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Case Comment

Landlords and administrators: a shift in the balance of power?

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Cases: Atlantic Computer Systems Plc, Re [1992] Ch. 505 (CA (Civ Div))

Exeter City Council v Bairstow [2007] EWHC 400 (Ch); [2007] 4 All E.R. 437 (Ch D (Companies Ct))

Goldacre (Offices) Ltd v Nortel Networks UK Ltd (In Administration) [2009] EWHC 3389 (Ch); [2010] Ch. 455 (Ch D (Companies Ct))

Lundy Granite Co, Re (1870-71) L.R. 6 Ch. App. 462 (CA in Chancery)

Sunberry Properties Ltd v Innovate Logistics Ltd (In Administration) [2008] EWCA Civ 1321; [2009] B.C.C. 164 (CA (Civ Div))

Toshoku Finance UK Plc (In Liquidation), Re [2002] UKHL 6; [2002] 1 W.L.R. 671 (HL)

***Insolv. Int. 59** In a blow to administrators that will surely impact on the timings of any administration, most particularly those involving a large property portfolio, H.H. Judge Purle, sitting in the High Court, has handed down a decision that will have ramifications potentially as serious as those of *Trident Fashions, Re,* for administrators in considering how long to remain in office, or indeed whether to accept an appointment at all.

In the (regrettably somewhat hurried) decision of *Goldacre (Office) Ltd v Nortel Networks UK Ltd (In Administration),* [1] the court has held that an administrator was liable to pay in advance a full quarter's rent contractually due under a commercial lease as an expense of the administration pursuant to Insolvency Rule (IR) 2.67, notwithstanding that the administrators were only occupying a small part of the premises, the majority of which were sublet or unoccupied. Further, the court held that the administrators would remain liable for so long as the administrators retained the use of any part of the premises, no matter how small. The even more worrying inference from the decision is that, wherever a company in administration trades from let premises the administrators will be liable to meet, as an expense of the administration, *all* liabilities arising under the lease during that period, unless they have managed to negotiate a concession with the landlord.

Landlords will be given a significant fillip by this decision, as the case could be seen as reversing a recent judicial trend in favour of administrators over the proprietary rights of landlords and will no doubt strengthen a landlord's position in their negotiations with the administrators of an insolvent tenant.

The facts

The tenant company occupied premises in Harlow pursuant to two long leases entered in to by the company prior to its insolvency. The administrators were using part of the premises for the purposes of the administration and rent had been paid for the September quarter, albeit late. Parts of the premises were sublet and the landlord had taken the step of serving notices on those subtenants pursuant to s.6 of the Law of Distress Amendment Act 1908, to require them to pay the sub-rents direct to the landlord.

The question before the court was to what extent the relatively minor use that the administrators were making of the premises rendered them liable to pay future rents contractually due under the leases.

The decision

The court decided that the administrators were liable to meet the full quarter's rent in advance as an expense of the administration in accordance with the terms of the lease and would remain so until they completely vacated the premises. Although the rents ranked as an expense of the administration, this did not necessarily entitle the landlord to receive payment as and when the rents fell due in all cases but in this particular case, since there were sufficient funds in the administration, the court held that it was appropriate for the administrators to discharge this expense on an ongoing basis as it fell due.

H.H. Judge Purle was influenced in his reasoning by the 2007 High Court decision in *Exeter City Council v Bairstow* [2] (more commonly referred to as the *Trident Fashions, Re* decision), which held that business rates ought properly to be met either as an expense of the administration pursuant to either IR 2.67(1)(a), being an expense properly incurred by the administrator in performing his functions in the administration, or as a necessary disbursement incurred by the administrators in the course of the administration, pursuant to IR 2.67(1)(f). In either case, these expenses rank ahead of the administrators' own remuneration.

Insolv. Int. 60 H.H. Judge Purle was also influenced by what is commonly referred to as the "salvage principle" or the "*Lundy Granite* principle", which established that liquidators are liable to pay rent as a liquidation expense where the liquidators make use of, or retain possession of, leasehold properties for the benefit of the liquidation.

