow:

- s.395 of the Companies Act 1985 395 CA 1985 (and from 1 October 2009, s.860 of the Companies Act 2006), which requires the registration of certain company charges, which charges are void against a liquidator, administrator, or a creditor, if not registered, does not apply (if it would otherwise do so)
- in administration, the normal restriction on the enforcement of security does not apply
- the moratorium which can be granted to small companies proposing a CVA does not prevent the enforcement of the landlord's rights under the deposit
- s.127 IA 1986 (avoidance of property dispositions made after the commencement of winding up) does not apply
- the power of disclaimer does not apply

The Regulations implement the European Parliament and Council Directive 2002/47/EC on financial collateral arrangements. They go much very much further than the Directive, which only applied to arrangements with certain specified financial institutions. It was argued last year that this rendered the Regulations invalid, but that was rejected: *R (Cukurova Finance International Ltd) v HM Treasury*²

Definitions

The key terms used in the Regulations are as follows:

- “financial collateral arrangement” means a title transfer financial collateral arrangement or a security financial collateral arrangement, whether or not these are covered by a master agreement or general terms and conditions;
- “title transfer financial collateral arrangement” means an agreement or arrangement, including a repurchase agreement, evidenced in writing, where-
 - (a) the purpose of the agreement or arrangement is to secure or otherwise cover the relevant financial obligations owed to the collateral-taker;
 - (b) the collateral-provider transfers legal and beneficial ownership in financial collateral to a collateral-taker on terms that when the relevant financial obligations are discharged the collateral-taker must transfer legal and beneficial ownership of equivalent financial collateral³ to the collateral-provider; and
 - (c) the collateral-provider and the collateral-taker are both non-natural persons;

² [2008] EWHC 2567 (Admin) (Moses LJ) 29/9/2008.

³ “Equivalent financial collateral” is defined as meaning - (a) in relation to cash, a payment of the same amount and in the same currency; (b) in relation to financial instruments, financial instruments of the same issuer or debtor, forming part of the same issue or class and of the same nominal amount, currency and description or, where the financial collateral arrangement provides for the transfer of other assets following the occurrence of any event relating to or affecting any financial instruments provided as financial collateral, those other assets, and includes the original financial collateral provided under the arrangement

- “security financial collateral arrangement” means an agreement or arrangement, evidenced in writing, where--
 - (a) the purpose of the agreement or arrangement is to secure the relevant financial obligations owed to the collateral-taker;
 - (b) the collateral-provider creates or there arises a security interest in financial collateral to secure those obligations;
 - (c) the financial collateral is delivered, transferred, held, registered or otherwise designated so as to be in the possession or under the control of the collateral-taker or a person acting on its behalf; any right of the collateral-provider to substitute equivalent financial collateral or withdraw excess financial collateral shall not prevent the financial collateral being in the possession or under the control of the collateral-taker; and
 - (d) the collateral-provider and the collateral-taker are both non-natural persons;
- “financial collateral” means either cash or financial instruments;

The application of the Regulations

Deposit held by landlord on trust

A typical rent deposit deed, where the landlord has legal title to the deposit account, held as security for the tenant’s obligations will probably be a “financial collateral arrangement”, provided that neither the landlord nor the tenant is an individual. It will not be a “title transfer financial collateral arrangement” because the landlord will not have beneficial ownership of the deposit account. It will, however, probably be a “security financial collateral arrangement”.

The contrary view has been expressed⁴ on the basis that this sort of deposit does not include an express charge of the tenant’s interest. However, probably the landlord’s title to the deposit account is a “security interest” as defined – “any legal or equitable interest or any right in security, other than a title transfer financial collateral arrangement, created or otherwise arising by way of security”.

Deposit held by landlord absolutely

This type of deposit will be a “title transfer financial collateral arrangement”.

Deposit held by tenant, charged to landlord

This type of deposit may not be a financial collateral arrangement. It is clearly not a “title transfer financial collateral arrangement”, because the landlord does not have legal title to the deposit.

It will only be a “security financial collateral arrangement” if the deposit is held on terms that it can be said that the account is held so as to be “under the control” of the landlord. If the landlord can draw on the account, without the tenant’s concurrence, then that condition may be satisfied.

Stakeholder

This is not a financial collateral arrangement.

⁴ By Alan Riley & Allyson Colby (2008) 55 Commercial Property Information p.11

Can the landlord keep the whole of the rent deposit after disclaimer?

Many deeds provide that the landlord may draw down any loss caused by disclaimer. There seems no reason why such provisions should not be given effect to. Further, even in the absence of such a provision, it is arguable that a liquidator/trustee in bankruptcy cannot disclaim a lease while retaining the right to the rent deposit. There are cases where the Courts have held that if a lease is disclaimed, ancillary rights go with the lease.

- In *Ex P. Allen In re Fussell*⁵, (trustee lost chattels in a leasehold factory when the lease was disclaimed)
- *Re Morrish ex p. Hart Dyke*⁶ (right to compensation at expiry of lease went on disclaimer)
- *Pearce v Bastable's Trustee in Bankruptcy*⁷ (contract for sale of leasehold property could not be disclaimed separately from the lease).
- *MEPC plc v Scottish Amicable*⁸ (disclaimer of licence to assign took lease with it)

However, in other cases a different result has been reached:

- *Re Gough*⁹ (contract to sell can be disclaimed without affecting a contract to buy)
- *Capital Prime Properties plc v Worthgate Ltd*¹⁰ (where a vendor had declared a trust of the property for the contracting purchaser, the disclaimer of the contract did not destroy the equitable interest of the purchaser who was entitled to be registered as proprietor)

Rent deposits and forfeiture

Does s.146 LPA 1925 apply to an obligation to top up a rent deposit?

Rent deposit deeds normally include a covenant by the tenant to top up the deposit if the landlord deducts money from it. They often provide that the landlord may forfeit the lease if there is a breach of any covenant in the rent deposit deed.

Such a provision is probably effective. S.1(2)(e) of the Law of Property Act 1925 provides that rights of entry exercisable over or in respect of a legal term of years absolute are one of the interests over land which are capable of subsisting or of being conveyed or created at law. There is no requirement that such rights of entry should be contained in the lease granting the term of years, nor that they should only be exercisable on breach of a covenant contained in the lease. A right of re-entry can be validly reserved on an assignment of a lease assignee on breach of the assignee's covenants in the assignment: *Shiloh Spinners v Harding*¹¹.

⁵ (1882) 20 Ch D 341

⁶ (1882) 22 Ch D 410

⁷ [1901] 2 KB 518

⁸ (1994) 67 P & CR 314

⁹ (1927) LJ Ch 239

¹⁰ [2000] 1 BCLC 647

¹¹ [1973] AC 691

If there is such a provision, does s.146 of the Law of Property Act 1925 apply to it? S.146(1) says: “A right of re-entry or forfeiture under any proviso or stipulation in a lease for a breach of any covenant or condition in the lease shall not be enforceable, by action or otherwise, unless and until the lessor serves on the lessee a notice...”.

Is a right of forfeiture contained in a collateral deed one which is “under any proviso or stipulation in a lease”? It is in relation to a lease, but not in a lease. This is not clear. Perhaps “lease” includes collateral agreements.

Does deducting money from a rent deposit amount to an act of waiver?

It is uncertain whether drawing down on a rent deposit for an unpaid instalment of rent would be treated as a waiver of the right to forfeit for accrued once and for all breaches of covenant committed prior to the rent day known to the landlord. To be a waiver, the act must be so unequivocal that when considered objectively it could only be regarded as being consistent with the lease continuing: *Greenwood Reversions v World Environment Foundation Ltd*¹² If the deposit deed allows deductions post termination of the lease, then perhaps deducting from the deposit is not sufficiently unequivocal. However, if the rent deposit deed requires notice to be given to the tenant, identifying the rent in respect of which the drawdown is made, then serving the notice may well be a waiver.

