SQUIRE SANDERS

CORPORATE RESCUE AND INSOLVENCY

CRAR CREEPS CLOSER

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Key Points

- The right of distress is expected to be abolished in April next year and replaced by an entirely new statutory regime, called Commercial Rent Arrears Recovery (CRAR).
- CRAR will oblige a landlord to give seven clear days' notice to a tenant before exercising the right of CRAR, prompting concerns that the new regime will be less effective and tenants will be more likely to remove assets during the notice period.
- Landlords of shops, pubs, hotels and other establishments where people have living accommodation on site may lose their right to exercise CRAR because of the residential element.
- Insolvency practitioners need to be aware of the new regime and how it interacts with the available insolvency processes.

After years of waiting, it is widely anticipated that in April next year, the ancient remedy of distress will be abolished and the new Commercial Rent Arrears Recovery regime (CRAR) will come into effect. This has been on the statute books since 2007, but its implementation recently took a big step forward with the passing of the Taking Control of Goods Regulations 2013 (the regulations), which provide much of the "flesh" that has been missing from the statutory skeleton laid out in the Tribunal Courts & Enforcement Act 2007 (TCEA 2007).

Distress

The right for a landlord to distrain against a tenant's goods for non-payment of rent is an ancient remedy, stretching far back into our legal subconscious. Its origin is lost in the mists of antiquity, but today it is a mishmash of common law rights, statute and commercial practice. It has been the subject of much criticism and a cause for concern for a number of years.

The report highlighted four main objections to the operation of distraint:

- Landlords used it to gain priority over other creditors.
- Distraint rendered third party goods vulnerable.
- The speed and severity of the remedy afforded the tenant little recourse to challenge the distraint.
- The exercise of a right of distraint is out of step with a modern debt enforcement regime and contrary to the human rights of the tenant to respect for his privacy and home, and to the peaceful enjoyment of his possessions.

Various Law Commission consultations led to the passing of the regulations, which sought to modernise and regulate the way in which civil judgments were enforced, seeking to strike a balance between the need for the judicial system to have teeth, so that its judgments continued to be respected, while implementing checks and balances that respected and protected an individual's human rights, and codified and simplified the enforcement process.

As part of that, the new CRAR regime seeks to redress the balance between the rights of landlord and tenant and more severely limit the circumstances in which a landlord can exercise such a dramatic self-help remedy as seizing a tenant's goods. The intention is that "the new regime will be accessible and fairer and set out more clearly the actions landlords and agents are legally entitled to undertake".

CRAR

Part 3 of TCEA 2007 contains the statutory framework for implementing CRAR. Section 71 provides: "the common law right to distrain for arrears of rent is abolished." Such elegance and economy of drafting is to be admired --in these few words, nearly 1,000 years of law and practice are swept aside. What we are left with is an entirely new regime --while the temptation will always be to look backwards to pre-existing case law for guidance, the clear intention is that we are starting again at ground zero and must await fresh case law on the correct interpretation of the new provisions.

While TCEA 2007 has been on the statute books for six years, CRAR is not yet in force. The general expectation is that Pt 3 of TCEA 2007 will come into force in April next year and the passing of the regulations is a big step towards this. A significant proportion of the provisions in CRAR await clarification or detail to be provided by regulation and the regulations provide a lot of that missing detail.

CRAR

There are a number of significant changes introduced by CRAR. Section 72 provides: "a landlord under a lease of commercial premises may use the procedure in Sch 12 (taking control of goods) to recover from the tenant rent payable under the lease." There are a number of terms used here that need greater explanation.

Who is a "Landlord"?

A landlord for these purposes is defined by s 73 as the "person for the time being entitled to the immediate reversion in the property comprised in the lease". This, therefore, is limited to only the tenant's immediate landlord.

Where a property is jointly owned, either proprietor will have the power to enforce under CRAR. Where a property is mortgaged, the secured lender will not be a landlord entitled to rely on CRAR, unless they have taken steps to enforce their security or take possession. Circumstances could arise where a lease has been granted of charged property without the lender's consent. In such circumstances, the lease is not binding on the lender, unless they choose to acknowledge it --similarly, the lender would not be entitled to rely upon CRAR unless they have acknowledged the lease.

What is a "Lease"?

Section 74 provides a broad definition of "lease" --it need only be evidenced in writing and will catch (for example) tenancies at will, statutory extensions or interim tenancies under the Landlord and Tenant Act 1954, where a tenant holds over following the expiry of the contractual term. It will not catch a licence to occupy (unless presumably that licence is held to operate as a lease, pursuant to *Street v Mountford* [1985] AC 809 principles).

What are "Commercial Premises"?

