# Help – the borrower has gone bust! How does that affect us?

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## Introduction: the Basics

1. This article seeks to provide some answers you could give if a lender client comes to you and explains that one of its corporate borrowers has entered administration or liquidation, and asks you how that will affect the lender.

2. Anyone who secretly feels a little nervous when asked about mortgages need not worry. You are in good company. In *Samuel v Jarrah Timber and Wood Paving Corpn*[1], no less a luminary than Lord Macnaghten said:

   "*no-one, I am sure, by the light of nature ever understood an English mortgage of real estate*".

3. So, it follows that the task of understanding how such a complicated creature is affected by the detailed insolvency regime is not an easy one. But, it does help to remember that a mortgage creates an interest in **property**, but is typically underpinned by a **contractual** promise to repay the debt. If the property and contractual aspects are considered separately, much falls into place.

4. Typically contractual remedies are superceded by the insolvency regime, but the lender retains its right to enforce its property rights.

5. But that is a simplification, and it is necessary to examine both aspects in a little more detail, and see what that means in practice.

6. Before we do that, there is one very important question that you need to ask the lender at the outset: did the administration / liquidation occur before or after the charge was taken?

7. If the administration / liquidation occurred **before** the charge was taken, and the charge was executed by the directors, the lender has a real problem (and so do the solicitors who acted for the lender at the time, who ought to have undertaken a

[1] [1904] AC 323 at 326.

Companies House search before completion to verify the borrower's status!). The directors had no power to execute the charge[2] so it will be void.

8. If the administration / liquidation occurred **after** the charge was given, and the charge is otherwise valid[3], what is the position?

Contractual remedies

9. Once the borrower enters administration or liquidation, the lender will generally not be able to make a claim in debt against the borrower[4]. Instead, it can prove in the liquidation / administration. It can prove even if the debt has not yet fallen due under the terms of the mortgage.

10. However, a creditor must disclose the security in its proof. If the lender does not disclose the security, and proves for the full amount of the debt, it must surrender the security, unless the Court relieves it from this obligation on the grounds that the omission was inadvertent or the result of an honest mistake[5].

11. Assuming the creditor does disclose the security, it can elect to surrender the security and prove for the full amount of the debt, but, since proving for a debt only results in the recovery of a small fraction of the debt, the best course is generally to maintain the security, and to prove for any shortfall between the amount realised or the estimated value of the security and the debt[6]. This is permissible.

Property remedies: Enforcing the Security

12. As mentioned, neither liquidation nor administration affects the existence of the security per se. Immediately following the appointment of the liquidator or the administrator, the lender will still have its charge. That remains the case throughout in a liquidation (subject to one exception where the security is leasehold considered below). But, in an administration, lenders must beware of the Court's power to order an administrator to dispose of property which is subject to a security as if it were not

[2] Insolvency Act 1986 Sch B1, para 64 and Sch 1 re administration; Re Mawcon [1969] 1 WLR 78 and Insolvency Act 1986 s 91(2) and 103 re liquidation. Note that in a voluntary liquidation, the directions may be authorised by the liquidator or the liquidation committee.
[3] And no challenges are made to the charge are made as a result of the insolvency, eg that it was a preference.
[4] In a compulsory winding up, no proceedings can be brought against the company without leave: Insolvency Act 1986 s 130(2). Leave will not be granted to enable one creditor to obtain priority over others. In a voluntary winding up, the Court is also likely, on an application by the liquidator under Insolvency Act 1986 s 112, to stay any action by one creditor which would have the effect of it obtaining priority over others. In an administration, no legal process can be taken without the permission of the administrator or the permission of the Court: Insolvency Act 1986 Schedule B1 paragraph 43(6). The same principles will apply.
[5] Insolvency Rules r 2.91 and 4.96.
[6] Insolvency Rules 1986 r 4.88 and 2.83.

subject to the security[7]. To date, to the best of my knowledge, the power has not been exercised against an arms' length lender[8], without its consent[9], and I anticipate that the Court would take some persuading that the security should be abrogated in this way.

13. So, the real question is more likely to be how the liquidation / administration affects the lender's right to enforce the security. To advise about this, there is another important question you will want to ask: had the lender already taken any steps to enforce the security before the liquidation / insolvency?

