Administration Expenses

Joanne Rumley, Bond Pearce Solicitors
Stephen Davies QC, Guildhall Chambers

Pre-amble

Earlier this year, the following postscript appeared in Insolvency Intelligence (2010) Vol 23 p.47:

"Administration expenses – what priority for lawyers' fees?

Hamish Anderson wrote his interesting article "Insolvent insolvencies" 17 (2001) IL & P 87 sometime prior to the global economic crash and even before administrations had been revamped to become the rescue procedure of choice. Nearly ten years on, internally insolvent administrations - where the costs and expenses of the administration exceed the assets in the estate - are more commonplace. The statutory scheme expressly recognises this possibility by providing the court with power under r.2.67(2) and (3) to re-order the statutory priority of expenses in cases where there is an insufficiency of assets to meet them.

A first issue in such cases is to be identify where in the statutory pecking order for expenses any particular expense should sit. This is not always an easy question to answer. The operation of the expenses regime has been the subject of cases such as *Re Toshoku Finance*, *Exeter City Council v Bairstow*, *Sunberry Properties* and *Goldacre*. But more questions remain than have been answered. The principal cause of the uncertainty is the clumsy grafting of r.2.67 on to (what is now) paragraph 99 Sch B1 to IA 1986 in conjunction with the subsequent introduction of r.2.67(4) – which placed the expenses listed in r.2.67(1) into paragraph 99(3).

Practitioners grapple daily to find the true effect of this amalgam but there are few easy answers, and often room for two views. It is not just a question of when expenses can safely be paid but also in what order they should be paid. Take a common example. An administrator instructs a firm of solicitors to provide legal services to him as administrator.

The starting point ought to be to rely on the reasonable inference that, by adopting for rule 2.67 the similar terms of the long-standing liquidation rule - rule 4.218 - the intention was that it should carry the same meaning (i.e. wherever such solicitors' fees would be payable under r..4.218, they should fall within the equivalent sub-paragraph of r.2.67).

But there is no equivalent of paragraph 99 in liquidation and, further, in certain crucial respects r.2.67 is differently worded to r.4.218.

The solicitors will wish to establish that their fees should be afforded super-priority under paragraph 99(4) as: "a sum payable in respect of a debt or liability arising out of a contract entered into by the former administrator."

In the alternative, they might contend that they come in at the top of the next league of priorities as: "expenses properly incurred by the administrator in performing his functions in the administration of the company" within r.2.67(1)(a). The applicability of that sub-rule might require a court to decide between the conflicting views expressed as to its ambit between David Richards J in the *Exeter* case (who suggested that its application was very narrowly defined) and those of HHJ Purle QC in *Goldacre* (who afforded to it a more expansive interpretation).

Others, jockeying for position, might wish to relegate the payment of solicitors' fees down to r.67(1)(f) : "any necessary disbursements by the administrator in the course of the administration" or (g): "the remuneration or emoluments of any person who has been employed by the administrator to perform any services for the company, as required or authorised under the Act or the Rules."

Each of these interpretations has its difficulties and none of the provisions fits easily. In the only reported decision to address the issue - *Re a Company (no 005174 of 1999)* – Neuberger J came down in favour of super-priority for the solicitors fees. But that was prior to the enactment of r.2.67 (and then r.2.67(4)). In other words, he was asked to construe only (what are now) paragraph 99(3) and (4) and to decide between the wording of those two sub-paragraphs. Nevertheless, the answer might well be the same today. What reflects poorly on the legislative scheme is that we cannot be certain. To compound matters, it would appear that the comprehensive proposed changes to the rules will not involve an ironing out of these creases."

This paper seeks to expand on this theme but with more emphasis on the question whether administrators are liable to pay rent and other leasehold liabilities as an expense.

Introduction

1. Any insolvency lawyer worth his or her salt appreciates that this is a complicated topic. Prior to the coming into force of the EA 2002, the application and operation of the rules which govern whether any particular item may rank as an administration expense were uncertain. The new regime introduced by that Act and subsequent amendments to it have increased the uncertainty. It would be a rash practitioner who expressed a perfect understanding of it.

2. This has been underlined by the decision of HHJ Purle QC in *Goldacre (Offices) Limited v Nortel Networks UK Limited* [2009] EWHC 3389 (Ch) in which the court decided, probably for the first time after full argument, that rent falling due under a pre-administration lease should be treated as an expense of the administration under r.2.67(1)(f) IR 1986 (or, possibly, r.2.67(1)(a)) in any case where an administrator is using part of the demised premises beneficially for the purposes of the administration. The decision has already caused some flushing amongst insolvency professionals. Quite apart from the judge's evident dislike for parts of previous decisions of David Richards J[1] in Exeter and the CA[2] respectively, the judge has grafted the *Lundy Granite* principle onto r.2.67 in circumstances which it is considered could, without further refinement, constitute a considerable blow for rescue operations in the middle market.

3. First, it is necessary to remind ourselves of the rather strange statutory regime.

Expenses of administration: Paragraph 99 of Sch B1 IA 1986 and Rule 2.67 IR 1986

4. The expenses of administration are set out in paragraph 99 schedule B1 to the Insolvency Act 1986 ("para 99") and Rule 2.67 Insolvency Rules 1986 ("rule 2.67").

