LEASEHOLD ISSUES MASTERCLASS

POWERS OF LEASING AND THE EFFECT OF A SURRENDER

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1. In this presentation, I shall consider the powers of leasing and of accepting a surrender where the land is the subject of a mortgage. In particular, I shall consider this in the context of the powers of the mortgagor and then in relation to the powers of the mortgagee in possession.

2. I apologise in advance that nothing I am going to tell you in the next 40 minutes or so is terribly new; there is not much new learning on issues surrounding powers of leasing and surrender. I will, however, mention one new case which touched on these issues and in which I appeared with other members of Chambers earlier in the year.

Powers of Leasing - The Mortgagor

3. Like many other areas of mortgage work, issues concerning the powers of leasing arise in two main ways; the contractual terms of the mortgage deed and the statutory powers set out in the Law of Property Act 1925. Of course, an owner of land has a prima facie right to let it as a matter of common law. However, such a letting will not bind a mortgagee unless authorised by the statute or the contract. In Iron Trades Employers Insurance Association v Union Land and House Investors [1937] Ch 313 there was a contractual provision that the statutory power of leasing should not be exercised without the consent of the mortgagee. When a lease was granted, the mortgagee argued that this was a breach of the terms of the agreement which gave rise

to a power to sell. Farwell J held that because the lease was granted without the consent of the mortgagee, it should be taken to have been a lease granted at common law and not subject to the statutory power of leasing. Thus, whilst there was no breach of the contractual terms, the lease did not bind the mortgagee.

4. I turn then to look at the statutory power of leasing. Section 99 of the 1925 Act provides for such a power of leasing for a mortgagor. The effect of a lease granted pursuant to this power is that it will bind the mortgage lender.

5. However, s.99 is quite specific about the nature of the leases which can be granted pursuant to that section. The lease must be an agricultural or occupation lease of no longer than 50 years in length or a building lease of no longer than 999 years in length. It must take effect in possession no later than 12 months after the date of the lease and it must be for the best rent that can reasonably be obtained having regard to the circumstances. Furthermore, the lease ought to contain a covenant to pay the rent and a forfeiture clause providing for re-entry if the rent remains unpaid for a period of which 30 days is the maximum.

6. Where a lease is granted which complies with s.99, a counterpart of the lease executed by the lessee must be sent by the mortgagor to the mortgagee within one month of the lease being granted: s.99(11). A failure to comply with this provision will not invalidate the lease, however. In Public Trustee v Lawrence [1912] 1 Ch 789 it was held that a failure to comply with this provision merely triggered an immediate right to exercise the power of sale.

7. Where a lease is granted which does not comply with those terms, it is not an authorised lease for the purposes of s.99. However, such a lease will take effect in equity as an agreement for a valid lease, varied in such a way as to comply with the provisions of s.99, if it was entered into in good faith and if the tenant has gone into occupation pursuant to s.152 of the 1925 Act.

8. Section 99 expressly applies, however, only where a contrary intention is not expressed in the mortgage deed and it is, of course, usual in practice for the mortgagor's powers of leasing to be dealt with in the express agreement between the mortgagor and mortgagee. The simplest and most effective means of regulating the position from the mortgage lender's point of view is to require that the mortgagee consents to any letting of the property in advance of that letting.

9. One question which has arisen in practice on more than one occasion is whether, where a mortgagee is asked for its consent to a letting of the property, it is under an obligation not unreasonably to withhold its consent to such a letting. Doubtless, you will be familiar with the implied proviso imposed on landlords by the Landlord and Tenant Act 1927 in the case of a covenant not to assign or underlet without the consent of the landlord.

10. The position here is different depending on the nature of the property to be let. In the case of an occupier-owned residential property, the law was considered by the Court of Appeal in Citibank International v Kessler [1999] 2 CMLR 603 in the context of an

argument concerning the purported refusal of consent to a letting of an English property by a German national and whether that was contrary to Article 48 of the EU Treaty concerning the free movement for workers within the EU. The Court concluded that there was no need to imply a term that a mortgagee's consent to a letting could not be unreasonably withheld. As Chadwick LJ noted "*The term* [requiring the consent of the mortgagee] *is required, in the mortgagee's interest, to protect his security; in that it prevents the mortgaged property becoming encumbered with an unwanted tenancy which may (particularly in the case of property in residential occupation) affect adversely his ability to exercise the remedies of possession and sale. There is nothing in section 99 of the Law of Property Act 1925 (or elsewhere) which qualifies the power to withhold consent"*.

