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# Insolvent Tenants & Rent Deposit Deeds

*Spring 2005*

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# Pitfalls, problems and possible solutions - for landlords with insolvent tenants

## Introduction

From a landlord's point of view, granting a lease to a tenant can be a risky business. Whether the tenant is a company or an individual, there is a risk that it may not perform its covenants under the lease. Of particular concern is whether a tenant will pay (and be able to pay) rent or service charges and whether it will treat the landlord's property with the same degree of care as the landlord would itself. There are various ways in which these risks might be lessened, such as obtaining a guarantee from a third party or entering into a rent deposit deed, but the ultimate solution always involves the risk and expense of litigation. This bulletin sets out some of the potential problems a landlord may experience should a tenant become insolvent, depending on which insolvency procedure is followed. It also considers in what circumstances the landlord's remedies of distress and forfeiture might be exercised. Finally, the bulletin considers rent deposit deeds as an alternative whereby a landlord might attempt to safeguard his position. However, this is not a detailed review of insolvency law, practice and procedure: rather the aim is to provide an overview of the salient rights and remedies at a landlord's disposal should its tenant become insolvent. The relevant legislation is in the Insolvency Act 1986 ("the 1986 Act"), which was most recently amended by the Enterprise Act 2002. This is supplemented by the Insolvency Rules 1986 ("the 1986 Rules").<sup>1</sup>

<sup>1</sup>References herein to section numbers or rules are to the 1986 Act or the 1986 Rules except where otherwise stated.

## Contents

- Voluntary Arrangements: Part I of (and Schedule A1 to) the 1986 Act for companies and Part VIII for individuals; Part I of the 1986 Rules for companies and Part V for individuals;
- Administrations: 'Old Administration' regime is Part II of the 1986 Act (being 'old' s.8 and ss.9-27) and the 'old' Part 2 of the 1986 Rules; 'New Administration' is 'new' s.8, Schedule B1 of the 1986 Act and 'new' Part 2 of the 1986 Rules<sup>2</sup>;
- Liquidations: Parts IV & V of 1986 Act, Part 4 of 1986 Rules;
- Bankruptcies: Part IX of 1986 Act and Part 6 of 1986 Rules;
- Distress and Forfeiture
- Rent Deposit Deeds

<sup>2</sup> NB There are now two section 8's in the 1986 Act, one dealing with the 'new administration' regime and giving effect to Schedule B1 to the 1986 Act and the other from the former Part II, dealing with the 'old administration' regime.

## Voluntary Arrangements

In essence, a voluntary arrangement is a contract imposed by statute between a debtor and his creditors: it is a means by which a debtor can try to avoid bankruptcy or liquidation. Usually, the debtor will put forward proposals to creditors. These proposals will be submitted to a nominee who in turn will submit a report to the court on the viability of the proposals (ss.2 and 256). The proposals will usually set out a plan of how the debtor's income and outgoings will be managed over a period of time so that there is sufficient money left to deal with the debts, either wholly or in part. A voluntary arrangement will almost certainly be of greater benefit to a creditor than forcing a liquidation or bankruptcy in which the Official Receiver's costs and other expenses can often eat considerably into any assets. However, this will only be the case if the proposal is adhered to.

The debtor's proposal must be approved at a meeting of creditors by a majority in excess of  $\frac{3}{4}$  in value of creditors who are present and voting (rr.1.19(1) and 5.23(1)). Where the creditors' meeting approves the proposal it will bind every creditor who had notice of the meeting, and who was entitled to vote at it (ss.5(2) and 260(2)).

Where the debtor is an individual, the first step for him to take usually is to apply to the court for an interim order. This application will nominate someone to act as supervisor of the arrangement (i.e. the nominee) (s.253). Where an application for an interim order is pending, a landlord cannot exercise a right of forfeiture by peaceable re-entry and the levying of any distress may be forbidden by the

court (s.254). Any proceedings pending against the debtor may be stayed or continued on terms. The same applies once an interim order is in force, and in addition, no bankruptcy petition may be presented during this time (s.252(2)). In respect of companies, there is a moratorium on proceedings against the company which lasts from the time proposals are filed with court until the meeting of creditors is held (pa. 8 of Schedule A1). The moratorium has a wider effect than an interim order (pa. 12 of Schedule A1).

