CORPORATE TENANT INSOLVENCY AND ENFORCING LEASEHOLD COVENANTS AGAINST THIRD PARTIES

Camilla Chorfi

selborne
CHAMBERS

10 Essex Street London WC2R 3AA

DX 185 Chancery Lane www.selbornechambers.co.uk

1. Once a corporate tenant becomes insolvent and enters a voluntary arrangement, an administrator is appointed, or is wound up, full recovery of rent is uncertain, potentially costly and may cause serious cash flow issues for a landlord. The situation will often be fraught, a landlord may not have been apprised of the information he feels he ought, and have to make swift decisions as to how best to go about recovering unpaid rent.

2. A simpler and frequently preferred strategy by landlords is to do away with pursuit of a supervisor or administrator and seek his remedies from a third party, often a surety, the tenant's predecessor, or even a subtenant.

3. This talk is divided into two parts. In the first I seek to give an outline of issues surrounding rent recovery a landlord confronts when a tenant becomes subject to an insolvency scheme, and in the second, the issues which arise when recourse is made to third parties.

PART 1: TENANT INSOLVENCY

4. A landlord will have a number of choices when faced with an insolvent tenant in arrears. He might:

i. Prove for his rent (&other sums) in the administration / voluntary arrangement / liquidation for the rent as an unsecured debt or expense;

ii. Forfeit the lease;

iii. Levy distress;

iv. Accept a surrender;

v. Recover the rent from other parties;

vi. Draw on a rent deposit.

5. Time does not permit a comprehensive treatment of all the above; I focus on i. and v. herein, (iii. & iv often flowing thereon), and the recent decisions affecting a landlord's ability to recover arrears of rent. I only deal with the most frequently encountered regimes: CVAs, administration and liquidation.

VOLUNTARY ARRANGEMENTS

6. A company or creditors' voluntary arrangement is a statutory contract between a company and its (unsecured) creditors – of which a landlord will be one – which provides for the repayment of some (or sometimes all) its debts over an agreed period.

7. *Thomas v Ken Thomas Ltd* [2007] 1 EGLR 31 remains the leading case on a landlord's entitlement to rent when a tenant enters a CVA. In *Thomas* it was held, *inter alia,* that any unpaid rent which accrued before the CVA was caught by the arrangement, but any falling due thereafter, must be paid in full (sometimes even if the terms of the CVA state to the contrary).

ADMINISTRATION

8. The objective of administration is to rescue an insolvent company as a going concern, or if impossible, to achieve the best dividend possible for its creditors.

9. Administrators cannot be compelled to pay pre-administration arrears / sums due for other breaches of covenant and a landlord will have to prove in the administration. His enforcement options are often fettered by the imposition of a moratorium.

10. It is also likely that an administrator will oppose any attempt by a landlord to draw on a rent deposit.

11. As for arrears accrued during the administration, over the last few years landlords have faced a battle with administrators, specifically over whether or not rent qualifies as an 'expense of the administration' under IA 86 r 2.67(1)(a) or (f) and whether as such was a mandatory liability or not. This uncertainly was largely due to the much criticised *Sunberry Properties Ltd v Innovate Logistics Ltd (in administration)* [2008] EWHA Civ 1321; [2009] BCC 164 which held that the court has a wide discretion over what is and isn't an administration expense, in that case refusing to allow a landlord rent, where an administrator had granted a licence to a buyer over the premises in a pre-pack.

12. Happily the case of *Goldacre (Offices) Ltd v Nortel Networks UK Ltd (in administration)* [2009]EWHC (Ch); [2010] 09 EG168, has brought certainty and reassurance to landlords. Quite simply if the administrator requires the premises or any part thereof, whether it be for storage, to continue trade or to hold an auction, rent (but also service charges and other liabilities under the lease) falls under r2.67(1)(a)or r2.67(1)(f) and must be paid.

13. The effect is that administrators who elect to retain leasehold premises may do so only on the terms of the lease. The *Sunberry* element of

discretion has been abolished. The court does not have discretion to declare to be or not to be an administration expense, but it does retain discretion over the landlord's ability exercise his remedy in respect of the arrears: see para 27ff.

14. The judgment does not specify however that the rents and other sums have to be paid *as they fall due*, simply that they accrue as described. This is an issue where there is a risk that the tenant's realisable assets will not be sufficient. A landlord may well be forced to wait and see what assets become available in due course, as even though rent will be a proper expense, others may take priority.

15. *Goldacre* is therefore arguably deficient in that respect, but there was no question in that case that the tenant's assets were more than sufficient to meet the landlord's claim.

