Playing second fiddle?

Priority in mortgage receivership: Cecily Crampin, Tricia Hemans & Imogen Dodds examine distribution of funds & multiple receivers

IN BRIEF

- Priority between those potentially entitled to a proportion of funds coming into the hands of a receiver.
- Issues of priority arising where there are multiple lenders and multiple receivers.

Playing second fiddle can be awkward at the best of times, but in the world of mortgage receivership, the creation of multiple charges and being one of two receivers appointed in respect of debts secured over the same asset can generate both practical and legal conundrums. This article considers the issues of priority between those potentially entitled to a proportion of funds coming into the hands of a receiver, and also issues of priority arising where there are multiple lenders and multiple receivers.

Priority when distributing funds

Distribution of income

The receiver's obligations in respect of monies received as income will depend on the source of the power which led them to receive the money and the type of funds received. Where a receiver is exercising a statutory power in accordance with the Law of Property Act 1925 (LPA 1925), the position is (unless contrary provision is made in the mortgage) governed by s 109(8) which provides a hierarchy of payments to be made as follows:

1. to discharge rents, taxes, rates and outgoings affecting the mortgaged property;
2. in keeping down all annual sums or other payments, and the interest on all principal sums, having priority to the mortgage under which the receiver was appointed;
3. in paying the receiver's commission, insurance policies and doing any necessary or proper repairs directed in writing by the lender;
4. in payment of the interest accruing due in respect of any principal money due under the mortgage;
5. in or towards discharge of the principal money if so directed in writing by the lender; and
6. the residue is to be paid to the person who, but for the possession of the receiver, would have been entitled to receive the income of which the receiver has been appointed, or who is otherwise entitled to the mortgaged property.

In theory, this should be straightforward to apply; however, the legislation is not crystal clear on the very real practical problem of what to do when there are insufficient funds available to pay everyone in a particular category.

It would seem that the best approach is to pay sums in relation to prior charges in order of priority with pro rata payments made in relation to those in other categories. The statute does not explicitly compel the receiver to pay each person entitled in full and as such, it would seem sensible to hold money back from those in inferior categories until satisfied that there would be enough money to pay those in earlier categories in full for everything that they will be entitled to.

In some cases, it may well be that the receiver has powers to collect income in addition to the statutory authority. This would enable the receiver to rely on the terms of the mortgage when deciding how to distribute income. Often times mortgages will simply follow the statutory regime but in some instances, alternative provisions are made. See for example, *Hale, Re, Lilley v Foad* [1899] 2 Ch 107, where a receiver who was authorised under the mortgage to carry on the borrower's business was held to be authorised to pay business debts in priority to payments due under the statutory regime.

Distribution of sale proceeds

The position can also be different in relation to sale by a receiver. If the receiver exercises the borrower's right to sell, this will not be an exercise of a statutory power (the statute refers only to the collection of income). The correct order of distribution of sale proceeds would therefore need to be determined by properly construing the terms of the mortgage. However, in many cases, this will follow the statutory scheme under s 109(8) either in whole or in part.

The costs of sale can present difficulties as these are not explicitly included in the statutory hierarchy. In *Marshall v Cottingham* [1982] Ch 82, the mortgage expressly stated that the costs of sale were to be paid before the statutory hierarchy came into play. The judge accepted that there was 'some force' in the argument that otherwise, the costs of sale would have to come out of the receiver's commission, as part of the 'costs, charges, and expenses' referred to in s 109(6), although was 'far from convinced' that that was correct.

Where the receiver exercises the lenders' power of sale, it seems likely that the mortgagee regime under s 105, LPA 1925 applies. This requires proceeds of sale to be distributed in the following order:

1. discharging any prior incumbrances to which the sale is not made subject;
2. paying all costs, charges and expenses properly incurred by the mortgagee as incident to the sale or any attempted sale; and
3. discharging the mortgage money, interest and costs and any other monies due under the mortgage;

with the residue to be paid to the person entitled to the mortgaged property, or authorised to give receipts for the proceeds of the sale thereof.

If there is a dispute or uncertainty as to distribution, it is open to the receiver to

make a stakeholder application to the court for directions under CPR 86.

Priority between multiple receivers

Further issues arise when multiple chargeholders over a single property each appoint a receiver. The obvious point to make is that the rights, and the powers of the receivers appointed, will depend on the priority of their respective charges. However, that only takes us so far, and does not provide a complete answer.

Let us take a scenario where O mortgages his property to the first chargeholder A and the second chargeholder B. So long as A remains silent (ie does not seek to enforce their charge), B is free to appoint receivers or pursue such other remedies as they see fit—although of course if receivers are appointed they must apply all monies received in accordance with the principles considered above.

What if A then decides to appoint their own receiver and does not wish to appoint the same person as B? Because A's charge has priority over B's, B's interest in the property (and right to possession) is and always has been encumbered by A's charge, and therefore to the various enforcement powers thereunder. B's receiver cannot interfere with A's receiver exercising the latter's powers (this would appear to follow from the principle in *Bayly v Went* (1884) 51 LT 764, which confirmed a receiver could injunct the borrower from distraining). It follows that A and their receiver will be able to displace B and the receiver B appointed.

