Landlord's Hypothec in Scots Law – A Guide For IPs

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With effect from 1st April 2008, Section 208 of the Bankruptcy and Diligence etc (Scotland) Act 2007 ("BAD") abolished the diligence of sequestration for rent and partially reformed the law on hypothec. A critical analysis of the Scottish Executive's handling of these changes at the Bill stage can be found in Andrew Steven's article *Goodbye to Sequestration for Rent*, 2006 SLT, page 17.

It is clear from the Policy Memorandum to the Bill that the main purpose of the changes was to abolish sequestration for rent while leaving a full analysis and subsequent reform (or even abolition) of hypothec for another day. Given the issues raised by the reform, further legislative intervention would be welcome and this article offers some thoughts from a practitioner's perspective on those issues.

The subject is discussed as follows:

- Firstly, a look at the nature of hypothec in the period prior to insolvency of the tenant;
- Secondly, consideration of the practical effects of hypothec once the tenant has gone into formal insolvency;
- Thirdly, the ranking issues raised by hypothec;
- Fourthly, thoughts on mitigating hypothec; and
- Fifthly, some concluding observations.

1. Prior to Insolvency - an unusual security

Section 208(2) states that landlord's hypothec:

(a) continues as a right in security; and

(b) "ranks accordingly" in sequestration, insolvency proceedings or other process in which there is ranking.

Right in security: Hypothec confers security in respect of rent due and unpaid. The right in security referred to in Section 208(2) is a reference to the standing of hypothec as a fixed security by operation of law[1]. As we shall see, this has important implications in the tenant's insolvency. However, in the period prior to formal insolvency, the landlord, by virtue of Section 208, has no means of actively enforcing hypothec. This marks out hypothec from other rights in security (eg. standard security, floating charge). Moreover, the tenant is entitled to sell the items covered by the hypothec and need not account to the landlord for any part of the sale proceeds, notwithstanding the presence of rent

[1] see, for example, Grampian Regional Council -v- Drill Stem (Inspection Services) Limited (In Receivership) 1994 S.C.L.R. 36

arrears.

Effect on attachment: Admittedly, the landlord is entitled to use the remedy of attachment and sale (by auction) provided by the Debt Arrangement and Attachment (Scotland) Act 2002 ("the 2002 Act") but this is a remedy available to any creditor. There are also complications with the relationship between hypothec and the 2002 Act:

Firstly, there is nothing in the 2002 Act which would give the landlord a prior ranking, by virtue of the hypothec, in the event that, prior to formal insolvency of the tenant but at a time when there are arrears of rent, another creditor exercises his rights under the 2002 Act by attaching and selling moveables belonging to the tenant (assuming that the hypothec remains alive at the time of the auction). This raises the question of whether, in the language of Section 208, the sale of items under the 2002 Act is a "process in which there is ranking"? If the answer is "yes", the landlord will be entitled to all or part of the sale proceeds, rendering the 2002 Act potentially much less useful to creditors of tenants (excluding the landlord as creditor) than would otherwise be the case. If the answer is "no", the hypothec will not assist the landlord in the attachment and sale scenario.

Secondly, auctions under the 2002 Act are to be held at an auction room unless it would be impractical to do so[2]. As hypothec applies only to moveables belonging to the tenant "kept in or on the subjects let"[3], there is some doubt as to whether removal of moveables to an auction room would remove those moveables from the scope of the hypothec. An interdict by the landlord against the tenant (contemplated by Section 208(5)(b)) would not assist the landlord as the moveables would be removed to the auction room by an officer of court, not by the tenant. The sensible interpretation of the two pieces of legislation, taken together, would be that moveables would remain subject to the hypothec notwithstanding their removal to an auction room provided the moveables were in or on the leased premises when the attachment proceedings were initiated.

2. Tenant's insolvency – practical issues

Once an Insolvency Practitioner ("IP") has been appointed to the tenant, the landlord has a ranking, by virtue of the hypothec being a fixed security, in respect of the property to which the hypothec applies (ie "corporeal moveable property kept in or on the subjects let"). As with all rights in security, an understanding of the ranking conferred by that right is crucial. However, before analysing that, it is appropriate to consider some practical issues and an issue specific to administrations regarding the sale by an administrator of items which are subject to the hypothec.