### **The Approved Arrangement**

Previously, everyone who had notice of the meeting and who was entitled to vote at it was bound by the arrangement once it had been approved. Now, anyone within the class of persons eligible to vote will be bound whether or not notice of the meeting is given. Although the creditors agree to accept the proposal in satisfaction of the debt, the arrangement does not operate like an accord and satisfaction which would extinguish the debt. The proposals can be modified by the creditors but only with the approval of the debtor (s.258). The arrangement remains subject to performance by the debtor and, unless expressly stated, it does not release third parties who are also liable for the debt. Thus, original tenants, directly covenanting assignees and sureties remain potentially liable for the full debt (*Mytre Investments v Reynolds* [1995] 3 All ER 588). A landlord voting in favour of an arrangement does not thereby waive an existing right to forfeit for arrears of rent but the right to forfeit is altered so that it stands as security for his modified debt (*Re: Mohammed Naeem (a bankrupt) (No. 18 of 1988)* [1990] 1 WLR 48).

### **Future Rent**

Although it seems reasonable to conclude that future rent is liquidated or ascertained, in fact, it has been treated as if it were an unascertained amount (*Doorbar v Alltime Securities Ltd* [1996] 1 WLR 456). The same applies to service charges. Usually a landlord will be allowed to vote to the extent that rent is the subject of the arrangement, and his vote will be weighted accordingly.

### **Secured Creditors**

Any proposal or modification which affects the right of a secured creditor to enforce his security can be approved without the secured creditor's consent (s.258). A landlord's right of re-entry is not regarded as security for these purposes (*Razzaq v Pala* [1997] 1 WLR 1336).

## **Administration**

The 'old administration' regime applies to administrations which commenced before 15th September 2003 and to a number of excepted categories (s.249 of the Enterprise Act 2002), such as building societies and public utilities. The 'new administration' regime applies to administrations commencing on or after that date. The rules have also been amended.

### **'Old Administrations'**

The aim of the 'old' administration regime was to preserve the business or at least to achieve a better realisation of the assets than on liquidation ('old' s.8).

This should be contrasted with the purposes of the 'new' regime which include rescuing the company as a going concern, achieving a better result for the company's creditors as whole than would be the case on a winding up, or realising property in order to make a distribution to one or more secured or preferential creditors (pa.3 of Schedule B1).

Previously, an administrator was appointed by petitioning the court. The presentation of a petition resulted in an immediate moratorium (s.10), which continued after an order was made (s.11). This moratorium precluded a landlord from exercising any right of forfeiture by peaceable re-entry, from enforcing any security over the debtor company's property, from levying distress and from commencing or continuing any other proceedings against the debtor. However, these actions could be taken with the court's permission, subject to such terms as the court might impose, although there was no automatic entitlement to permission (*Re: Atlantic Computer Systems plc* [1992] Ch 505). Rent will generally not be paid as an expense of the administration.

### **'New Administration'**

An administrator can now be appointed by the company or directors without the need to petition the court. A moratorium on legal process and enforcement of security - similar to that in respect of the 'old administration' - will apply once a company is in administration (pa. 43 of Schedule B1). It should be remembered that an administrator is an officer of the court and has a duty to act 'in the interests of the company's creditors as a whole' (pa. 3(2) of Schedule B1), not simply in the interests of the appointer. There are three statutory objectives (pa. 3(1) of Schedule

B1) in light of which the administrator should perform his functions. There are a number of differences introduced by the 'new administration' regime and these are discussed on the next page.

First, the Crown preference has been abolished (s.251 of the Enterprise Act 2002).

Secondly, top slicing has been introduced in corporate insolvency. This is one of the major innovations of the Enterprise Act 2002 and its aim is ensure that unsecured creditors receive something from the assets in circumstances where there is a floating charge (s.176A). This only applies to floating charges created after 15th September 2003 and it does not apply where there is a fixed charge. It does not apply either where the company's net property is less than £10,000 and the office holder is of the view that the costs of distributing are disproportionate or where the assets are greater than £10,000 and the office holder applies to the court for an order disapplying the provisions on the grounds that the costs of the distribution would be disproportionate. The amount set aside is 50% of the first £10,000 of net property and 20% thereafter up to a current maximum of £600,000.

