

ICLR: Appeal Cases/1997/HINDCASTLE LTD. RESPONDENT and BARBARA ATTENBOROUGH ASSOCIATES LTD. and Others APPELLANTS - [1997] A.C. 70

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[HOUSE OF LORDS]

HINDCASTLE LTD. RESPONDENT and BARBARA ATTENBOROUGH ASSOCIATES LTD. and Others APPELLANTS

1995 Dec. 12, 13, 14; 1996 Feb. 22

Lord Keith of Kinkel, Lord Griffiths, Lord Browne-Wilkinson, Lord Lloyd of Berwick and Lord Nicholls of Birkenhead

Insolvency - Winding up - Disclaimer of lease - Intermediate assignee covenanting with lessor to pay rent - Ultimate assignee becoming insolvent - Disclaimer by liquidator - Arrears of rent accruing after disclaimer - Whether original lessee, intermediate assignee and surety liable to lessor - Insolvency Act 1986 (c. 45), s. 178(4)

In October 1983 the plaintiff granted the first defendant a lease of office premises for a term of 20 years. In 1987 the lease was assigned to the second defendant pursuant to a licence to assign which contained a covenant on the part of the second defendant with the lessor to pay the rent and to observe and perform the covenants in the lease for the remainder of the term of years. The third defendant joined in the licence to assign as surety in order to guarantee the performance of the obligations undertaken by the second defendant. The obligations of the surety were to expire after 10 years from the date of the lease. In 1989 the second defendant assigned the lease with consent to a company which in 1992 went into voluntary liquidation. The liquidator disclaimed the lease under section 178 of the Insolvency Act 1986.¹ The plaintiff, by actions commenced before August 1993, claimed arrears of rent from the defendants and was granted summary judgment under R.S.C., Ord. 14. The Court of Appeal dismissed the second and third defendants' appeal.

On appeal by the second and third defendants:-

Held, dismissing the appeal, that the disclaimer of the lease by the liquidator under section 178 of the Insolvency Act 1986 did not operate to determine the liability under the lease of the original lessee or of his surety; and that, accordingly, since the second defendant by its covenant had placed itself in the same position, as against the plaintiff, as the original lessee had been, both the second and third defendants remained liable to the plaintiff (post, pp. **79B-C, 82G-83A, 94A-D, 96B-D, F**).

Hill v. East and West India Dock Co. (1884) 9 App.Cas. 448, H.L.(E.) applied.

Warnford Investments Ltd. v. Duckworth [1979] Ch. 127 considered.

Stacey v. Hill [1901] 1 K.B. 660, C.A. overruled.

Decision of the Court of Appeal [1995] Q.B. 95; [1994] 3 W.L.R. 1100; [1994] 4 All E.R. 129 affirmed.

The following cases are referred to in the opinions of their Lordships:

Finley, In re; Ex parte Clothworkers' Co. (1888) 21 Q.B.D. 475, C.A.

Harding v. Preece (1882) 9 Q.B.D. 281, D.C.

¹ Insolvency Act 1886, s. 178(4): see post, p. 86C.

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Hill v. East and West India Dock Co. (1884) 9 App.Cas. 448, H.L.(E.)

Inglis v. MacDougal (1817) 1 Moo.Rep. 196

Katherine et Cie. Ltd., In re [1932] 1 Ch. 70

Smith (W.H.) Ltd. v. Wyndram Investments Ltd. [1994] 2 B.C.L.C. 571

Smyth v. North (1872) L.R. 7 Ex. 242

Stacey v. Hill [1901] 1 K.B. 660, C.A.

Tempany (Maurice) v. Royal Liver Trustees Ltd. [1984] B.C.L.C. 568

Tuck v. Fyson (1829) 6 Bing. 321

Walton, Ex parte; In re Levy (1881) 17 Ch.D. 746, C.A.

