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Rights of tenants and landlords in insolvency

Two recent Victorian decisions have clarified the legal principles applied by the courts in relation to tenants' and landlords' rights in an insolvency administration:

1. Administrators commonly apply for extensions of the convening period for the purpose of extending the moratorium. Often, extensions of the moratorium aim to allow the administrators (or, through them, secured creditors and their appointed receivers) to effect a sale of a business, with its leasehold intact, as a going concern. However, the recent decision in *IMO Colorado Group Limited* [2011] VSC 552 should serve as a warning to administrators and receivers that the courts will not necessarily prevent landlords from re-entry onto premises leased by the company in administration.
2. Often a liquidator of a landlord may wish to sell property unencumbered, including by any leasehold interests. Liquidators have wide powers to disclaim 'onerous property'. However, following *Willmott Forests Ltd (Receivers and Managers Appointed) (In Liq) & Ors* [2012] VSC 29, liquidators of landlords cannot disclaim a lease with the effect of extinguishing the tenant's leasehold estate or interest in land, due to the both contractual and proprietary nature of leases.

IMO Colorado Group Limited

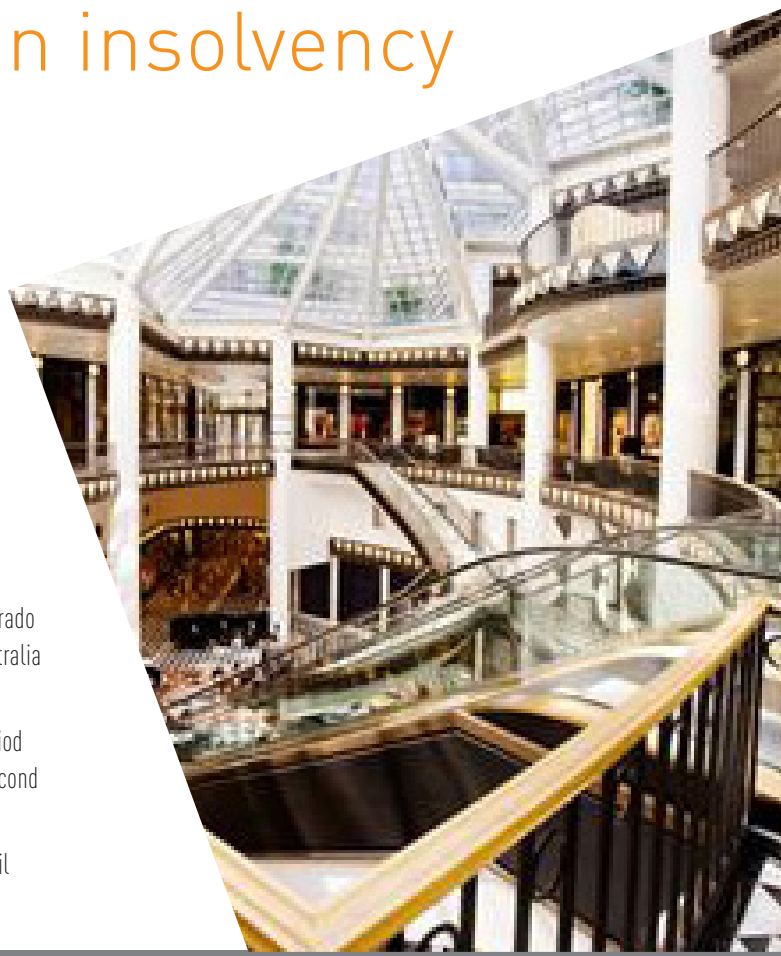
Background

The landlords of Westfield Southland and Westfield Carousel, made application for leave of the court under section 440C of the *Corporations Act 2001* (Cth) (**Act**) to enforce their rights to possession of two retail premises within their shopping centres that were leased by the tenant, Colorado Group Limited (Administrators Appointed) (**Colorado**).

The Colorado group commenced administration on 30 March 2011, reportedly owing $440 million to primary secured lenders, $20 million to unsecured lenders and $13 million in employee entitlements. The group comprised 10 companies, of which Colorado was the main contracting entity, with stores located in both Australia and New Zealand.

In May 2011, Colorado had been granted an extension to the period within which the administrators were required to convene the second meetings of creditors of the entire group, until 3 February 2012.

The Colorado lease at Westfield Southland commenced on 3 April 2006, for a five year term. The parties undertook negotiations



for renewal, but no subsequent agreement was reached. The term expired on 2 April 2011, a few days after administration commenced.

The Colorado lease at Westfield Carousel commenced on 4 October 2004, for a five year term. The term was extended twice, with the last extension expiring 17 May 2011. It was confirmed on 16 March 2011 that Colorado would not be offered another premises within the shopping centre.

Both Westfield Southland and Westfield Carousel had made other arrangements regarding the premises occupied by Colorado. Westfield Southland had entered negotiations with a prospective tenant to lease the Colorado premises at Westfield Southland, who was temporarily placed in another location within the shopping centre as a result of the administrators' hold over the property. Westfield Carousel arranged for the premises of Colorado at Westfield Carousel to be subdivided into two tenancies, and re-fitted to be leased to two new tenants. The subdivision and fit out had been postponed following the commencement of the administration.

The proceedings

The court was asked to consider the following issues:

1. notwithstanding the status of a lease agreement, whether tenants under administration are entitled to withhold possession of property from a landlord by virtue of s 440C; and
2. whether the interests of tenants under administration and the interests of creditors generally, outweigh the interests of landlords.

