LAVAN LEGAL
Leaders in Law

Property Update

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The impact of insolvency on leases

This is the final article in a series of three which considers the impact of insolvency on leases. As most tenants of commercial or retail premises are companies, we will deal with corporate insolvency rather than insolvency of individuals. In this article we deal with company liquidation.

The issue of insolvency and leases is not new. However, like most fundamental issues, it goes through cycles of importance.

Steadily increasing interest rates coupled with the recent economic downturn, the current lack of credit and softness in consumer and business spending pose challenges for landlords of corporate tenants. Corporate entities are succumbing to the pressure of creditors and the repercussions of excessive debt, and the number of corporate entities entering into a form of external administration is increasing.

Insolvency of tenants has consequences with respect to the ability of landlords to:

- ensure payment of rent and recovery of arrears;

- recover possession of leased premises; and
- institute and continue legal proceedings in relation to any breaches of the lease by the insolvent tenants.

The purpose of liquidation of an insolvent company is to have an independent and qualified person (the liquidator) take control of the company so that its affairs can be wound up in an orderly and fair way for the benefit of all creditors.

A company may be placed into liquidation many ways, including the following:

- creditors' voluntary liquidation – this occurs where the creditors of the company resolve to place the company into liquidation; or
- court-appointed liquidation – this occurs where an application is made to the court that the company is insolvent and should be 'wound up' in insolvency.

The liquidation process is designed to ensure all of the assets of the company are realised and appropriate investigations

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and statutory reporting is conducted with a view to distributing the residual assets to the creditors in satisfaction of their debts. Creditors usually receive only a fraction of the value of their debt.

Sometimes a 'provisional liquidator' is appointed before a company is put into voluntary liquidation by a court. A provisional liquidator is a liquidator appointed by the court to preserve a company's assets until a winding-up application is decided.

Will the landlord continue to receive rent?

A liquidator is not personally liable for rent during the liquidation. Nor is a liquidator responsible for arrears of rent. However, if the liquidator remains in occupation of the premises of the insolvent company, the rent for this period of occupation will be a liquidator's expense. The landlord will be entitled to a higher priority payment, ahead of other unsecured creditors, pursuant to section 556(1)(a) of the *Corporations Act*, but only for the rental payable for the period of occupation by the liquidator.

A landlord will be able to prove for arrears of rent in the liquidation.

Can the landlord recover possession of the premises?

If the lease permits, the landlord may terminate the lease and re-enter the premises. A liquidator may also vacate the premises at any time.

Can the landlord commence or continue legal proceedings against the company during liquidation?

After a company goes into liquidation, a landlord can no longer commence or continue legal action against the company without the leave of the court (section 471B *Corporations Act*).

Courts will be reluctant to set in motion a chain of events which could, and probably would, give one creditor an advantage over other creditors, thereby circumventing the statutory regime.

Leave of the court is generally granted in circumstances where:

- leave is sought to obtain declaratory or injunctive relief that cannot be obtained otherwise than by a successful application to the court; or
- there is some degree of public interest in the proposed proceedings.

However, the landlord may commence legal action against any guarantors of the lease.

What happens if the liquidator disclaims the lease?

If the liquidator disclaims the lease, this terminates the tenant's rights, interests and liabilities in relation to the lease.

Disclaimer also means that the landlord can re-enter the leased premises and re-let them. It also removes the registration of a registered lease from the certificate of title to the leased premises, as the liquidator must file, serve and notify the Registrar of the notice of disclaimer (section 568C(3) of the *Corporations Act*). The disclaimer will take effect 14 days after the Registrar is notified.

If the liquidator decides to disclaim the lease pursuant to section 568(1A) of the *Corporations Act*, the liquidator will notify the landlord of this.

If a lease is disclaimed, the landlord becomes a creditor of the tenant and the landlord may prove for loss resulting from the disclaimer, as an unsecured creditor in the winding up of the company (section 568D(2) *Corporations Act*). As an unsecured creditor, the landlord is entitled to receive a rateable distribution of the proceeds arising from the realisation of the tenant's assets.

Under section 568B(1)of the *Corporations Act*, the landlord may apply to the court to have the disclaimer set aside. This application must be made within 14 days of receiving the notice of the disclaimer. The court will set aside the disclaimer only if it is satisfied that allowing the disclaimer to stand would result in the landlord suffering prejudice that is grossly out of proportion to any prejudice that the landlord may suffer if the disclaimer was set aside.

Section 568(8) of the *Corporations Act* provides that where a liquidator has yet to disclaim a lease, a landlord may make a written application to the liquidator to

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request the liquidator to either disclaim the lease or keep it on foot.