14. **Where the lender has not yet commenced enforcement**, the lender may want to seek possession and sell the security. Alternatively, it may want to appoint a receiver. Can it?

15. The first matter which needs to be checked is whether the lender is entitled to enforce the security. This depends on the terms of s 101 and 103 of the Law of Property Act 1925 and the terms of the mortgage.

16. If there is no existing entitlement to enforce the security, the lender must sit tight unless and until the relevant conditions are satisfied. If the administrator (or the liquidator, although this is less likely) pays the instalments as they fall due, so that the conditions are not satisfied, the lender may be able to do very little beyond prove for the estimated shortfall.

17. Sometimes, the mortgage deed will provide that an event of insolvency entitles the lender to enforce its security. Where the borrower is in liquidation, the lender cannot rely on such a provision to sell or appoint a receiver without the leave of the Court[10]. The application should be made in the winding up proceedings, or, in a voluntary liquidation, by part 8 claim form.

18. Furthermore, even if the lender is entitled to enforce under the terms of the mortgage, the lender will require the permission of the Court to:

[7] Insolvency Act 1986 Schedule B1 paragraph 71
[8] It was exercised against directors who had security over the company's property in *O'Connell v Rollings [2014] EWCA Civ 639*
[9] The secured creditors did consent in *Re Phones 4 U Ltd (in administration) [2014] EWHC 3571*
[10] Law of Property Act 1925 s 110 and 205(1)(i).

(1) take any proceedings against the company, including possession proceedings, if the company is in compulsory liquidation or administration[11]; or,
(2) in the case of an administration only, to appoint a receiver or sell, unless the administrator consents[12].

19. If the borrower is in compulsory liquidation, permission will generally be given – unless there is some special ground for refusing. An example might be if the liquidator has already taken steps to agree a sale which will discharge the whole of the lender's debt, or at a price which the Court is satisfied is a proper price. Otherwise, the Court will generally allow the lender to enforce its proprietary rights.

20. If the borrower is in administration, the position is less straight-forward. The Court must balance the creditor's right to its security against the aim of the administration (namely the survival of the company if possible, and if not a more advantageous realisation of the company's assets than would arise from a liquidation)[13]. The evidence in support of the application should therefore set out what prejudice the creditor will suffer if it cannot enforce its security, and in particular should deal with the value of the property, the balance outstanding and the monthly instalments. Leave is more likely to be given if it will not impede the purposes of the administration, for example if the property is not the only asset in the administration, or if the lender will suffer significant losses if leave is refused, but, if possession of the property is necessary for the continuation of the company's business, leave can be refused[14].

21. **If the lender has issued possession proceedings, but these have not yet resulted in an order,** the position is similar. The lender cannot continue with the proceedings without leave[15]. In an administration, the lender would also be precluded from selling out of Court without leave (or the consent of the administrator)[16].

**22. If the lender has possession of the Property**, it is entitled to remain as mortgagee in possession if the company is wound up[17].

[11] See f/n 4 above. Leave is not required to appoint a receiver in a liquidation (unless the only ground for doing so is the liquidation – see above): *Re Henry pound Son & Hutchins (1889) LR 42 Ch D 402; Re Potter Oils Ltd (no2) [1986] 1 WLR 201.*
[12] Insolvency Act 1986 Schedule B1 paragraph 43(2) prevents any step "to enforce security" being taken without leave or the consent of the administrator. This includes appointing a receiver: *Sinai v Hooper [2003] EWHC 910.*
[13] *Re Atlantic Computer Systems plc [1990] BCC 859 at 880*
[14] *Innovate Logistics Ltd v Sunberry Properties Ltd [2008] EWCA Civ 1321*
[15] Insolvency Act 1986 s 130(2) and Schedule B1 paragraph 43(6)
[16] Insolvency Act 1986 Schedule B1 paragraph 43(2)
[17] *In re Joyce (1874-75) LR 10 Ch App 222*

**23.** But, if the company goes into administration, the mortgagee in possession will not be able to sell, or take any other step to enforce the security, without leave or the administrator's consent. In the absence of any authority about what happens to a mortgagee in possession when an administrator is appointed, it is uncertain whether the mortgagee in possession can do anything at all.