5. Para 99 is entitled "Vacation of office: charges and liabilities" and provides:

> "99(1) This paragraph applies where a person ceases to be the administrator of a company (whether because he vacates office by reason of resignation, death or otherwise, because he is removed from office or because his appointment ceases to have effect).
>
> 99(2) In this paragraph—
>
> > "the former administrator" means the person referred to in sub-paragraph (1), and
> >
> > "cessation" means the time when he ceases to be the company's administrator.

[1] In *Exeter City Council v Bairstow* [2007] BCLC 236
[2] In *Sunberry Properties Ltd v Innovate Logistic Ltd* [2009] 1 BCLC 145

99(3) The former administrator's remuneration and expenses shall be—

(a) charged on and payable out of property of which he had custody or control immediately before cessation, and

(b) payable in priority to any security to which paragraph 70 applies.

99(4) A sum payable in respect of a debt or liability arising out of a contract entered into by the former administrator or a predecessor before cessation shall be –

(a) charged on and payable out of property of which the former administrator had custody or control immediately before cessation, and

(b) payable in priority to any charge arising under sub-paragraph (3).

99(5) Sub-paragraph (4) shall apply to a liability arising under a contract of employment which was adopted by the former administrator or a predecessor before cessation; and for that purpose—

(a) action taken within the period of 14 days after an administrator's appointment shall not be taken to amount or contribute to the adoption of a contract,

(b) no account shall be taken of a liability which arises, or in so far as it arises, by reference to anything which is done or which occurs before the adoption of the contract of employment, and

(c) no account shall be taken of a liability to make a payment other than wages or salary.

99(6) In sub-paragraph (5)(c) "wages or salary" includes—

(a) a sum payable in respect of a period of holiday (for which purpose the sum shall be treated as relating to the period by reference to which the entitlement to holiday accrued),

(b) a sum payable in respect of a period of absence through illness or other good cause,

(c) a sum payable in lieu of holiday,

(d) in respect of a period, a sum which would be treated as earnings for that period for the purposes of an enactment about social security, and

(e) a contribution to an occupational pension scheme."

6. Rule 2.67(1) provides:

"(1) The expenses of the administration are payable in the following order of priority–

(a) expenses properly incurred by the administrator in performing his functions in the administration of the company;

(b) the cost of any security provided by the administrator in accordance with the Act or the Rules;

(c) where an administration order was made, the costs of the applicant and any person appearing on the hearing of the application and where the administrator was appointed otherwise than by order of the court, any costs and expenses of the appointor in connection with the making of the appointment and the costs and expenses incurred by any other person in giving notice of intention to appoint an administrator;

(d) any amount payable to a person employed or authorised, under Chapter 5 of this Part of the Rules, to assist in the preparation of a statement of affairs or statement of concurrence;

(e) any allowance made, by order of the court, towards costs on an application for release from the obligation to submit a statement of affairs or statement of concurrence;

(f) any necessary disbursements by the administrator in the course of the administration (including any expenses incurred by members of the creditors' committee or their representatives and allowed for by the administrator under Rule 2.63, but not including any payment of corporation tax in circumstances referred to in sub-paragraph (j) below);

(g) the remuneration or emoluments of any person who has been employed by the administrator to perform any services for the company, as required or authorised under the Act or the Rules;

(h) the remuneration of the administrator agreed under Chapter 11 of this Part of the Rules;

(j) the amount of any corporation tax on chargeable gains accruing on the realisation of any asset of the company (without regard to whether the realisation is effected by the administrator, a secured creditor, or a receiver or manager appointed to deal with a security).

(2) The priorities laid down by paragraph (1) of this Rule are subject to the power of the court to make orders under paragraph (3) of this Rule where the assets are insufficient to satisfy the liabilities.

(3) The court may, in the event of the assets being insufficient to satisfy the liabilities, make an order as to the payment out of the assets of the expenses incurred in the administration in such order of priority as the court thinks just.

(4) For the purposes of paragraph 99(3), the former administrator's remuneration and expenses shall comprise all those items set out in paragraph (1) of this Rule."

7. Combining both para 99 and rule 2.67 (and omitting the expenses not relevant for present purposes) gives the following order of priority:

a. A sum payable in respect of a debt or liability arising out of a contract entered into by the [former] administrator (para 99(4)).

b. The [former] administrator's remuneration and expenses payable in the order (para 99(3)):

i. expenses properly incurred by the administrator in performing his functions in the administration of the company (rule 2.67(1)(a)).

ii. any necessary disbursements by the administrator in the course of the administration (rule 2.67(1)(f)).

iii. the remuneration or emoluments of any person who has been employed by the administrator to perform any services for the company, as required or authorised under the Act or the Rules (rule 2.67(1)(g)).

iv. the remuneration of the administrator agreed under Chapter 11 of Part 2 of the Rules (rule 2.67(1)(h)).

v. the amount of any corporation tax on chargeable gains accruing on the realisation of any asset of the company (rule 2.67(1)(j)).

8. The order can, of course, be altered by the court if it there are insufficient assets to satisfy all the expenses and it considers it just to do so under rule 2.67(3). Note : there is no power in the court to re-order the expenses which fall within the super priority of para 99(4) of schedule B1.