LIQUIDATION

16. The purpose of liquidation, or winding up, is to gather and realise a company's assets and settle its liabilities ahead of its dissolution.

17. A landlord will have to prove for any arrears accrued beforehand, as an unsecured creditor (IR 86 r 4.92(1)). The tenant's liability under lease

covenants, including rent, continue subject to the liquidators' ability to disclaim: s178 Insolvency Act 86. If a liquidator takes no action as to the lease, a landlord may force a binding election within 28 days by serving notice. This gives him certainty as to his position, but also raises an arguable case that from then on, should the liquidator fail properly to disclaim the lease, the rent should be deemed an expense of the liquidation and have priority over other claims.

18. The lease must however have been retained for the *benefit* of the liquidation: *In re Lundy Granite Co, ex parte Heavan* (1871) LR Ch App 462. This is unlikely to be the case where there is simply an ineffective disclaimer, or mere inactivity.

19. Once disclaimed, a landlord can nevertheless prove for future rents, subject to the usual adjustments and discounting, under s178(6) IA 86.

<u>PART II – RECOVERY FROM THIRD PARTIES</u>

20. As aforementioned, given the difficulty and risks associated with pursuing a tenant subject to the schemes I have described, it is frequently more attractive instead to recover from:

a. the guarantor of the existing tenant;

b. an original tenant;

c. an original tenant's guarantor;

d. mortgagees; or

e. subtenants.

21. No one of the abovementioned parties need be exhausted before the next is pursued for payment, nor in any particular order; *Norwich Union Life Insurance Society v Low Profile Fashions Ltd* (1991) 64 P&CR 187, CA. Nor does a landlord have a positive duty to pursue them at all; there is no obligation to mitigate his loss whilst the lease remains in existence.

<u>The nature of the guarantee</u>

22. A well drafted guarantee will make the guarantor a direct covenantor with the landlord so that, in the event the tenant's rights and liabilities are affected by an insolvency arrangement, the guarantee remains directly enforceable. If not, the dissolution of the tenant will end the guarantor's liabilities. There are three typical aspects to guarantees relating to leasehold obligations. They are:

a. The simple guarantee covenant. Here the guarantor covenants that the tenant will comply with the covenants in the lease. The guarantor, upon the default of the tenant, becomes liable in damages to the landlord;

b. The indemnity. Unlike the simple guarantee the guarantor's liability falls to be paid as a debt, rather than damages (accordingly no losses have to be proved), because the guarantor undertakes to perform the tenant's covenants if the tenant does not; or

c. An obligation to take a new lease (usually for the residue). This is intended to protect the landlord in the event the lease comes to a premature end, often by forfeiture.

23. The manner in which sureties and former tenants may attract liability is of course also determined by whether the demise occurred pre or post 1 January 1996.

Pre 1996

24. In a pre 1996 lease there is privity of contract between the landlord and the tenant and the landlord may enforce all terms against the

tenant during the term of the tenancy so long as the landlord retains the reversion. The tenant remains liable notwithstanding any assignment of the lease by him to an assignee.

25. Guarantors are similarly not released on the assignment of a pre-1996 lease, unless there is an express discharge: *Baynton v Morgan* (1888) 22 QBD 74.

26. This of course is onerous for the original tenant, who years after a proper assignment, finds himself on the hook for rent due from a tenant over whom he had no control and which may have increased considerably after several reviews,

<u>The Landlord and Tenant Act1995 ("the 1995 Act")</u>

27. The 1995 Act redressed this unfairness by radically limiting the transmission of liability, the default position being that both tenants and their guarantors are automatically released from liability on a lawful assignment.

28. Mechanisms for preserving liability under certain circumstances were however created.

Authorised Guarantee Agreements ("AGAs")

29. Section 16(1) of the Act provides:

> Where on an assignment a tenant is to any extent released from a tenant covenant of a tenancy by virtue of this Act ("the relevant covenant") nothing in this Act (and in particular section 25) shall preclude him from entering into an authorised guarantee agreement with respect to the performance of that covenant by the assignee .