2.1 *Practical issues in insolvency*

Section 208 is silent as to how the landlord should go about ensuring that he receives his entitlement out of the hypothec. Clearly, submitting a claim to the IP is straightforward in terms of calculating the

2 Section 27 of the 2002 Act

3 Section 208(2)(a) of BAD

amount of arrears due and unpaid. However, to make Section 208 meaningful from a landlord's perspective, the onus must rest with the IP, not with the landlord, to identify the items subject to the hypothec. The items are within the control of the IP who is deemed to know of the existence of the hypothec and it must be for the IP to keep a record of the proceeds of sale of items subject to the hypothec. A useful analogy is with the position applying to floating charge creditors - those creditors do not know at any given time what assets are subject to their security but, at least in terms of the current practice as between IPs and floating charge creditors, IPs are not obliged in insolvency to identify those assets.

That current practice is not necessarily a correct statement of the law (of which there appears to be none). Moreover, the position of floating charge creditors is generally different from that of hypothec creditors insofar as the floating charge in Scotland is almost invariably over the "whole of the property and undertaking" of the grantor of the floating charge. As a result, there is rarely any argument as between the IP and the floating charge creditor as to whether or not an asset was subject to the floating charge at the point of insolvency.

In the case of retail tenants, the business of the insolvent tenant may well include EPOS equipment which should enable the IP to identify when items were sold and at what price. In the case of retail insolvencies where there has been a pre-pack sale, the position of the IP may be more problematic as the purchaser under the pre-pack will usually also acquire the EPOS equipment, thus rendering more difficult the ability of the IP to identify what has been sold, when it has been sold and at what price. The IP might have to rely on information provided by the purchaser. One would expect the IP to ensure that provision is made in any pre-pack sale documentation for such information is to be provided to the IP but such a contractual right may be difficult to enforce in practice and, of course, is vulnerable in the event that the purchaser under the pre-pack arrangement itself becomes insolvent.

If the onus of identifying hypothec assets rests with the IP and not with the landlord, there is no obligation on the IP, from a hypothec perspective, to concern himself with the value of sales during any period when the rent is up to date. This is because the hypothec subsists only for so long as rent is due and unpaid[4]. In a typical administration, the IP is likely to pay
rent for as long as the tenant, through the IP, is trading from the premises[5]. However, there may be arrears of rent as at the date of appointment of the IP for which the IP will not accept responsibility and which will therefore be subject to the hypothec. In those circumstances, the value of sales from the date of appointment onwards *will* be relevant to the landlord's claim. Moreover, the IP may well tender payment of rent on a basis different from that stipulated in the lease (eg. monthly as opposed to quarterly) and therefore, strictly speaking, unless the landlord and the IP agree to vary the lease to provide for a different payment pattern, a proportion of the rent will be due and unpaid notwithstanding that the first month of a quarter has been paid. Again, in that case, the value of sales from the quarter date onwards will be relevant to the landlord.

4 Section 208(8)(b) of BAD

5 Per the "balancing of interests" approach in *Re Atlantic Computer Systems plc [1992] Ch 505* and see also *Goldacre (Offices) Limited -v- Nortel Networks UK Limited (In Administration) [2009] EWHC 3389 (Ch)*

If the onus of identifying hypothec assets was to rest on the landlord and not with the IP, there are a number of reasons why the practical value of the hypothec may be greatly diminished:

Firstly, hypothec applies only to property which is "owned" by the tenant[6]. This must exclude property which is supplied to the tenant under a contract containing a valid retention of title clause. How is the landlord expected to identify such items from those which are not subject to such a clause? Similar issues arise with hire purchase assets[7].

Secondly, where the IP is trading from the premises, stock will be replenished regularly – must the landlord visit the premises every day to make a note of the new stock? And how can the landlord differentiate between one day's stock and the next day's stock – one pair of Levi 501s looks exactly like another pair.

