INSOLVENCY UPDATE
FOR PROPERTY LITIGATORS

Presented at
The Property Litigation Association Annual Conference
at Keble College, Oxford on Friday, 22 March 2019

by

Kavan Gunaratna
Enterprise Chambers

Real estate and L&T litigation is at the heart of Kavan's practice but he is also extremely well regarded for his work in insolvency and commercial disputes.

Between Chambers UK, Chambers Global and the Legal 500, he is ranked as a leading junior in the fields of Real Estate Litigation, Insolvency and Chancery Commercial, where quotes about him have included the following:
"*unfailingly brilliant"; "one of the best barristers in the area*"
"*exceptionally user-friendly"; "a delight to work with*"; "*clients love him*"
"*highly intelligent, quick to get to the bottom of an issue, articulate and charming*"
"*has a masterful grasp of the law*" and "*as strong with strategic advice*"
"*a wonderful opponent - very able and slightly deadly*"
"*knows exactly how to present a case to a judge*" *and* "*gets amazing results*".

He is an author of '*The Landlord and Tenant Factbook*' and '*Butterworth's Property Insolvency*' amongst other publications, and has given talks to the PLA and insolvency bodies including R3 and the ICAEW.

ENTERPRISE CHAMBERS

9 Old Square
Lincoln's Inn
London WC2A 3SR

Tel: 020 7405 9471
Fax: 020 7242 1447
Email: kavangunaratna@enterprisechambers.com

So What's New in Property-Insolvency?

Introduction

1. Property litigators should be aware of 5 recent developments in the property-insolvency context. These notes provide a brief outline and structure for our review of those 5 developments during the next 45 minutes. If you are reading these notes now as we start, please stop and look up, or you will miss the detail not included in these abbreviated notes!

2. The 5 developments are:

   (1) *Re Birchen House Ltd* [2018] EWHC 1107 (Ch)
   applying *Re Alpha (Student) Nottingham Ltd* [2017] EWHC 209 (Ch)

   (2) *Re SHB Realisations Ltd* [2018] EWHC 402 (Ch)

   (3) *McDonagh v Bank of Scotland plc* [2019] 4 WLR 12

   (4) *Stockport MBC v Punj Lloyd Ltd* [2018] EWHC 3776 (Admin)

   (5) The Government Paper proposing new legislation entitled '*Insolvency and Corporate Governance*' 26.8.18.

3. Under each of those headings, we will consider the following questions:

   a) when will it be relevant to you?

   b) what was the legal context?

   c) what were the key facts? and

   d) what did it decide?

(1) *Re Birchen House Ltd* (aka *Williams v Broadoak Private Finance Ltd*) [2018] EWHC 1107 (Ch) applying *Re Alpha (Student) Nottingham Ltd* (*Eason v Wong*) [2017] EWHC 209 (Ch)

a) When will they be relevant to you?

4. *Birchen House* and *Alpha Student* may be relevant to you if you:

- if you are acting for clients who bought off-plan properties where the freeholder/developer has since become insolvent – especially where the development was never built; or

- if you are acting for a potential purchaser of the freehold development site in those such circumstances.

b) What was the legal context?

5. The cases were decided in the context of 3 sets of legal principle/ legal provision:

- First, the principles upon which purchasers may acquire a form of charge, to secure repayment of their deposits if the vendor fails to complete.

- Second, the provisions entitling purchasers to register and protect such rights.

- Third, the provisions enabling insolvency office-holders ('IPs') to sell the vendor's estate, even without the consent of purchasers holding such security rights.

6. By way of a basic recap on the first point:

- Practitioners are usually most familiar with the 'unpaid vendor's lien'.

- Less-often encountered is the disappointed 'purchaser's lien', but this will likewise arise to protect the purchaser and to help her to recover outstanding sums (such as a deposit paid to purchase a property), when the vendor has failed to complete.

- An equitable lien is a form of charge over the subject property, meaning that the holder is not just an unsecured creditor if the vendor becomes insolvent, and meaning that the holder can ask the court for an order for sale or the appointment of a receiver.

7. On the second point mentioned in paragraph 5 above, the purchase's rights may of course be protected by UN1; and if duly protected by notice, the holder would normally be able to maintain their interest in the land against subsequent purchasers.