Rent deposits when the tenant is in receivership

Receivership does not involve a moratorium, and the landlord’s rights under the rent deposit deed are not affected. That is so both in the case of an administrative receiver appointed under a floating charge (where still possible i.e. under a pre-15 September 2003 floating charge), and in the case of a fixed charge receiver.

Rent deposits when the tenant is in voluntary liquidation

There is no automatic moratorium in a voluntary liquidation, whether members or creditors. Accordingly, it will not affect the landlord’s rights under the rent deposit deed. Although an application can be made under s.112 IA 1986 to apply the power in s.126 IA 1986, this is probably not relevant. S.126 provides that the company, or any creditor or contributory, may, where any action or proceeding against the company apply to the court which may restrain the proceedings on such terms as it thinks fit. However, as the landlord does not need to issue proceedings in order to enforce his rights, that power should not affect the landlord’s position.

Rent deposits when the tenant being wound up the court

The petition

The petition for the winding up order should not affect the landlord’s rights under a rent deposit deed. The power to restrain proceedings pending a winding up order given by s.126 is probably not relevant: see above.

¹² [2008] EWCA Civ 47.

Once a winding up order is made

Once a winding up order is made, s.130(2): applies: “When a winding-up order has been made or a provisional liquidator has been appointed, no action or proceeding shall be proceeded with or commenced against the company or its property, except by leave of the court and subject to such terms as the court may impose”

Is drawing down on a rent deposit is an “action” or a “proceeding”? It is not an “action” but is it a “proceeding”? Probably not. Distraint for rent is, but that has been treated as something of an anomaly.¹³ See *Bristol Airport Plc. v. Powdrill*¹⁴ for a discussion of when “proceeding” can be taken as referring to extra-curial activity. Peaceable re-entry is not within the phrase “no other proceedings, and no execution or other legal process, may be commenced or continued and no distress may be levied against the debtor or his property except with the leave of the court”: *Re a Debtor No 13A/IO/95*¹⁵.

Does any charge need to be registered?

Under s.395 CA 1985/s.860 CA 2006, a charge created by a company registered in England and Wales and being a charge to which s.395/s.860 applies is, so far as any security on the company's property or undertaking is conferred by the charge, void against the liquidator or administrator and any creditor of the company, unless the registered within 21 days after the date of the charge's creation.

There has been debate in the past as to whether a rent deposit taken from a company needed to be registered against the company. This was conceded in *Re Greenport Ltd; Obaray v Gateway (London) Ltd*¹⁶ but the decision in that case makes it clear that the concession was probably wrongly made. Hazel Williamson QC (sitting as a Deputy High Court Judge) held that a provision in a rent deposit deed that the landlord was entitled to appropriate arrears of rent from the deposit account amounted to a charge over the deposit, and as that was not a charge over “book debts”, and did not fall into any other category of property where charges had to be registered, the non-registration of the charge was irrelevant.

If the rent deposit is a financial collateral arrangement, it need not be registered in any event: see reg 4(4).

Rent deposits when the tenant is in administration

IA 1986 Sch B1 para 43(2):

- No step may be taken to enforce security over the company's property except--
- (a) with the consent of the administrator, or
 - (b) with the permission of the court.

If the rent deposit is a financial collateral arrangement then para 43(2) does not apply

¹³ *Re Bellaglade Ltd* [1977] 1 WLR 617, *Herbert Berry Associates Ltd v IRC* [1977] 1 WLR 1437, *Re Memco Engineering Ltd* [1986] Ch 86.

¹⁴ [1990] Ch. 744

¹⁵ [1995] 1 WLR 1127

¹⁶ [2004] 1 BCLC 55, [2001] L & TR 20.

Otherwise:

Deposit held by landlord on trust

Para 43(2) does apply as drawing on the deposit is enforcing security over the company's property, namely its beneficial interest in the deposit.

Deposit held by landlord absolutely

Para 43(2) probably does not apply; there is no security. The fact that the landlord owes the tenant a contractual obligation at a future date to make a payment does not make the deposit "security".

Deposit held by tenant, charged to landlord

Para 43(2) applies.

Stakeholder

Para 43(2) probably does not apply; there is no security.

Rent deposits when the tenant proposes a corporate voluntary arrangement

The small companies moratorium

Sch A1 IA 1986 para 12(1)(g): During the period for which a moratorium is in force for a company ... (g) no other steps may be taken to enforce any security over the company's property, or to repossess goods in the company's possession under any hire-purchase agreement, except with the leave of the court and subject to such terms as the court may impose

If the rent deposit is a financial collateral arrangement then para 12 does not apply: reg 8(5).

Otherwise, the position is the same as in administration; see above.

Once the arrangement is approved

Under s.4(3) and Sch A1 para 31(4) IA 1986, a meeting summoned to consider a proposal for a voluntary arrangement "shall not approve any proposal or modification to a proposal which affects the right of a secured creditor of the company to enforce his security, except with the concurrence of the creditor concerned."

In those cases where the landlord's rights are purely contractual i.e. rent deposits types 2 and 4, this provision will not apply. Where the landlord holds a proprietary interest, as in rent deposits types 1 and 3, it will apply.

A landlord with a type 2 or 4 deposit, faced with a proposal that interfered with its contractual rights, can vote against the proposal and, if the requisite majority of creditors vote in favour, can apply to the Court to set it aside if it is unfairly prejudicial.

Where this provision does apply, because the landlord is a "secured creditor", what will the effect be if the proposal is that the landlord should accept less than full payment of rent covered by the deposit?

In *Re Naeem* [1990] 1 WLR 48, a landlord challenged an IVA as unfairly prejudicial, because it stopped him from forfeiting. Hoffmann J rejected that challenge. He said:

“That, in my judgment, is not the right construction of the arrangement. In my view it was only intended to bind the creditors in their character of creditors. It did not affect proprietary rights such as those of the landlord to forfeit the lease
....

What the arrangement does do is to bind the landlord as a creditor for the unpaid rent. To that extent it has indirectly an effect on the landlord's right to forfeit for non-payment of rent. Apart from the arrangement, the bankrupt would only have been relieved against forfeiture for non-payment of rent on condition that all the arrears were paid. Equally the landlord could have proceeded on the same grounds against an assignee of the tenant, and the assignee too could have obtained relief only on the same terms.

While the terms of relief are a matter for the discretion of the judge to whom the application is made, it is unlikely that, after the landlord's right to arrears of rent has been extinguished and replaced by its rights in the arrangement, any condition of full repayment would be imposed before the bankrupt or an assignee could obtain relief. Mr. Lewison submits that this would be unfair prejudice to the landlord. I do not agree. The right to forfeit for non-payment of rent is in order to provide the landlord with security for payment of that rent, whatever it may be. The effect of the arrangement is to modify the landlord's claim for arrears of rent in the same way as the claims of other creditors. It does not appear to me to be unfair prejudice that after such modification the right to forfeit should only stand as security for recovery of the modified debt rather than the original one.”

Some commentators have interpreted that as meaning that, if a VA proposes that only part of a debt will be paid, a secured creditor can only enforce his security in respect of the reduced debt¹⁷, and suggest that the case will not be followed. They point out, correctly, that later cases show that the right to forfeit is not “security” and the landlord is not, by virtue of his right of re-entry, a “secured creditor”: *Thomas v Ken Thomas Ltd*¹⁸. However, this does not seem to be relevant to the basis of Hoffmann J's reasoning.