One of the major changes between the old and new regimes is that CRAR is limited to commercial premises only. This is in step with the desire to protect an individual's human rights --the ability to distrain on residential property is abolished completely. The definition of "commercial premises" is by way of exception -the right of CRAR will not apply to any premises, part of which is occupied as a dwelling. The only exception to this is if the residential dwelling has been created illegally or in breach of the terms of the lease --a tenant cannot evade or defeat CRAR by illegally squatting at commercial premises in breach of the terms of the lease (or letting someone else into occupation without consent).

This will be of concern to landlords and lenders who hold interests in mixed use premises (obvious examples would be pubs and corner shops with flats above, but could extend to care homes or hotels with staff accommodation). The likelihood is that the new CRAR regime will lead to landlords more carefully dividing up such mixed use premises, granting separate leases of the commercial and residential elements.

What is "Rent"?

Another major change is the limitation of what is recoverable as "rent". Under the old regime, "rent" could include a broad range of claims, since many commercial leases would seek to reserve as rent payments such as insurance premia, service charges, professional fees, repairs, rates and other ancillary costs. Under There are going to be circumstances where landlords will find it difficult to accurately calculate the amount of rent payable. Take, for example, a turnover lease, where the rent is variable and assessed periodically depending upon the volume of sales generated from retail premises. Depending on when the default arises, the landlord may simply not have the information available to accurately calculate the amount of rent then due.

Equally, with premises where the rent is a single "all inclusive figure", that captures all matters such as service charge and insurance, the landlord may have difficulty stripping out the rent element for the purposes of CRAR. Doubtless this will be a rich field for contesting the validity of notices given by landlords to retail tenants.

Under the new regime, there are two further difficulties for landlords in calculating what rent is owed. The first is that there must be a minimum level of arrears owing before CRAR may be exercised. Under the regulations this has been set at seven days' rent.

The second, and much more problematic, is an obligation on the landlord to make allowance for "permitted deductions" --this requires the landlord to seek to assess and value any right of set off or counterclaim that the tenant may have and to exercise CRAR only in relation to the net sum. This would be particularly difficult where the tenant may have a claim for an unliquidated sum, eg, for nuisance or interference with the right to quiet enjoyment. Again, it is not difficult to see situations where a tenant would rely upon a miscalculation of the correct set-off as grounds for disputing the validity of a CRAR notice.

The Requirement for Notice

One of the most contentious parts of the new regime has been the introduction of a requirement for a landlord to give notice to the tenant before being entitled to exercise its CRAR rights. The length of that notice has been a subject of heated debate but is settled by the regulations as "seven clear days" (clear days excludes Sundays, Bank Holidays and Christmas Day). The concern expressed is that the requirement to give notice effectively destroys the effectiveness of the remedy, since the tenant, having been forewarned of the landlord's intentions, will simply remove the goods during the notice period. The Ministry of Justice, having taken this risk into account and weighed it up against the countermanding desire to introduce greater balance and protection for tenants, considered that seven days was appropriate.

It is open to a landlord to apply to court for an order reducing the notice period --presumably where the landlord perceives there to be a significant risk that a tenant will uplift and remove goods. Equally the tenant will have a right to apply for an order setting aside or suspending the notice.

Procedure

At the point at which the landlord decides to exercise its CRAR rights, it must give a notice in a prescribed form to the tenant, via a suitably certified enforcement agent. The regulations have set out further detail on who may act as an enforcement agent and what information must be contained in the notice. It remains to be seen whether the courts will apply a strict interpretation, invalidating notices that fail to comply with the prescribed formula, even if the defect is minor or immaterial.

The notice must contain the landlord's assessment of the amount due. The notice can be served in a variety of methods, including personal or electronic service and must give seven clear days' notice. The enforcement agent must keep a written record of the time notice is given. The landlord is obliged to give a further notice at the expiry of the notice period, confirming the amount due. This is to avoid the landlord exercising CRAR for nominal sums, where the tenant has discharged the majority of the debt --the minimum amount due at the expiry of the notice must still be above the threshold of seven days' rent arrears for CRAR From the point at which the notice is given, the tenant's goods become "bound" and can only be dealt with subject to the landlord's power of enforcement. However, a *bona fide* purchaser for value without notice of the enforcement notice will acquire good title. This provision is highly problematic for insolvency practitioners: if a notice is served, it in effect creates a hiatus period during which the company cannot dispose of its goods (and therefore trade), or if it does, the proceeds of sale must be held for the benefit of the landlord. The landlord (via the enforcement agent), however, has no right to enter the premises, or take stock of what goods are on site, until expiry of the notice. This creates a massive evidential problem for both parties.

The clear risk is that the tenant chooses to dispose of goods during the notice period, either by sale or removal off site and does not account to the landlord for the proceeds. The landlord must then prove that the tenant has disposed of bound goods. Gone are the punitive remedies available for poundbreach or rescous, where the landlord could recover two or three times the value of the goods moved. Under the new regime, the tenant appears free of sanction if dealing with bound goods during the notice period, before the enforcement agent takes control.