9. Although at first sight the application of the order of priority may appear simple, there are a number of inherent difficulties:

a. para 99 applies retrospectively i.e. it applies on the vacation of office by the administrator. Therefore the question arises as to the order of expenses payable during the course of the administration. Are they to be applied in the same order? Or should they be paid out as and when they arise leaving the strict order of priority to be applied to only those expenses which remain unpaid when the administrator vacates office.

b. if they are to be applied in the same order during administration as they are when the administrator vacates office (and in our opinion they are), how is an administrator to deal with paying an expense in one of the lower categories if it is not certain whether there will be sufficient funds to pay an expense in one of the higher categories? Should an administrator wait until he vacates office to ascertain a final list of expense creditors or at least until there is certainty as to the extent of expenses and realisations? A deficiency as regards expenses will not usually arise because it will be apparent at the outset that there will be sufficient funds to pay all the expenses, in which case they can be paid as they arise. The issue arises on the rare (but increasingly occurring) occasion when there are insufficient funds to cover all the expenses in full.

10. In order to resolve these questions it is necessary to examine briefly the history of these provisions.

11. Para 99 effectively re-enacted s19 IA 1986 with minor changes in wording (which are thought to be a modernisation of the language and for present purposes are not considered to be significant). This was achieved with effect from 15th September 2003 by Part X of the Enterprise Act 2002 and at the same time as the introduction of schedule B1 into the Act. Para 99(3) corresponds to s19(4) and para 99(4) corresponds to s19(5). Prior to the introduction of para 99 there was no equivalent to rule 2.67. Rule 2.67 also came into force on 15th September 2003. Consequently, the expenses of administration pre-15th September 2003 were "debts and liabilities incurred ... under contracts entered into by [the administrator]" and "remuneration and any expenses properly incurred by [the administrator]" under what are now paras 99(4) and 99(3) respectively. There was no prescribed list of expenses and the generally held view was that the administrator had a discretion as to which expenses to pay and in which order. The decisions of the Court of Appeal in *Re Atlantic Computer Systems plc* [1990] BCC 859 and the House of Lords in *Centre Reinsurance International Co v Freakley* [2006] UKHL 45 support this view.

12. The question which expenses fell within s 19(4) and which fell within 19(5) arose often in practice but was seldom addressed in the reported case law. However, the issue arose directly for determination in *Re a Company (no 005174 of 1999)* [2000] 1 WLR 502,

involving the payment of solicitors' fees for legal advice given to the administrator. Neuberger J took the view that:

> "As a matter of language it seems to me that a payment by the liquidator for legal advice falls equally naturally within the expressions "expenses properly incurred by him" and also "debts or liabilities incurred under contracts entered into by him." In my judgment, legal expenses properly incurred by an administrator in connection with his duty or role as an administrator fall within section 19(5), and not within section 19(4), as a matter of construction....
>
> "It seems to me that section 19(4) and (5) are best reconciled by limiting the expenses falling within subsection (4) to those which are not within subsection (5) . The administrator may for instance use petrol, stationery, stamps and other items which he or she cannot say were incurred pursuant to contracts which fell within section 19(5), as no contract was entered into by the administrator in respect of them save when the petrol, stationery or stamps were bought which may have been before the administration or for general purposes. However, the expenditure would, as I see it, be recoverable under section 19(4). This produces to my mind a more consistent correlation between subsections (4) and (5). In my judgment, section 19(4) applies to cases where the administrator is entitled to recover sums other than under contracts he or she entered into on behalf of the company, i.e. his or her remuneration, and outgoings which cannot be said to fall within section 19(5)." (at page 514)

13. Neuberger J. therefore gave precedence to s19(5). Expenses incurred by the administrator would fall within s19(5) and if they could not be brought within the wording of this section they would fall within the residual category of s19(4). In this regard it is to be noted that the expenses in rule 2.67(1) are very narrow and cannot be described as liabilities arising out of a contract (with the possible exception of those within 2.67(1)(g)) such that, if an expense can be categorised as a liability arising out of a contract, it falls within para 99(4)). In particular, the expenses in 2.67(1)(a) were held by David Richards J in *Exeter City Council v Bairstow* [2007] EWHC 400 (Ch) to be restricted to "...typically small items such as travel expenditure ... ". These roughly correspond to those found by Neuberger J in *Re a Company (no 005174 of 1999)* to fall within s19(4) namely "...petrol, stationery, stamps and other items ...". However, HHJ Purle QC doubted this proposition in *Goldacre* (see paras 9 and 10). This may not be regarded a moot point and it is a very important one in any case where there is an insufficiency of assets from which to pay all expenses.

14. The other expenses listed in 2.67(1) are:-

i. the costs of security provided by the administrator (2.67(1)(b));
ii. the costs of any applicant for an administration order (2.67(1)(c));
iii. the costs of the preparation of the statement of affairs (2.67(1)(d));
iv. necessary disbursements which include statutory liabilities i.e. corporation tax (*Toshoku*) business rates (*Exeter City Council v Bairstow*) and, in our opinion, VAT (2.67(1)(f));
v. the remuneration and emoluments of employees (2.67(1)(g));
vi. the remuneration of the administrator (2.67(1)(h)); and
vii. corporation tax on chargeable gains (2.67(1)(j)).