11. This position was supported by the Court of Appeal in Starling v Lloyds TSB Bank [2000] 1 EGLR 101. In that case, the point was put in a slightly different way. Counsel argued that a mortgagee has a duty to act in good faith towards the mortgagor in taking any positive action in relation to the mortgaged property. The allegation was that in considering and rejecting the application by the mortgagor to let the property, the bank had not acted in good faith. Whilst upholding the requirement for good faith, the Court of Appeal held that there was nothing in the facts of the case which showed that the bank had, to use the definition in Medforth v Blake [1999] 3 AER 97, demonstrated any dishonesty, improper motive or bad faith.

12. The law is rather different, however, when it comes to commercial premises including residential premises mortgaged for commercial purposes such as a buy-to-let

mortgage. In Commercial First Business v Atkins [2012] EWC 4388 (Ch) Judge Hodge QC held that a term could be implied into a legal charge that a mortgagee could not withhold its consent unreasonably. Like the analogous situation in the law of landlord and tenant, because the implied term is a proviso to the obligation not to let without the consent of the mortgagee, if the mortgagee does unreasonably withhold its consent to the letting, then the letting can validly proceed without the consent of the mortgagee. However, like the position in landlord and tenant law, such a failure does not give rise to a claim in damages against the mortgagee. Such a claim in damages was introduced in the law of landlord and tenant by the Landlord and Tenant Act 1988.

13. The Court also considered in detail the criteria which should be applied in determining whether consent has been unreasonably withheld by a mortgagee. Acknowledging that the issue of reasonableness is a question of fact in each case, Judge Hodge QC identified the following propositions; first, the purpose of a condition against letting without consent is to protect the mortgagee's security and ensure that it was not burdened with an unsatisfactory lease; second, the mortgagee could not refuse consent on grounds that had nothing to do with the mortgagor-mortgagee relationship with regard to the subject matter of the mortgaged security and the proposed letting; third, it is for the mortgagor to prove that consent has been withheld unreasonably rather than for the mortgagee to show that it has been withheld reasonably; fourth, the mortgagee does not have to prove that the conclusions leading him to withhold his consent are justified if they are conclusions that might have been reached by a reasonable mortgagee in the circumstances; fifth, the mortgagee might

reasonably refuse consent because he objected to the proposed tenant's intended use of the property, even if it was not a use forbidden by the mortgage; because he considered that the proposed rent was too low; or on the basis of some objectively justifiable criteria, even if they were not contained in the mortgage terms and conditions; finally whilst the mortgagee need usually only consider his own interests, there might be exceptional cases where, if consent was withheld, there would be such disproportion between the benefit to the mortgagee and the detriment to the mortgagor that a refusal would be unreasonable. If those criteria sound familiar to those of you who also practice in landlord and tenant, that's because they are almost identical to the criteria adopted in cases of that type and deriving from International Drilling Fluids v Louisville Investments .

14. It was also suggested in that case that in addition, a mortgagee might have an equitable duty to act with due diligence which extended beyond the obligation to act in good faith. The Court rejected this contention. Judge Hodge said "In my judgment, the authorities lead to the conclusion that the discretion enjoyed by a mortgagee of commercial investment property, when considering an application to let that property, is limited by concepts of honesty, good faith and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. Given that a mortgagee need usually only consider its own relevant security interests when considering an application by the mortgagor for consent to let the mortgaged property, in my judgment there is no sound foundation for imposing any more extensive equitable duties upon the mortgagee."

15. I turn now to consider the mortgagor's powers of surrender. Having granted a lease which binds the mortgagee, to what extent is it open to the mortgagor to accept a surrender of that lease. After all, it may be that it is the income stream from the lease which enables the mortgagor to be in a position to pay the mortgage instalments. Once again, we must consider both the power granted by statute and the more usual contractual position.

16. Section 100 of the 1925 Act provides that a mortgagor has the power to accept a surrender of a lease in very limited circumstances where it intends to grant a further lease to replace the lease which is being surrendered. The new lease, which must be take effect in possession within one month of the surrender, must not only comply with the requirements of s.99 at which we looked earlier but must also not be less in duration than the remainder of the term which is being surrendered and must not reserve a rent which is less than the rent which would have been payable under the existing lease if it had not been surrendered.

17. The power is therefore extremely limited in its scope and is clearly designed to protect the mortgagee against the risk that the mortgagor will remove the income stream used to pay the mortgagee. If and in so far as a surrender is to take place, the lease must be replaced by another lease which will provide an aggregate income no less than that which is being replaced.

18. Unsurprisingly, that somewhat limited provision is usually the subject of a contractual variation and one would usually expect to find a provision which either completely

prohibits a surrender of a lease or prohibits a surrender without the consent of the mortgagee.