For an insolvency practitioner involved on behalf of the tenant during this notice period, it will be tempting to dispose of goods (or indeed the whole business) before the notice expires, perhaps under the protection of an interim moratorium following the filing of a notice of intention to appoint administrators (the typical "pre-pack" scenario).

An insolvency practitioner should, of course, be ever mindful of his obligations to all creditors as an officer of the court. In such a scenario, it may be best to treat the proceeds of sale of goods located at the premises, that are subject to the notice, as being subject to a lien in favour of the landlord, for the amount claimed in the notice and to account accordingly. A commercial agreement could be sought to avoid the need for a court battle over the principles of *Re Atlantic Computer Systems plc* [1992] Ch 505.

Procedure

Once the notice has expired, the enforcement agent is authorised to enter the premises and "take control" of goods. Entry must be by way of the usual means used to access the premises (in most cases this will mean the door) and will bring to an end some of the more inventive methods of gaining entry employed in the past. Entry can only be between the hours of 6am and 9pm, unless the premises in question are usually open for business beyond those hours. The enforcement agent can seek a warrant to use reasonable force to gain entry to the premises, if necessary. This does not allow the use of force against a person, only property.

Under the new legislation, the enforcement agent may take control by physically removing the goods, securing the goods at the premises, or entering into a "controlled goods agreement" (CGA). This last option will operate something like the old walking possession agreement, although the process and terms of entering into a CGA are more strictly prescribed. Interfering with controlled goods is a criminal offence, so the regulations do contain some sanctions to prevent a tenant breaching the terms of the CGA, although how strictly these will be enforced remains to be seen.

In certain cases, the enforcement agent also has the power to take control by locking down the premises containing the goods. This right could inadvertently give a landlord significant leverage in an insolvency situation if the business under stress operates from a single site. The effect would be much the same as the landlord forfeiting the lease --the business interruption and threat to goodwill caused by being locked out of the premises would be massive, prompting the tenant business to the negotiating table with alacrity.

The enforcement agent must wait at least seven days after taking control before selling and has 12 months within which to sell the controlled goods. Taking into account the need for seven clear days' arrears and seven days' notice (in each case not counting Sunday or Bank Holidays), this means there will be a minimum gap of 24 days between arrears beginning to accrue and the enforcement agent being able to sell.

Third party goods are excluded, but CRAR is exercisable against any goods that the tenant has an interest in. This would include co-owned and mortgaged goods. If an enforcement agent seeks to take control of third party goods, the onus is on the third party to apply to court for an order recovering their goods. Goods simply caught by a floating charge-crystallised or uncrystallised-will not be protected from CRAR.

As with distraint, there will be a number of goods that are exempt from CRAR, such as tools of trade, but only up to a value of £1,350.00.

If a liquidation intervenes, before the goods are sold or before the enforcement agent accounts to the landlord, ss 183 and 184, Insolvency Act 1986 will apply and the goods or the proceeds will be handed over to the liquidator.

Sub-Tenancies

Under s 6 of the Law of Distress Amendment Act 1908, a superior landlord had the right to serve a notice on a subtenant, requiring them to pay sub-rents directly to the superior landlord, rather than to their immediate landlord. This provision is abolished and is replaced by an equivalent right under s 81 of TCEA 2007. The major difference between the two regimes is that the superior landlord must give the sub-tenant not less than 14 clear days' notice before the obligation to pay up sub-rents becomes enforceable. The concern with this provision is that the sub-tenant may quite lawfully pay the rent to the immediate tenant during the notice period, leaving the superior landlord exposed until the next rental period.

Conclusion

While there are some parallels between the old and new regimes, there is little doubting that the introduction of the new CRAR regime next year will represent the loss of a significant weapon from the landlord's arsenal of remedies. The requirement to give prior notice to a tenant is widely viewed as destroying the effectiveness of the remedy. The position is, perhaps, not as bleak as painted --for a significant number of businesses it will not be practicable to simply remove or dispose of all goods on site in the space of seven days. Equally, enforcement agents will develop practical steps to record, as far as possible, what is on site at the point of giving notice --no doubt personal service will be popular.

Nevertheless, there is a likelihood that landlords will seek ever increasing security at the outset of a lease, be it deposits, guarantees or other assurances.

From an insolvency practitioner's perspective, while the new regime will soften a landlord's position, a landlord's notice to exercise CRAR will still create rights in the tenant's goods that cannot be simply ignored. Receipt of such a notice may also be the wake-up call a tenant needs to prompt it to seek urgent advice from an insolvency professional during the notice period.

For good or ill, the new regime is coming soon and landlords, tenants and advisors alike, all need to start preparing for it.

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