15. In parallel to these decisions on administration expenses, the HL decided in *Kahn v IRC, Re Toshoku Finance (UK) Ltd* [2002] UKHL 6 that, as far as liquidations were concerned, rule 4.218 gave an exhaustive list of expenses, holding that there was no discretion as to how they were to be applied. The task of the liquidator was to ascertain into which category an expense fell and to apply the rules as to priority accordingly.

16. There are a number of theories as to why rule 2.67 was introduced. The predominant one is that when the administration regime was recast it allowed administrators to make distributions to be made to creditors thus obviating the need for liquidation. Such distributions would be permanent, giving rise to the need to identify a similar regime for the

priority of expenses as that obtaining in liquidation. It is also understood that HMRC were concerned that this would allow the administrator to pay distributions following payment of expenses, which were considered to be at the discretion of the administrator, and would thus allow the administrator to make a distribution to creditors whilst at the same time excluding debts due to HMRC. Given that Parliament made it clear that it was intended that the administration procedure should become the "insolvency procedure of choice", it was considered necessary to make the administration expenses regime mirror that of liquidation so that the choice between the two should only be influenced by commercial factors and not other factors such as differences in the way the two regimes were taxed.

17. However, the introduction of rule 2.67 was not tied into para 99 and, to the extent that para 99 appeared to allow a discretion (following the decisions on s19) as compared to the strict order of priority provided for in rule 2.67, the two sets of provisions appeared to be contradictory. The apparent contradiction was resolved with effect from 1 April 2005 when rule 2.67(4) was added - providing that the administrator's remuneration and expenses mentioned in para 99(3) are those set out in rule 2.67 (Insolvency (Amendment) Rules 2005 (SI 2005/527), r.8).

18. The order of priority in rule 2.67 is obviously based on that set out in rule 4.218 for liquidations; however, liquidations have no equivalent to the priorities set out in para 99. This, in turn, gives rise to number of questions: first, is there any discretion left as to the payment of expenses in administration?; secondly, if rule 2.67 mirrors rule 4.218 and expenses previously in s19(5) (now para 99(4)) are now subsumed into the categories in rule 2.67, what expenses are now left in para 99(4) - other than employment contracts adopted by the administrator which are specifically provided for in 99(5)?

Judical interpretation

19. Some of these issues were addressed by David Richards J in *Exeter City Council v Bairstow* [2007] EWHC 400 (Ch), a case involving business rates. It had previously been held in *Freakley* that what was or was not an expense was a question for the administrator subject to the supervision of the court. Lord Hoffmann said:

> "The provisions of s.19(4) and (5) entrust to the administrator (subject to the supervision of the court) the power to decide what expenditure is necessary for the purposes of the administration and should therefore receive priority. But there is no reason to extend that priority to expenditure which neither the administrator nor the court has specifically approved."

20. On this basis, under the old regime, business rates were not an expense of administration. However, in the *Toshoku Case* it was held (again Lord Hoffmann) that the case of *Re Kentish Homes Ltd* [1993] BCLC 1375, in which a post-liquidation liability to pay the community charge was held not to be an expense of liquidation, was wrongly decided. Consequently, a liability to pay post-liquidation rates was an expense and was a necessary disbursement. Following the introduction of rule 2.67(4), David Richards J held that the legislature must clearly have had in mind rule 4.218 when enacting it and so if something is an expense of liquidation it would be an expense of administration under the corresponding rule.

> "... the reasonable inference is, that by adopting for rule 2.67 the same terms as rule 4.218, the intention was that it should carry the same meaning."

21. He therefore held that the introduction of rule 2.67(4) importing rule 2.67(1) into para 99(3) had the effect of making rates an expense of administration.

22. It would appear that, based on the decisions of David Richards J in *Exeter City Council* and HHJ Purle QC in *Goldacre,* the application of 2.67 is to be informed by the application of rule 4.218. It is therefore necessary to determine whether a payment constitutes an expense and then to categorise the expense within those set out in rule 2.67. There is no (longer

any) discretion in this matter. However, David Richards J was also of the opinion ([2007] EWHC 400 (Ch) at paragraph 63) that:

> "The costs of purchasing goods or services essential to the business would, if supplied under contracts made by the administrators, enjoy super-priority over expenses under paragraph 99(4)."

23. This continues to recognise the distinction drawn between s19(4) and s19(5) by Neuberger J and is consistent with the view expressed above that the expenses in rule 2.67 are not those incurred under contracts entered into by the administrator.

24. As already stated, in the vast majority of administrations the asset realisations will be sufficient to pay the expenses in full. It is usual therefore for an administrator to pay the expenses as and when they occur. This was recognised in the pre-Enterprise Act period by Dillon LJ in *Powdrill v Watson; Re Paramount Airways Ltd (No.3)* [1994] 2 All E R 513 at 522:

> "Although strictly sums payable are, under s.19(5), only payable when the administrator vacates office, it is well understood that administrators will, in the ordinary way, pay expenses of administration including the salaries and other payments to employees as they arise during the continuance of the administration. There is no need to wait until the end, and it would be impossible as a practical matter to do that. What is picked up at the end are those matters which fall within the phrase, but have not been paid".