30. The parties have a fair amount of latitude as to what can and can't be included in the AGA

> 16 (4) An agreement is not an authorised guarantee agreement to the extent that it purports—
>
> (a) to impose on the tenant any requirement to guarantee in any way the performance of the relevant covenant by any person other than the assignee; or
>
> (b) to impose on the tenant any liability, restriction or other requirement (of whatever nature) in relation to any time after the assignee is released from that covenant by virtue of this Act.
>
> (5) Subject to subsection (4), an authorised guarantee agreement may—
>
> (c) impose on the tenant any liability as sole or principal debtor in respect of any obligation owed by the assignee under the relevant covenant;
>
> (d) impose on the tenant liabilities as guarantor in respect of the assignee's performance of that covenant which are no more onerous than those to which he would be subject in the event of his being liable as sole or

principal debtor in respect of any obligation owed by the assignee under that covenant;

(e) require the tenant, in the event of the tenancy assigned by him being disclaimed, to enter into a new tenancy of the premises comprised in the assignment—

(i) whose term expires not later than the term of the tenancy assigned by the tenant, and

(ii) whose tenant covenants are no more onerous than those of that tenancy;

(d) make provision incidental or supplementary to any provision made by virtue of any of paragraphs (a) to (c).

31. The liability of the outgoing tenant under the AGA can be expressed to subsist notwithstanding the contractual term of the lease has expired and a continuation tenancy under s 24 of the Landlord and Tenant Act 1954 has arisen, and that the tenant is also liable for any interim rent ordered under s 24A of the 1954 Act: see the case of *Herbert Duncan Ltd v Cluttons* [1993] QB 589.

32. S 16(5) does not contemplate an AGA providing for the appointment of a replacement guarantor, in the event of the outgoing tenant meeting with death, bankruptcy or liquidation. The outgoing tenant

also cannot bind itself to be joined as a guarantor in any renewal of the lease as that would be a new lease and thus a different tenancy.

33. In the event that a provision of an AGA offends ss 16(4) or 25 then it will be excised. The result that the remainder of the AGA remains in force, but as a fail safe it is useful to insert a severance provision in the AGA.

AGAs and Guarantors

34. It has now been confirmed that only an outgoing tenant may enter into an AGA, and his guarantor may not. Unwelcome news for landlords was broken this February when judgment in *Good Harvest Partnership LLP v Centaur Services Ltd* [2010] EWHC 330 (Ch); [2010] 14 EG 114 was handed down.

35. The facts were briefly as follows. Chiron CS Limited ("Chiron") was granted an underlease in 2001, guaranteed by Centaur Services Limited. The underlease stated that as a condition for giving consent to the tenant assigning it, the landlord could require that the tenant and its guarantor enter into an AGA.

36. In September 2004 Chiron assigned the underlease. The landlord, Chiron and Centaur entered into an AGA, under which Chiron and Centaur each covenanted with the landlord that the assignee would pay the rent and perform the underlessee's covenants from the assignment until the next lawful assignment.

37. A surrender of the intermediate lease took place and, Good Harvest Partnership LLP became the landlord and brought proceedings to recover rent from Centaur under the AGA. Centaur disputed the claim, arguing that the AGA was void and unenforceable as against Centaur because of the Act's anti-avoidance provisions.

38. Good Harvest argued that Centaur had been released from its original obligations under the underlease from the date of assignment and entered in fresh ones. Furthermore, there was no good reason barring a guarantor from giving such guarantees, and had Parliament intended on providing guarantors with such protection it would have done so expressly.

39. On the application for summary judgment, Mr Justice Newey agreed with Centaur. The requirement for Centaur to guarantee the assignee fell foul of s25, and was unenforceable in so far as it related to Centaur, from whom Good Harvest was consequently unable to recover its rent.

40. The Court considered the Act would be frustrated if the guarantor was required to enter into a further guarantee when the lease was assigned. An AGA was a tenant specific provision with no equivalent in respect of guarantors. It was however recognised by his Lordship that the principle of freedom of contract was to a degree fettered by the 1995 Act with somewhat arbitrary, though necessary, results.

41. Landlords must check any guarantee offered on an assignment by a contractual guarantor of an outgoing tenant, as if it is in a 'direct' form, as in *Good Harvest* it is liable to excision and fail, but it remains to be seen whether 'sub-guarantees' (ie where a contractual guarantor guarantee's an outgoing tenant's AGA) will be effective. It has been repeatedly suggested that sub-guarantees are similarly void, and no distinction can properly be made.

42. The practical difficulties of assessing the security of a proposed consent have arguably been amplified. On the positive side, landlords are now armed with good reason to refuse consent to assign. If a landlord does have serious concerns over giving consent where he is reasonably required to give it, the case of *Norwich Union Life & Pensions v Linpac Mouldings Ltd* [2009] EWHC 1602 (Ch); [2010] 1 P&CR 11 may assist. In that case it was held doubt over a material legal point meant a landlord's refusal to consent was reasonable.

43. The decision is now being appealed and due to be heard late June 2010.

44. I now turn to some of the problems encountered with respect to the specific insolvency arrangements considered above.

CVAs

45. The courts have on a number of occasions considered the effect of the limitation of a tenant's liability by virtue of the approval of a VA on that of his guarantor.