The important distinction to note from H.H. Judge Purle's reasoning is that the court was not, in establishing that principle, saying that rent in and of itself is an expense, since it is properly a contractual liability that the company incurred at the time it entered into the lease for the whole of the lease term. What the principle establishes is that, where a liquidator is using the premises for the purposes of the liquidation, it is just and equitable to treat that rent liability *as if it were an expense of the winding up* and accord it the same priority.

H.H. Judge Purle then considered the wording of IR 4.218 (liquidation expenses) and IR 2.67 (administration expenses) and concluded that there was no practical distinction between the two and therefore the *Lundy Granite* principle was equally applicable to administrations as it was to liquidations.

H.H. Judge Purle, relying on the recent decision in *Lehman Brothers International (Europe) (In Administration), Re* [3] also concluded that, for the purposes of IR 2.67(f) a "necessary" disbursement would include any payment to a party that ought to be made in fairness (in circumstances where a counterparty's rights had been prejudiced by the administration) and that it was not necessary for that counterparty to have threatened legal action to render a payment "necessary". As such, in the case of a landlord, it was not required that a landlord should first have sought permission to commence forfeiture or distraint proceedings to render a rent payment a "necessary" disbursement for the purposes of IR 2.67.

The administrators sought to argue that, first there is a public policy argument that holding rent as an expense undermines the rescue culture intended by the legislation and secondly that, although administrators could not expect to have the use of premises for free, the payments ought to be tailored to the use actually made by the administrators.

H.H. Judge Purle rejected both of these arguments, reasoning that, first the *Lundy Granite* principle arose in circumstances where liquidators were commonly trading businesses and so in that regard, modern administrations were coming to resemble liquidations and the court had clearly felt, in establishing that principle, that it did not run contrary to achieving the purposes of the liquidation and secondly that, following the reasoning in *Powdrill v Watson,* [4] where a liquidator was deemed to have adopted a contract, he was liable for all liabilities arising under that contract.

These are two very worrying conclusions for administrators.

The first ignores the fact that liquidators have the ability to disclaim onerous property, whereas an administrator does not, and runs contrary to the reasoning in the well known decision of *Atlantic Computer Systems Plc, Re,* [5] where the Court of Appeal concluded that an administration is more akin to a receivership than a liquidation.

The second conclusion is even more worrying, since the corollary of this must be that if rent is

payable as an expense and the administrator is deemed to have “adopted” the lease contract, then this would potentially render the administrators liable for any and all claims arising under the lease during the period of their occupation as an expense of the administration. This conclusion is supported by H.H. Judge Purle's approval of the decision in *Levi & Co Ltd, Re,* [6] where a liquidator was held liable to meet a dilapidations claim as a liquidation expense (a decision also previously approved in *Powdrill*).

A landlord's remedies under the lease are, in essence, only a contractual remedy flowing from a pre-insolvency contract. Why should a landlord be preferred ahead of other unsecured contractual creditors, whose claims rank only as an unsecured claim against the company?

There is judicial conflict between the flexible, discretionary approach to expenses adopted in *Atlantic Computer Systems Plc, Re* and the more prescriptive approach adopted by the House of Lords in *Toshoku Finance UK Plc (In Liquidation), Re.* [7] The conflict centres around whether, and to what degree, the question of what constitutes an “expense” for the purposes of an administration is a matter of judicial discretion. In this decision, H.H. Judge Purle (it is submitted quite properly) prefers the prescriptive approach adopted by the House of Lords in *Toshoku Finance UK Plc (In Liquidation), Re* and followed in *Trident Fashions, Re,* that the court has no discretion in deciding what should, or should not, be an expense. The question of what constitutes an “expense” or a “necessary disbursement” of the administration is a question only of judicial interpretation of the proper construction of the wording of para.99 and IR 2.67. It is not for the courts to second guess the legislators on this point and to determine on a case-by-case basis whether it is appropriate that a particular liability should rank as an expense in any particular case.