On receiving this application, the liquidator has 28 days to decide what it will do. If, at the end of the 28 day period, the liquidator has failed to disclaim the lease, then the liquidator is deemed to have adopted the lease and loses its right to disclaim it in the future.

If the liquidator decides not to disclaim the lease, under section 568(9) of the *Corporations Act*, the landlord may apply to the court and request the court to make an order discharging or rescinding the lease.

If the court allows the lease to be discharged or rescinded, it may also impose terms of damages or restitution by, or to, either party for the non-performance, as the court thinks fit.

According to *Re Tryam Pty Ltd (in liq) and the Companies Act* (1979) 4 ACLR 729 at 731, the object of this section is:

'possibly to provide the court with the power to adjust the rights of the parties to an uncompleted contract where one becomes bankrupt, since the mere bankruptcy of one party to such a contract does not itself entitle the other party to rescind it.'

Re Tryam (at 731) also refers to *Pennington, Company Law,* (4th ed), which states that:

'The Court is particularly disposed to give relief of this nature when neither the company nor the other party has carried out their obligations under the contract, and the enforcement of this contract against the other party would result in him having to perform his obligations in full, but would leave him merely with the right to prove for damages in the winding up of the company and possibly receive only a small dividend.'

Bank guarantee

It is common for a landlord to request some form of security from the tenant. This is often in the form of a bank guarantee. Liquidation will not prevent the landlord from presenting a bank guarantee. In many liquidation scenarios, bank guarantees are the only way that the landlord can actually recover for loss incurred as a result of the tenant's default or failure to perform under the lease.

Deregistration of company

A liquidation effectively comes to an end when the liquidator has realised and distributed all the company's available property and made their report to ASIC. In a creditors' voluntary liquidation, the liquidator must hold a final joint meeting of the creditors and members to give an account of how liquidation has been conducted and how company property has been disposed of. After the final meeting is held, the company is automatically deregistered by ASIC three months after a notice of the holding of the meeting is lodged.

Lavan comment

It is clear that the implications for a landlord of an insolvent tenant are significant. Landlords need to be aware of their rights and entitlements should such a situation arise. Insolvency can be a complicated process. Landlords should obtain appropriate professional advice as soon as the landlord becomes aware of the insolvency (or potential insolvency) of a tenant to ensure its position is fully protected as best as possible.

The best outcomes in insolvency situations are reached if the landlord and the tenant regard each other as partners in the enterprise. The landlord needs tenants in its buildings or shopping centres. Tenants need the landlord's premises to run their businesses and earn income.

If there is openness between the landlord and the tenants as to how their respective businesses are travelling and there is a lot of mutual good faith and understanding between them, tough economic times can be navigated quite successfully.

If you have any queries about the issues with insolvency and leases, please contact Alison Robertson, Partner, on (08) 9288 6872 / alison.robertson@lavanlegal.com.au or Peter Beekink, Partner, on (08) 9288 6751 / peter.beekink@lavanlegal.com.au.

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The following table provides a summary of key corporate insolvency issues regarding administration, receivership and liquidation, which have been discussed in our Property Update three part series 'The impact of insolvency on leases'.

