International Corporate Rescue

ChaseCambria
SOUTH SQUARE
Centre for Commercial Law
UCL LAWS

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

www.chasecambria.com

Annual Subscriptions:
Subscription prices 2013 (6 issues)
Print or electronic access:
EUR 695.00 / USD 845.00 / GBP 495.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

ARTICLE

Illuminating for Insolvency Practitioners and Unsecured Creditors; But Turbulence for Landlords

Julian Cahn, Partner, Restructuring and Insolvency, Stephenson Harwood LLP, London, UK

The priority of insolvency expenses

In the course of his duties, an insolvency practitioner will incur necessary liabilities to third parties. For example, if the company continues to trade during its administration, the administrator may need to purchase raw materials, or occupy commercial premises. The costs and expenses properly incurred by an insolvency practitioner pursuant to his appointment over an insolvent estate are known as *insolvency expenses*.

A liability of the insolvent company can only rank as an insolvency expense if it falls into a number of broad, generic categories set out at: rule 2.67(1) of the Insolvency Rules 1986 (for administration expenses); or rule 4.218(3) of the Insolvency Rules 1986 (for liquidation expenses).

The significance of insolvency expenses is that they are paid out of any assets realised by the officeholder in priority to any distributions made to floating charge holders or unsecured creditors. This means that in general, post-insolvency liabilities (i.e insolvency expenses) rank in priority to the debts of creditors, incurred pre-insolvency.

The development of relevant caselaw

For over 140 years an exception to the basic rule on insolvency expenses (as outlined above) has existed, namely the '*Lundy Granite*' principle.[1] This principle relates to rent incurred pursuant to an obligation set out in a pre-liquidation lease. Although such rent is not incurred by the liquidator, where the liquidator actively retains or uses the premises (as opposed to passively holding them) for the purposes and benefit of the winding-up, rent accruing during that period of retention or use will be an expense of the winding up.

It should be noted that in *Lundy Granite* and subsequent cases,[2] the court was not saying that the liability to pay rent had been incurred as an expense of the winding up. Instead, (if the circumstances are correct) the court has on various occasions decided that as the landlord was deprived of enjoyment of the property[3] it would be 'just and equitable ... to treat the rent liability *as if it were* [emphasis added] an expense of the winding up and to accord it the same priority'[4]. In short, the landlord:

> 'must show why he should have such an advantage over the other creditors. It was not sufficient that the liquidator retained possession for the benefit of the estate if it was also for the benefit of the landlord. Not offering to surrender or simply doing nothing was not regarded as retaining possession for the benefit of the estate...'[5]

Much more recently, in *Goldacre (Offices) Ltd v Nortel Networks UK Ltd*[6] and to the further advantage of landlords, the *Lundy Granite* principle was extended to administrations, so that landlords of tenants in administration are allowed to claim rent as an expense of the administration where rent falls due during the administration and when administrators use the leasehold premises for the purposes of the administration (or, in other words, for the benefit of creditors).

Landlords of companies in either administration or liquidation therefore have the opportunity to be paid advance rent due, in priority to other creditors.

This principle, relating to rent due *before* an insolvency event, was considered in two cases decided earlier this year. As will be seen below, both decisions have eaten away at the advantage given to landlords by *Goldacre*.

Notes

1 *Lundy Granite Co, Re, ex p Heavan* (1871) LR 6 Ch App 462 (CA).
2 For example: *Progress Assurance Co* case LR 9 Eq 370; *Re Oak Pitts Colliery* (1822) 21 CD 322; and *Re Toshoku Finance UK plc* [2002] 1 W.L.R. 671.
3 'if the company for its own purposes, and with a view to the realisation of the property to better advantage, remains in possession of the estate, which the lessor is therefore not able to obtain possession of, common sense and ordinary justice require the court to see that the landlord receives the full value of the property' per James LJ in *Progress Assurance Co,* at page 466.
4 Lord Hoffman, at paragraph 27 of *Re Toshoku Finance UK plc*, summarising the conclusions of Lindley LJ in *Re Oak Pitts Colliery.*
5 *Re Oak Pitts Colliery*, per Lindley LJ at p. 329.
6 [2010] Ch 455; [2010] 2 BCLC 248.

Leisure (Norwich) II Ltd and others v Luminar Lava Ignite Ltd (in administration) and other[7]

The Luminar group operated over 70 nightclubs and bars, boasting 'the largest square footage of nightclub capacity in the country'. According to its website, the group 'operate exciting and entertaining venues where people can meet, eat, drink and dance. We strive to create memorable experiences that our customers love coming back to, over and over again'.