Looking specifically at the position of a landlord, following this reasoning the court's discretion is not as to whether the rent ranks as an expense in any particular case. This is a question that is determined under IR 2.67 as a matter of construction. The court's real discretion lies in whether it should permit the landlord to exercise a particular remedy to recover that expense immediately (e.g. permit forfeiture, or distraint or to commence proceedings), or whether the landlord should have to wait to receive payment in due course, along with all other creditors. In determining this, the correct approach is still to apply the “balancing act” test laid down in *Atlantic Computer Systems Plc, Re.*

The conclusion from this is that H.H. Judge Purle has determined that in circumstances where an administrator makes use of any part of a leasehold premises during the course of the administration, all lease liabilities accruing during that period, including (but not limited to) rent, are in all cases deemed to rank as an expense or necessary disbursement of the administration on a proper construction of IR 2.67, in the same way that liability for rates was determined to be an expense or necessary disbursement of the administration in *Trident Fashions, Re.*

The latter decision necessitated urgent legislative clarification to alleviate the burden on administrators. We can only presume that, if Parliament did not intend that such lease liabilities should receive such priority in all cases, then this too will require urgent clarification, to prevent landlords from effectively receiving preferential ***Insolv. Int. 61*** status for what had previously been presumed to be only an unsecured claim against the company in administration.

H.H. Judge Purle did consider the impact of the recent Court of Appeal decision in *Sunberry Properties Ltd v Innovate Logistics Ltd (In Administration).* [8] H.H. Judge Purle distinguishes this important pro-administrator decision by concluding that the main point under appeal was the question of when is it appropriate to lift the statutory moratorium to allow a landlord to exercise its proprietary remedies, rather than the status of the rent due under the lease.

In the *Innovate* case, Mummery L.J. said (at [59]) the landlord:

“ *… does not have an absolute legal entitlement to be paid 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* ”.

Administrators have relied on this decision to considerable effect in negotiations with landlords, to reduce the insolvent tenant's rent liability.

H.H. Judge Purle however concluded that he was not bound to follow this flexible approach, on the basis that the parties in the *Innovate* case had both accepted that the landlord was not automatically entitled to be paid the rents reserved in the lease on a contractual basis during the period of occupation by the company in administration. On the basis that the Court of Appeal had not been

asked to adjudicate on this point, H.H. Judge Purle was not bound to accept the same position.

Further, H.H. Judge Purle concluded that, if the effect of the *Innovate* decision was to oblige him to exercise a discretion to determine how much rent it would be fair for the administrators to pay in this case, then he would exercise that discretion to conclude that, on the facts before him, it was fair for the administrators to pay the whole of the rents falling due on the December quarter date. This was based on evidence from the landlord's surveyor that, for so long as the company in administration occupied any part of the premises, there was no realistic possibility of maximising the return from the remainder of the premises, as it would adversely impact on the ability to re-let or develop the premises. On this basis, H.H. Judge Purle did not consider it appropriate to order that the administrators should only pay an apportioned rent for that part of the premises the company was actually using.

Further, in interpreting the *Innovate* decision, H.H. Judge Purle, relying on the House of Lords decision in *Toshoku Finance UK Plc (In Liquidation), Re* reasoned that, although the court may have a discretion as to whether or not to allow a landlord to commence forfeiture proceedings or exercise distraint, it has no discretion to declare something to be or not to be a liquidation expense or, by extension, an administration expense under IR 2.67.

There is a crumb of comfort for administrators. H.H. Judge Purle recognised that the fact that rent is an administration expense does not then automatically oblige the administrators to pay it when it falls due under the lease. It is a matter for the administrators whether they pay such expenses as they go along, depending on the assets available and other commercial factors. Following the above reasoning, it is then a matter for the court to determine whether it would be appropriate for a landlord to be allowed to take enforcement action if the administrator is not meeting rent payments when they fall due, still applying the *Atlantic Computers Systems Plc, Re* balancing act test in reaching such a decision.

H.H. Judge Purle concluded by saying that, for so long as the administrators occupied any part of the premises, the whole of the rents falling due under that lease will continue to be payable as an administration expense quarterly in advance, until such time as the administrators vacate those premises entirely. At the point the administrators vacate, the rent will cease to be payable as an expense. H.H. Judge Purle makes no comment on whether the administrators would be entitled to any rebate for an advance payment in such circumstances but following the above reasoning, one presumes this would not be his intent.

