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Property Update

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The impact of insolvency on leases

This is the first in a series of three articles considering 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 the first article we deal with company administration. In the subsequent articles we will deal with receivership and 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, all 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 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.

What is 'insolvency'?

A person is 'solvent' if, and only if, the person is able to pay all that person's debts as and when they become due and payable. A person who is not solvent is 'insolvent' s95A(2), Corporations Act.

External administration

External administration (commonly called 'administration') occurs where an insolvency practitioner, an 'administrator', is appointed to take control of a company in order to maximise that company's ability to continue

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to trade or to provide a better return for its shareholders and creditors.

An administrator can be appointed:

- by the company itself;
- by a liquidator or provisional liquidator of the company; or
- by a chargee who is entitled to enforce a charge over the whole or substantially the whole of the company's property.

A 'charge' is a form of security for a debt taken by a creditor over company assets, for example, a mortgage or a fixed and floating charge.

Once an administrator is appointed, the administrator will assume control of the property and business of the company and begin investigating its affairs. The administrator will notify interested parties of his or her appointment. Within five days of the appointment, the administrator will convene and hold a meeting of creditors. Following this meeting, the administrator will continue his or her investigations in order to decide if the creditors' interests would be best served by formulating an arrangement, terminating the administration or winding up the company.

The administrator must then hold another creditors' meeting. This meeting will usually be held 21 days from the beginning of the administration, but may be extended by Court order.

When it convenes the second meeting, the administrator must send a notice to the creditors, a report of the company's affairs and a statement explaining what the administrator considers to be the best course of action for the company. If the administrator considers that a deed of company arrangement (**DOCA**) should be entered into, the statement must include details of the arrangement.

At the second meeting, the creditors can decide whether the company should execute the DOCA, the administration should end or the company should be wound up.

Proof of debt

When a company becomes insolvent and an insolvency practitioner is appointed over that company, the insolvency practitioner will contact known creditors of the company to invite them to lodge a 'proof of debt'.

A 'proof of debt' is a form completed by creditors, setting out details of their claim against the company, including how the debt arose and the amount claimed.

A landlord can lodge a proof of debt for:

- any money outstanding at the time of the appointment of the insolvency practitioner; and
- any money that becomes due for payment after the appointment and cannot be collected from the insolvency practitioner - this should include the unpaid rent for the balance of the lease term.

A claim for future money (which would otherwise have been paid by the company during the balance of the term of the lease, if the company had not become insolvent) may have to be discounted at a rate which is prescribed by the Corporations Regulations. Currently, the discount rate is 8% per year calculated to the time when the debt would have become payable according to the terms on which it was contracted (Regulation 5.6.44).

In addition to rent, this future money will also include the costs of 'making good' the premises at the end of the lease.

Priority of debts

A landlord will usually be an unsecured creditor. Priority is given to secured creditors in relation to the realisation of the company's debts.

Will the landlord continue to receive rent?

An administrator is not required to pay rent for five business days after the commencement of the company's administration. This is the 'grace period' imposed by the *Corporations Act* 2001 (cth) to enable the administrator to assess the tenant's circumstances.

After this grace period, the administrator will be liable for the rent for so long as the tenant under its control 'uses, occupies or is in possession' of the premises. This obligation to pay rent continues until:

- the administrator gives the landlord notice that the company is vacating the premises;
- the company actually leaves the premises; or
- the administration ends (whether the company actually continues to occupy the premises or not).

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The tenant will also be liable for 'making good' the premises if the premises are returned to the landlord after the administration ends or the administrator consents to the landlord retaking possession of the premises.

Can the landlord recover possession of the premises?

Most commercial leases contain clauses which allow the landlord to immediately terminate the lease and re-enter the premises once the tenant becomes insolvent.

However, by reason of s 440C of the *Corporations Act* 2001 (cth), the landlord cannot recover possession of the premises during the period of administration without a court order or the written consent of the administrator. A landlord may serve default notices but generally can only act on these once the administration has ended.

A landlord faced with an insolvent tenant who is in default should contact the administrator to:

- provide the administrator with a notice of default, in accordance with the default provisions of the lease; and
- request that the administrator consents to the landlord taking possession of the premises.

The landlord must ensure that the default notice is prepared exactly in accordance with the default provisions of the lease, and is properly served pursuant to the notice provisions of the lease.

If the administrator does not consent, and remains in possession of the premises (by leaving equipment in the premises), the landlord will either need to:

- apply to the court for orders for possession of the premises; or
- wait until the administration ends before taking steps to take possession of the premises.