The Act only prevents approval of “a proposal which affects the right of a secured creditor of the company to enforce his security”. It is arguable that it does not prevent approval of a proposal which does not affect the enforcement of the security, but does reduce the debt secured by the security.

¹⁷ See e.g. *Bailey & Groves: Corporate Insolvency Law and Practice* (3rd ed. 2007) para 9.50

¹⁸ [2007] 1 EGLR 31

Rent deposits when the tenant is bankrupt

S.285 IA 1986 provides:

- (1) At any time when proceedings on a bankruptcy petition are pending or an individual has been adjudged bankrupt the court may stay any action, execution or other legal process against the property or person of the debtor or, as the case may be, of the bankrupt.
- (2) Any court in which proceedings are pending against any individual may, on proof that a bankruptcy petition has been presented in respect of that individual or that he is an undischarged bankrupt, either stay the proceedings or allow them to continue on such terms as it thinks fit.
- (3) After the making of a bankruptcy order no person who is a creditor of the bankrupt in respect of a debt provable in the bankruptcy shall—
 - (a) have any remedy against the property or person of the bankrupt in respect of that debt, or
 - (b) before the discharge of the bankrupt, commence any action or other legal proceedings against the bankrupt except with the leave of the court and on such terms as the court may impose.This is subject to sections 346 (enforcement procedures) and 347 (limited right to distress).
- (4) Subject as follows, subsection (3) does not affect the right of a secured creditor of the bankrupt to enforce his security.

Having regard to the limitations of that section, bankruptcy will probably not affect the landlord's rights under any form of rent deposit. Types 1 and 3 make the landlord a secured creditor who is enforcing his security. Type 2 gives the landlord contractual obligations to make a payment, but nothing in the bankruptcy regime affects the landlord's right to keep the money he was paid (unless the payment was a transaction at an undervalue or a preference). Type 4 does not involve any remedy against the property or person of the bankrupt.

Rent deposits when the tenant proposes an individual voluntary arrangement

Interim order

The effect of an interim order is set out in s.252 IA 1986:

- (2) An interim order has the effect that, during the period for which it is in force—
 - (a) no bankruptcy petition relating to the debtor may be presented or proceeded with,
 - (aa) no landlord or other person to whom rent is payable may exercise any right of forfeiture by peaceable re-entry in relation to premises let to the debtor in respect of a failure by the debtor to comply with any term or condition of his tenancy of such premises, except with the leave of the court and

- (b) no other proceedings, and no execution or other legal process, may be commenced or continued and no distress may be levied against the debtor or his property except with the leave of the court.

Note that, unlike with a small company moratorium, there is no restriction on steps being taken to enforce any security over the individual's property. Thus the landlord's rights are probably unaffected – again, drawing on a deposit is probably not “proceedings”. Forfeiture by peaceable re-entry was not caught until para (aa) was introduced: *Re a Debtor No 13A/IO/95*¹⁹.

Once the arrangement is approved

S.258(4) provides that the meeting shall not approve any proposal or modification which affects the right of a secured creditor of the debtor to enforce his security, except with the concurrence of the creditor concerned. The analysis here is the same as with a CVA.

PRE-PACKS

What is a pre-pack?

A ‘pre-pack’ refers to a pre-packaged sale by an administrator²⁰. The sale is negotiated with a purchaser prior to the appointment of the insolvency practitioner, and is carried out shortly after the appointment. The sale takes place before any meeting of creditors, so that by the time it takes place, the creditors are presented with a *fait accompli*.

Pre-pack sales lawful

Pre-pack sales are lawful – the administrators may sell all the company's assets prior to the creditors' meeting and without a direction of the court²¹.

Furthermore, they may be effected even against the wishes of the majority creditor: *DKLL Solicitors v HMRC*²². In that case, the High Court made an administration order in respect of an insolvent firm of solicitors to allow the business to be sold immediately. That was so notwithstanding the opposition of HMRC, its majority creditor, which had petitioned to wind it up, and even though HMRC would have been able at a creditors' meeting, if there was one, to defeat the sale of the firm's business that was proposed to follow immediately after the administration order. The solicitors, DKLL, had liabilities exceeding £2.4m, including a debt owed to HMRC of at least £1.7m. The estimated funds available for creditors on a forced sale in the event of liquidation would be approximately £105,000, while under the proposed order, the sale would be for £400,000. Andrew Simmonds QC, sitting as a deputy High Court judge, said that the court placed great reliance on the expertise and experience of impartial insolvency

¹⁹ [1995] 1 WLR 1127

²⁰ Or a liquidator; normally, the sales are by an administrator

²¹ : *Re T&D Industries* [2000] 1 WLR 646, *Re Transbus International Limited* [2004] 1WLR 2654

²² [2008] 1 BCLC 112

practitioners. There was no evidence to suggest that the assets could be realised for a higher sum. This was the only way of saving the jobs of DKLL's 50 employees. It was the best way to look after the affairs of DKLL's clients.

The Statement of Insolvency Practice number 16, introduced on 1 January 2009, requires administrators to explain to creditors the background to their appointment and the reasons why they considered that a 'pre-pack' sale would be the best outcome for creditors.

The landlord faced with a pre-pack

A landlord faced with a pre-pack may be faced with:

- an application for licence to assign to the purchaser; the alternative being that the now empty shell of the insolvent company remains tenant
- an abandoned property, with the insolvent tenant retaining the lease, but with all the assets of any value being sold to the purchaser
- a situation where the purchaser wants to trade from the property without taking an assignment

In the first situation, the landlord will have to consider the application, and its alternatives.

In the second situation, the position is much the same as where the tenant goes into liquidation. The landlord will need to consider if forfeiture is desirable, considering matters such as

- the position of any sureties or previous tenants
- any rent deposit
- any subtenants
- liability for rates

In the third situation, the landlord may want to pressurise the purchaser of the business into taking an assignment. Such an attempt failed in *Innovate Logistics v Sunberry Properties Ltd*²³. There, the landlord, S, sought permission to commence proceedings terminating a licence granted by the tenant, R (in administration), to a company, Y, which had purchased R's business from the administrators as a going concern as part of a pre-pack sale. A balancing exercise was required between the legitimate interests of S and those of the other creditors. Occupation of the property was required for the purposes of the administration. The judge ought to have asked himself whether S had shown that it was inequitable to prevent it from commencing the proceedings for a mandatory injunction. For the period until Y delivered up possession to the administrators the administrators should pay to S the monthly payments of the licence fee which Y was required to pay to R, equal to one month's passing rent under the lease, together with any interest that had been earned by the company on the licence fee. The court declined to order the administrators to pay S the full contractual rent as set out in the lease apportioned from the start of the administration to the date when Y vacated, or to pay interest on overdue sums at the contractual rate.

²³ [2008] EWCA Civ 1261

VARIATIONS

Where a tenant requests the variation of a lease, or a temporary waiver of its terms, the landlord may be concerned as to the effect of an agreement on his rights against third parties:

- sureties
- previous tenants (under old tenancies, or who are liable under AGAs)
- subtenants, where a notice is served under s.6 of the Law of Distress Amendment Act 1908, or (once it comes into force) s.81 of the Tribunals, Courts and Enforcement Act 2007

Deemed surrender and re-grant

The first point to note is that, in certain circumstances, a variation of a lease will take effect, as a matter of law, as a surrender and re-grant. This will only be so, however, if the variation cannot be effected without the grant of a new lease. This will only be the case if there is a change in either:

- the premises demised, with new premises added; or
- the length of the term is increased, although this includes adding an option to extend the term: *Baker v Merckel*²⁴

It will not be the case with an agreement:

- to increase the rent: *Jenkin R Lewis & Son Ltd v Kerman*²⁵
- adding a new tenant: *Trustees of S.P. Saunders v Ralph*²⁶
- an agreement for the payment of a single rent for two properties held by the tenant under separate leases from the same landlord: *D.J.W. Childers Trustees v Anker*²⁷
- a deed of variation to permit the tenant to grant subtenancies and licences more freely and increasing the rent: *Friends Provident Life Office v BRB*²⁸

If there is a surrender and re-grant, all third parties will be released.