Thirdly, given that the lease entitles the tenant to exclusive possession of the premises, does the landlord have a specific reserved right to enter the premises to identify the moveables? Some leases contain such a reserved right (the familiar right to enter to "take inventories of the Tenant's stock, fixtures and fittings….") but many do not.

In short, if the onus is on the landlord to provide the IP with a detailed statement of claim, Section 208 renders the landlord's hypothec of little benefit in very many cases. At least under the previous regime, the landlord could take control by forcing a sale of the items through an action of sequestration of rent and he took whatever the items were sold for (subject to the Crown's prior claim under Section 64 of the Taxes Management Act 1970), even where, in certain cases, the items did not belong to the tenant.

2.2 *Paragraph 71 order – required for hypothec assets?*

The references in the preceding discussion to the sale of items by the IP assumes that the IP is free to sell items which are covered by the hypothec. In the case of administrations, the position is not without doubt, notwithstanding the explicit power of sale given to an administrator by the Insolvency Act 1986 ("IA 1986")[8].

The doubt arises because Paragraph 71 of Schedule B1 to IA 1986 provides that "The court may by order enable the administrator of a company to dispose of property which is subject to a security (other than a floating charge) as if it were not subject to the security." It is easy to understand the utility of this provision where the security is a standard security but Paragraph 71 is not expressly limited to standard securities and therefore must apply to all securities (other than floating charges), including hypothec. But does this mean that, where hypothec exists, an administrator must obtain a court order prior to selling any moveable items owned by the tenant (eg a pair of jeans or a CD)? If this is the law, it is

6 Section 208(4) of BAD

7 Section 104 of the Consumer Credit Act 1974 (c.39) provides that goods comprised in a hire-purchase agreement or conditional sale agreement which have not become vested in the debtor are not subject to hypothec once the debtor has defaulted/the creditor has begun court proceedings to enforce the contract – this provision would appear no longer to be necessary, given the broad terms of Section 208(4)

8 Schedule 1, paragraph 2

probably safe to state that it is most certainly not the practice and the implications are difficult to assess although there would seem to be little to be gained by a landlord raising the issue with administrators where (as ought to be the case) the administrator has sold the moveable items at market value.

The sensible interpretation of Paragraph 71 is that it does not impose a statutory prohibition on selling secured property without a court order and is simply intended to allow the administrator a remedy where a sale of an asset or assets cannot commercially be effected due to the existence of the security. In other words, Paragraph 71 provides a remedy but does not state a prohibition. So, for example, where the administrator wishes to sell heritable property, although there might (unusually) not be anything in the standard security conditions prohibiting a sale of the property under burden of the standard security, it would be almost unheard of for a buyer to purchase the property without the standard security being discharged as the act of sale does not remove the property from the scope of the standard security. In those circumstances, if the heritable creditor refused to discharge the security, the administrator would be entitled to seek a court order under Paragraph 71.

In contrast, there is an obvious attraction in the proposition that the sale of moveable items which are caught by the hypothec removes those items from the hypothec (because those items are, by virtue of the sale, no longer owned by the tenant), meaning that the buyer acquires an unencumbered title and therefore an administrator would have no need to concern himself with Paragraph 71. This would be consistent with the universal practice in administrations and would align the hypothec with crystallised floating charges. The difficulty with that proposition is that floating charges are expressly dealt with by Paragraph 70 (which provides that an administrator may dispose of property which is subject to a floating charge as if it were not subject to the charge) and this indicates that the legislature intended that floating charges should be treated differently from other securities.

Some assistance may be found in the equivalent provision for receiverships[9]. That provision applies where the receiver wishes to sell property which is subject to a security and is "unable to obtain the consent" of the creditor. The receiver may apply to the court for authority to sell the property free of such security. The language used indicates that the remedy is relevant only where the security is of a character such that a sale of the relevant asset requires the consent of the secured creditor but that reference must be made to the law relating to that security to decide whether, in any particular case, the consent of the secured creditor is required before that asset may be sold.