8. On the third point, if a company enters into administration, the administrator has express statutory power to apply to the court for permission to sell the company's land as if it were not subject to any of the fixed charges which it is in fact subject to. Paragraph 71 of Schedule B1 to the Insolvency Act 1986 provides that:

   "The court may by order enable the administrator…to dispose of property which is subject to a security…as if it were not subject to the security… where the court thinks that disposal of the property would be likely to promote the purpose of administration… subject to the condition that there be applied towards discharging the sums secured by the security…the net proceeds of disposal of the property…"

   However, there is no direct equivalent in liquidation.

9. In the context of those 3 sets of principles/provisions, some important questions remained to be answered or clarified when *Birchen House* and *Alpha Student* came to be decided. In particular:

   - Whilst it was clear that a purchaser's lien could arise over specific and identifiable property, could any such interest arise (and be enforceable) when the intended property did not even physically exist, for instance because the freehold/developer had gone bust before laying one brick on site?

   - If the purchase was intended to be of a new leasehold interest which had never been created (and so did not legally exist), how could any such lien work / what would it be over?

- In what sort of circumstances could the office-holder sell the freehold title free of charges, despite the objections of an unpaid purchaser who was insisting that their UN1 would remain on the title? Could that be done in liquidation as well as administration?

c) What were the key facts?

10. In brief, in *Alpha Student*:

    - The freeholder acquired the site in 2012 with a view to constructing a block of student suites on it.
    - It sold c.130 of the intended suites off-plan to purchasers who together paid deposits totalling c.£3.2m against the promised grant of 999 year leases.
    - In 2015, the freeholder ran into financial difficulties and was placed into insolvent liquidation, without having started construction of the new block and without having created any of the intended leases.
    - The purchasers had entered UN1s to protect their rights.
    - The liquidators found a potential purchaser who would pay £1.25m for a clear freehold title.
    - Issues arose as to whether the purchasers had liens over the freehold and whether they could refuse the removal of their UN1s when they were not paid off in full.

11. In *Birchen House*:

    - The freeholder acquired the property in 2015 with a view to constructing 62 new apartments on it.
    - From 2016, it sold the intended apartments off-plan, taking deposits of typically 25% from each.
    - It also obtained loan finance secured by a mortgage, with around £4.4m advanced.
    - In 2017, it ran into financial difficulty and was placed into administration.

- The building was substantially incomplete and the leases had not been granted.
- A few of the purchasers had registered UN1.
- Offers had been made to the administrators to buy the freehold title but free of any security interests.
- The court considered whether the purchasers had enforceable liens and whether the freehold could be sold free of their interests.

d) What did they decide?

12. Did the purchasers have liens over apartments that did not even physically exist?

13. In *Alpha Student*, Arnold J. noted the previous authorities on purchaser's liens including:

    - *Hewitt v Court* (1983) 149 CLR 639 (High Court of Australia), where Gibbs CJ said "*No doubt if the construction of the building had never been commenced there could have been no lien for the deposit…*"; and

    - *Chattey v Farndale Holdings Inc* (1998) 75 P&CR 298 (CA), where Morritt LJ recorded that, in that particular case, "*…the development had advanced sufficient [sic] far when work ceased… to enable that property to be identified physically without any difficulty… [but] The question of how to give effect to a purchaser's lien in cases in which the relevant building or part does not exist does not arise.*"

14. Having noted the doubts raised in the previous case law, the decision in *Alpha* proceeded on the footing that the purchasers *did* have such liens (each sale contract having attached the draft form of lease with a floor plan showing the suite in question).

15. It should be noted, however, that this was based on a concession by the Liquidators. The Liquidators accepted that the purchasers had liens, although sought to run a separate argument (rejected by the court) that those liens were unenforceable. In *Birchen House*, the court followed *Alpha Student*, again without the point being taken.

16. The point of principle therefore remains open to a decision when fully argued, although in the meantime, in practical terms, these decisions are likely to encourage the view that liens will arise regardless of the fact that the apartments have not even been constructed.

17. What about the fact that: (i) the lien is meant to be over the legal estate being sold and purchased (e.g. the 999 year lease); but (ii) such leases had never been created? How could the purchaser's lien work in those circumstances?