46. Guarantors are not automatically released by the approval of an arrangement.

47. In the well known case of *Prudential Assurance Co Ltd and others v PRD Powerhouse Ltd and others* [2007] 19 EG 164 (CS), it was confirmed that a landlord could, in principle, lose the benefit of a guarantor's full covenant.

48. Powerhouse's VA focused on its expensive leasehold portfolio and proposed that landlords of premises it intended to keep open would be paid full future rents, but those of premises it planned to close would only be paid a dividend. Further the obligations of Powerhouse's parent guarantor to the landlords of the closed premises would be discharged, in consideration for the guarantor agreeing to make the dividend payment.

49. The VA was challenged by the landlords of the closed premises on the basis that they had been unfairly prejudiced, and that there had been material irregularities in relation to the meeting. They further sought a declaration that the terms of the VA were invalid or ineffective in that they went beyond that which was permitted by the IA 86.

50. Mr Justice Etherton held that the concept of guarantor release was in itself permissible. However, this was not as a result of a 'discharge' but rather a clause in the VA which created a contractual obligation on the affected landlords not to pursue the respective guarantors. Furthermore, this was an obligation made between Powerhouse and the landlords and so directly enforceable by it, not the guarantors. The 'release' was only co-extensive with the debtors' ability to enforce the relevant provision, so is arguably only suspensory in nature.

51. He also found that because no value was attached to the guarantees by the VA, the landlords had been unfairly prejudiced, because their status as guaranteed creditors ought to have been reflected by the prospect of an enhanced dividend. Had the value of the guarantee been recognised in the proposal, thereby placing guaranteed creditors in a more advantageous position than the other unsecured creditors, then the challenge may have failed.

52. Compare that position to that of an original tenant. In *RA Securities Ltd* [1995] 3 All ER 581 it was held that the entry of an assignee into a VA did not affect an original tenant's obligations.

ADMINISTRATION

53. Administration does not affect a guarantor's liabilities under the lease. Because an administrator has no powers of disclaimer, the guarantor cannot apply for a vesting order. Nor can he apply for an overriding lease under s 19 1995 Act.

54. A guarantor who discharges the tenant's obligations when called upon by the landlord, may in turn pursue an administrator for continuing rents: *Re Downer Enterprises Ltd* [1974] 2 All ER 1074.

LIQUIDATION

55. The distinguishing characteristic of liquidation is that a liquidator may disclaim an onerous leasehold interest.

56. However, the cases of *Hindcastle Ltd v Barbara Attenborough Associates Limited* [1996] 1 All ER 737 (which concerned pre- 1996 leases) and *Shaw v Doleman* [2009] EWCA Civ 279 (which concerned a new lease) established that even though disclaimer ends the rights and liabilities as between the insolvent tenant and the landlord, the rights and liabilities of all third parties, including guarantors, remain.

57. An AGA will only terminate when the lease is disclaimed if that is what the parties have intended and it includes specific provisions to that effect.

Note: Section 17

58. S17 of the 1995 Act provides a "limitation period" for recovery from lease guarantors. S17(1), (2) and (3) provides as follows:

Restriction on liability of former tenant or his guarantor for rent or service charge etc

(1) This section applies where a person ("the former tenant") is as a result of an assignment no longer a tenant under a tenancy but—

(a) (in the case of a tenancy which is a new tenancy) he has under an authorised guarantee agreement guaranteed the performance by his assignee of a tenant covenant of the tenancy under which any fixed charge is payable; or

(b) (in the case of any tenancy) he remains bound by such a covenant.

(2) The former tenant shall not be liable under that agreement or (as the case may be) the covenant to pay any amount in respect of any fixed charge payable under the covenant unless, within the period of six months beginning with the date when the charge becomes due, the landlord serves on the former tenant a notice informing him—

(a) that the charge is now due; and

(b) that in respect of the charge the landlord intends to recover from the former tenant such amount as is specified in the notice and (where payable) interest calculated on such basis as is so specified.

(3) Where a person ("the guarantor") has agreed to guarantee the performance by the former tenant of such a covenant as is mentioned in subsection (1), the guarantor shall not be liable under the agreement to pay any amount in respect of any fixed charge payable under the covenant unless, within the period of six months beginning with the date when the charge becomes due, the landlord serves on the guarantor a notice informing him—

(a) that the charge is now due; and

(b) that in respect of the charge the landlord intends to recover from the guarantor such amount as is specified in the notice and (where payable) interest calculated on such basis as is so specified.