However, it appears that Luminar's nightclubs were not as exciting and entertaining as management boasted, because in late October 2011 administrators were appointed over various companies within the group.

The decision in *Luminar* was made in response to an application brought by landlords of various properties leased to four companies within the Luminar group that were in administration. At the time that the four companies went into administration, each of them owed rent due for payment on the September 2011 quarter day.[8] The landlords therefore applied to the court for an order that all outstanding rent for each of the four Luminar companies should be treated as an expense of the relevant administration, even though those sums became due prior to the administrators' appointment taking effect (and were therefore pre-insolvency liabilities).

His Honour Judge Pelling QC held that since, on the facts, the rent owed by each of the four Luminar companies was payable in advance and had fallen due for payment before the commencement of the administration, it was not recoverable by the landlords as an administration or insolvency expense. To clarify the position, he noted that only rent that falls due during an administration (or liquidation) period (i.e. after the relevant officeholders' appointment) is payable as an insolvency expense.

In this regard, a distinction can be drawn between *Goldacre* and *Luminar.*[9] Whilst both decisions relate to a period during which the office holder was using premises, *Goldacre* relates to rent that fell due for payment during the administration period, after the administrators had been appointed; whilst *Luminar* relates to rent falling due at a time before the administrators were in office.

Luminar therefore represents a favourable result for insolvency practitioners. The commercial significance of the decision is that it provides an incentive to appoint administrators just after a quarter day. Doing this allows them to trade the business from rented premises for the remainder of the quarter without having to pay rent. Indeed, it is perhaps no coincidence that JJB Sports plc was placed into administration on Monday 1 October 2012, the first business day after the Michaelmas quarter day on 29 September 2012. For a business leasing over 250 premises, it appears that a far better return for the general body of creditors has been achieved by ensuring that landlords were not due, as an administration expense and therefore in priority to other creditors, the final quarterly rental payment of 2012.

Luminar has attracted much criticism within the industry. The feeling is that a much fairer system, for both landlords and officeholders, would simply be to pay for what is used. In the meantime, landlords might be better served asking that rent be paid in advance on a monthly (not quarterly) basis. Whilst presumably more difficult to administer, such a change would reduce landlords' potential exposure to lost income streams. It may also help administrators, as it would make more likely the prospect of being able to agree a company voluntary arrangement in circumstances where only one or two months' worth of rent is due.[10] On the other hand, a monthly advance rental payment system would also reduce the sums that landlords might expect to receive in priority to other creditors should their tenant go into administration or liquidation before a quarter day.

MK Airlines Property Ltd (in administration) v (1) Stephen Katz and (2) John Alexander as joint liquidators of MK Airlines Limited (in liquidation)[11]

MK Airlines Property Ltd ('MKAP') is a subsidiary of MK Airlines Ltd ('MK'). MK operated a cargo airline business. In February 2007, MKAP purchased MK's

Notes

7 [2012] EWHC 951 (Ch); [2012] BCC 497.

8 In British and Irish tradition, quarter days were four dates in the year when servants were hired, and rents were due. These days fell on religious festivals roughly three months apart, and were around the start of each season. The relevant dates and their names were:

25th March – Lady Day
24th June – Midsummer Day
29th September – Michaelmas Day
25th December – Christmas Day

Today, the significance of quarter days is that they are normally the deadline days for quarterly advance payment of commercial property rent.

9 Although it should be noted that the decision is in line with the reasoning in *Goldacre* – indeed both sides in the *Luminar* case sought to rely on the decision in *Goldacre*.

10 As opposed to three months advance rent being due as per the quarter day system.

11 An unreported decision of Mr N Strauss QC sitting as a deputy judge handed down on 16 May 2012, not to be confused with the Chancellor of the High Court's decision in *Re MK Airlines* [2012] EWHC 1018 (Ch).

main operating premises at Landhurst, East Sussex and leased the property back to MK. Rent was payable on quarter days.

MK has been in various insolvency processes. Having previously been in and out of administration, it entered provisional liquidation on 22 June 2010. Subsequent to that date, MKAP made a claim against MK for rental arrears accrued during the provisional liquidation period. MKAP's claim was for two quarters of rent: rent due on the Midsummer quarter day (24 June 2010); and the Michaelmas quarter day (29 September 2010).