Warnford Investments Ltd. v. Duckworth [1979] Ch. 127; [1978] 2 W.L.R. 741; [1978] 2 All E.R. 517

The following additional cases were cited in argument:

A.E. Realisations (1985) Ltd., In re [1988] 1 W.L.R. 200; [1987] 3 All E.R. 33

City of London Corporation v. Fell [1994] 1 A.C. 458; [1993] 3 W.L.R. 1164; [1993] 4 All E.R. 968, H.L.(E.)

Deering v. Earl of Winchelsea (Note) (1787) 2 B. & P. 270

Downer Enterprises Ltd., In re [1974] 1 All E.R. 1460

Fenton, In re; Ex parte Fenton Textile Association Ltd. [1931] 1 Ch. 85, C.A.

Friends' Provident Life Office v. British Railways Board [1996] 1 All E.R. 336, C.A.

Manning v. Flight (1832) 3 B. & Ad. 211

Morris (D.) & Sons Ltd. v. Jeffreys (1932) 49 T.L.R. 76

Moule v. Garrett (1872) L.R. 7 Ex. 101

Murphy v. Sawyer-Hoare [1994] 2 B.C.L.C. 59

Taylor v. Young (1820) 3 B. & Ald. 521

Thompson and Cottrell's Contract, In re [1943] Ch. 97; [1943] 1 All E.R. 169

Wells (Sir Thomas Spencer), In re; Swinburne-Hanham v. Howard [1933] Ch. 29, C.A.

Yarmarine (I.W.), In re [1992] B.C.L.C. 276

APPEAL from the Court of Appeal.

This was an appeal by leave dated 9 February 1995 of the House of Lords (Lord Jauncey of Tullichettle, Lord Mustill and Lord Lloyd of Berwick) by the second defendants, CIT Developments Ltd., and the third defendant, Patrick John Howard Whitten, from the judgment dated 15 June 1994 of the Court of Appeal (Sir Stephen Brown P., Rose and Millett L.JJ.) dismissing an appeal by the second and third defendants from two orders both dated 14 October 1993 of Mr. Simon Goldblatt

Q.C. sitting as a deputy judge of the Queen's Bench Division by which he granted summary judgment under R.S.C., Ord. 14 in favour of the plaintiff, Hindcastle Ltd., for arrears of rent due under a lease after the lessee, Prest Ltd., had gone into insolvency liquidation and the liquidator had disclaimed the lease. The first defendant, Barbara Attenborough Associates Ltd., the original lessee took no part in the proceedings in the Court of Appeal or in the House of Lords.

The facts are stated in the opinion of Lord Nicholls of Birkenhead.

David Oliver Q.C. and **Carolyn Walton** for the second and third defendants. The disclaimer of the lease under section 178 of the Insolvency Act 1986 by the liquidator of the second assignee released the first assignee and surety (the second and third defendants) from their liabilities to the

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lessor under the licence. The disclaimer operated to determine the lease and the liabilities of the original tenant, intermediate assignee and surety. [Reference was made to sections 179, 181, 182 of the Insolvency Act 1986 and rules 4.187-4.194 of the Insolvency Rules 1986 (S.I. 1986 No. 1925).]

The genesis of the statutory provisions is to be found in the Bankruptcy Act 1883. Almost identical provisions have appeared in every bankruptcy Act since then. They were first extended from personal to corporate insolvency by the Companies Act 1929. As to earlier legislation, the most important provision for present purposes is section 32 of the Bankruptcy Act 1869 (32 & 33 Vict. c. 71) which was replaced by section 55 of the Bankruptcy Act 1883. [Reference was made to section 267 of the Companies Act 1929 and section 323 of the Companies Act 1948.]

The purpose of the disclaimer provisions in the Act of 1986 is to release the insolvent company from onerous obligations and thus minimise the loss to the estate and maximise the amount of funds available for distribution to the creditors.