If there is any risk of this happening, the “variation” should be dealt with as a separate lease of the additional premises, or of the same premises, taking effect as a future lease, or a concurrent overriding lease.

²⁴ [1960] 1 QB 657

²⁵ [1971] Ch 477

²⁶ (1993) 66 P&CR 335

²⁷ [1996] 1 EGLR 1

²⁸ [1996] 1 All ER 336

Release of sureties

Absent any contrary provision in the guarantee agreement, sureties are released by any variation in the terms of the tenancy which may adversely affect the surety: *Holme v. Brunskill*²⁹ Modern surety clauses contract out of this rule, and such contracting out is valid³⁰ - but the clause should be checked to make sure it is excluded.

Provided there is a contracting out provision, and provided the agreement is a variation and not a surrender and re-grant, the surety cannot claim to have been released completely.

Reduction in liability of third parties

If the landlord agrees with the current tenant to reduce the rent by 20%, can the landlord recover the full rent from a surety or a previous tenant?

The answer depends on the terms of the agreement between landlord and tenant and whether, expressly or impliedly, it leaves the obligations of co-obligors unaffected: *Watts v Lord Aldington* [1999] L&TR 578, *Johnson v Davies* [1999] Ch 117, *Sun Life Assurance Society plc v Tantofex (Engineers) Ltd* [1999] 2 EGLR 135, *Finley v. Connell Associates* [1999] Lloyd's Rep PN 895.

If the agreement is expressed as a personal indulgence, or a covenant by the landlord not to sue the tenant for the 20%, while expressly reserving the landlord's rights against third parties, the position is clear. However, an express reservation of rights may set the alarm bells ringing for the tenant. If the landlord does claim against previous tenants or sureties, they may seek an indemnity from the tenant, who will end up paying the 20% indirectly.

If the agreement is silent as to whether the right to sue sureties or previous tenants is reserved, then it is clear that it will be a question of interpreting the agreement as to whether there is a reservation.

However, it is very unclear, on the authorities how the matter should be approached. Is the default position that co-obligors are released, or that they are not released? Is there a different rule for previous tenants who are severally liable and for sureties?

There are authorities which suggest that, unless it is clearly implicit that the right to sue co-obligors is reserved, they will be released: see *Watts v Lord Aldington* [1999] L&TR 578 and *Finley v. Connell Associates* [1999] Lloyd's Rep PN 895, a surety case. In *Greene King plc v Stanley* [2001] EWCA Civ 1966, again, the question asked by the Court of Appeal was whether an IVA contained an express or implied reservation of the right to sue a surety – not whether it contained an express or implied agreement releasing the surety.

However, in *Sun Life Assurance Society plc v Tantofex (Engineers) Ltd* [1999] 2 EGLR 135 Mr J Martin QC sitting as a deputy High Court Judge adopted the opposite

²⁹ (1878) 3 Q.B.D. 495 (surety released by surrender of part of a farm which potentially affected the ability of the lessee to deliver up a flock of sheep in good condition at the end of the lease).

³⁰ see *BM Samuels Finance Group plc v Beechmanor Ltd* (1994) 67 P & CR 282, *Triodos Bank v Dobbs* [2005] EWCA Civ 630, *Wittmann v Willdav Engineering* [2007] EWCA Civ 824

approach in a claim against the original tenant. His approach was that unless a release was clearly implicit, or the release amounted to treating the obligation as performed, the right to sue co-obligors was reserved. That approach seems inconsistent with the other line of cases. However, it draws some support from *Johnson v Davies* [1999] Ch 117, where the Court of Appeal held that there was an implied agreement to not to enforce debts against the debtor while the debtor complied with his obligations under an IVA proposal, but it was not necessary to also imply a term that they would not sue any co-debtors.

It seems that, if the terms of the agreement between the landlord and the current tenant are such that the tenant accepts a payment in full satisfaction of performance of the tenant's obligations, no claim against another party will be possible: *Deanplan Ltd v Mahmoud*³¹ as analysed in *Sun Life Assurance Society plc v Tantofex (Engineers) Ltd*. That is consistent with *Milverton Group Ltd v Warner World Ltd*³² and the decision of the House of Lords in *Jameson v Central Electricity Generating Board*³³.

Claiming rent from sub-tenants

S.6 of the Law of Distress Amendment Act 1908

The current right is set out in s.6 of the Law of Distress Amendment Act 1908:

“In cases where the rent of the immediate tenant of the superior landlord is in arrear it shall be lawful for such superior landlord to serve upon any under tenant or lodger a notice (by registered post addressed to such under tenant or lodger upon the premises) stating the amount of such arrears of rent, and requiring all future payments of rent, whether the same has already accrued due or not, by such under tenant or lodger to be made direct to the superior landlord giving such notice until such arrears shall have been duly paid, and such notice shall operate to transfer to the superior landlord the right to recover, receive, and give a discharge for such rent.”

The question here is whether “the rent of the immediate tenant of the superior landlord is in arrear” so that it is possible to serve a notice “stating the amount of such arrears of rent”.

If the landlord has agreed with the current tenant to accept 80% of the contractual rent then, however that agreement is expressed, can one describe the rent as being “in arrear”? There is no authority on this point and the answer is unclear.

S.81 of the Tribunals, Courts and Enforcement Act 2007

A similar question will arise under s.81 of the Tribunals, Courts and Enforcement Act 2007 when it comes into force.

S.81 provides:

81 Right to rent from sub-tenant

³¹ [1993] Ch 151

³² [1995] 2 EGLR 28

³³ [1999] 1 All ER 193

- (1) This section applies where CRAR³⁴ is exercisable by a landlord to recover rent due and payable from a tenant (the immediate tenant).
- (2) The landlord may serve a notice on any sub-tenant.
- (3) The notice must state the amount of rent that the landlord has the right to recover from the immediate tenant by CRAR (the "notified amount").
- (4) When it takes effect the notice transfers to the landlord the right to recover, receive and give a discharge for any rent payable by the sub-tenant under the sub-lease, until--
 - (a) the notified amount has been paid (by payments under the notice or otherwise), or
 - (b) the notice is replaced or withdrawn...
- (7) In determining for the purposes of this section whether CRAR is exercisable, section 77 applies with these modifications--
 - (a) if notice of enforcement has not been given, references to that notice are to be read as references to the notice under this section;
 - (b) if goods have not been taken control of, section 77(3)(b) does not apply.
- (8) In this section and sections 82 to 84--
 - (a) "sub-tenant" means a tenant (below the immediate tenant) of any of the premises comprised in the headlease (and "sub-lease" is to be read accordingly);
 - (b) "headlease" means the lease between the landlord and the immediate tenant.

S.77 provides, so far as relevant:

77 The rent recoverable

- (1) CRAR is not exercisable except to recover rent that meets each of these conditions--
 - (a) it has become due and payable before notice of enforcement is given;
 - (b) it is certain, or capable of being calculated with certainty.
- (2) The amount of any rent recoverable by CRAR is reduced by any permitted deduction...
- (7) Permitted deductions, against any rent, are any deduction, recoupment or set-off that the tenant would be entitled to claim (in law or equity) in an action by the landlord for that rent.