19. An issue surrounding the surrender of leases and the effect on a mortgagee arose in the recent decision in Co-operative Bank v Hayes Freehold [2017] EWHC 1820 (Ch). In that case, the freehold owner had mortgaged the freehold interest in the property to the Co-operative Bank. There was then a lease structure comprising a head lease in favour, coincidentally, of another bank and an underlease which came to be owned by an entity in the same group of companies as the freehold. The rent, which was the same under each lease, passed from one group company, through the tenant, and back to the other group company. The idea was then floated to collapse that structure and leave the freehold owner with vacant possession. Both the freeholder and the underlessee had entered into mortgage debentures in relation to their respective interests. In each case, they had entered into covenants with the mortgagee not to surrender either of the leasehold interests without the consent of the Co-operative Bank. Notwithstanding that, a Deed of Surrender was entered into by the freehold owner, tenant bank and underlessee pursuant to which the leasehold structure was collapsed by a surrender of both leasehold interests. The tenant bank accepted that the surrender of its lease was not valid as against the Co-operative Bank, largely because of the operation of s.100 of the 1925 Act. That left the tenant bank in the position of having to continue to meet the rent payable under the lease but, potentially, without the benefit of rent being paid by the underlessee. The tenant bank therefore brought a claim against the guarantor of the underlessee (which was part of a different group of companies) contending, amongst other causes of action which are not relevant here,

that the surrender of the underlease was similarly invalid and that the guarantor of the underlessee therefore remained liable for the rent under the underlease.

20. The guarantor contended that there was nothing to prevent the surrender of the underlease taking effect pursuant to the Deed of Surrender. The tenant bank was not prevented by s.100 of the Act from taking a surrender because the tenant bank's interest was not charged. There was a covenant not to surrender without the consent of the Co-operative Bank but, by analogy with the cases where assignments of leases take place without the consent of the landlord in breach of covenant and where the assignment itself is effective to pass ownership of the leasehold interest, the surrender of the underlease should be treated as effective albeit that both the freeholder and underlessee would be liable in damages for the breach of the covenant. At trial, this analysis was accepted by the tenant bank and adopted by the Judge, Henry Carr J. The facts of this case were somewhat unusual and I accept that it is unlikely that the point will arise in practice again – not least because of the extraordinary chain of events and negligence which allowed the Deed of Surrender to be entered into in the first place – but it is certainly worth reading as a cautionary tale.

21. Having considered the powers of the mortgagor in relation to letting and accepting surrenders, I now want to look briefly at the effect on a leasehold interest of a mortgagee taking possession of a property.

22. First, a mortgagee in possession will immediately be entitled to the rents and profits from the mortgaged property. A legal mortgagee can rely on his notional lease of the

reversion to claim the rent arising under a lease granted by the mortgagor. A legal charge is put into the same position by s.87 of the Law of Property Act. Similarly, the mortgagee in possession is entitled to enforce the tenant covenants in the lease. For leases granted before the coming into force of the Landlord and Tenant (Covenants) Act 1995, the mortgagee in possession can rely on s.141 of the 1925 Act. In cases where the lease is a new lease for the purposes of the 1995 Act, s.15(1)(b) of that Act expressly provides that a mortgagee in possession has the same rights to enforce the covenants in the lease as the reversioner. A similar position exists in relation to the mortgagee in possession's obligations to comply with the landlord covenants in a lease. The mortgagee in possession is liable to comply with those covenants either pursuant to s.142 of the 1925 Act or, in the case of a new lease, by virtue of s.15 of the 1995 Act.

23. A mortgagee can take possession of a property by giving notice to the tenant requesting payment of the rent in the future. Indeed, when such a notice is given, the mortgagee's title then relates back to the date when the right to take possession first accrued, usually the date on which the mortgage was granted. That means that the mortgagee taking possession can bring a claim against a trespasser in relation to a trespass committed before his notice was actually served. Serving such a notice entitles the mortgagee not only to rent falling due in the future but also any arrears of rent which might have accrued and which remain unpaid at the date on which notice is given. A mortgagee in possession has all the remedies which the tenant would have had including distraining for the rent where that is possible.

24. When the mortgagee goes into possession of the property, that puts an end to the rights of the mortgagor in relation to that tenancy. So the mortgagor will have no right to claim the rent under any tenancy and that is the case even where the mortgagee in possession does not request the rent from the tenant. Furthermore, the mortgagee is still entitled to claim rent from the tenant where the mortgagee has gone into possession and the tenant paid the rent in advance to the mortgagor prior to the mortgagee assuming possession. This is because the mortgagee's right to the rent is not as an assignee of a chose in action but rather because of the its interest in the land. For the same reason, it is not possible for the tenant to set off a claim which it might have against the mortgagor landlord against a mortgagee in possession.