Thirdly, administrative receivers can no longer be appointed under debentures created on or after 15th September 2003 (s.250 of the Enterprise Act 2002). Instead, the holder of a 'qualifying floating charge' is entitled to appoint an administrator (pa. 14(1) of Schedule B1) without applying to the Court. A floating charge qualifies if it states that it is a 'qualifying floating charge' and purports to grant the right to appoint an administrator or an administrative receiver. The

holder of a qualifying floating charge is one who holds one or more such charges which relate to the whole or most of the company's assets. Therefore, a charge over part of the company's assets will only confer the right to apply to court for the appointment of an administrator.

There are new provisions at rule 2.67 concerning the expenses of the administration. This is the first time such provisions have been included. It may be that rent will in future rank under paragraph (f) of r.2.67 as a necessary disbursement of the administrator in the same way that it has been held to rank under paragraph (m) of r.4.218 in respect of liquidations, where premises have been used for trading purposes in the hope of realising the company's assets to better advantage (*Re: Linda Marie Ltd (In Liquidation)* (1988) 4 BCC 463).

## Liquidation

There are three types of liquidation: compulsory winding up by the court; a creditors' voluntary winding up; and a members' voluntary winding up.

### Voluntary Liquidation

There is no automatic moratorium in a voluntary winding up but a liquidator or creditor may apply to the court under s.112. Under this section, the court has power to exercise any powers which it could have exercised if the winding up had been ordered by the court: this includes the power to stay or restrain any action or proceedings under s.126.

## Compulsory Liquidation

The winding up is deemed to commence from the date of presentation of the petition. Any disposition of the company's property made after this date is void unless the court orders otherwise (s.127). The court's permission is not required to commence proceedings against the debtor company between the presentation of a petition and the making of a winding-up, and this includes forfeiture. Once an order has been made, permission is required to continue or commence proceedings (s.130), again including forfeiture by issue of proceedings. It is unclear whether this provision applies to forfeiture by re-entry. However, it has been held to include the levying of distress, and so by analogy it may well apply to forfeiture by re-entry (*Re Memco Engineering Ltd* [1986] Ch 86). The court will generally grant permission unless it would be inequitable to distrain: otherwise the distress levied will be void. Landlords need to consider whether to take proceedings or wait and see whether the liquidator uses the premises, thereby ensuring that continuing rent is paid.

A company in liquidation remains liable under the terms of a lease until disclaimed or the company is dissolved. Pre-liquidation rent arrears are an unsecured debt. Post-liquidation rent will be an expense in the liquidation if the liquidator has retained possession for the purpose of preserving or getting in the company's assets or if it is a necessary disbursement (rule 4.218 and see *Re: Linda Marie Ltd* supra).

## Bankruptcy

From the making of a bankruptcy order until discharge was formerly a period of 3 years. That has now been reduced to one year (s.279) and this change has caused a recent increase in the number of people being declared bankrupt, including an increase in petitions presented by debtors themselves. At the end of this time, the bankrupt is discharged (s.281) so that he is released from his bankruptcy debts.

The presentation of a petition does not establish a moratorium on other proceedings or action, but the court has power to stay any action, execution or other legal process against the debtor (s.285). As with compulsory liquidation, any disposition of property during the period between presentation and the making of a bankruptcy order is void. Once a bankruptcy order is made, a landlord (or any creditor) has no remedy against the debtor in respect of a debt provable in the bankruptcy and he must not commence any action against the debtor in respect of such a debt. However, this provision does not affect the right of a secured creditor and it does not prevent a landlord from exercising its right to forfeit a lease or to levy distress.

Upon the making of a bankruptcy order, the bankrupt's estate (which is defined at s.283) vests in the Official Receiver and, if one is subsequently appointed, the trustee in bankruptcy (s.306). The trustee then realises the estate and the creditors are paid *pari passu*.

## Landlords' rights: distress and forfeiture

The right to distrain for rent (distress) arises automatically out of the relationship of landlord and tenant. Generally speaking, the right to distress arises as soon as rent is overdue. A landlord may enter the demised premises and seize such chattels found there as provide reasonable security for the outstanding rent and expenses. The right to distrain is regulated by statute, in particular the Law of Distress Amendment Act 1908.

In respect of forfeiture, the insolvency or bankruptcy of a tenant is often a ground for forfeiture, depending on the terms of the proviso for re-entry. The landlord must decide whether to forfeit by peaceable re-entry or by issue of proceedings. The granting of relief under section 146 of the Law of Property Act 1925 will depend on which of sections 146(9) and 146(10) applies in the circumstances.