25. As wages and salaries command a super priority over other expenses under para 99(5), these will be paid in priority to all other expenses and it is probable that an administrator is safe to pay them out as and when they arise. Only if there were other debts and liabilities incurred, which rank pari passu with the wages and salary, and insufficient funds to pay them all, would there be an issue. However, where there are different classes of expense, should the administrator pay out expenses in a lower category before those in a higher category and risk having insufficient funds when it comes to paying those in the higher category?

26. The issue in relation to liquidation expenses was addressed by Lord Hoffmann in Toshoku:

> "The fact that a debt counts as an expense of the liquidation does not necessarily mean that the creditor should be allowed immediately to bring proceedings or levy execution. The order of priorities under rule 4.218(1) may mean that if he is paid at once, the assets to satisfy prior expense claims may be insufficient. So the question of remedy is entirely a matter of discretion. But the discretion does not determine whether a claim is a liquidation expense or not. It is rather the other way round; the claim must be a liquidation expense before the court can have a discretion to grant a remedy which will enable the creditor to obtain payment in priority to other claims."

27. Following *Exeter City Council* and *Goldacre*, if the administrator has no discretion as to how the order of expenses is to be paid because rule 2.67 is to be construed as mirroring rule 4.218, it follows that the reasoning adopted by Lord Hoffmann in *Toshoku* (as to whether it is permissible to pay out expenses when it is uncertain whether expenses in a higher category will ultimately be satisfied) should also be followed. Consequently, if there is any doubt as to whether there are sufficient funds to satisfy the totality of the prospective expenses, the Administrators should refuse to pay those that are doubtful or seek the court's permission before paying them.

28. Alternatively it is for the expense creditor to apply to court to seek an earlier payment.

The categories of expense

29. Rule 4.218 provides for the expenses of liquidation. Set out below are the liquidation expenses with the administration rule equivalent given in brackets.

"(3) ... the expenses are payable in the following order of priority—

(a) expenses which-

(i) ...
(ii) are properly chargeable or incurred by the official receiver or the liquidator in preserving, realising or getting in any of the assets of the company ...
(iii) ...
(iv) ...

(b) ...
(c) ...
(d)

(i) ...
(ii) .;

(e) the cost of any security provided by a provisional liquidator, liquidator or special manager in accordance with the Act or the Rules; (***Administration rule 2.67(1)(b)***)

(f) ...;

(g) ...

(h) the costs of the petitioner, and of any person appearing on the petition whose costs are allowed by the court; (***Administration rule 2.67(1)(c)***)

(i)

(j);

(k) any amount payable to a person employed or authorised, under Chapter 6 of this Part of the Rules, to assist in the preparation of a statement of affairs or of accounts;

(***Administration rule 2.67(1)(d)***)

(l) any allowance made, by order of the court, towards costs on an application for release from the obligation to submit a statement of affairs, or for an extension of time for submitting such a statement; (***Administration rule 2.67(1)(e)***)

(la) ...

(m) any necessary disbursements by the liquidator in the course of his administration (including any expenses incurred by members of the liquidation committee or their representatives and allowed by the liquidator under Rule 4.169, but not including any payment of corporation tax in circumstances referred to in sub-paragraph (p) below);

(***Administration rule 2.67(1)(f)***)

(n) the remuneration or emoluments of any person who has been employed by the liquidator to perform any services for the company, as required or authorised by or under the Act or the Rules; (***Administration rule 2.67(1)(g)***)

(o) the remuneration of the liquidator, up to any amount not exceeding that which is payable under Schedule 6; (***Administration rule 2.67(1)(h)***)

(p) the amount of any corporation tax on chargeable gains accruing on the realisation of any asset of the company (without regard to whether the realisation

is effected by the liquidator, a secured creditor, or a receiver or manager appointed to deal with a security); (***Administration rule 2.67(1)(j)***)

(q) ...

(r) any other expenses properly chargeable by the liquidator in carrying out his functions in the liquidation.

30. The two sets of provisions are effectively identical. There are 2 points to be made.

31. **First**, rule 2.67(1)(a) provides for expenses "properly incurred by the administrator in performing his functions in the administration of the company" there is no corresponding rule in 4.218. Instead, rule 4.218 provides for expenses which "are properly chargeable or incurred by ... the liquidator in preserving, realising or getting in any of the assets of the company". At first sight these might look similar. Any variations might be explained by the different functions of an administrator and a liquidator. In the case of the administrator the functions are potentially far wider in that an administrator must perform his functions with one of the objectives in paragraph 3 of schedule B1 in mind, namely: (a) rescuing the company as a going concern; or (b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration); or (c) realising property in order to make a distribution to one or more secured or preferential creditors. As is regularly pointed out, this is intended to be a rescue procedure; the primary intention is that the company and/or its business should survive. Whereas in the case of a liquidator the functions are effectively to realise the assets in what is a terminal procedure; ultimately the company will be dissolved but in the meantime the liquidator is to hold the assets until they are realised for the benefit of creditors.

a. However, in *Exeter City Council,* David Richards J adopted a very restrictive interpretation for the meaning of expenses "properly incurred by the administrator in performing his functions in the administration of the company" (for these purposes it will be assumed that his view will be preferred to that of HHJ Purle QC in *Goldacre*). He said ([2007] EWHC 400 (Ch) at paragraph 52):