If the correct interpretation of Paragraph 71 is the commercially undesirable one (that a court order is needed for the sale of any moveables which are subject to the hypothec), Paragraph 71(3) provides that the court order is subject to the condition that the net proceeds of the disposal (there is no clue as to what "net" means) must be applied towards discharging the sums secured by the security.

If the sensible and more favourable (to administrators) interpretation of Paragraph 71 applies, strictly speaking, the administrator must not make a distribution from the proceeds of sale of the moveables caught by the hypothec for as long as, and to the extent that, there are arrears of rent, save to the

9 Section 61 of IA 1986

extent that the IP is bound to account to the landlord under the hypothec. It should be remembered, however, that the "pay as you go" effect of *Atlantic Computers* in administrations[10] means that, for as long as the administrator is using the premises, there ought not to be any arrears of rent in respect of that period of use and therefore the hypothec ought not to come into play to that extent save, as already mentioned, where rent is paid informally on a basis (eg. monthly) different from that required by the lease (eg. quarterly). Once the administrator has no further use of the premises and ceases to pay rent, the hypothec will bite, albeit there may well be very few items of value left in the premises by that stage.

3. Ranking of hypothec

An analysis of the crucial issue of ranking requires consideration of two different categories of rent arrears:

- Pre-appointment arrears
- Post-appointment arrears

3.1 *Pre-appointment arrears*

In respect of pre-appointment arrears, the landlord's hypothec, as a fixed security, ranks ahead of a floating charge held by another creditor and also ahead of the IP's own expenses and remuneration. [11] In short, the landlord is entitled to the full proceeds of sale of the items subject to the hypothec in priority to all other parties to the extent that those proceeds are less than the amount of the arrears of rent (the only exception to this priority claim would be where there was a prior fixed security holder but, in the case of moveables, that is very unlikely).

This means that the IP (whether administrator, receiver or liquidator) must be very careful when making a distribution to creditors and must avoid ending up with insufficient funds to meet the landlord's prior claim, having made distributions to other creditors on an erroneous basis.

Given that hypothec has long been recognised as a fixed security by operation of law, the prominent ranking of hypothec at least in respect of pre-appointment arrears of rent is not an innovation introduced by Section 208 of BAD and it is to be wondered whether the pre BAD remedy of sequestration for rent led to landlords (and IPs) placing insufficient importance on the ranking of hypothec. If so, there may be implications for both landlords and IPs if landlords' claims have not been adjudicated upon properly by IPs.

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10 as (arguably) extended by *Goldacre (Offices) Limited -v- Nortel Networks UK Limited (In Administration) [2009] EWHC 3389 (Ch)*

11 In the case of administrations, the authority for this is Paragraph 116 of Schedule B1 to IA 1986, read with Section 464(2) of the Companies Act 1985 ("CA 1985"); in the case of receiverships, the authority is Section 60(1)(a) of IA 1986 and Section 464(2) of CA 1985; and in the case of liquidations, the authority is Rule 4.66 of the Insolvency Rules (Scotland) 1986 ("the Scottish Insolvency Rules"), a fixed security (by operation of law) giving a right which is "preferable to the rights of a liquidator".

3.2 *Post-appointment arrears*

In respect of arrears accruing after the date of appointment of the IP, the position is problematic and differs depending on the insolvency regime concerned.

3.2.1 Administrations

In administrations, the post-appointment arrears are treated in the same way as the pre-appointment arrears ie. they rank ahead of the claims of other creditors (subject to the same (rare) fixed security exception and the post-appointment exception discussed below). This may seem at odds with the general principle of insolvency law that the priority of claims of creditors is fixed as at the date of appointment of the IP and that securities may not be created after that date. However, this is the case for two reasons:

(i) Section 208 of BAD does not limit hypothec to arrears accruing prior to the date of appointment of the IP; and

(ii) Appointment of administrators appears not to cause a floating charge to crystallise.[12]

This means that the hypothec enjoys a "top of the tree" ranking in terms of Paragraph 116(a) of Schedule B1 to IA 1986, being a "fixed security which is over property subject to a floating charge and which ranks prior to, or *pari passu* with, the floating charge".