In a further victory for insolvency practitioners, Nicholas Strauss QC, sitting as a deputy judge, held that there was no reason why the *Lundy Granite* principle should not apply to a provisional liquidation.

However, he did not accept the submission that 'the landlord would in all cases be entitled to priority' (with regard to the payment of rent), stating that 'it will always depend upon whether or not the administrator, provisional liquidator or liquidator, as the case may be has either retained the property for the purposes of advantageously disposing of it, or has continued to use it. Doing nothing would not suffice.'[12]

Accordingly, the judge considered whether, on the evidence before him in this particular instance, the motives of the provisional liquidators of MK in retaining the lease of the premises were for the convenience or benefit of the provisional liquidation and/or the liquidation. The premises were being used to house airframes, aircraft engines, aircraft spare parts and a flight simulator. All of these assets were self-evidently heavy and therefore difficult to move. Evidence given to the court by the provisional liquidators explained that there were no cheaper premises at which these items could be housed; and in addition the costs of packing and transit would have to be paid and there was a risk that the assets might be damaged in transit. Accordingly the provisional liquidators had decided to continue to store the assets at the premises owned by MKAP.

On this basis, the judge concluded that the provisional liquidators' purposes in retaining the premises was to benefit the provisional liquidation, as they had taken the view that MK's assets would be realised more advantageously if the premises at Landhurst were retained and the relevant items stored there.

That said, the judge distinguished between rent due on the Midsummer quarter day; and rent due on the Michaelmas quarter day. Whilst the rent due on the Midsummer quarter day was not to be an expense of the liquidation, the rent due on the Michaelmas quarter day was. This was because as the provisional liquidators were appointed on 22 June 2010, the judge took the view that in retaining the lease a mere two days before the Midsummer quarter day of 24 June 2010, no motive of benefitting the provisional liquidation; and indeed no strategy for the provisional liquidation as a whole, could feasibly be established (and indeed there was no evidence that it had been established) by the time that the Midsummer rent was due. However, as the premises continued to be used up until and beyond September 2010, it was clear that by the time that the Michaelmas rent was due, the liquidators had decided that occupying the premises would benefit creditors.

In summary therefore, the provisional liquidator's motivation was critical to determining whether rent due in advance would rank as an insolvency expense. Merely taking a decision to retain and secure property on the premises did not go far enough to trigger the *Lundy Granite* principle.

That said and as stated above, the judge did find that a decision to retain the premises for the benefit of the liquidation was made at some time between the Midsummer 2010 and Michaelmas 2010 quarter days. Therefore, he also considered whether a proportion of the June-September 2010 rent should be paid by the liquidators. However, he held that there should be no apportionment for the June-September rental quarter, between rent incurred when no motive to benefit the provisional liquidation was established; and rent incurred when a motive to benefit had been established. This was in reliance on the ruling given in *Goldacre* that rent would not fall to be apportioned in circumstances where it was a term of the lease that each time that rent was payable, it was payable in full.

Possible way forward

In *Bloom v Pensions Regulator*,[13] Briggs J described the law on administration expenses as a whole as being '*a legislative mess*'. The treatment of rent as an insolvency expense seems to be a good illustration of Briggs J's point, seeing as it has the potential to lead to a tactical game on the part of insolvency practitioners regarding when to put a company into administration or liquidation. As matters stand, there seems to be no prospect for discretion and both landlords and insolvency practitioners are vulnerable to an all-or-nothing result.

Two high profile retail administrations – JJB Sports and Comet – have occurred in recent months. Similar casualties may well follow shortly. Such insolvencies represent a scenario where a large retailer owes advance rent in relation to hundreds of relatively sizeable premises; and the landlords of such premises are no doubt claiming that such advance rent constitutes an insolvency expense, as per *Goldacre*. Bearing in mind

Notes

12 Paragraph 35(c) of the judgment.
13 [2010] EWHC 3010 (Ch), also known as *Re Nortel GmbH.*

the scale of such insolvencies, the 'anti-landlord' decisions in *Luminar* and *MK Airlines* may well encourage a challenge to *Goldacre* and its interpretation of the *Lundy Granite* principle. In any event, it seems that rather than rely on the piecemeal development of caselaw with its routes in the reasoning of a Victorian judge, Parliament should provide a coherent and modern philosophy of the basis upon which insolvency expenses should be identified.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists' Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

For more information about *International Corporate Rescue*, please visit www.chasecambria.com