A lease is a bundle of rights and obligations: it cannot be a unilateral contract. Therefore, once the tenant company's "rights, interests and liabilities" are determined by disclaimer the lease must, as a matter of logic, cease to exist, since the landlord's covenants have no meaning where there is no occupying tenant. Once the lease has ceased, so has the liability of the previous tenants and sureties. The release of the original tenant, any intermediate assignee and any surety is necessary to achieve the purpose of the legislation. If the original tenant remains liable to the landlord for the company's rent, the liabilities of the company in respect of the property are not determined because the company remains liable to indemnify those who pay its debts for it (see *Moule v. Garrett* (1872) L.R. 7 Ex. 101, 104) and therefore remains liable in relation to the property. This interpretation is fortified in section 178(4)(b) of the Act of 1986 by the words "except so far as is necessary for the purpose of releasing the company from any liability."

If the original tenant is not released from liability and the company is liable to indemnify the original tenant for the payment of rent, the company, although deprived of the property, is then liable for the profit for the whole of the capitalised value of the rent for the whole of the residue of the term, including an uplift for any rent reviews. This may be more onerous to the company than if it had not disclaimed the lease. If, however, the original tenant is released from liability, so that in no sense can the lease continue to exist, and the landlord

takes back the property, the landlord then has a claim for his loss. But his loss is likely to be considerably less than that of the original tenant because he has the benefit of the land which he can sell or relet. Thus the loss to the estate is minimised.

The purpose of section 178(6) of the Act of 1986 in the context of the disclaimer of a lease is to enable a person who is entitled to possession of the property (or an estate in the property) to prove for his loss. This would include the lessor, or a mortgagee, or a sub-tenant who has a sub-demise of the lease. This reflects the scheme of the Act of 1986 which protects those with estates carved out of the lease.

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The notice and vesting provisions, sections 179 and 182, make specific provision for notice of disclaimer to be given to underlessees and mortgagees, and for the vesting of the property in them, thus underlining the fact that the legislature treats the lease out of which a further estate has been carved differently from the lease in respect of which no such sub-estate or right of possession exists, as in this case. The intention of the legislation is that, where there is no underlessee or mortgagee, the lease comes to an end on disclaimer and cannot re-vest.

In *Stacey v. Hill* [1901] 1 K.B. 660, the Court of Appeal held that the purpose of the disclaimer provisions is to free the bankrupt and his property from any future liabilities in relation to the property. Thus where a surety would have a right of indemnity against the bankrupt in relation to rent, he should also be released by the disclaimer. In *Hill v. East and West India Dock Co.* (1884) 9 App.Cas. 448 a majority of the House of Lords held that whereas the purpose of the disclaimer provisions is to release the bankrupt, a disclaimer should not affect the rights or liabilities of other persons. Thus the original tenant was not released by the disclaimer from his liability to the landlord to pay rent accruing due after the disclaimer. The decision thus affirmed the reasoning of the Court of Appeal in *Ex parte Walton; In re Levy* (1881) 17 Ch.D. 746 that the words in section 23 of the Bankruptcy Act 1869, "should be deemed to have been surrendered," were to be construed as meaning that the lease should be deemed to have been surrendered so far only as necessary to effectuate the purpose of that Act. The fact that the original tenant would have an indemnity in relation to the rent he paid against the bankrupt's estate and therefore the bankrupt's estate was not released from liability was not considered by the House of Lords in *Hill v. East and West India Dock Co.* The reasoning in *Stacey v. Hill* [1901] 1 K.B. 660 and the reasoning in *Hill v. East and West India Dock Co.*, 9 App.Cas. 448 are thus inconsistent. It is impossible to reconcile the two cases as a matter of principle and there is no logically supportable distinction between them. This has led to a state of confusion in the law which holds that a surety is released where the lease has been disclaimed by an original tenant whereas, where an assignee disclaims, the original tenant remains liable.