The post-appointment exception referred to above is found in Paragraph 115 of Schedule B1 to IA 1986 in terms of which, if an administrator thinks that the company has insufficient property to enable a distribution to be made to unsecured creditors other than under the prescribed part rules, "he may" file a notice to that effect with the registrar of companies[13]. Paragraph 115(3) states that, on delivery of the notice to the registrar of companies, any floating charge granted by the company shall, unless it has already so attached, attach to the property which is subject to the charge and that attachment shall have effect as if each floating charge is a fixed security over the property to which it has attached.

By way of example, if the administrator files such a notice at a time when there are no post-appointment arrears of rent, the floating charge will crystallise and rank prior to any hypothec coming into existence later on account of the administrator failing to pay the rent on time.

The exception in Paragraph 115 is probably not of material commercial significance as, if the company has "insufficient property", a post-appointment hypothec is unlikely to be of benefit in any event.

The uncertainty over the meaning of Paragraph 71 of Schedule B1 to IA 1986 (discussed at paragraph

12 "Attachment or crystallisation of a floating charge only occurs on the appointment of a receiver under that charge or on winding up…". *The Law and Practice of Receivership in Scotland,* Third Edition, para. 202

13 Paragraph 115(2) of Schedule B1 to IA 1986

2.2 above) should be borne in mind in relation to post-appointment arrears as much as for pre-appointment arrears.

3.2.2 Receiverships

In the case of receiverships (and liquidations), although the landlord is first in the queue for pre-appointment arrears, he ranks lower down the queue in respect of arrears accruing post-appointment, at least as respects the proceeds of sale of moveable items situated within the premises as at the date of appointment. The position regarding *acquirenda* is unclear (see sub-paragraph (b) below).

(a) Non-*acquirenda*: By virtue of Section 53(7) of IA 1986, on appointment of a receiver by the floating chargeholder, the floating charge attaches to the property then subject to the charge; such attachment "has effect as if the charge was a fixed security over the property to which it has attached". The purpose for which the attachment "has effect" is not specified but it is generally regarded as referring to ranking. Applying this to priority of claims listed in Section 60 of IA 1986, the hypothec (ie. fixed security) arising after appointment of the receiver is not a "fixed security which is over property subject to the floating charge *and which ranks prior to, or pari passu with, the floating charge*;". This is because, for the purposes of ranking, there are by that stage two fixed securities – the deemed fixed security (ie the crystallised floating charge) and the "hypothec fixed security". Fixed securities rank according to their respective dates of creation and therefore the "hypothec fixed security" ranks after the deemed fixed security and, in a receivership, the former occupies the lowly position conferred by Section 60(2)(b) of the 1986 Act.

It is important to remember that this reasoning assumes that Section 53(7) directs us to construe references in Section 60 to a fixed security as including a deemed fixed security. Such an assumption would be consistent with the general rule of insolvency that priority of claims are fixed as at the date of appointment of the IP but would significantly weaken the value of hypothec to a landlord in relation to post-appointment arrears. Moreover, the assumption would give rise to an inconsistency as between one insolvency regime (administration) and another (receivership) although this may not be important in practice as the statutory moratorium on irritancy in administrations[14] has no equivalent in receiverships and therefore a landlord of a tenant in receivership is, in one way, in a better position to protect his interests than the landlord of a tenant in administration (albeit *Atlantic Computers* (or, possibly, the *Nortel Networks* case cited earlier) should mean that there aren't any post-appointment rent arrears at the end of the administration in respect of the period during which the administrators made use of the premises).

If that assumption is wrong and references to a fixed security in Section 60 are references to only actual fixed securities (including fixed securities by operation of law) and not to deemed fixed securities under Section 53(7), the hypothec arising in respect of post-appointment arrears in receiverships will retain its "top of the tree" ranking in Section 60(1)(a). This would produce the same practical problem for the

[14] Paragraph 43(5) of Schedule B1 to IA 1986

receiver as applies to an administrator, that is to say, the proceeds of sale from the moveables caught by the hypothec must not be paid out to anyone, save to the extent that the IP is bound to account to the landlord under the hypothec.