But what exactly does A need to do as a matter of procedure to achieve that? And what do we mean by 'displacement' (the word conveniently used in many of the authorities, possibly because it avoids engaging with this question). Is B's receiver discharged by the appointment of A's? And what if A or the receiver they appoint deals with the property in a way which B does not consider to be in their best interests—does B have any rights of recourse?

Does A need to apply to court?

If there is already a receiver appointed over the property, does A need the court to sanction the appointment of their receiver, or can they simply rely on their powers under the charge (or alternatively under statute)?

The answer to this will depend on whether the receiver appointed first in time was in fact appointed by the court. Because it is a contempt to interfere with an officer of the court—which the court-appointed receiver would be—carrying out their duties, A will need to obtain leave before they can appoint receivers themselves (or go into possession)—*Pound (Henry) Son and Hutchins, Re* (1889) 42 Ch D 402 (albeit leave will likely be granted pretty much as a matter of course).

However, if the order appointing the first receiver was expressly subject to the prior incumbrancer's rights, then no application is needed (*Underhay v Read* (1887) 20 QBD 209). In practice an application will often be made anyway.

Several authorities confirm that if A makes such an application, and the earlier receiver is displaced, that displacement will be backdated to the date on which A's application was served so that the mortgagee is not prejudiced by procedural delay at court. As a result, any monies paid to the receiver from that point onwards will be held for A (*Preston v Tunbridge Wells Opera House Ltd* [1903] 2 Ch 323; *Metropolitan Amalgamated Estates Ltd, Re, Fairweather v Metropolitan Amalgamated Estates Ltd* [1912] 2 Ch 497; and *Belbridge Property Trust Ltd, Re, Swale Estates Ltd v Belbridge Property Trust Ltd* [1941] Ch 304).

If the receiver already in situ was not court-appointed, then it seems that no application by A is necessary. Although there is no clear authority confirming this, it seems to be analogous to the cases where the appointment was via order of the court but an order expressly subject to the rights of the prior incumbrancer. This is because the charge under which the non-court-appointed receiver was appointed was itself subject to the rights of the prior encumbrance.

Is B's receiver discharged by the appointment of A's receiver?

As already noted, many of the cases describe what happens to B's receiver when A's receiver is appointed as them being 'displaced'. But does it follow that they are necessarily discharged—or are their powers merely suspended, such that if the receivership initiated by A terminated, no further appointment would be necessary and B's receiver could continue?

There seems to be no automatic discharge of B's receiver, although there is very little analysis of this in the cases (perhaps unsurprisingly, given it will not matter so long as A's receiver remains in office).

Limited support for this can be gleaned from *Bass Breweries Ltd v Delaney* [1994] BCC 851, which rather unusually involved two fixed chargeholders who had executed a deed of priority by which they agreed their charges, over a pub, would be ranked equally. Each subsequently invoked its powers to appoint a receiver, but the receivers appointed by one of the charges (W) took possession first. The other chargeholder (B) sought an order restraining the exclusion of its receivers, or alternatively the appointment of an independent receiver by the court. It was held not to be open to them to exclude B and ultimately determined that there should be a court-appointed receiver instead.

In *Bass*, there is no suggestion that the appointment of a receiver by one chargeholder precluded the other from appointing its own. While this was a case involving two chargeholders with equal priority, it does lend support to the view that what matters is the terms of the mortgage under which the receiver is appointed. Unless the second charge expressly provides for the receiver's discharge upon an appointment by a prior incumbrancer, then there does not seem to be any good reason why that would automatically end the appointment.

Does B have any rights of recourse?

Finally, what if B does not approve of the action proposed by A's receivers, and considers that it may jeopardise the recovery of monies outstanding under their own loan. Is there anything B can do?

A, and their receivers, do owe duties to B, but these are limited. A mortgagee (or receiver) owes no duty in negligence to a subsequent mortgagee (*Downsview Nominees Ltd v First City Corpn Ltd* [1993] AC 295). Instead, its duties are equitable, and limited to:

(i) acting in good faith and for proper purposes; and
(ii) taking reasonable care to obtain a proper price.

If A is in breach of those duties, B can seek damages, or possibly injunctive relief, but that is a high bar.

It is of course always open to a subsequent chargeholder (as a person interested in the equity of redemption of the first charge) to redeem a prior encumbrance. Alternatively, B (again as a person interested in the equity of redemption—*Alpstream AG v PK Airfinance Sarl* [2015] EWCA Civ 1318) could seek an order for sale under s 91, LPA 1925, although in practice a court may well be reluctant to interfere with A's exercise of their rights of enforcement under their charge where nothing improper or unusual is occurring.

As such, B's options are limited. While this may seem harsh from B's perspective, it does have to be borne in mind that B's interest in the property is and always has been subject to A's better rights as prior encumbrancer with only the equitable duties for protection. That was the security B bargained for, and that is the security to which they are entitled. NLJ

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