	Voluntary Administration	Receivership	Liquidation
Who does the insolvency practitioner represent?	The tenant (the insolvent company) or the court.	The security holder or the court.	The tenant (the insolvent company) or the court.
Is the tenant still liable to perform its obligations under the lease, including the obligation to pay rent?	If a section 443B(3) notice is issued the tenant still remains liable for monies owed under the lease (subject to any Deed of Company Arrangement). The administrator is not liable for monies owed under the lease. If a section 443B(3) notice is not issued within five business days of the administrator being appointed and the tenant continues to use or occupy the premises, the administrator becomes liable for rent and other monies owed under the lease.	Section 419A of the Act allows the receiver seven days, after entering the premises, to notify the landlord that it wishes to occupy the premises. If a notice is sent the receiver is liable to comply with the lease. If a notice is not sent the receiver is liable until: • it retires; • the corporation ceases to occupy the premises; or • the court excuses the receiver. If the lease has not been terminated and the receiver retires, the tenant remains liable for the arrears in rent. Generally the receiver is not liable for contracts entered into before its appointment, unless the receiver has accepted liability.	If the lease is not disclaimed, the liquidator is liable for the rent under the lease. If the lease is disclaimed, the liquidator is not liable for the rent under the lease.
Can the landlord recover rent following the appointment of the insolvency practitioner?	If the landlord enters into a Deed of Company Arrangement, the landlord must claim the full amount of the unpaid rent for the remainder of the term. If the period of administration ends (without a Deed of Company Arrangement being entered into) and the tenant continues to trade the tenant will remain liable for the rent. If the tenant is wound up, a liquidator will be appointed and the recovery of rent will depend on whether the lease is disclaimed. See comments on Liquidation.	If the tenant continues to trade after the receiver has retired and the landlord has not terminated the lease, the tenant will be liable for the arrears on rent. If the tenant is wound up, the landlord must prove its outstanding rent with the other unsecured creditors.	If the lease is disclaimed, the landlord becomes a creditor of the tenant. The landlord can claim for loss under the full term of the lease. If the lease is not disclaimed, the landlord's right for rent during that period of liquidation receives priority over the debts of unsecured creditors.
Can the landlord still enforce a bank guarantee or use a security deposit following the appointment of an insolvency practitioner?	A bank guarantee or security deposit held by the landlord can be enforced or used at any time by the landlord.	A bank guarantee or security deposit held by the landlord can be enforced or used at anytime by the landlord.	A bank guarantee or security deposit held by the landlord can be enforced or used at any time by the landlord.
Can the insolvency practitioner disclaim the lease?	Although an administrator has no ability to disclaim the lease, the administrator avoids personal liability by giving notice under section 443B(3) stating that it does not intend to exercise any rights in respect of the leased premises. A section 443B(3) notice does not affect the landlord's rights against the insolvent company. Note: service of such notice accompanied by a notice to the landlord that the tenant has ceased trading constitutes repudiation which the landlord may accept as terminating the tenancy *(Lam Soon Australia Pty Ltd (administrator appointed) v Molit (No 55) Pty Ltd* (1996) 70 FCR 34).	A receiver has no ability to disclaim the lease.	Section 568(1A) of the Act allows a liquidator to disclaim the lease without the leave of the court.
What impact does a tenant's insolvency have on the guarantors of that tenant's obligations under the lease?	Personal/director's guarantees can only be enforced after the administration of the tenant has been completed (despite DOCA being entered into), unless the guarantees are from an unrelated third party.	Personal/director's guarantees can be enforced against the tenant during receivership.	Personal/director's guarantees can be enforced against the tenant during liquidation.

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	Voluntary Administration	Receivership	Liquidation
What other rights does the landlord have?	Section 440C prevents the landlord from re-entering the premises during administration (despite any provisions of the lease giving the landlord a right of re-entry) without the consent of the administrator or leave of the court. This does not apply to where the lease has already ended by the time the administrator is appointed and the landlord has already entered into premises. The landlord should, however, still issue a default notice and notice of termination, as the landlord will be able to resume possession of the premises once the voluntary administration ends, unless the lease is assigned with the landlord's consent as part of the administration process.		If the lease is disclaimed, the landlord has 14 days to apply to the court to have the disclaimer set aside. In making its decision, the court balances the prejudice caused to the landlord against the prejudice caused to the other creditors. If the liquidator has not disclaimed the lease, the landlord can write to the liquidator pursuant to section 568(8) of the *Corporations Act* and request that the liquidator disclaims the lease or keep it on foot. The liquidator then has 28 days to decide what it will do. If the liquidator does not reply within this time period, it is deemed to have kept the lease on foot and the right to disclaim is then lost. If the lease has not been disclaimed, section 568(9) of the Act allows the landlord to apply to the court for an order for the lease to be rescinded.
Can the landlord commence or continue legal proceedings?	Under sections 440B and 440D of the Act, subject to the administrator's consent or leave of the court, there is a moratorium on proceedings against the insolvent tenant and its property whilst it is in administration.	There is no moratorium on legal proceedings.	Under section 471B of the Act, subject to leave of the court, there is a moratorium on proceedings against the insolvent tenant and its property whilst it is in liquidation.
Can the insolvency practitioner assign the lease?	Subject to the provisions of the lease and any possible security over the lease, the administrator has the ability to assign the lease.	Subject to the provisions of the lease and any possible security over the lease, the receiver has the ability to assign the lease.	Subject to the provisions of the lease and any possible security over the lease, the liquidator has the ability to assign the lease.
What should the landlord do once it receives a notice that an insolvency practitioner has been appointed over the tenant?	The landlord should attend all meetings called by the administrator to ask questions and learn about the tenant's affairs.	The landlord should make enquires with the receiver in order to assess the likelihood that the tenant will be able to continue its business and if it will have the ability to fulfil its obligations under the lease.	The landlord should attend the meetings called by the liquidator to ask questions and learn about the tenant's affairs.

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