Practical implications for administrators

The decision has a potentially very significant impact for administrators on their pre-appointment planning, particularly on the timing and duration of administrations. The potentially open-ended exposure to liability under existing leases as an expense will make cash-flow and trading forecasts less accurate and prediction of potential recoveries less certain. Administrators should also take advice early on (ideally pre-appointment) on the terms of any leases that are in place, to help better understand their potential exposure on appointment.

Timing of appointment

In terms of timings, administrators may wish to consider the following:

• Following the logic of the decision, if an administrator takes up office after a quarter day (or other rental trigger date in the lease), the rent liability has already accrued and therefore should rank only as an unsecured claim against the company in administration. The liability to meet rent as an expense will not accrue until the next rental trigger date in the lease. If rent is payable quarterly in advance and an administrator is only in occupation for two months, then they ought, in line with *Nortel,* to be able to argue that their liability is only to pay rent as an expense for the two months that they actually occupy the premises.

• If, as is commonly the case at the moment, a landlord has granted an informal concession to a tenant that rent can be paid monthly rather than quarterly, an administrator cannot count on benefitting from the same arrangement on taking up office and the landlord may insist upon its full contractual entitlements as an expense of the administration.

• If the administrators grant a licence to occupy to a buyer of the business, they will need to give

careful consideration as to whether that licence period will straddle a rental trigger date. If so, there will need to be provision made for the whole of that rent period to be paid. Ideally, this ***Insolv. Int. 62*** is a cost that would be passed on to the buyer but this is ultimately a point for commercial negotiation.

• Before accepting appointment, the administrators should look to identify which premises will be required for the purposes of the administration and wherever possible seek to have the company clear out of any surplus premises prior to appointment, to minimise exposure to liability in respect of those premises.

• In appropriate circumstances, the administrators should consider applying to the court to exercise its powers to vary the order of priorities of expenses, pursuant to IR 2.67(3), to limit or postpone the landlord's entitlement to rent.

• The period between filing a notice of intention to appoint and making the appointment is an ideal opportunity to try and reach a commercial settlement with a landlord as to the extent of liabilities that will be met post-appointment. Proposed administrators of a distressed company may not, from a tactical point of view, want to have to negotiate with landlords before being appointed without the protection of the moratorium, as the risk of the landlord taking unilateral action to frustrate the process is just too great. Equally though, if they enter into office and no agreement has been reached, landlords will seek to rely on this decision as entitling them to receive their full contractual entitlements under the lease as an expense and if this is not agreed to, actions by the landlords for a declaration to this effect and/or an order lifting the protection of the moratorium are ever more likely. This greatly weakens the administrator's negotiating position once in office.

It remains the case that how much rent an administrator will pay for temporary occupation remains primarily a point for commercial negotiation between the landlord and the administrators. This decision will, however, lead some landlords to conclude that they are entitled to demand a full quarter's rent in advance and this case potentially represents a shift in power away from administrators and towards landlords in such negotiations. If this is true, then in circumstances where the rental liability is significant, it will be critical for administrators that they reach a legally binding agreement with landlords as to how rent will be dealt with before taking up office, or at least ensure that the rent has been paid in advance before they take up office. This marks a move back to the way this issue used to be dealt with in old-style administrative receiverships, which gives the landlord a bigger seat at the negotiating table and arguably goes against the benefits that were conferred by the provisions in para.44 Sch.B1 that extended the statutory moratorium to prevent a landlord from exercising its powers of forfeiture or distraint in an administration.

Pre packs/business sales

In a pre pack situation, where the buyer of the business is allowed into occupation under licence, the buyer will doubtless have been asked to indemnify the administrators against all lease liabilities for the duration of the licence. If that licence period straddles a rental trigger date under the lease, the administrators will need to provide for the rent due for that whole rental period, not just the licence period.

Administrators will now need to be far more proactive in ensuring payments due under the licence are made and made upfront if possible, preferably via the administrators. They will also need to monitor more closely the actions of the licensee whilst in occupation, to identify any potential liabilities incurred that may now be considered to rank as an expense of the administration.

As a separate point, following on from the recent success in using CVAs to assist distressed retail businesses, this decision will surely act as an added incentive for businesses with large property portfolios to more seriously consider a CVA instead of an administration as the best way to restructure their business.