In summary:

**Company Voluntary Arrangement** - no forfeiture or distress without the court's permission during the moratorium (pa. 12 of Schedule A1)

**Individual Voluntary Arrangement** - no forfeiture or distress without the court's permission while an interim order is in force (s.252)

**Administration** - no forfeiture or distress without the court's permission or the consent of the administrator (pa. 43 of Schedule B1)

**Compulsory Liquidation** - distress is void (s.128) unless the court orders otherwise and it is likely that both methods of forfeiture require the court's

permission (s.130) after the commencement of the winding up

**Voluntary Liquidation** - the liquidator can apply under s.112 for the court to exercise any of the powers it has in respect of a compulsory liquidation

**Bankruptcy** - distress is limited to 6 months' arrears prior to the commencement of the bankruptcy (s.347) but there is no restriction in respect of forfeiture

## Rent Deposit Deeds

Rent deposit deeds are a useful way for a landlord to try and secure his position at the start of a lease. Although expressed to be in respect of rent, the reality is that deposits are taken for many obligations under the lease, including any damages claims arising from a breach of the covenants to repair. There are a number of different forms the deed could take including: a debtor-creditor arrangement, with or without a charge; a (quasi) trust arrangement; stakeholder.

As with all deposits, they are capable in theory of being subject to an order that they be repaid to the payer of the deposit if it is held to be a penalty: therefore the amount to be held at any time should be a genuine reflection of the tenant's potential liabilities.

A landlord will want to ensure that the monies do not belong to the tenant thereby avoiding problems which would arise on the tenant's insolvency, unless they are subject to a charge in favour of the landlord which will be effective

against a liquidator, etc. In the absence of a specific provision relating to ownership the court is likely to come to the conclusion that the monies are owned by the tenant (see **Re Chelsea Cloisters** (1980) 41 P&CR 98).

Landlords need to ensure that the mechanism for deducting sums from the deposit in the event of any default by the tenant and the mechanism for replenishing the deposit is carefully specified. The court is unlikely to hold that a deduction is valid unless it clearly falls within the wording of the relevant clause. The landlord will also need to make provision for the use of the deposit at the end of the term for any outstanding liabilities for dilapidations, otherwise the deposit may be assumed to return to the tenant. Provision should be made for the payment of any interest, to whom that interest belongs and who should pay tax on it.

Where the effect of the deed is to create a charge over the monies it should usually be registered at Companies House, otherwise it will be invalid against a liquidator of the tenant (but see the case of **Obaray** on the next page).

### Reported Decisions

There are very few reported decisions concerning rent deposit deeds. In **Hua Chao Commercial Bank v Chiaphua Industries** [1987] AC 99, the Privy Council held that the rights and obligations in the deed under consideration in that case were personal and did not run with the land and the parties' successors in title did not automatically take the benefit. Benefits therefore need to be expressly assigned in respect of a deed entered into before the coming into force of the Landlord and

Tenant (Covenants) Act 1995 (see ss.3(1) & 3(6)(a)). It is suggested, however, that even after 1996 provision should be made to include the express assignment of the benefit of the deed.

In ***Obaray v Gateway (London)*** ([2001] L&TR 20) a Deputy Judge of the Chancery Division held that where a rent deposit deed on its true construction entitled the landlord to make deductions to recover arrears of rent, the landlord was not obliged to repay the whole of the sum to the tenant's liquidator, notwithstanding that the deed was not registered under s.395(1) of the Companies Act 1985.

### ***David Nicholls***

***David Nicholls*** specialises in property and land law. He is interested in the law of real property, including easements, rights of way, restrictive covenants and markets and fairs. He also acts regularly in landlord and tenant matters, including possession claims and 1954 Act matters, as well as advising on leasehold valuation and enfranchisement cases. He acts for individuals, property companies and the banks. He is experienced in commercial and insolvency work, particularly in a property context.



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## Property @ 11 Stone Buildings

**Edward Cohen** - in the course of his general commercial and Chancery practice, he deals with commercial landlord and tenant cases including, in particular, questions of interpretation of commercial leases, rights and remedies of landlords and obligations of tenants arising out of such leases and their assignment and applications for new business tenancies and the terms of such tenancies. He also advises on other property and land issues whether involving contractual issues or more technical aspects and handles such cases when they become contentious. Cases handled involve, in particular, contracts/options for the sale of land, restrictive covenants and mortgages. In view of his wide-ranging practice, he is able to deal with property and land disputes that also involve other areas of law, including insolvency, and his commercial experience enables him to bring a commercial perspective to bear upon such disputes both in relation to the substantive disputes and to the settlement of such disputes.