(b) *Acquirenda*: Where moveable items are acquired by the company in receivership (eg stock), those items will be caught by the deemed fixed security ie the crystallised floating charge, under the rule of *acquirenda*. If those items are then brought on to the premises at a time when there are rent arrears, those items will be caught by the "hypothec fixed security". But how do these two fixed securities rank?

The first point to make is that if ownership of the relevant moveables has become vest in the tenant in receivership prior to delivery of the items to the premises, those items will become caught by the deemed fixed security prior to being caught by the "hypothec fixed security". This means that the deemed fixed security will rank ahead of the "hypothec fixed security" and the latter will occupy the lowly ranking position conferred by Section 60(2)(b) of the 1986 Act.

However, if the date of acquisition of those moveable items by the tenant in receivership is also the date on which those moveables become subject to the "hypothec fixed security" ie the date of delivery to the premises, an interesting question arises as to whether the two securities rank *pari passu*. If they do, the receiver will be obliged to account to the landlord for the entire proceeds of sale of those moveable items in accordance with the priority of claims laid down in Section 60(1)(a) of IA 1986 (the "hypothec fixed security" being a fixed security which is over property subject to the floating charge and which ranks prior to, or *pari passu* with, the floating charge;" [15]). If they do not rank *pari passu* (and the deemed fixed security ranks ahead of the "hypothec fixed security") the "hypothec fixed security" will enjoy the low ranking under Section 60(2)(b) of IA 1986.

The answer requires an analysis of when exactly *acquirenda* becomes subject to the deemed fixed security. If the deemed fixed security has a fixed date of creation ie the date of appointment of the receiver, the ranking as against the "hypothec fixed security" should be the same as for non-*acquirenda* situations (as in paragraph 3.2.2 (a) above). In other words, irrespective of how many days, weeks, months or even years have passed between the date

of appointment of the receiver and the date of the receiver's purchase of the relevant moveable items, those items would be subject to the deemed fixed security with effect from the date of appointment of the receiver and the “hypothec fixed security” would always rank after the deemed fixed security.

Alternatively, if the date of creation of the deemed fixed security in so far as concerns the *acquirenda* is the date on which the tenant becomes the owner of the *acquirenda*, it would seem that transfer of title upon delivery of the moveables to the premises at a time when there are rent arrears will result in the deemed fixed security ranking *pari passu* with the "hypothec fixed security".

15 This statement is subject to the assumption mentioned in paragraph 3.2.2 (a)

On the basis that

- receiverships are becoming less common
- title to moveables passes prior to delivery in some cases
- some kinds of moveables are not bought outright by the receiver in any event (eg RoT stock)

the answer to the question above might turn out not to be material.

3.2.3 Liquidations

Unlike administrations and, to a lesser extent, receiverships, a company in liquidation will almost certainly not be trading from the premises and therefore arrears of rent are likely to accrue as soon as the first rent payment date arrives after a liquidator has been appointed (and there are likely to be pre-liquidation arrears too). The existence in the premises of valuable items belonging to the tenant is therefore of interest to the landlord in terms of his hypothec.

The complications surrounding *acquirenda* discussed above in the context of receiverships are unlikely to be encountered in liquidations due to the infrequency with which a liquidator will trade from the premises in such a way that items are being acquired and brought on to the premises. The issue will not be explored further.

Although the landlord is first in the queue for pre-liquidation arrears, he ranks lower down the queue in respect of arrears which accrue during the liquidation.

Where the liquidator fails to pay the rent due as at the first rent payment date after the company has gone into liquidation, for the purposes of ranking there may be, as at that rent payment date, effectively three fixed securities:

(a) the "hypothec fixed security" which has arisen pre-liquidation in respect of pre-liquidation arrears of rent;
(b) the "deemed fixed security" ie the floating charge attaching on liquidation; and
(c) the "hypothec fixed security" which arises on that first rent payment date.