25. If the lease does not bind the mortgagee, however, then the mortgagee is not entitled to claim rent under the lease whether rent in arrears or going forward in the future. Of course, once the mortgagee takes possession, it is open to it to treat the mortgagor's tenant as its own tenant. That can happen either by express agreement or by implication by conduct or estoppel. Obviously, the main way in which this would occur would be for the tenant to pay its rent direct to the mortgagee in possession and for the mortgagee to accept that rent. However, the mere fact of payment may not be sufficient and like many "quo animo" cases, the issue will turn on all the circumstances. In one case, Paratus AMC v Fosuhene [2013]EWCA Civ 827 a mortgagee accepted payments believing that they were coming from the mortgagor whilst in reality, they were the payment of rent by the tenant. It was held that the mortgagee had not accepted the tenant as its own. Once the mortgagee adopts the mortgagor's tenant as his own, it is no longer open to it to contend that its consent was

not given and to treat the tenant as a trespasser. Once that relationship has been established, then it is open to the mortgagee to exercise all remedies which the landlord could have exercised in relation to breaches of covenant. Of course, there is nothing to prevent the mortgagee in possession from granting a new lease to the tenant if it so chooses. Alternatively, it can collect damages for trespass from the tenant and again, because the mortgagee's right is taken to have arisen from the time that its right to possession accrued, it will be entitled to mesne profits for the whole of that period, subject to any limitation defence. It should also be noted that where the mortgagor's tenant pays rent to a receiver, that will not create a direct relationship between the tenant and the mortgagee because, pursuant to s.109 of the 1925 Act, the receiver is deemed to be the agent of the mortgagor and not the mortgagee.

26. At the risk of straying into something a little esoteric now, I will just say a few words about leasehold enfranchisement and the way in which a mortgagee in possession interacts with that area of law. As you will be aware, the enfranchisement of houses is dealt with by the Leasehold Reform Act 1967 whilst for flats, the relevant law is contained in the Leasehold Reform Housing and Urban Development Act 1993. Under the 1967 Act, where the landlord's mortgagee is in possession, the lessee is given a choice by Para 9 of Schedule 3 to the Act of whether to serve its Notice of Claim on the landlord or on the mortgagee. However, even if the notice is served on the landlord, any further steps in the enfranchisement process must be taken by the mortgagee. This includes adopting the right of the landlord to avoid enfranchisement by seeking to redevelop the property with any compensation payable to the tenant being secured by the charge. Where the enfranchisement process is completed, any

conveyance which the landlord is obliged to enter into must either be entered into by the landlord at the direction of the mortgagee in possession or by the mortgagee in possession in the name of the landlord. The premium paid by the landlord will be treated by the mortgagee as proceeds of sale of the property.

27. Under the 1993 Act, the notice commencing the claim can also be given to the landlord or to the mortgagee in possession and if it is given to the mortgagee, it will be treated as having been given to the landlord. In any event, the Act imposes a duty on the person receiving the notice to serve a copy of it on the landlord or mortgagee as the case may be. As with the 1967 Act, where the mortgagee is in possession, any steps taken in the enfranchisment process must be taken by the mortgagee in possession as if it was the landlord.

28. Finally, I want to look at the powers of a mortgagee in possession in relation to leasing and taking surrenders. Broadly, these are similar to the powers we have already looked at which are given to mortgagors under the Law of Property Act 1925. Section 99 of the Act gives the mortgagee in possession the right to create a lease which complies with that section which will bind both the mortgagor and prior incumbrancers. The same rights are given to a mortgagee who has appointed a receiver under its statutory powers and the Act enables the mortgagee to delegate its powers of leasing the property to the receiver: s.99(19). By virtue of s.8 of the 1925 Act, leases can be granted by the mortgagee in possession or legal charge in possession in the name of the mortgagor.

29. So far as surrenders are concerned, the position is also broadly similar to that for a mortgagor. It should be noted, however, that s.100(10) provides that the power to accept a surrender conferred on a mortgagee in possession will not prejudicially affect the rights of any other mortgagee interested under another mortgage which exists at the date of the agreement. In addition, where the mortgagee appoints a receiver under its statutory powers, then if the receiver acts by the mortgagee, the receiver can accept a surrender. Once again, the mortgagee is able to delegate his power of surrender to the receiver.

30. In relation to registered land, s.52 of the Land Registration Act 2002 provides that the proprietor of a registered charge has all the powers of disposition conferred on the owner of a legal mortgage. So the proprietor of a legal charge in possession of the property has the power of leasing and accepting a surrender conferred by s.99 and s.100 subject to any variations contained in the charge itself. If the powers are expressly wholly excluded by the terms of the charge, then a restriction should be placed on the register to that effect.