If the landlord has agreed to reduce the rent payable by the current tenant, can it be said that the rent is "due and payable from" the tenant, so that it is possible to serve a notice stating "the amount of rent that the landlord has the right to recover from the immediate tenant by CRAR"? The answer is far from clear.

³⁴ Under s.72, a landlord under a lease of commercial premises may use the procedure in Schedule 12 (taking control of goods) to recover from the tenant rent payable under the lease. The power to do this is referred to as CRAR (commercial rent arrears recovery).

DISCLAIMER AND SUBTENANTS

The issue

Take this situation:

- The landlord grants a tenancy to T, with S covenanting as surety in the usual terms
- T grants a subtenancy to a subtenant, ST, who pays a rent deposit
- T goes into liquidation and the liquidator disclaims the lease
- S, who can be required by the landlord to take up a new lease, instead applies for a vesting order in respect of the existing lease. He wishes to do this so he can take over the rent deposit and the benefit of ST's covenants.

That was the situation in *In Re AE Realisations (1985) Ltd*³⁵. Vinelott J held that there was no point making a vesting order as ST was entitled to walk away from his liability under the sub-lease, and to take the rent deposit with him.

Was that right?

The statutory provisions

The effect of a disclaimer is governed by s.178(4) of the Insolvency Act 1986 (in the case of companies):

“A disclaimer under this section –

- (a) operates so as to determine, as from the date of the disclaimer, the rights, interests and liabilities of the company in or in respect of the property disclaimed; but
- (b) does not, except so far as is necessary for the purpose of releasing the company from any liability, affect the rights or liabilities of any other person.”

Under s.181, any person who “claims an interest in the disclaimed property” or any person “who is under any liability in respect of the disclaimed property, not being a liability discharged by the disclaimer”, may apply to the court for an order vesting the “disclaimed property” in either a person entitled to it, or a trustee for such a person, or a person under any liability in respect of the disclaimed property, or a trustee for such a person.

S.182 imposes restrictions on the power of the court to vest property of a leasehold nature in any person claiming under the company as underlessee or mortgagee. The court can make such a vesting order only on terms which subject the underlessee or mortgagee to the same liabilities and obligations as the company was subject to under the lease at the commencement of the winding up, or subject to the same liabilities and obligations as the underlessee or mortgagee would be subject to if the lease had been assigned to him at the commencement of the winding up: s.182(1).

In a case where s.182(1) applies, and no person claiming under the company as underlessee or mortgagee is willing to accept an order on the terms required by the statute, the court may vest the company's estate or interest in the property in any person who is liable, whether personally or in a representative capacity, and whether alone or jointly with the company, to perform the lessee's covenants in the lease:

³⁵ [1988] 1 WLR 200

s.182(3). Where s.182(1) applies, and a person claiming under the company as underlessee or mortgagee declines to accept an order under s.181, that person is excluded from all interest in the property: s.182(4).

Hindcastle v Barbara Attenborough Associates

The application of those provisions came before the House of Lords in *Hindcastle v Barbara Attenborough Associates*³⁶. Lord Nicholls gave the leading speech. He analysed the effect of disclaimer on a lease as follows.

First, he considered the case where there was only a landlord and a tenant. In that case, he said that disclaimer operates to determine all the tenant's obligations under the tenant's covenants, and all his rights under the landlord's covenants. In order to determine these rights and obligations it is necessary, in the nature of things, that the landlord's obligations and rights, which are the reverse side of the tenant's rights and obligations, must also be determined. If the tenant's liabilities to the landlord are to be extinguished, of necessity so also must be the landlord's rights against the tenant. The one cannot be achieved without the other. Disclaimer also operates to determine the tenant's interest in the property, namely the lease. Determination of a leasehold estate has the effect of accelerating the reversion expectant upon the determination of that estate. The leasehold estate ceases to exist.

Second, he explained the position where there is a third party involved, such as a guarantor. He said that in such cases, the position is different. The disclaimer ends the lease. However, the statute takes effect as a deeming provision so far as other persons' preserved rights and obligations are concerned. The rights and liabilities of others, such as guarantors and original tenants, remain as though the lease had continued and not been determined. He said that, if no vesting order is made and the landlord takes possession, the liabilities of other persons to pay the rent and perform the tenant's covenants will come to an end as far as the future is concerned. If the landlord acts in this way, he is no longer merely the involuntary recipient of a disclaimed lease. By his own act of taking possession he has demonstrated that he regards the lease as ended for all purposes. His conduct is inconsistent with there being a continuing liability on others to perform the tenant covenants in the lease. He cannot have possession of the property and, at the same time, claim rent for the property from others.

Third, he considered the position of third parties with proprietary interests, such as subtenants. He explained their position as follows:

“The third typical case is where a third party has acquired such an interest. The prime example is a subtenant. I can deal with this very shortly. In order to free the tenant from liability, it is necessary to extinguish the landlord's rights against the tenant and also the subtenant's rights against the tenant. The tenant's interest in the property is determined, but not so as to affect the interest of the subtenant. Determination of the subtenant's interest in the property is not necessary to free the tenant from liability. Hence the subtenant's interest continues. No deeming is necessary to produce this result. Here the deeming relates to the terms on which the subtenant's proprietary interest continues. His interest continues unaffected by the determination of the tenant's interest. Accordingly the subtenant holds his estate on the same terms, and subject to

³⁶ [1997] AC 70

the same rights and obligations, as would be applicable if the tenant's interest had continued. If he pays the rent and performs the tenant covenants in the disclaimed lease, the landlord cannot eject him. If he does not, the landlord can distrain upon his goods for the rent reserved by the disclaimed lease or bring forfeiture proceedings. In practice, matters are likely to be brought to a head by one of the parties making an application for a vesting order.”

Note, however, that there was no sub-tenant in the *Hindcastle* case, so it could be said that this passage was *obiter*

Previous cases on the position of a subtenant

Lord Nicholls' analysis of a subtenant's position appears consistent with earlier cases in which the effect of a disclaimer on a subtenant had been considered. In *In re Cock, Ex parte Shilson*³⁷, it was held that, after disclaimer, the landlord could bring the subtenant to court and require him to elect either to take a vesting order or be barred from all interest in the property. That decision was approved and followed by the Court of Appeal in *In re Finley*³⁸.

Sterling Estates v Pickard UK Ltd

There is one post-*Hindcastle* case of some relevance.

In *Sterling Estates v Pickard UK Ltd*³⁹, Mr Crystal QC (sitting as a deputy High Court judge) considered an application by a freeholder to vest a disclaimed headlease in the freeholder with the benefit of underleases. The underlessees had made it clear that, if put to an election by the freeholder, they would elect to be excluded from all interest in the property. Mr Crystal held that the freeholder was not entitled to take a vesting order of the headlease with the benefit of the underleases. He said:

“Lord Nicholls' analysis of the consequences of disclaimer on insolvency on a subtenant makes it plain that the subtenant does not, by virtue of the disclaimer of the interest of the tenant in the property, lose his, the subtenant's, interest in the property itself. He remains entitled to possession of the property; the landlord is not therefore entitled to it. He can only become entitled to possession of the property as against the subtenant by invoking the mechanism contained in section 182. In cases where the economic implications are the same as in the present case, where a landlord puts a subtenant to his election and the subtenant elects not to accept an order under section 181, he is excluded from all further interest in the property. His sublease then goes and with it the subtenant's right to continue in possession of the property.”