> "... its terms ("expenses properly incurred by the administrators") are virtually identical to the words of section 19(4) which were construed in *Centre Reinsurance Co v Freakley* to mean expenses for which the administrator made himself personally liable. It was objected by Mr Trower that as the administrator acts as agent for the company (schedule B1 para 69) there is no little or no scope for personal liability. However, the administrator was also an agent under the old regime considered in *Centre Reinsurance Co v Freakley* (section 14(5)). Notwithstanding his agency status, there may be circumstances under both regimes when the administrator considers that he must assume personal liability. This is expressly contemplated by the 1986 Act in at least one instance, the supply of utilities (section 233). There are also likely to be circumstances where the administrator has properly incurred expenses which he has paid from his own resources and for which he can claim reimbursement, typically small items such as travel expenditure: see *In re A company (no 005174 of 1999)* [2000] 1 WLR 502 at 513-514. Secondly, if paragraph (a) is confined in this way, its priority over other expenses is more readily explicable. Thirdly, the City Council's construction would result in an overlap between paragraph (a) and other expenses. In particular this would apply to rates which, if the decision in *In re Toshoku Finance UK plc* is to be applied to administrations, would constitute necessary disbursements falling within paragraph (f). There is no sound reason for treating rates for the purposes of rule 2.67 as expenses incurred by the administrator as opposed to necessary disbursements."

b. If the words in rule 2.67(1)(a) "are virtually identical to the words of section 19(4)" (and therefore to be interpreted as having the same function) and section 19(4) was re-enacted in para 99(3) it follows that rule 2.67(1)(a) is the same as para 99(3). The

linkage of rule 2.67(1) to para 99 by the introduction of rule 2.67(4) either extends para 99(3) by adding further classes of expense below those already included in para 99(3) or, as in our opinion is more probable, merely lists those expenses which do not arise out of contracts entered into by the administrator but which need to be paid in priority to anything else.

c. Notwithstanding: (i) David Richards J's finding that the expenses in rule 2.67 are to be interpreted in the light of rule 4.218; and (ii) the similarity between the rule 2.67(1)(a) and rule 4.218(3)(a)(ii) (see paragraph 41 above), it is inconceivable that 4.218(3)(a)(ii) should be restricted to expenditure for which the liquidator is personally liable. Rule 4.218(3)(a)(ii) goes to the heart of a liquidator's function namely, preserving, realising or getting in any of the assets of the company for the benefit of the creditors.

d. Consequently, unless HHJ Purle QC is correct in *Goldacre*, there appears to be no such provision for administrations i.e. there is no provision in rule 2.67 (1) which allows the administrator to pay expenses which go to the heart of his functions in para 3. It is strongly arguable that this is the purpose of para 99(4). This was obliquely recognised by David Richards J when he said ([2007] EWHC 400 (Ch) at paragraph 63):

> "The costs of purchasing goods or services essential to the business would, if supplied under contracts made by the administrators, enjoy super-priority over expenses under paragraph 99(4)."

e. If an administrator incurs a contractual debt or liability in performing his duties in paragraph 3 this will be an expense in para 99(4). Other non-contractual liabilities fall into one of the other categories of expense in rule 2.67(1).

f. Against this background, it is instructive to enquire which category of expense fall the fees of lawyers instructed by the administrator to advise him on legal issues arising in the course of his office – para 99(4), rule 2.67(1)(a) or (f) ? Where there is an insufficiency, this might well matter greatly.

32. **Secondly**, rule 2.67 has no equivalent to the catch-all rule 4.218(3)(r) (namely: "any other expenses properly chargeable by the liquidator in carrying out his functions in the liquidation"). This is a residual category. It is unclear why there is no such residual category for administrations. It may be to the extent that the expenses are properly chargeable they are already included in the wider priority regime created by para 99(4). It is difficult to envisage a situation where the administrator has not incurred a debt of liability and yet is under an obligation to pay. Statutory liabilities would be dealt with as necessary disbursements under 2.67(1)(f).

But what of the "Liquidation expense", "Lundy Granite" or "salvage" principle?

33. Prior to *Goldacre* it was generally accepted that in certain circumstances amounts due under a pre-liquidation (and, by analogy in *Toshoku*, pre-administration) contract (such as a lease) could be treated "***as if***" they were expenses of the liquidation/administration. This principle was originally derived from a series of cases considering a landlord's ability to distrain on the assets of a company in liquidation (*Lundy Granite*). Debts arising out of a pre-liquidation/pre-administration contract would normally be provable in the liquidation/administration. However, the courts developed a discretion such that "when a liquidator retains property for the purposes of advantageously disposing of it, or when he continues to use it, the rent of it ought to be regarded as a debt contracted for the purposes of winding up the company, and ought to be paid in full like any other debt or expense properly incurred by the liquidator for the same purpose…"(*re Oak Pits Colliery Co (1882) 21 Ch D 322,330)*.