Of course, if there are no pre-liquidation arrears, only securities (b) and (c) will exist.

Two related ranking issues arise:

First issue: What is the ranking as between the "deemed fixed security" (security (b) above) and the "hypothec fixed security" (security (c) above)?

Second issue: Does the "hypothec fixed security" (security (c) above) give the landlord a right which is "preferable to the rights of a liquidator", as would appear to be the case with a hypothec arising in

relation to pre-liquidation arrears?

As to the first issue, the position is unclear. Section 464(2) of the Companies Act 1985 gives a fixed security arising by operation of law priority over a floating charge. There is nothing in that provision to limit its operation to a fixed security arising by operation of law *prior* to the liquidation. However, as Section 463(2) of the same Act provides that the liquidation provisions of the Insolvency Act 1986 have effect in relation to a floating charge as if the charge were a fixed security over the property to which it has attached, it is arguable that the "hypothec fixed security" arising during the liquidation must rank after the "deemed fixed security" arising on liquidation on the grounds that fixed securities rank according to the respective dates of creation. In other words, the relevant point in time for the purposes of Section 464(2) is the date on which the company goes into liquidation.

If the rule of ranking in Section 464(2) is specific to the situation pertaining as at the date of liquidation, any arrears of rent arising during the liquidation will rank after the floating charge which has attached on liquidation; if that rule is not specific to the date of liquidation, the "hypothec fixed security" will continue to rank ahead of the "deemed fixed security".

As to the second issue, there is, instinctively, appeal in the proposition that the only right of a secured creditor which is preferable to the rights of a liquidator is a right in security created prior to the company going into liquidation e.g. hypothec in respect of pre-liquidation arrears.

If that proposition is correct, the ranking of the hypothec, arising during the liquidation, is unclear. Broadly speaking, Rule 4.66 lists the following order of priority:

1. Expenses of the liquidation
2. Preferential debts
3. Ordinary debts

The hypothec, as a secured debt, must surely rank ahead of ordinary debts, notwithstanding that the hypothec arises after the tenant company has gone into liquidation. However, it is an open question as to where the hypothec, if not "preferable to the rights of the liquidator", ranks in a liquidation in competition with expenses and preferential debts.

If the proposition above is not correct and the right deriving from the "hypothec fixed security" arising during the liquidation *is* "preferable to the rights of the liquidator", the claim of the landlord, secured by the hypothec, will be determined ahead of the claims ranked in terms of Rule 4.66. The only ranking issue which would then fall to be considered, in so far as the landlord is concerned, would be the first issue discussed above.

4. Mitigating hypothec

Under the law prior to 1st April 2008, it was not unknown for an IP to try to defeat an attempt by the

landlord to enforce hypothec (through an action of sequestration for rent) by removing the tenant's moveable items from the leased premises. The success of such steps could not be guaranteed; in one case[16] a warrant to carry back was granted to a landlord in a situation where the items were removed after the Sheriff had granted the warrant for sequestration but before the Sheriff Officers had arrived at the premises and made up the inventory of items. The effect of a warrant to carry back is to compel the tenant (in that case, the receivers) to put the items back in the leased premises.

There is nothing in the language of Section 208 of BAD to suggest that, on the assumption that there are subsisting rent arrears, hypothec "crystallises" upon appointment of an IP in the same way that a floating charge attaches to the tenant's property upon appointment of a receiver or liquidator. That being the case, although a *sale* by the IP will give rise to issues of ranking, a disposal not involving the realisation of proceeds will remove the items in question from the scope of the hypothec.

Support for this proposition can be found in Section 208 itself. Section 208(5)(b) provides for protection of a good faith purchaser for value where the property is acquired after the grant of an interdict in favour of the landlord, prohibiting the tenant from disposing of or removing items secured by the hypothec – the implication is that the common law remedies available to a landlord to protect hypothec remain as relevant.[17]

If removal of the items from the leased premises (other than by way of sale) removes those items from the hypothec, would it be legitimate under any circumstances for an IP to remove items, bearing in mind that the effect may be to reduce the recovery to a secured creditor (ie the landlord under the hypothec) and increase the recovery to unsecured creditors (and the IP in respect of his fees and expenses)?