³⁷ (1887) 20 Q.B.D. 343

³⁸ (1888) 21 Q.B.D. 475

³⁹ [1997] 2 EGLR 33

In Re AE Realisations (1985) Ltd

Vinelott J analysed the position of a subtenant after a disclaimer as follows. He said that, pending an application for a vesting order, the position of an underlessee was that:

- The insolvent tenant's liability under the underlease and the liability of the undertenant under the underlease were both extinguished.
- The underlessee did not become bound by any privity of contract or of estate to the landlord.
- The underlessee was entitled to remain in possession of the property during the term of the underlease and so long as the lease would, apart from the forfeiture, have remained in existence.
- Neither the landlord nor the underlessee could enforce directly the covenants of the lease.
- The state of affairs could be remedied by the landlord applying to the court to compel the underlessee to take a vesting order or be excluded from all interest in the property.

So far, Vinelott J's analysis appears entirely consistent with that of Lord Nicholls in *Hindcastle*.

However, Vinelott J developed the analysis by two further stages:

- He held that no order formally putting the underlessee to his election is needed where the underlessee has made it plain that he does not want to take a vesting order and is anxious to vacate the property.
- He said that "the disclaimer destroyed the underlease and the only effect of a vesting order, if made, would be to destroy the interest of the underlessee, that is, his right to remain in occupation, paying the rent reserved by and performing the covenants contained in the lease during the term created by the underlease."

Query whether those two further aspects of his analysis were correct:

- In deciding that the disclaimer "destroyed the underlease" he differed from an earlier case, *In re Thompson and Cottrell's Contract*⁴⁰, where Uthwatt J said that having first observed, at p. 99, that: "It is quite clear that a disclaimer does not determine the lease and all interests carved out of it by way of sub-lease or otherwise and that it is limited to determining the rights, interests and liabilities of the bankrupt in respect of the property. The rights of third parties remain on foot, except so far as it is necessary to release the bankrupt and his estate".
- The way that Lord Nicholls expressed himself in *Hindcastle* and Mr Crystal put the matter in *Sterling Estates* suggests that, unless and until the landlord takes steps to assert his right of forfeiture, or puts the underlessee to his election to take a vesting order or be barred from all interest in the property, the underlease continues. If so, it may be that the two further stages in Vinelott J's analysis in *In Re AE Realisations (1985) Ltd* were not correct.

Stephen Jourdan
March 2009

⁴⁰ [1943] 1 All E.R. 169

PART 2

**RENT AS AN EXPENSE
OF THE LIQUIDATION OR ADMINISTRATION**

by Jonathan Small QC

Liquidation

1. In the case of voluntary winding ups it is expressly provided that all expenses properly occurred in the winding up are payable out of the company's assets in priority to all other claims: section 115, Insolvency Act 1986. There is no direct equivalent in the 1986 Act as regards winding up by the court, however it is clear that the legislature intended the position to be the same: see section 156 and 175(2). For good measure Rule 4.18 of the Insolvency Rules 1986 provides that the "expenses of the liquidation" appear out of the assets of the company available for payment of general creditors. They take priority over the mainstream creditors and so do not have to be proved in the liquidation.

2. This talk considers first the extent to which rent due to a landlord for property which the liquidator retains ought to be paid in full (if the assets are there to meet it) as an expense of the liquidation.

3. As a matter of principle it is not obvious what the right answer should be. The lease and therefore the tenant company's liability will have come into existence prior to the liquidation. The liability gives rise to a debt and, ordinarily, debts are to be proved in the liquidation⁴¹. On the other hand the liquidator will often be using the demised premises for the purposes of winding up the company: he may be storing goods in the premises for sale and he may end up selling or otherwise assigning the lease. If the lease is to be used as an asset to profit the company and therefore the other creditors, justice would suggest that the rent should be paid in full as an expense of the liquidation.

4. Bizarrely this crucial point is not settled.

⁴¹ See Rules 12.3 and 13.12.

5. Rule 4.218(3) sets out a long list of expenses and provides for their order of priority. However that provision does not simply concern itself with the priority of various categories of expense. The House of Lords has held definitively in *Re: Toshoku Finance UK* [2002] 1 WLR 671 that any cost falling within the categories in Rule 4.218 is to be treated as an expense.

6. Unhelpfully for our purposes, rent is not mentioned as a specific category of expense. However there are two potential candidates:

- (a)(ii) expenses which are properly chargeable or incurred by the official receiver or the liquidator in preserving, realising or getting in any of the assets of the company or otherwise in the preparation or conduct of any legal proceedings ...
- (m) any necessary disbursements by the liquidator in the course of his administration ...

7. The House of Lords has held⁴² that the courts will interpret Rule 4.218 to include debts which, under earlier case law, are deemed to be expenses of the liquidation. However to the extent that under the earlier law there may have been a discretion to allow a particular cost as an expense of the liquidation, no such discretion continues. Either the matter falls within one of the paragraphs of Rule 4.218(3) or it does not.

8. That brings me to consider in what circumstances the court formerly treated rent as comprising an expense in the liquidation. The principle was set out in the seminal case of *In Re: Lundy Granite Co., ex p. Heaven* (1871) LR 6 Ch App 462 where James LJ said at 466:

“If the company for its own purposes, and with a view to the realisation of the property to better advantage, remains in possession of the estate, which the lessor is therefore not able to obtain possession of, commonsense and ordinary justice require the court to see that the landlord receives the full value of the property.”

⁴² *Toshoku*, para. 38.

9. The question now is whether the rent in question can be said to be incurred “*in preserving, realising or getting in any of the assets of the company*” (sub-para. (a)) or constitute “*necessary disbursements*” by the liquidator in the course of his administration (sub-para. (m)). The earlier cases assist in this regard.⁴³ As the House of Lords pointed out, in respect of the equitable doctrine by which the court identified expenses and allowed for their payment in full, “*the discretion hardened into principle*”⁴⁴. This principle can now be used to unravel the delphic wording of Rule 4.218.

10. In *Toshoku* Lord Hoffmann described the principle enunciated in *Re Lundy Granite* as “restrictive”. He illustrated this with respect to the following two cases.

In Re: ABC Coupler & Engineering Co. (No.3) [1970] 1 WLR 702

The liquidator on appointment closed down the business which had been conducted on the premises, had the company’s plant and machinery valued and thought about what he should do. It was only from the time that he decided to put the lease on the market that the court held that the liquidator was retaining the premises for the benefit of the winding up and was liable to pay the rent in full.

In Re: HH Realisations (1975) 31 P&CR 249

The court held that a company ceased to be liable to pay the rent in full from the time it gave notice to the landlord that it was seeking authority to disclaim the lease, even though it remained in occupation for nearly two months longer.

These two cases illustrate clearly that mere occupation is not enough to render the rental liability an expense in the liquidation.

11. Finally there is the question of priorities which may matter if there is only a limited pool of assets. In *Toshoku* Lord Hoffmann suggested that ordinarily debts such as rent under a lease will be treated as coming within paragraph (a). If that is so it is good news for landlords because it puts them right at the front of the queue⁴⁵.

⁴³ *Toshoku*, para. 38.

⁴⁴ *Toshoku* at para. 29.

⁴⁵ Subject to the ability of the court to re-order the priorities: section 156 of the Insolvency Act 1986.

12. However, in *Re Linda Marie Ltd* [1989] BCLC 46 at 54 Warner J. held that the rental liability of the liquidator who intended to continue trading to enable him to assign the lease was a “necessary disbursement” rather than a payment to “preserve” property. His Lordship disallowed the priority which should be allowed by a finding that the liability was incurred in preservation of property:

“I do not think that, on the facts of this case, that liability is correctly described as having been incurred in ‘preserving’ the underlease. It was simply a liability that went with the other lease and was an inevitable consequence of allowing it to run on. There is, to my mind, a distinction between the ‘preservation’ of property, which connotes some positive action taken in relation to it, and the mere retention of property, which may be the result of inaction.”