34. HHJ Purle QC considered the *Lundy Granite* principle and recognised that it applied to *Goldacre* noting that "under that principle, liquidators are held liable to pay rent as a

liquidation expense where the liquidators make use of or retain, for the benefit of the liquidation, possession of leasehold premises", however later in his judgment he concludes that "where the office holder makes use of or decides to retain the property….such liability accruing during that period is in my judgment to be treated as an expense"

35. The conclusion that rent in these circumstances is an expense sits uneasily with previous decisions. Lord Hoffmann was clear in *Toshoku*, when commenting on *re Oak Pits Colliery* Co, that "it is important to notice that Lindley LJ was not saying that the liability to pay rent had been incurred as an expense of the winding up. It plainly had not. The liability had been incurred by the company before the winding up for the whole term of the lease. Lindley LJ was saying that it would be just and equitable, in the circumstance to which he refers, to treat the rent liability as if it were an expense of the winding up and to accord it the same priority."

36. It is submitted that in every case where a payment arises out of a pre-administration contract the creditor is likely to be required to demonstrate that the asset has been used by the administrator for the benefit of the administration such that the court should exercises its discretion and allow the payment to be treated as one akin to an expense (such that it will rank within the Rule 2.67 expenses regime). This approach chimes with the comments in *Re Atlantic Computer Systems plc* that there needs to be flexibility in the system and that there is no automatic right to have payments such as rent or lease payments made just because a creditor does not have possession of its asset.

37. *Goldacre* raises many questions and, for the time being at least, provides some answers. It confirms that it is necessary for the landlord to establish that the liability in question must fall within r.2.67 if it is to receive payment of rent as an expense of the administration. It also demonstrates that the only means of doing so (unless one wishes to persuade a court that the reserved and considered judgment of David Richards J in the *Exeter* case was wrong in relation to the narrow interpretation of r.2.67(1)(a)) is to show that the *Lundy Granite* principle applies. However, it provides no further guidance as to the practical circumstances when the *Lundy Granite* principle as to use applies and for insolvency lawyers and practitioners this remains the greatest area of uncertainty.

38. In *Goldacre*, the administrators had already paid rent under an existing lease for the beneficial use of the premises and the question arose whether they were liable for the future rent as an expense of the administration. In many cases, the position might be different.

39. In circumstances where the administrator takes an appointment and is then in the position of deciding whether or not he needs the premises for the administration Lord Hoffmann's comments in *Toshoku* are helpful when he states "not offering to surrender or simply doing nothing was not regarded as retaining possession for the benefit of the estate." Choice on the part of the administrator also featured in *Re Atlantic Computer Systems plc* when Lord Nicholls was discussing the *Lundy Granite* principle and commented that it applies to existing contract which "the liquidator chooses to continue". In addition, there are liquidation cases which assist such as *In re A.B.C Coupler & Engineering Co. Ltd (No.3)* [1970] 1 WLR 702 where the liquidator closed down the business, had the plant and machinery valued and took time to think about what he should do. The court held that it was only after the liquidator had made a decision to put the lease on the market (presumably because it had value) that the liquidator was retaining the premises for the benefit of the winding up and rent was then payable. In addition, there is authority for the proposition that rent ceases to be payable from the time at which a liquidator gives notice to the landlord that it wishes to disclaim a lease, even though they remained in occupation for a further period (*In re HH Realisations Ltd* (1975) 31 P &CR 249. This analogy, it is submitted, should apply to giving notice of desire to surrender in administration (where disclaimer is not available) regardless of whether or not the landlord accepts the surrender letter.

40. Taking this a stage further, what then is the position in the first stage of the administration, when the administrator is considering the nature and extent of proposals to make to creditors. *Goldacre* did not address the issue whether administrators are permitted a 'breathing space' to decide whether or not to use premises for the benefit of creditors before

any liability to pay rent as an expense arises. For example, if a monthly rental payment fell due two days after the company has entered administration are the administrators obligated to pay that rent in full as an administration expense even if by the end of that week they have decided to return the premises to the landlord? In this respect, the reasoning and decision in *In re A.B.C Coupler & Engineering Co. Ltd* is relevant. Even if the lease had remained in existence, as *Coupler* demonstrates, there may well be no beneficial use of the premises during the early period when a decision is still to be made whether to adopt the lease.

41. It will be remembered that the central issue in *Goldacre* was whether administrators who occupied part of premises were entitled to pay a proportionate rent or not. In deciding this point, HHJ Purle QC did not focus on the actual use made of the property by the administrators but instead he looked at the issue from the landlord's point of view. As a result, because it was not possible for the landlord to maximise the return from the property with the administrators using part and the prospect of redevelopment was adversely affected the full rent was found to be payable.

42. It is considered that this approach which focuses on the deprivation suffered by the landlord does not follow the *Lundy Granite* line of reasoning which considers the position from the insolvent company's point of view and what use it is fairly making of the premises and should therefore pay for.

43. Although not strictly necessary for the decision in *Goldacre,* HHJ Purle QC considered the position of all liabilities arising under a lease as part of his decision. He said ([2009] EWHC 3389 (Ch) at paragraph 20) :

> "The fuller citation of the authority in the *Levi* case, and its approval in *Powdrill*, establishes that a liquidator electing to hold leasehold premises can do so only on the terms and conditions contained in the lease, and that any liability incurred while the lease is being enjoyed or retained for the benefit of the liquidation is payable in full as a liquidation expense. The same principle in my judgment applies in an administration."