What does “retain or use any part of the premises” actually mean?

A serious question mark will now also hang over when an administrator can be truly said to have vacated a premises. Usually, when an administrator decides the premises are no longer required for the purposes of the administration, they will simply write to the landlord and advise them of this, without taking any particular steps to clear the premises of detritus or to reinstate the premises. Any

claims flowing from loss incurred by the landlord in remedying these breaches of the lease would normally be considered to rank only as an unsecured claim. Now, though, if the administrators are to be deemed to have adopted the lease, there is an argument that such costs rank as an expense of the administration.

Also, and potentially of greater significance, if any of the company's items remain on the premises, can the company be said to have truly “vacated”, so as to bring to an end the administrator's liability for rent as an expense? An administrator may now face the unpalatable fact that they can no longer simply abandon an unwanted premises but will have to incur costs to physically clear (and possibly reinstate) those premises fully, to avoid incurring ongoing rent liability as an expense of the administration. It is unclear what the effect of third party goods being left on site would be.

On this point there is, perhaps, a parallel to be drawn with the position on rates. Following the *Trident Fashions, Re* decision, statute has since provided an exception to liability for rates in respect of unoccupied premises. Section 65(5) of the Local Government (Finance) Act 1988 provides that a hereditament that is not in use will be treated as unoccupied if it is only being used for the storage of plant, machinery or equipment used when the premises were last in use or which are intended for use on the premises. Could a similar exception be argued in the case of rent liability? Without the benefit of similar legislation to this effect, an administrator may struggle to successfully argue that a company has truly ceased to use the premises when any company assets remain stored there.

In the face of such arguments from a hostile landlord, this decision has seriously weakened the administrators' position. Administrators will now have to be very careful ***Insolv. Int. 63*** before deciding to trade a business for any length of time that funds will be available to meet all lease liabilities, not just on a pro rata basis but on a contractual basis, as set out in the lease.

There is a further, more general, issue with placing such an interpretation on IR 2.67. It would flow from this that, were an administrator to make use of anything supplied to the company under contract, by using that item, the administrator would then potentially be responsible to meet all contractual liabilities arising during that period as an expense or necessary disbursement of the administration. The *Lundy Granite* principle relates to lease liabilities but it is not difficult to see the argument that this should be extended to any obligation or liability incurred whilst an administrator retains any property (of whatever nature) for the purposes of the administration.

The need to move companies into liquidation and to disclaim such leases as soon as possible, is now ever more pressing. Administrators will now face the same difficult trading decisions regarding rent liability that flowed from the decision in *Trident Fashions, Re* concerning rates. Urgent legislative intervention is required to clarify the position if the rescue culture promoted by the Enterprise Act is not to be jeopardised. If it is truly considered that an administration now more closely resembles a liquidation than a receivership, then it must be thought only proper that administrators should be given the same power to disclaim onerous property that a liquidator enjoys.

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(Editor's Note: a contrary view of *Nortel* will be published in the next issue of *Insolvency Intelligence*).

Insolv. Int. 2010, 23(4), 59-63

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1. *Goldacre (Office) Ltd v Nortel Networks UK Ltd (In Administration)* [2009] EWHC 3389 (Ch).
2. *Exeter City Council v Bairstow* [2007] EWHC 400 (Ch); [2007] Bus. L.R. 813.
3. *Lehman Brothers International (Europe) (In Administration), Re* [2009] EWHC 2545 (Ch).
4. *Powdrill v Watson* [1995] 2 A.C. 394; [1995] 2 W.L.R. 312 HL.
5. *Atlantic Computer Systems Plc, Re* [1992] Ch. 505; [1992] 2 W.L.R. 367 CA (Civ Div).
6. *Levi & Co Ltd, Re* [1919] 1 Ch. 416 Ch D.
7. *Toshoku Finance UK Plc (In Liquidation), Re* [2002] UKHL 6; [2002] 1 W.L.R. 671.
8. *Sunberry Properties Ltd v Innovate Logistics Ltd (In Administration)* [2008] EWCA Civ 1321; [2009] B.C.C. 164.