59. The provision applies to pre and post 1996 leases. Where a guarantor has guaranteed the performance by a former tenant the guarantor is not liable for any "fixed charge" unless the guarantor has been served with a notice under s 17 within six months of the charge becoming due. It should be remembered that s 17 applies to guarantors of former tenants rather than guarantors of current tenants. In the case of a guarantor of a current tenant the limitation period applicable will be six or even twelve years.

Subtenants

60. Section 6 Law of Distress Amendment Act 1908 allows valuable recourse against a subtenant, where an intermediate tenant falls into arrears.

61. A landlord can serve notice of a tenant's arrears on a sub-tenant, requiring that all future rents be paid by the sub tenant directly to the landlord until such time as the tenant's arrears are discharged. If the sub tenant fails to pay the arrears, a landlord may then distrain against the subtenant's goods.

62. Note, this method of recovery will not realise arrears all at once, or at all. The advantage is that it will deprive a tenant of income from its subtenant and may compel a wilful defaulter to pay up. The attraction is obvious if the subtenant is a better covenant than the tenant himself.

63. A s 6 notice is still effective even if a receiver has been appointed under the LPA 1925 over the intermediate tenant's interest. However, when a tenant is in administration it is not clear whether this amounts

to enforcement of security, contrary to any moratorium that may be in place.

64. Another tip is to check consents / licences to sublet, as often they contain direct covenants between the subtenant and the landlord ensuring the subtenant's compliance with the covenants of the intermediate lease. Typically payment of rent is not one such covenant, but repairs may well be.

Release of guarantors (and how to avoid it)

65. Landlords are generally concerned that a guarantor will often look for ways to wriggle out of its obligations. Generally death does not release a guarantor, and liabilities owed by a guarantor are provable as usual should he / it enter an insolvency scheme.

66. Common tactics employed to avoid guarantees often include arguing that a guarantor's promise lacks consideration and is thus not binding. This is a risk where a guarantee is contained in a later document, discrete from the lease and not by deed.

67. The two more common scenarios, to which one must be alert, lest a guarantor is inadvertently released, are lease variations and forfeiture.

Variations

68. A guarantor's liabilities to a landlord are referable to both the terms of the guarantee and the lease. Therefore in the event that different terms are agreed with a tenant, but not the guarantor, the latter may be released (subject to the terms of the guarantee itself): see *Holme v Brunskill* (1878)3 QBD 495; *Selous Street Properties Ltd v Oronel Fabrics Ltd* [1984] 1 EGLR 50.

69. It is plain that a variation of the term or the level of rent may result in the release of the guarantor. Note, (and this is particularly pertinent in times of recession), concessions agreed with respect to when and how the rent is to be paid will similarly operate as a release, unless there are express provisions to the contrary: see *Overend, Gurney and Co Ltd (Liquidators) v Oriental Financial Corporation Ltd (Liquidators)* (1874) LR 7 HL 348.

70. However, an original tenant under an old lease will not be released from liability, even if the varied terms are more onerous, unless of course they amount to a surrender and re-grant. The original tenant will only be liable for the rent he has covenanted to pay: s 18 1995 Act. See also the case of *Friends Provident Life Office v British Railways Board* [1996] 1 All ER 336, wherein it was emphasised that the nature of an original tenant's liability (pursuant to a pre – 1996 lease) was fundamentally different from that of a guarantor.

71. It follows therefore that an original tenant's guarantor will not be released by a variation: *Metropolitan Properties Co. (Regis) Ltd v Bartholomew* [1996] 1 EGLR 92.

Forfeiture

72. Forfeiture ends the lease absolutely. Although a landlord may still recover arrears accrued up until that point, unless a guarantor is obliged to take a new lease, all liabilities to him will cease.

73. Even where the tenant or another party defaults, landlords are well advised to think twice before forfeiting the lease. The present tenant

market, empty rates liability and insurance implications for vacant premises should deter any hasty threats to forfeit.

74. Therefore, care needs to be taken by landlords that they do not act in such a way as to provide a guarantor with a defence that a lease has been forfeited. Consideration should be given to the manner in which premises are secured or possession proceedings against trespassers are taken. Similarly, if another legal entity enters occupation of a property (whether pursuant to a pre-pack or otherwise), the guarantor might argue that he has been released, because a surrender of the lease he guaranteed, and re – grant, has taken place.

75. None of these suggestions can however better acting early and swiftly. A landlord needs to monitor struggling tenants closely to ensure his interests are protected, whether by identifying unlawful assignments, or applying pressure on an administrator, or challenging a VA. Vigilance and proactivity, as always, is everything.

CAMILLA CHORFI

Selborne Chambers

camilla.chorfi@selbornechambers.co.uk