18. In *Alpha Student*, the court confirmed that it did not matter that the intended leasehold title had not yet been created as long as: (i) it was identifiable; and (ii) the vendor had contracted to create it out of another estate which did exist (e.g. its freehold). The lien would then attach to the vendor's freehold title, although in theory, the lien would be limited in its geographical extent to the apartment. Likewise in *Birchen House* the purchaser's liens arose regardless of the fact that the leases had never been granted.

19. On the question of whether the office-holder could sell the freehold title free of the liens (despite their holders objecting, being unpaid, and having registered UN1s):

- *Birchen House* illustrates the court's willingness to allow Administrators to sell the freehold as if not subject to the liens under para. 71 of Sched. B1, provided the valuation evidence indicates that the sale price will correspondingly higher.

- The case of *Alpha Student* indicates that, even in a liquidation (with no equivalent express statutory power), the court may be willing to override the proprietary rights of the lien-holders and prevent them from exercising ransom rights: see the prior decision of Snowden J. on 11/12/15.

***(2) Re SHB Realisations Ltd* (formerly BHS Ltd), aka *Wright v Prudential Assurance Co Ltd* [2018] EWHC 402 (Ch)**

a) When will it be relevant to you?

20. *SHB* may be relevant to you:

- if you are acting for a landlord or a tenant in connection with the tenant’s CVA, which contains a rent concession that may be revoked in certain circumstances; and

- if you are acting for a landlord, where the tenant went into administration, the administrators retained possession and paid the passing rent as an expense, but the rent is later down the line retrospectively increased.

b) What was the legal context?

21. *SHB* was decided in the context of:

- the decision of the Supreme Court in *Cavendish Square Holdings Ltd BV v Makdessi* [2016] UKSC 67, restating the law about unenforceable contractual penalty clauses;

- the principle that a CVA operates as (or like) a contract;

- the decision in *Vivienne Westwood Ltd v Conduit Street Developments Ltd* [2017] EWHC 350 (Ch), applying the law on penalties to an apparent 'rent concession';

- the decision in *Re Game Station, Jervis v Pillar Denton* [2015] Ch 87, CA concerning the payment of rent as an expense of a company's administration.

22. By way of a very basic reminder of certain aspects of each:

- Following *Cavendish* (and *Vivienne Westwood*, as noted below), it is important to distinguish between two scenarios:

    - First, where a contracting party is under a primary obligation to do one thing (say, pay £90k per year to the other party) but in the event of a breach comes under a new/secondary obligation to do something more onerous (say, pay an extra £20k per year on top of the £90k making £110k) – in which case, that more onerous secondary obligation may be struck down as an unenforceable penalty.

    - Second, where the contracting party's primary obligation is to pay £110k per year to the other but, if and so long as he meets certain conditions (e.g. paying promptly), he can pay £20k less per year. In that scenario, no new/secondary obligation is being imposed for a breach of contract, and the rules about penalties are therefore not engaged at all just because he ends up being required to pay the £110k which was always his primary obligation anyway.

- In *Vivienne Westwood*:
  - the High Court had to interpret a side letter (entered into alongside a lease), which ostensibly provided for a rent concession against the rent stated in the lease, and which concession was terminable if the terms of the side letter were not complied with.
  - The side letter stated that in the event of its termination, “the rents will be immediately payable in the manner set out in the Lease as if this agreement had never existed”.
  - The deputy Judge decided that the tenant’s true primary obligation was only ever to pay the sums in the side letter (not the higher sums stated in the lease). Therefore, a secondary and more onerous obligation was being imposed upon the tenant in response to a breach, and that arrangement could be and was struck down as an unenforceable penalty.

- In *Re Game Station*:
  - Lewison LJ explained that “the office holder must make payments at the rate of the rent for the duration of any period during which he retains possession of the demised property for the benefit of the winding up or administration…payable as expenses of the winding up or administration”.

c) What were the key facts?