44. This raises a couple of important issues which need to be considered in more detail. First, it is this reasoning which is central to the finding by HHJ Purle QC that an administrator must pay in full, as an expense of the administration, any rent which falls due on a quarter day arising during a period of beneficial use of the premises by the administrator, even where the administrator does not occupy for the full quarter. This aspect of the decision is in stark contrast to what had become the accepted position before the decision in *Goldacre* that an administrator would only pay the rent covering such period for which the premises were actually used beneficially for the administration.

45. In the context of rent, HHJ Purle QC did not develop his reasoning sufficiently to cover the position where an administrator only uses a property for a short period of time which does not include any rental quarter dates under the lease. This leaves uncertainty as to what payments an administrator needs to make in this situation. In our opinion, logic dictates that an administrator should only pay the rent for such period as they occupy and use the premises beneficially.

46. The second consequence of the statement that 'any liability incurred while the lease is being enjoyed is payable in full as an expense' concerns the fact that the obligations of a tenant under a lease generally go well beyond the simple obligation to pay rent. Any standard commercial lease will impose obligations on the tenant to keep the premises in good repair; decorate regularly; insure; pay utilities and indemnify in respect of any breach of covenant. Again, this is an area of the decision not developed by HHJ Purle QC because it was not necessary to do so.

47. In reaching his decision, HHJ Purle QC, endorsed (as applying to administrations) the liquidation case of *Re Levi & Co. Ltd [1919] 1 Ch 416*, a case where a liquidator retained premises until the expiry of the lease with the result that they were ordered to pay a

dilapidations claim in full because the lease contained a covenant to deliver the premises up in a good state of repair on expiry of the lease.

48. A *Re Levi* situation can be avoided merely by ensuring that a property is not being used on the expiry of the lease. However, commercial leases do generally contain an ongoing obligation to keep premises in a good state of repair and if an administrator decides to use severely dilapidated premises, it is unclear following *Goldacre* what their potential obligations might be.

49. A strict interpretation of HHJ Purle QC's judgment would result in an administrator having to meet in full any claim for breach of the covenant to keep the premises in good repair. However, such an interpretation is not consistent with the rescue culture but more importantly is contrary to pari passu principles by giving the entirety priority to what is likely to be a historical dilapidations claim.

50. It is considered that a more logical interpretation in line with *Lundy Granite* and the accepted position before *Goldacre* is that only those dilapidations that are caused during the period of use are payable as an expense of the administration. This was an argument put forward in *Re Levi* but was dismissed by J. Astbury because the case involved a covenant to deliver up the premises in good repair.

51. There was no question raised in the judgment in *Goldacre* as to whether there was a market for the premises in the hands of the landlord. By contrast, in many cases in the current climate there is no such market – see e.g. the facts of *Sunberry*. It is unclear whether "rent" or an occupation fee should be payable when the landlord cannot re-let?

52. It is predicted that the real problem posed by *Goldacre* derives from the understandable reliance placed by the judge on para 39 of Lord Hoffmann's judgment in *Toshuko* (see para 26 of *Goldacre*). This point will be amplified at the seminar. In the meantime, it might be worth bringing out a few more wrinkles in the statutory expense regime for administrators by a brief consideration of the position when they *receive* rent. The following problems arise and will be canvassed at more length at the seminar:

Post Goldacre – practical considerations

53. Pending clarification from the courts on the extent of the liabilities arising under the lease which will fall to be paid as an expense of the administration/liquidation, office holders may wish to consider the following.

(i) Timing of appointment

54. Currently it appears that if an administrator is in office on a quarter day and is either in occupation of the premises or allowing occupation by a third party for the benefit of the administration creditors, the entire quarter day's rent will be payable as an expense.

55. Therefore, it may be possible to avoid this by starting the administration just after a quarter day and then ensuring that the premises are vacated, or the rent accounted for by the third party, before the next quarter day's rent is payable. Obviously this won't always be possible where appointments are made as a matter of urgency but, in cases where the timing of an appointment can be planned, it is a worthwhile consideration.

(ii) Condition of premises

56. As discussed above, it may be the case that Dilapidations claims fall to be paid as an expense. Depending on the condition of the premises, this could be very expensive. Therefore, office holders may wish to consider inspecting the condition of premises before accepting an appointment.

(iii) Negotiation with Landlord / use of notice of intention to appoint

57. The outcome of the Goldacre case appears to put landlords in a stronger position than they may have been considered to have been in previously.

58. As such, it would be sensible for office holders to consider speaking with the landlord in order to agree a way forward and to obtain an idea of the value of any claim that a landlord may be considering submitting prior to the making of an appointment. In order to protect the company's affairs pending the outcome of such negotiations, it would be advisable, where possible, to file a notice of intention to appoint at court in order to obtain the interim moratorium. This will prevent the landlord taking pre-emptive action which would be to the detriment of the other creditors.

59. In the event that it is agreed that the cost of repair of any damage to the premises occurring during the administration will be paid as an expense, it would be worth arranging for a schedule of condition to be prepared at the outset and agreed with the landlord in order to avoid future conflict.

60. As a final thought, whilst the analysis in Goldacre relates to liabilities under a property lease it seems likely that creditors will seek to apply the reasoning to other types of contract, particularly those with obvious similarities such as lease-purchase contracts.

Joanne Rumley, Bond Pearce Solicitors
Stephen Davies QC, Guildhall Chambers
April 2010