13. However in cases where rent is an expense in the liquidation I would respectfully suggest that Lord Hoffmann’s obiter views are correct. In *Re: Linda Marie*, Warner J. went on to say that rent might have priority under sub-paragraph (a) in a case where, for example, it was paid in order to avoid the forfeiture of a lease and so enable the liquidator to realise the lease advantageously. Surely it cannot depend upon whether the landlord threatens forfeiture. If it does then anyone acting for the landlord would be well advised to threaten forfeiture before every rent date. Accordingly it is submitted that *Re: Linda Marie* was incorrectly decided (to the extent that it excluded paragraph (a)): where, as a matter of principle, rent is an expense in the liquidation it will almost always be paid to preserve the lease because, if it is not paid, the lease is liable to forfeiture which would compromise the liquidator’s intentions for the company’s assets.

Administration

14. In the context under discussion, there is a considerable overlap between the rules governing expenses in the liquidation and expenses in the administration.

15. Paragraph 99 of Schedule B1 to the Insolvency Act 1986 makes provision for the priority of former administrators’ expenses. Rule 2.67 of the Insolvency Rules 1986 makes similar provision for the categorisation of prioritisation of expenses of administration as Rule 4.218. The potentially relevant categories are

- (a) *expenses properly incurred by the administrator in performing his functions in the administration of the company ...*
- (f) *any necessary disbursements by the administrator in the course of the administration ...*

16. David Richards J. has held in *Exeter City Council v. Bairstow* [2007] 4 AE 437 that the changes in the Rules in respect of administrations, brought about by the Enterprise Act 2002 meant that the effect of the House of Lords decision in *Toshoku* now applied to the corresponding Rule 2.67: Rule 2.67 is in substantially similar terms to the liquidation Rule 4.218 and was introduced after the decision in *Toshoku*. If this is correct then in administrations, as with liquidations, to be an expense of the administration, all that is necessary is to demonstrate that the cost in question falls within one of the categories of Rule 2.67.⁴⁶

17. Unfortunately this clarity is put in doubt by a recent decision of the Court of Appeal: *Innovate Logistics v. Sunberry Properties* [2008] EWCA Civ 1321. The company in administration had granted an occupational licence to a third party. That third party was paying a monthly rent which the company intended to pass on by way of discharge of its rental obligations under its lease. The rent however was due quarterly in advance. The landlord submitted that it had no “automatic” right to be paid contractual rent due or the contractual amounts falling due during the occupation of the company in administration, as an expense of the administration⁴⁷. Following this submission/concession the Court of Appeal went on to hold⁴⁸:

“[The landlord] does not have an absolute legal entitlement to pay contractual rent and interest as an administration expense. On this point the court has a wide discretion exercisable according to the circumstances of the case.”

18. If the landlord and the Court of Appeal had meant to say that not all rental payments are expenses in the administration and whether they were would depend upon whether they fell within any of the defined categories in Rule 2.67, that would be uncontroversial and in line with *Toshoku* and *Exeter City Council*. However it seems that the Court of Appeal were going beyond this.

⁴⁶ Which came into force on 15th September 2003.

⁴⁷ Para. 46.

⁴⁸ Para. 59.

19. To understand the status of *Innovate Logistics* in this respect, it is necessary to look at that case a little more deeply. The case concerned the landlord's application under paragraph 43 of Schedule B1 of the 1986 Act to take action against the tenant company (in administration) for unlawfully granting a licence to a third party. It seems that the commercial thrust behind the litigation was to put pressure upon the third party (who was a good covenant) to take an assignment of the lease. At first instance the court had granted permission to the landlord. The appeal was brought on within a matter of days (at the commencement of the Long Vacation in summer 2008). At the end of the hearing the Court of Appeal indicated that they would allow the appeal and give judgment later. This meant that the landlord could not take action against the unlawful granting of the licence to the third party. Thereupon the landlord sought an order in respect of the rent. It sought interest for late payment (since it was only being passed on the third party's monthly payments). It seems that this application was made as an invitation to the court to attach conditions to the *refusal* of the landlord's application for permission to take proceedings. It does not appear from the face of the judgment that the landlord was in fact asking for an order that the full quarterly rent be paid as an expense in the liquidation.

20. The Court of Appeal rejected this consequential application of the landlord. However in so rejecting it, the court appears to have taken into account what it saw as the landlord's inability to receive the rent unconditionally as an expense in the liquidation.

21. If this is the true context of the Court of Appeal's remarks on whether or not the rent is an expense of the liquidation, these may well be obiter. Otherwise, whereas the Court of Appeal are plainly not bound by the decision in *Exeter City Council* (being only a first instance decision), there is a strong argument to the effect that the Court of Appeal's comments on the administrators' liability to pay rent in that case are erroneous. If the remarks are not obiter and if they cannot be distinguished, then any future aggrieved landlords may have to go to the Court of Appeal and have the decision overturned, arguing that it is *per incuriam*, neither *Exeter City Council* nor *Toshoku* being adverted to in the judgments. Otherwise, it is a House of Lords point.

PART 3

LANDLORDS' RIGHTS OF ACTION AGAINST THE ADMINISTRATOR OR THE LIQUIDATOR

by Jonathan Small QC

Administration

1. There is a statutory moratorium preventing actions against company administration in that:

- (i) no step may be taken to enforce security over the company's property except (a) with the consent of the administrator or (b) with the permission of the court: para 43(2) of Schedule B1 to the 1986 Act;
- (ii) a landlord may not exercise a right of forfeiture by peaceable re-entry in relation to premises let to the company except (a) with the consent of the administrator or (b) with the consent of the court: para 43(4); and
- (iii) no legal process (including legal proceedings, execution, distress and diligence) may be instituted or continued against the company or property of the company except (a) with the consent of the administrator or (b) with the consent of the court: para 43(6).

2. There is also an interim moratorium in the immediate run up to the appointment of an administrator: para 44.

3. An administration is of course only intended to be only an interim and temporary regime. It is a breathing space while the company seeks to achieve one of the statutory purposes, typically achieving a better result of the company's creditors as a whole than would be likely if the company were wound up without first being in administration (paragraph 3(1)(b), Schedule B1). The statutory moratorium should be understood in this context.

4. The guidance in the Court of Appeal decision of *Re Atlantic Computer Systems* [1992] Ch 505 at 542/44 continues to apply to paragraph 43 where landlords make an application to the court for consent to bring forfeiture proceedings or other proceedings to enforce the terms of the lease:

- (i) the general rule in the normal case is that if a creditor sought to exercise a proprietary right that was unlikely to impede the achievement of the purpose for which the administration was being pursued, then leave should normally be given;
- (ii) where the situation is otherwise and there is a likelihood the proprietary right would impede the achievement of the purpose of the administration, then the court must carry out a balancing exercise, balancing the legitimate of the lessor and the legitimate interest of the other creditors;
- (iii) the underlying principle is that an administration for the benefit of unsecured creditors should not be conducted at the expense of those who have proprietary rights, save to the extent that this was unavoidable; accordingly in carrying out the balancing exercise, great important or weight was normally given to the proprietary interests of the lessor.