23. The key facts were as follows:
    - In March 2016, BHS proposed a CVA to reduce its rental obligations. In relation to some stores (i.e. those considered viable if a rent reduction was achieved), it proposed a rent concession of at least 25% for 3 years. This included two stores let to BHS by Prudential.
    - A clause of the CVA provided that if the CVA was terminated:
      “the compromises…effected under the terms of the CVA shall be deemed never to have happened, such that all Landlords…shall have the claims…that they would have had if the CVA Proposal had never been approved”.
    - The CVA was approved in March 2016.
    - In April 2016, BHS went into administration because of its cash flow difficulties.
    - The CVA continued in force whilst the company was in administration, with the rent being paid at the concessionary rate.

- The Administrators beneficially retained the premises for c.3 months.
- In November and December 2016, BHS entered into liquidation and the CVA was terminated for a breach of its terms.

24. Prudential relied on the clause quoted above to claim that the rent concession was revoked, and that back-rent of 25% was therefore owed (and payable as an expense).

25. However, the Liquidators claimed: that BHS's primary obligation had become an obligation to pay the varied rent; that the extra 25% was only payable because of a breach of contract and could therefore be challenged as an unenforceable penalty like in *Vivienne Westwood;* and in any case, that rent should not retrospectively be treated as an expense.

d) What did it decide?

26. In summary, the High Court decided that:

- *Vivienne Westwood* should be distinguished. In that case, the tenant did not start off paying rent at any higher original rate, given that the side letter rent was agreed from the very outset of the lease. The switch to the higher rent stated in the lease therefore did not amount to the withdrawal of a rent 'concession', but to the imposition of a new, more onerous obligation as a result of the tenant's breach, which paved the way for it to be struck down as a penalty.

- In contrast, the terms of the BHS CVA: (1) provided for a reduction in the original rent; but (2) made that reduction subject to revocation on termination of the CVA. One could not look at (1) in isolation of (2), as they went hand in hand. BHS's 'primary obligation' remained an obligation to pay the full lease rents, and the CVA entailed a true rent 'concession'. The withdrawal of that concession did not amount to a new obligation being imposed on BHS and could not therefore be a penalty.

- In any case, the law on contractual penalties could not be applied to a provision in a CVA. The fact that a CVA has 'contractual effect' does not mean that all aspects of contract law apply to it. The rules about penalties were inapt in this context because the CVA was only a deemed/ hypothetical contract.

- The back-rent should be payable as an expense of the administration for the 3 months that the administrators beneficially retained possession of the stores. It did not matter that, at the time the rent was falling due, that back rent was only contingent or in a sum yet to be ascertained.

<u>(3) McDonagh v Bank of Scotland plc [2019] 4 WLR 12</u>

a) When will it be relevant to you?

27. *McDonagh* may be relevant to you:

- If you are acting for a lender (or receivers appointed by it) which wants to bring about a sale of the mortgaged property as part of a portfolio with others; or

- If you are acting for a borrower who thinks that such a portfolio sale would achieve a poorer return than a sale of their property on its own would.

b) What was the legal context?

28. The case was decided in the context of the following:

- First, the well-known principle (identified in *Silven Properties v Royal Bank of Scotland* [2004] 1 WLR 997 CA) that, once a mortgage-lender or receiver has decided to sell the property, they owe an equitable duty to the borrower "to take care to obtain the best price reasonably obtainable for the property".

- Second, the principle that, provided the lender/receiver had exposed the property to the market and considered genuine offers for it, they would receive a degree of protection from claims they had breached that duty. The court could then focus on the steps they had taken to sell, rather than having to examine expert opinions as to the true value of the property: *Michael v Miller* [2004] EWCA Civ 282 at [141].

29. Prior to this decision – query therefore, what the lender/ receiver's exposure would be if they did not attempt to sell the property separately but instead included it as

part of one large portfolio – especially if they did not expressly turn their minds to their duty to the borrower, in doing so?

c) What were the key facts?

30. In short:

- In 2007 Mr McDonagh bought the property for c.£10m with a £7.5m RBS loan.
- In 2010, he was unable to repay the debt and the bank appointed receivers.
- By that time, following the property crash, the property was worth several £m less.
- The bank was looking to arrange a portfolio sale of a number of properties.
- In 2011, consistent with the Bank's desire, the receivers marketed the property for sale as part of a portfolio of 30+ properties, and agreed a sale of them for £41m of which c.£3.8m was apportioned to Mr McDonagh's.