24. **If the lender has appointed a receiver**:

(a) In an administration, the receiver must vacate office if the administrator requires him to[18]. If he is not required to vacate, probably, he cannot exercise any management power without the consent of the administrator, or take any steps to enforce the security[19].

(b) In a liquidation, the receiver remains receiver, and will remain in possession unless and until the Court orders him to give up possession. But, his powers are limited.

**A word about receivers**

25. Section 109 of the Law of Property Act provides that a receiver is deemed to be the agent of the mortgagor (unless the mortgage deed provides otherwise). Contractual powers to appoint a receiver also invariably provide that the receiver is to be the agent of the mortgagor. This provides an important protection for the lender, and is often the reason that a lender will appoint a receiver rather than taking possession itself.

26. It is therefore important to note that the accepted view seems to be that if the borrower is being wound up[20], the receiver is **not** the agent of the borrower, at least for all purposes[21]. If a receiver has been appointed prior to the liquidation, the receiver's status will change when the company is wound up[22]. In this situation, the lender will want to consider whether to terminate the receivership. That will depend on what the

[18] Insolvency Act 1986 Schedule B1, paragraph 41(2)
[19] Because the receivers acts are steps to enforce security over the company's property: Schedule B1, paragraph 43(2). The company cannot exercise any management power without the consent of the administrator: Schedule B1, paragraph 64.
[20] The position in an administration is less clear. Presumably, since the receiver cannot do anything without the administrator's consent to him exercising management powers on behalf of the company (Schedule B1 paragraph 64), if he does take any steps, he will still take those as an agent for the company.
[21] The case typically cited as authority for that proposition is *Gosling v Gaskell [1897] AC575.* For a voluntary liquidation, see *Thomas v Todd [1926] 2 KB 511*.
[22] Probably, this dates from the time when the winding up petition is presented: Insolvency Act 1986 s 129(2). This means that the receivers' agency in respect of acts done between commencement and the order being made is retrospectively invalidated.

receiver needs to do and the extent to which the lender is willing to take on liability for the receiver's acts, as we will see in a moment.

27. Similarly, if the lender has not already appointed a receiver, it will want to think carefully about whether to do so after the borrower is in liquidation. Although it is perfectly possible to appoint a receiver when the borrower is in liquidation[23], there may be no advantage in doing so – because the receiver will not be the borrower's agent in these circumstances – and a disadvantage, because the receiver will in practice have to take on liability for the receiver's acts. Let us examine both of those propositions in more detail.

Not the borrower's agent

28. The receiver will not be able to enter fresh contracts on behalf of the borrower. This also means that the receiver cannot grant leases, because the receiver cannot impose any fresh obligations on the borrower.

29. But the receiver probably can give good receipts for rent due under existing leases[24], even if the borrower is in liquidation and he is not operating as the borrower's agent. So if there is an existing sub-lease, and the mortgagee simply wants the receiver to collect the rent, appointing a receiver might be the right course.

30. Also, if the mortgage deed includes a power of attorney empowering the receiver to sell the mortgaged property in the name of the borrower, the receiver can still sell the property on behalf of the borrower[25]. Land Registry will treat a transfer executed by a receiver after a winding up as conferring good title[26] .

31. It follows that, before advising the lender whose borrower is in liquidation whether to appoint a receiver, you need to know what the lender proposes that the receiver should actually do, to ascertain whether he will be able to do it.

Liability for the receiver's acts

32. A well advised receiver will require the lender to provide a full indemnity before accepting an appointment, particularly where the borrower is in liquidation (in case he

[23] *In re Northern Garage Ltd [1946] Ch 188*
[24] Law of Property Act 1925 s 109(3). This appears to be independent of the deemed agency created by s 109(2), not least because of the reference to a power to demand rent in the name of the mortgagee.
[25] *Sowman v David Samuel Trust [1978] 1 WLR 22*
[26] Land Registry Practice Guide 36A paragraph 3.3.

is personally liable for his acts), and in some cases the receiver will be found to be acting as the lender's agent instead[27].