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

If a company goes into administration, this has the effect of placing a stay on all existing civil proceedings against the company, except where the leave of the court or the consent of the administrator has been obtained.

No new legal action can be commenced against the company without the consent of the administrator or the leave of the court (section 440D(1) *Corporations Act* 2001 (cth)). In practice, it is very unlikely that the consent of either the administrator or the court will be obtained to either continuing or proposed legal action.

Therefore, a landlord will be unable to continue any existing action, or bring any new action, against a company in administration for the period of the administration.

Can the landlord commence legal proceedings against guarantors?

A corporate tenant will often be required to provide personal guarantees by third parties (usually the directors of the tenant) to secure the performance of the lease obligations.

However, on the appointment of an administrator, there is a moratorium that lasts until the second meeting of creditors on taking action against directors who have provided personal guarantees for the debts of the company.

While proceedings cannot be issued against directors during the moratorium, it is important for the landlord to determine its losses quickly so there is no delay in issuing enforcement action if necessary at the end of the moratorium.

In determining potential loss a landlord should consider mitigation (i.e. attempts to re-let the premises), the financial strength of the guarantor, the prospects of successfully enforcing the guarantee, the costs that may be incurred in removing the fitout, rectification and make good costs, and the rent and outgoings that would have been payable if the lease had run to expiry.

Bank guarantees and insurance bonds - can a landlord still call on them?

Tenants entering into commercial leases typically have to provide some form of surety to the landlord to cover the risk of their defaulting on the lease or the landlord having to 'make good' the premises, before offering the premises to the market.

A landlord is still entitled to call up a bank guarantee that it holds to reimburse it for rent or other costs owed by the tenant. As

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a bank guarantee is a guaranteed payment from a bank (who is a third party) it is not considered an unfair preferential payment, because the tenant is not making the payment.

Insurance bonds are not commonly used in respect of leasing transactions. One major drawback with insurance bonds is that they usually cannot be called on until the lease has been terminated. Once the lease has been terminated the landlord can call on the guarantor (the insurer) to release the bond amount. The guarantor (the insurer) will then seek recovery from the tenant to recover the bond amount paid to the landlord, plus any associated costs.

We recommend the use of bank guarantees because of the ease by which the landlord can access the money secured by the bank guarantee. We do not recommend the landlord holds security deposits. This is because such deposits are an asset of the tenant. On the insolvency of the tenant, the administration may be able to claim the security deposit as an asset subject to the administration.

Deeds of Company Arrangement

A Deed of Company Arrangement is a binding arrangement between a company and its creditors governing how the company's affairs will be dealt with. A DOCA aims to maximise the chances of the company, or as much of its business as possible, continuing, or to provide a better return for creditors than an immediate winding up of the company, or both.

As a creditor, a landlord will be entitled to vote on the future of the tenant. A landlord will receive information from the administrators in relation to the first and second creditors' meetings. The key meeting is the second creditors' meeting, which must be held within 20 business days of the administrator's appointment (see section 439A *Corporations Act* 2001 (cth)).

Landlords should carefully consider any DOCA proposals. Under section 444D(3) of the *Corporations Act* 2001 (cth), if a landlord votes in favour of a DOCA, the landlord will be bound by that DOCA.

Landlords should be aware that if the tenant's creditors decide to enter into a DOCA then (depending on the terms of the deed) the landlord usually must claim in the DOCA for the entire rent payable under the lease, including the unpaid rent for the remainder of the term. The landlord's claim in the DOCA must be qualified by the landlord's contractual and common law obligations to mitigate its loss.

However, unless the DOCA deals expressly with the lease and either the court has made an order or the landlord has voted in favour of the DOCA, the landlord's rights in relation to the lease are not affected by the DOCA.

Therefore, if a landlord does not vote in favour of a DOCA, the landlord retains its rights in relation to the premises and can take possession of the premises notwithstanding the DOCA.

If a landlord does not wish to negotiate a compromise of its rights by way of a DOCA, the landlord should not vote in favour of the DOCA.

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 they become aware of the insolvency (or potential insolvency) of a tenant to ensure their position is 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 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 Inge Lauw, Senior Associate, on (08) 9288 6905 or email inge.lauw@lavanlegal.com.au.

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Tarryn is a Solicitor in the Property Services Group.

Tarryn practices in the areas of leasing and commercial property. Her experience includes working on major acquisitions and sales of land and business as well as retail, office and industrial leasing projects.

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