A practical introduction

Jeremy Whiteson provides an overview of the conflicting interests raised by a property insolvency

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When financial difficulties are encountered by property owners and tenants, particular issues arise. While property law grants property owners special privileges not enjoyed by other creditors, insolvency law seeks a fair distribution of an insolvent debtor's limited assets. It arms creditors with weapons to challenge the extent of these special property owners' rights. The struggle between these competing forces can lead to results that are far from predictable. In this article I introduce some of the issues raised by reference to a hypothetical but not uncommon scenario: a hapless landlord with multiple tenants, several of which are faced with financial difficulties.

Preparing for the storm

A cautious landlord will consider insolvency issues when discussing terms with a proposed new tenant. The landlord will explore whether third-party guarantees, rent deposits or security are needed, and agree all appropriate triggers for forfeiture and enforcement of these remedies. They will then monitor the position and re-assess their exposure regularly. An early and proactive approach to a tenant's difficulties may improve the outcome for the landlord.

The insolvent tenant scenario

The occupier of Unit A (an independent company) is late on rent and has not responded to the landlord's statutory demand (a preliminary step to a winding-up petition). There is no rent deposit, guarantee or previous tenant of this lease. What should be done next?

Liquidation

One approach would be to continue with the winding-up process by issue of a petition. This may frighten the tenant into paying arrears, but is not without risks.

If there is a *bona fide* dispute, the tenant can easily defeat the petition with penal cost sanctions on the landlord. The petition will freeze the business (making operation of its bank account and continuation of trade impossible without a court order) until the appointment of a responsible insolvency practitioner as liquidator (if this happens at all), by which time there will often be little left.

What there is may be snatched by those with a prior claim, such as secured creditors (like the tenant's bank) or employees (who may have preferential status), and as there are limited rights to withdraw, the process may become almost unstoppable.

Traditional remedies: distress and forfeiture

Distress (and its possible statutory replacement of commercial rent arrears recovery) is a landlord's right to remove and sell assets on the leased premises to recover rent due.

Forfeiture is the landlord's right to terminate a lease through a court application or 'peaceable re-entry' (which can often be effected by landlords going into the premises and changing the locks).

However, these routes also have limitations. Formal insolvency (particularly administration) will impose restrictions on the exercise of these rights and can be used as a tactic to defeat them.

An alternative: supporting a rescue plan

This may be to trade out of insolvency (perhaps with the protection of an administration or voluntary arrangement), an orderly realisation of assets, or a compromise with creditors.

The landlord may also be able to recover ongoing rent as a priority

In brief

- Complex issues are raised when property owners and tenants face financial difficulty.
- Risks can be mitigated by careful preparation, regular monitoring, specialist advice and flexibility of approach.
- The insolvency of a tenant may prevent a landlord exercising traditional remedies of distress and forfeiture and render aggressive debt-collection strategies unattractive.
- Insolvency procedures can be used by tenants with the intention of crystallising liabilities under unwanted leases and evading responsibility under group guarantees.

expense of administration or liquidation.

By working with the tenant rather than in conflict with it and starting the process early, it may be possible to negotiate an improved position. However, this will not always be appropriate.

Landlords need early information and a flexible attitude to find the best approach for each situation.

The unwanted lease

Unit B is held by a subsidiary of an international group of companies. The tenant has ceased trading and has no other assets or liabilities. The tenant has asked to surrender its lease and offered what the landlord considers a derisory sum. The tenant's parent says it is not prepared to commit more money and will abandon the tenant if the current offer is not accepted. This tenant is the first occupier under the lease and there is no parent company guarantee or rent deposit.

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The parent's risks

A high-profile group will prefer to avoid an insolvent liquidation. It can badly affect their reputation and credit rating, and could expose the directors to personal liability. A reminder of these risks may provoke settlement, but how should the parties approach this negotiation?

The liquidation alternative

A solvent 'members' voluntary' liquidation would avoid these risks for the parent and offer a mechanism for valuing the landlord's claim.

Liquidators and trustees in bankruptcy may disclaim an interest in leases and other 'onerous property'. This is put into effect by notice served on interested parties at any time but can be provoked by serving notice on the liquidator or trustee requiring a decision in the following 28 days. Any person suffering loss as a result of the disclaimer has a right to claim for compensation. The approach to valuing compensation on disclaimer of leases has been clarified in the *Park Air Services* case. Essentially, the landlord is entitled to claim the rent for the remainder of the term under the original lease, minus the amounts it could be expected to receive from a new tenant discounted by an appropriate amount to reflect early payment.

Rent payable under the hypothetical new lease will be a matter for expert evidence (within which there will be room for debate). Negotiation towards this position offers a logical framework for discussion without the cost and inconvenience of a formal liquidation process.

Escaping the parent guarantee

The lease of Unit C has been guaranteed by the tenant's parent company. The landlord is, therefore, relatively relaxed when the tenant falls into arrears, as the parent company is a substantial concern with many other interests. However, he is alarmed to receive a proposal for the tenant's voluntary arrangement purporting to prevent him from claiming under the guarantee.

Voluntary arrangements

A voluntary arrangement is a deal between a debtor and its creditors that, once approved by 75% of creditors (by value) and a majority of shareholders, binds all of them. A disappointed creditor can challenge the proposal on the grounds of material irregularity or that it is unfairly prejudicial to its interests, but must do so within 28 days. Clearly therefore, a creditor needs to digest the terms of the proposal early in the process and take prompt action to protect its interests.

The *Powerhouse* approach

In the recent *Prudential Assurance Co Ltd & ors v Powerhouse Ltd & Ors* [2007] a retailer with multiple outlets proposed a voluntary arrangement to restructure its business. It closed 35 shops and offered to pay 28% of arrears to all landlords regardless of whether they had a parent guarantee.

The Court decided that the proposal was not effective to release a claim by landlords against a guarantor, but it was possible to prevent a landlord enforcing a guarantee.

On the facts of this case, the proposal was considered to be unfairly prejudicial to the landlords' position. However, there were strong indications that if the voluntary arrangement has been carefully structured (perhaps with some compensatory payment to the landlords losing the benefit of a guarantee) a different outcome may have resulted. It seems highly likely that other attempts will be made to bridge this gap.

Where does this leave the landlord?

Faced with this collection of problem tenants, the landlord has difficulty paying interest on the debt he took out to buy the building. What should he do?

Take advice and then talk to the bank quickly. An early constructive discussion with stakeholders will help to find a solution that optimises value for all.

Lessons learnt

Act earlier and act quickly, with the benefit of specialist advice. This is a complicated area and there are many options open at each stage. Failure to address these choices early can limit the alternatives. ■

Christopher Moran Holdings Ltd v Bairstow & anor
[1999] UKHL 2

Prudential Assurance Co Ltd & ors v Powerhouse Ltd & ors
[2007] EWHC 1002 (Ch)