Procedural point

33. If the lender does decide to proceed with appointing a receiver, the receiver will require the Court's permission to take possession of the property from a Court appointed liquidator or any administrator[28]. Permission should be given as a matter of course[29].

**Special Considerations Affecting Leasehold Securities**

34. If the security is a leasehold estate, the lender will want to know if there is any danger that the lease can be brought to an end as a result of the liquidation / administration, and if so, what impact that will have on its position.

35. Consideration therefore needs to be given to the law relating to disclaimer and forfeiture.

Disclaimer

36. A liquidator (in a compulsory or voluntary winding up) can disclaim "onerous property"[30]. This includes a lease which contains covenants on the part of the tenant which are yet to be performed[31]. Of course whether the liquidator will in practice disclaim will depend largely on whether sufficient value could be realised by assigning the lease to cover any liabilities.

37. The liquidator does not require the leave of the Court to disclaim. He disclaims by filing a notice containing the prescribed information at Court[32]. The Court must seal and endorse the notice[33].

38. A copy of the endorsed notice must be provided to the lender within 7 business days[34]. The disclaimer will take effect 14 days after service of that notice[35] - unless

[27] For example, *Amercian Express v Hurley (1986) 2 BCC 98993*
[28] *Re Henry Pound Son & Hutchins (1889) LR 42 Ch D 402; Schedule B1 paragraph 5.* If the lender requires leave to appoint the receiver, he can apply to the Court for permission for the receiver to take possession from the liquidator at the same time. Otherwise, the application should be made in the existing proceedings.
[29] *Re Potters Oils [1986] 1 WLR 201 at 206*
[30] Insolvency Act 1986 s 178. An administrator does not have such a power.
[31] *Eyre v Hall [1986] 2 EGLR 95*
[32] Insolvency Rules r4.187
[33] ibid

before then an application is made[36] for a vesting order. The mortgagee can make such an application[37], but generally it is not in its interest to do so. For, the disclaimer operates to determine the rights, interests and liabilities of the company in and in respect of the property disclaimed, but does not affect the right or liabilities of any other person[38]. This means that the disclaimer does not bring the leasehold estate to an end, or destroy the charge per se. If a vesting order is made, the lease will be vested in the mortgagee, so that the mortgagee will be liable for the tenant's lease covenants. This may include liability for completed breaches which existed at the commencement of the winding up[39]. Generally, the mortgagee will not want to apply for a vesting order.

39. However, the landlord[40] may apply for an order vesting the leasehold estate in the lender, so that it has someone "on the hook" to perform the tenant's covenants in the lease. If there is a sub-tenant, the landlord may apply against the sub-tenant instead, but where there is not, a well advised landlord will make such an application. This will have the effect of putting the mortgagee to his election: either he must accept the vesting order, or he will be excluded from all interest in the property[41]. Since the liquidator is unlikely to have disclaimed if the lease had a value, the mortgagee must consider this carefully.

Forfeiture

**40.** The other way in which a lease can sometimes be brought to an end as a result of insolvency is forfeiture. That is the subject of a separate paper, by Adam Rosenthal. All that needs to be said about it here is that just as the lender requires leave before issuing proceedings against a company in compulsory liquidation or administration, or before taking other steps to enforce against a company in administration, the landlord will also require permission to take forfeiture proceedings against a company in compulsory liquidation or administration. It will also require permission if it wishes to forfeit by peaceable re-entry against a company in administration, unless the administrator consents to the re-entry[42].

[34] Insolvency Rules r 4.188(2)
[35] Or, the last such notice, if there are multiple people with derivative interests
[36] Under s 181 of the Insolvency Act 1986
[37] And can in fact do it for up to 3 months after it knew of the disclaimer: Insolvency Rules r4.194
[38] Insolvency Act 1986 s 178(4)
[39] Or, at the Court's discretion, he may be treated as if the lease had been assigned to him immediately before the commencement of the winding up: Insolvency Act 1986 s 182(1)

[40] *In re Finley, ex p Clothworkers' Co* (1888) L.R. 21 Q.B.D. 475
[41] Insolvency Act 1986 s 182(4)
[42] Schedule B1, paragraph 43(4)

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