31. Mr McDonagh claimed that:

- In principle, it was simply not open to the receivers to sell the property in a portfolio.

- Even if it was open to them to do so, the receivers must first have specifically analysed whether their duty to Mr McDonagh would be best served by selling his property separately or as part of a portfolio. He alleged they had failed to turn their minds to that question.

d) What did it decide?

32. In summary, the High Court decided that:

- There was no principle which made a portfolio sale automatically wrong. Some properties might be difficult to sell separately and might sell more readily in a portfolio or be exposed to a different kind of purchaser, leading to a better price. Conversely, a property might already be hugely attractive and be used as bait to increase the price of weaker properties in the portfolio.

- In each case, the lender/receiver must specifically turn their mind to whether, from the point of view of the borrower, the inclusion of the property in the portfolio would be likely to produce a better result for the borrower.

- It is not good enough for the receiver to just consider whether the portfolio sale would achieve a better result for the lender. The aggregate sale price for the portfolio might be higher but that does not mean that every individual property is better off sold in the portfolio.

- There was just about enough evidence that the receivers had considered that question and the relevant comparison (based on the legal and internal advice they received and the valuation reports they commissioned) so they were not in breach.

(4) *Stockport MBC v Punj Lloyd Ltd* [2018] EWHC 3776 (Admin)

a) When will it be relevant to you?

33. *Stockport v Punj Lloyd* may be relevant to you:

- If you are acting for a landlord who can compel the tenant's guarantor to take a new lease if the tenant becomes insolvent and the lease is disclaimed.

- If you are advising the guarantor in that scenario, especially about its potential exposure to business rates for the property after the landlord has served notice requiring it to take such a lease.

b) What was the legal context?

34. The decision was made in the context of the following:

- Section 178(4) of the Insolvency Act 1986, which provides that the disclaimer of a tenant company's lease by its liquidator "operates…to determine…the interests…of the [tenant] company in…the property…".

- The fact that, when a landlord validly serves notice on a tenant's guarantor requiring it to take a new lease, there comes into being a specifically enforceable agreement for the grant of such a lease.

- The principle in *Walsh v Lonsdale* (1882) 21 Ch D 9 that a specifically enforceable agreement for the grant of a lease should be treated as giving rise to a lease in equity even before the lease has been completed.

- Sections 45 and 65 of the Local Government Finance Act 1988, which impose business rates liability on the owner of (unoccupied) property, i.e. the person entitled to possession of it.

c) *What were the key facts?*

35. The key facts were as follows:

- In 2011, the tenant of commercial premises got into financial difficulties and entered into administration.
- It vacated the premises and purported to surrender the lease but the landlord (Padwick) refused to accept the return of the keys as a valid surrender.
- In 2013, the tenant entered into liquidation and its liquidator disclaimed the lease.
- The lease provided that:

  "if the Lease is disclaimed….the Landlord may…by notice require the Guarantor to accept…a new lease of the Premises…for…the residue…of the Term".
- In December 2013, the landlord served notice on the guarantor (Punj Lloyd) requiring it to take such a new lease.
- In April 2014, the landlord issued a claim for specific performance against the guarantor to require it to take the new lease.
- In April 2016, after the court upheld the landlord's claim, the court executed a new lease in the guarantor's name, with the term backdated to the disclaimer in 2013.

- The Council claimed c.£0.8m of business rates from the guarantor for a period before the lease was executed, on the basis that the guarantor had been liable to take such a lease for the past two years, as reflected by the term's backdating.

36. The guarantor claimed that the landlord, not it, was the person liable to the council for the rates in the period before the guarantor's lease was actually executed.

d) What did it decide?

37. In summary, the High Court decided that:

- The council needed to pursue the landlord (not the guarantor) for rates in the period before the landlord obtained specific performance of the agreement to take the new lease.

- The landlord could not rely on the *Walsh v Lonsdale* principle in this statutory rating context. If the landlord had used its legal right to take possession, the guarantor could not have claimed that it was a trespasser on the land. The landlord therefore could not claim that the guarantor was the person entitled to possession.

38. By way of footnote in the business rates context (although it is not so much of an insolvency case), see *Rossendale BC v Hurstwood Properties (A) Ltd & Others* [2019] EWCA Civ 364 – concerning one type of business rates avoidance scheme entailing the use of shell SPV tenants which are placed into members' voluntary liquidation.