Section 440C of the Act provides that during the administration of a company, the owner or lessor of property that is used or occupied by, or is in the possession of, the company, cannot take possession of the property or otherwise recover it, except:

- with the administrator's written consent; or
- with the leave of the court.

Section 440C falls within Part 5.3A of the Act and its application must fall within the expressed objectives set forth in s 435A, namely that the business, property and affairs of an insolvent company are to be administered in a way that:

- maximises the chances of the company, or as much as possible of its business, continuing in existence; or
- if it is not possible for the company or its business to continue in existence, results in a better return for the company's creditors and members than would result from an immediate winding up of the company.

The decision

Associate Justice Gardiner of the Supreme Court of Victoria held that:

- landlords bear the onus of proof of persuading the court that the leave should be granted, given they are the parties seeking it;
- leave should only be granted if it does not contradict the objective of the administration, in this case Part 5.3A. Both stores made up only a minor percentage of the undertakings of Colorado and there was no evidence to suggest such contradiction;
- the prohibition on landlords taking possession of property leased to parties under administration should be relaxed if the prohibition would be inequitable. In this case the leases had expired and so the goodwill of Colorado (interpreted as a feature of s 435A) diminished, while the prohibition under s 440C remained inequitable as against the landlords;
- it is necessary to balance the interests of the parties. In doing so, the benefit to unsecured creditors should not be at the expense of parties seeking to exercise proprietary rights. The creditors in this case would receive no benefit from rejecting the application for leave, whereas the plaintiffs would suffer ongoing financial loss;
- loss is assessable with regard to a non exhaustive list of factors including the: expected timeframe of the

administration proposed by the administrators; ability to pay rent while in administration or after; impact on the financial position of the company. Applying these to the present circumstances – given the unsecured creditors were unlikely to receive dividends, current rentals were being paid by receivers, and the administrators' proposals would not include arrangements with the plaintiffs as a result of the expiration of lease agreements – the receivers and administrators were not successful in demonstrating a negative effect on the likelihood of Colorado entering into a deed of company arrangements if the leave were granted;

- assessing the probability of the suggested consequences, it was more probable than not that the losses faced by Westfield Southland and Westfield Carousel exceeded those of Colorado; and
- the conduct of the parties did not suggest unethical behaviour.

The loss to the plaintiffs was significant, in that it outweighed the loss incurred by Colorado, and was vital to the granting of leave. As the plaintiffs were unable to lease the premises to the intended new tenants, they were losing receivable income. The court agreed to grant leave to the plaintiffs in taking possession of their respective premises.

Willmott Forests Limited

Background

Willmott Forests Limited (**WFL**) follows Timbercorp, Great Southern and Enviroinvest in the recent spate of large agribusiness managed investment schemes collapsing. Like many of those schemes, WFL was the responsible entity/manager of several managed investment schemes that conducted agricultural operations on land either owned by WFL or leased by WFL from third parties. WFL entered into lease and licence agreements with the members of the scheme (known as 'Growers'), who had rights to grow and harvest trees on the land.

Upon their appointment, the liquidators of WFL entered into agreements to sell the freehold land, unencumbered by the Growers' rights. When the Growers refused to give up their rights, the liquidators obtained approval from the Federal Court to amend the scheme constitutions and other documents to enable WFL to terminate the Growers' rights and disclaim the lease and licence agreements pursuant to s 568 of the Act. The Federal Court expressly left open the question of whether such a disclaimer would be effective to extinguish the Growers' leasehold estate or interest in the subject land. The liquidators applied to the Supreme Court for judicial advice on this question.

The position at law

Section 568 empowers liquidators to disclaim certain property of the company, including contracts, land burdened with onerous covenants and property that is difficult to sell. Liquidators cannot disclaim a contract (except an unprofitable contract or a lease of land) without approval of the court. Section 568D(1) provides that the effect of a disclaimer is to terminate the company's rights, interests, liabilities and property 'for or in respect of' the disclaimed property, but the rights of other parties are not affected 'except so far as is necessary in order to release the company or its property from liability'.

Counsel for the liquidators submitted that the effect of a disclaimer of a lease is that the tenant's leasehold estate ceases to exist.

The decision

Justice Davies in the Supreme Court of Victoria rejected this submission, stating that:

> *'[it] fails to give due regard to the position in law that a lease creates both contractual and proprietary rights. A lease is a contract between the parties but a lease is also the grant by the landlord of an estate in land in the tenant, which is a different estate in land to the landlord's freehold estate. The leasehold interest is a legal estate of which the tenant is the owner.'*

Her Honour held that a disclaimer of a lease by the liquidator of a landlord would only terminate the rights, interests, liabilities and property of the landlord, but would not bring the lease to an end for all purposes. Importantly, the tenant's proprietary rights in the land would continue to subsist. Unless a resolution was reached by 15 January, the conditions precedent for the sale of land would not be met and the sale would fall through. The liquidators would then face a new round of negotiations with the Growers to give up their rights.

The decision is a significant victory for tenants, and may cause difficulties for liquidators, particularly where the subject company has a sizable property portfolio or recalcitrant tenants. Liquidators should review carefully the property portfolio of companies to which they are appointed and be mindful that they are unable to evict tenants merely by disclaiming the lease as onerous.

Conclusion

The above decisions clarify the rights between landlords and tenants where one party becomes insolvent. The decisions in effect may preserve the pre-existing proprietary rights of parties to a lease during an insolvency administration.

(Please **click here** for an article written by Jamie Bedelis – Senior Associate and member of our Commercial Property team – on a recent decision of the Victorian Civil and Administrative Tribunal (**VCAT**), where VCAT found that a landlord was entitled to terminate a lease upon the bankruptcy of the tenant's guarantor.)

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