First of all, the motivation of the IP may not be as questionable as might initially be thought. It is not uncommon for an IP of a business with more than one trading location to close some or all of the poorer performing units and move the stock to one or more of the better performing units. Indeed, in administrations for example, the administrator may consider himself *obliged* to do so in order to perform his statutory functions under Paragraphs 3 and 4 of Schedule B1 to IA 1986.

The fact that a particular landlord is potentially prejudiced by the emptying of stock from his premises may well be justifiable if the potential consequence of the removal of stock is to achieve a better result for the tenant's creditors *as a whole*.

However, if the administrator removes the stock simply to defeat the landlord's fixed security claim because otherwise that claim will take a large bite out (or consume entirely) the pot potentially available to unsecured creditors (and the IP in respect of his fees and expenses), the administrator must think twice before proceeding.

16 *Novacold -v- Fridge Freight (Fyvie) Limited (In receivership) 1999* SCLR 409

17 The wording of Section 208(5) is obscure as, for example, it implies that the absence of good faith on the part of a purchaser causes hypothec to continue in respect of the items acquired – for how long would hypothec continue to apply in such "bad faith" circumstances? Would hypothec continue to apply if the bad faith purchaser sold on to a third party, in good faith or otherwise?

A receiver might have less qualms about removing stock to defeat the hypothec, given the receiver's relationship with the floating charge holder, a potential beneficiary of the sale of stock removed from leased premises in the middle of the night.

A liquidator might regard himself as in a similar position to an administrator and therefore ought to tread carefully.

As indicated above, IPs should remember that landlords have common law remedies to try to stop items being removed from the premises or to have those items put back if already removed, albeit that a landlord may have to overcome a moratorium on court action if those remedies are to be implemented.[18]

5. Conclusion

It is important that landlords and their advisers are aware of the benefit which Section 208 gives to them. They must not take the position that, as they do not hold any formal security deed, there is little point in claiming for arrears of rent. They are not unsecured, although whether that security catches anything will depend on the facts of each case.

The abolition of sequestration for rent might help to focus attention on the status of hypothec as a right in security, a status which existed prior to the enactment of Section 208 but which might not have been given the correct treatment in all cases.

Hypothec is likely to be of greatest significance in relation to pre-appointment arrears as IPs rarely agree to make any contribution to such arrears.

A landlord should act quickly as soon as his tenant goes into formal insolvency. The hypothec and the arrears should be intimated to the IP without delay, notwithstanding the IP's own responsibility to the landlord as holder of a fixed security.

From an IP's perspective, hypothec must be properly understood and applied in all cases where the insolvent tenant company owns moveable property. Failure to understand hypothec could give rise to difficult situations if the landlord's prior claim is overlooked, including (possibly) personal liability on the part of the IP.

Where the landlord has a prior ranking by virtue of the hypothec (whether in respect of pre-appointment arrears or, subject to the ranking issues discussed above in relation to receiverships and liquidations, post-appointment arrears), the IP should not be taking any part of the proceeds of sale of the relevant moveables to pay fees or expenses, irrespective of whether the landlord has submitted a claim in

[18] Paragraph 43(6) of IA 1986 in the case of administrations, Section 130(2) of IA 1986 in the case of a winding-up by the court and Section 113 of IA 1986 in the case of members' or creditors' voluntary winding up of a Scottish company where the liquidator has obtained protection from the court

respect of arrears of rent. Clearly, the landlord must submit his claim prior to distribution of a final dividend to creditors by the liquidator but, until then, the IP should not disburse any part of those sale proceeds.

The uncertainty over Paragraph 71 of Schedule B1 to IA 1986 as well as the general lack of clarity as to the ranking conferred by hypothec, particularly in relation to post-appointment arrears, deserves attention by the Scottish Parliament although, given the lack of political significance of the issue, it would not be surprising if clarity ends up being provided by the judicial outcome of one or more disputes between landlords and IPs.

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