(5) The Government Paper proposing new legislation: '*Insolvency and Corporate Governance*' 26.8.18

a) When will it be relevant to you?

39. The Government Paper may be relevant to you if and when:

- you are advising either a landlord or a tenant company; and

- the tenant is in financial difficulties and wishes to consider its options for a form of restructuring and wants to prevent any forfeiture/enforcement action in the meantime; and

- these proposals are adopted into amending legislation.

b) What was the legal context?

40. The Government Paper was published on 26.8.18 to set out its proposals for new legislation in response to two sets of law-reform consultations which it held: the first being the '2016 Review of the Corporate Insolvency Framework'; and the second being its 2018 consultation entitled 'Insolvency and Corporate Governance' (hot off the heals of a number of high-profile insolvencies including BHS and Carillion).

41. The 2016 Review, and the proposals arising from it, is the one of more immediate relevance here. And of those proposals, the most noteworthy for landlord was the suggestion that financially distressed companies should be able to seek a lengthy 'preliminary moratorium' during which time its creditors (very often including landlords) would be prevented from taking action against the company or its property, whilst it considered its options for rescue and/or made preparations for a form of restructuring.

42. The legal context for that included the following:

- An apparent wish by the Government to amend the Insolvency Act 1986 in a way that would promote the rescue of a greater number of viable but financially-distressed companies.

- The longstanding more debtor-centric regime in the US and the moves in the EU to legislate for greater debtor protection.

- The absence in the Insolvency Act of any meaningful provision for companies to have such a 'breathing space' to work out their insolvency options – putting aside: (i) the 'small company moratorium' under Schedule A1 when a small company was to propose a CVA; and (ii) the 10 business day moratorium which could be obtained under Schedule B1 where the company had a 'settled intention' to appoint administrators and there was a prior chargeholder to whom notice had to be given.

c) *What are the key facts/ points?*

43. The key points in Paper regarding a new preliminary moratorium ("PM") are as follows (references below to the 'tenant' are to the company in financial distress; the proposals are not restricted to companies that hold leases):

- Under the new PM regime, the tenant if eligible would get an initial period of 4 weeks in which landlords and other creditors would be precluded from taking forfeiture or other enforcement action whilst it considered its options for rescue. The period would be extendable to 8 weeks without creditor consent, or beyond that with 50% of secured and unsecured creditor consent or court order, or pending a CVA meeting of creditors.

- To be eligible for a PM:
    - The tenant must be in a state of 'prospective insolvency' such that it will become insolvent if action is not taken – however the PM will not be available to a tenant which is 'already insolvent'.
    - The tenant's rescue must be shown to be more likely than not to occur, at least in the event that the PM is invoked.
    - Importantly, the tenant must have the funds or ability to pay its debts (including its rent) as they fall due during the PM.
    - The tenant cannot have entered into a PM or an administration or a CVA in the previous 12 months, and if a creditor's winding-up petition is already pending, the court must approve any PM.

- A qualified insolvency practitioner must be appointed as 'Monitor' and must:
    - Confirm whether the tenant meets the eligibility criteria at commencement (and at the 4-to-8-week extension point).
    - Notify all creditors of the PM and register it at Companies House.
    - Terminate the PM if the eligibility criteria cease to be met.
    - Sanction any disposals of assets outside the normal course of business.
    - Refrain from acting as the tenant's administrator or liquidator within the next year, although may provide insolvency advice and supervise a CVA.

- The PM will be a largely out-of-court process, subject to creditor challenge in court. The tenant's existing board of directors will remain in control of it during the PM.

d) What did it decide?

44. The Government Paper now confirms that it will definitely seek to legislate for a PM regime in the terms noted above, 'as soon as parliamentary time permits' (!). The terms now proposed mark a shift in a number of respects from the terms of the proposals initially consulted on (e.g. as to the length of the PM, the eligibility criteria, the qualifications and role of the Monitor, and suspension of duties previously offered to directors), no doubt as a result of the consultation responses received. It is likely these new terms will command much wider support.

KAVAN GUNARATNA

Enterprise Chambers

9 Old Square

Lincoln's Inn

March 2019