5. One potentially important dictum should be noted, where the purpose of the process is to enforce a rental obligation. The House of Lords pointed out in *Toshoku* that there is a distinction between (a) rent being treated as an expense in the administration/liquidation and (b) the remedy to enforce payment. The fact that a debt counts as an expense in liquidation/administration does not necessarily mean that the creditor should be allowed immediately to bring proceedings or levy execution. Remedy is a matter of discretion under the Act. However:

*“... the claim must be a liquidation expense before the court can have any discretion to grant a remedy within would enable the creditor to obtain payment in priority to other claims”.*⁴⁹

6. However, I respectfully suggest that this dictum was *obiter* and, read literally, would go too far. I would submit that, where rent is an expense of the liquidation/administration, the courts will grant leave to enforce payment much more readily than where it is not. *Re Atlantic Computers* itself was a case in which the payments under the relevant hire agreements was held not to be an expense of the liquidation yet the Court of Appeal granted leave to enforce the security for payment.

7. The popularity of ‘pre-packaged’ administration means that landlords are often faced with a third party in the occupation of the demised premises, in breach of

⁴⁹ *Toshoku*, para 39 per Lord Hoffmann

covenant. The landlord's expected reaction to this will vary depending upon the circumstances:

- (i) where the premises are under-rented, he may genuinely seize upon the breach of the alienation clause to forfeit the lease;
- (ii) where the premises are over-rented, he may actively seek an assignment of the lease into the hands of Newco.

8. Two recent cases illustrate the courts' approach.

Metro Nominees (Wandsworth) (No. 1) v Rayment

9. The insolvent company have the benefit of a lease of commercial premises. The company went into administration on 11th January 2006. On 24th January 2006 the administrators entered into an agreement with a third party for the sale of the undertaking and assets including the lease. The lease was to be assigned for a consideration of £1. The agreement also provided for the occupation by the third party of the premises, contrary to the alienation provisions in the lease. His Honour Judge Norris QC held that the purpose of the administration was a better realisation of the company's assets and that the realisation was achieved when the lease was agreed to be sold for £1. The company was no longer trading and did not need the premises. The only person likely to be affected was the third party but it was not the interests of that party to which the court had regard, but the interests of the unsecured creditors as a whole.

Innovate Logistics v Sunberry [2008] EWCA Civ 1321

10. This was a pre-pack administration. On the day of going into administration, the business and assets were sold to a third party (YHL). The administrators were concerned that if the £20m of frozen goods stored in the demised premises were not delivered to customers, this would impede the administrators' ability to get in the company's substantial book debts. The sale to YHL was on the terms that YHL undertook the company's obligations to outstanding customers and got in the book debt. YHL was granted an occupational licence for 6 months, contrary to the express terms of the lease. YHL was to pay rent on a monthly basis, apportioned to the rent under the lease, which was passed on to the landlord. The landlord wished to enforce the alienation covenants by a mandatory injunction, in order to put pressure upon YHL (a good covenant) to take the (over-rented) lease. The landlord argued that it lost its "bargaining position". The Court of Appeal held that granting permission to enforce the

alienation covenants would impede the administration, ultimately it would prevent YHL from getting in the book debt. Thus it was necessary to carry out the balancing exercise. The landlord's only loss was a loss of "bargaining position" and interest on delayed rent payments. Weighing up the parties' respective positions the result was "obviously" in favour of refusing permission. Indeed Stanley Burton LJ doubted whether an alleged loss of bargaining position could ever be a relevant consideration under paragraph 43:

"In a case such as this, where [the landlord] contends that it is indisputably entitled to an injunction if it is permitted to bring proceedings, the courts principal, if not only, focus must be on the consequences of the grant of that injunction rather than on what [the landlord] might obtain by the threat of those proceedings."

11. However one should be wary before ascribing any general principle to *Metro* that where the administrator has sold the business and agreed to assign the lease, it would be proper to permit the landlord to proceed with a forfeiture action. The lease had of course not been assigned (had this taken place then forfeiture could be pursued against Newco without reference to paragraph 43). In *Metro* all the unsecured creditors were getting for the assets was £1. If this were a substantial sum and forfeiting the lease would jeopardise the performance of the sale agreement to the prejudice of the unsecured creditors, the question would have to be rethought; similarly, if the contract with the purchaser provided for some sort of penalty to the administrator in the event of the court granting leave to commence forfeiture proceedings.

12. If the lease had yet to be assigned and Newco's occupation was benefiting the company in administration (e.g. presenting an orderly face to existing customers, as in *Innovate Logistics*), the court may be far less willing to grant the landlord's application, even if the ultimate sale price of the assets is £1. In *Metro*, the entire business was sold but as *Innovate Logistics* demonstrates, this will not always be the case. It may be appropriate to deny the landlord his remedy pending the (unlawful) assignment of the lease, at which point the landlord will be free to take action against Newco as the new tenant.

13. *Innovate Logistics* suggests that the court will have regard to (i) the landlord's motive and (ii) the commercial effect upon the landlord's proposed actions not only (negatively) on the company but (positively) on the landlord. Providing there remains some real benefit to the company by allowing Newco to remain in occupation, the court

may be less inclined to assist the landlord if the state of the market is such that, realistically, the landlord would end up re-letting to Newco in any event.

14. What should a landlord now do, if he is faced with an *Innovate Logistics* situation i.e. an over-rented property and a good covenant in occupation, albeit temporarily. An application simply to enforce the alienation provisions by mandatory injunction has been uncovered for what it is: an attempt to put pressure upon the good covenant to take an assignment of over-rented property. What if the landlord had applied to forfeit the premises? Such course would have the following potential benefits:

- (i) in *Re Atlantic Computer Systems* much emphasis is laid upon the landlord's proprietary rights; it may be argued that a forfeiture action is more proprietary in nature than an action for the specific performance of the lease covenants (being more personal in nature);
- (ii) a forfeiture action would indicate that the landlord was really quite upset and wished to bring the lease to an end; by contrast in the circumstances of *Innovate Logistics*, an application for a mandatory injunction appears cynical since (i) the landlord has no wish to bring the lease to an end and (ii) had no objection to YHL's occupation, simply wanted YHL in as assignee rather than licensee.

15. In the above scenario, it would be better if the landlord's action could be coupled with a complaint of non-payment of rent. This will often be possible in an administration situation, just as it was in *Innovate Logistics* (where the rent was paid monthly instead of quarterly). *Re Atlantic Computer Systems* of course confirmed an attempt by the landlord to repossess his property because of non-payment of rent.

16. Having said that, an application to forfeit over-rented premises where there is the possibility of doing a deal with a good covenant who may have an on-going need for the premises, would be high-wire stuff. Further, ultimately the court is concerned with balancing the prejudice to the landlord against the prejudice to the unsecured creditors. If the landlord is, on the facts, little troubled by the temporary occupation of a third party who is paying rent, the remedy chosen may not make any difference.

Liquidation

17. By section 130(2) of the Insolvency Act 1986, when a winding-up order has been made or a provisional liquidator appointed “*no action or proceedings shall be proceeded with or commenced against the company or its property, except by leave of the court and subject to such terms as the court may impose*”. Section 130(3) provides that no action should be commenced or proceeded with against the company or its property.

18. These limitations plainly cover v forfeiture by action. However it remains unclear whether they extend to forfeiture by peaceable re-entry.

19. As stated above, an administration is only a temporary matter while the affairs of the company are brought to order. By contrast, in the case of a winding up, the company has reached the end of its life. The basic object of the winding up process, in the case of an insolvent company, is to achieve an equal distribution of the company’s assets among the unsecured creditors. A secured creditor will not, as such, participate in the ensuing distribution.

20. Accordingly if a landlord seeks leave to obtain possession (through forfeiture) of his own property, leave should be granted pretty much as of course, at least where the rent is an expense of the liquidation: in *Re Atlantic Computer Systems* [1992] Ch D 505 at 527.

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