**Nigel Meares** deals with problems and disputes that involve the Law of Real Property, sale of land, land registration, restrictive covenants, rights of way and other easements, adverse possession, mortgages - have been a central part of his practice since 1977. He has wide experience in litigation involving commercial and residential property, for example disputes between landlord and tenant, vendor and



purchaser, and neighbouring owners. Areas of specialist advice and drafting include freehold and leasehold conveyancing schemes and Housing Association work.

Nigel was involved in the case **West Bromwich Building Society v Wilkinson & Wilkinson** which went to the House of Lords. The decision is likely to affect thousands of negative equity borrowers who lost their homes in the recession of the domestic housing market in the early 1990s.

**Jonathan Arkush** has a wide experience in most types of disputes and litigation involving property. These include such matters as vendor & purchaser, conveyancing, title, landlord & tenant, misdescription and misrepresentation in contracts for the sale of land, auction contracts, rights of way and other easements, boundary disputes, squatters and trespassers, adverse possession and licences. He has dealt with markets and fairs, both statutory and under charter, and rights to prevent rival markets. He is frequently instructed in relation to mortgage disputes both by lenders and borrowers and has considerable experience of advising and litigation in **Barclays Bank v O'Brien** cases.



**Charles Holbeck's** experience covers the whole field of property and land law, including commercial and residential landlord and tenant disputes, manorial rights, leasehold enfranchisement, possession proceedings, mortgages, easements, restrictive covenants, options, conveyancing, boundary disputes, dilapidation claims, licences, adverse



possession, land registration, rights of co-owners, applications for sale of land, planning, trusts of land, land taxation, overage agreements, proprietary estoppel, property related negligence and insolvency, and equitable claims as they affect land.

**Sally Barber** is experienced in a wide range of chancery and commercial litigation with particular emphasis on company and insolvency law. From early in her career she gained much experience in Chancery matters with a property bias, which has proved invaluable on many occasions since when dealing with property disputes arising in an insolvency context.



**Marilyn Kennedy-McGregor** lectured on business computing at The City University Business School and ran her own computer consultancy company before coming to the Bar. Known as a forceful advocate she specialises in commercial and real estate litigation, professional negligence, family provision, contested wills and inheritance claims. She also has in recent years been building an increasingly busy planning and environmental law practice acting for major house builders and property developers.



**Adam Deacock** deals with all aspects of real property including contracts for sale of land, landlord and tenant (including rent review and leasehold enfranchisement), mortgages, restrictive covenants, easements, boundary



disputes. He is particularly skilled where property disputes arise in an insolvency context.

**Amanda Eilledge** is a property and commercial litigator. Her property work includes commercial and residential landlord & tenant, mortgages, boundary disputes, easements, adverse possession claims, restrictive covenants, options, co-ownership and leasehold enfranchisement. Amanda's commercial practice involves litigation and arbitration in areas such as contract, fraud, partnerships, financial services and sports related disputes.



She also enjoys employment law especially relating to restrictive covenants and confidential information, discrimination and claims for dismissal. In addition she deals with professional negligence claims arising out of these areas.

**Tim Cowen** practises in property litigation. He has particular expertise in landlord and tenant, including commercial leases, residential tenancies and leasehold enfranchisement. Other specialties include mortgage disputes, all aspects of real property, questions of title, conveyancing problems, property-related insolvency and professional negligence cases. He has also represented a number of local authorities in property matters and related judicial review. Tim regularly contributes to our property bulletin and lectures on commercial property topics. He was appointed Deputy Adjudicator to HM Land Registry.



**Gary Lidington** worked as a management consultant in the public sector before coming to the Bar. He specialises in all aspects of commercial and property litigation. Other aspects of his practice include professional negligence and construction and technology disputes. He is experienced in all forms of Alternative Dispute Resolution. He was a judicial assistant to the Lord Chief Justice, Lord Woolf, for a legal term in 2002. His loyal client base are testament to his practical, commercially minded, tactically astute and client-centred approach to his work.



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