The reasoning in *Stacey v. Hill* is to be preferred for the following reasons. (i) It was decided on wording almost identical to that of section 178(4)(b) of the Insolvency Act 1986. If either the first assignee or his surety pay the rent due after disclaimer, it or he can claim an indemnity from the company in liquidation, and the liquidator would have to indemnify the first assignee or his surety: see *In re Downer Enterprises Ltd.* [1974] 1 All E.R. 1460. (ii) The question is whether the release of the first assignee and the surety is necessary for the purpose of releasing the second assignee (in liquidation) from any liability. Given the right of indemnity of the first assignee and the surety against the second assignee, the answer to that question is in the affirmative. (iii) The lessor's remedy is to take back the premises, re-let them and prove for damages in the liquidation: see *Stacey v. Hill* [1901] 1 K.B. 660, 666.

Hill v. East and West India Dock Co., 9 App.Cas. 448 should be distinguished, or not followed. It was decided under section 23 of the Bankruptcy Act 1869 which was materially different from section 55 of

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the Bankruptcy Act 1883 and the present legislation. There was no express provision as to the effect of the disclaimer on the bankrupt's rights and liabilities. There was no provision as to the trustee's liability. There

was no provision in relation to underlessees and mortgagees, and there were no vesting provisions. *In re Finley; Ex parte Clothworkers' Co.* (1888) 21 Q.B.D. 475, 482 Lindley L.J. observed that section 55 of the Bankruptcy Act 1883 was "an entirely new enactment" from section 23 of the Bankruptcy Act 1869. The fact that section 55 had new provisions in it should be borne in mind when considering the weight to be given to the old authorities. Moreover, none of the previous cases considered the argument that, as a result of a surety's or an original tenant's indemnity, the bankrupt estate remained liable unless they were also released.

Millett L.J. below held that there is no relevant distinction to be drawn between the position of the original tenant and that of a surety for the bankrupt assignee, each being liable to the lessor and having a claim for indemnity against a bankrupt estate. Millett L.J. was correct in holding that the part of Sir Robert Megarry V.-C.'s judgment in *Warnford Investments Ltd. v. Duckworth* [1979] Ch. 127 which dealt with such a distinction is untenable.

The main reasoning, however, in the judgment below is wrong for the following reasons. It cannot be right that there are two separate and distinct liabilities in respect of the liability to pay the rent under a lease. If that were so, landlords would be able to claim rent from two people independently, without the one being able to recover from the other. It has never been the case that an original tenant is liable without recourse to the tenant for the time being: see *Moule v. Garrett*, L.R. 7 Ex. 101. It is wrong in law and logic to say that the surety's right of indemnity against a principal debtor is wholly different from that of an original tenant. An original tenant's liability to be indemnified by his assignee is co-extensive with his liability to meet the obligations of the assignee to the landlord - it arises when the assignment takes place, and it expires when the assignee's liability expires. The rights of a surety and an original tenant to be indemnified both arise as a result of the equitable principle of indemnification. That principle derives from *Deering v. Lord Winchelsea* (1817) 2 B. & P. 270 and was applied in *Moule v. Garrett*, L.R. 7 Ex. 101, 104, to an original tenant's right to indemnity from his assignee.

Millett L.J.'s view that the effect of the disclaimer is to abrogate the original tenant's right of indemnity is contrary to *Harding v. Preece* (1882) 9 Q.B.D. 281 which held that an original tenant who paid the rent due after the disclaimer by his bankrupt assignee trustee was entitled to be paid by the bankrupt's surety. In *Harding v. Preece* the surety was in favour of the original tenant and not the landlord, and it was held that he was not released. On no logical basis can the identity of the person who has the benefit of the contract of suretyship be a relevant criterion for deciding whether the surety is liable or not. Millett L.J.'s solution in the Court of Appeal to the problem is not sustainable because it is based on a premise which is wrong in law, and should not be upheld. *Warnford Investments Ltd. v. Duckworth* [1979] Ch. 127 is flawed for the same reasons and because the decision is founded on the illogical premise that the disclaimed lease could always revert and therefore come back into

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existence, like a "dormant volcano:" see *In re Thompson and Cottrell's Contract* [1943] Ch. 97.

The present law is based on the anachronistic Victorian attitude that a landlord should have the double protection of rights in personam and rights in rem. That this attitude is no longer relevant is reflected by the thinking behind the Landlord and Tenant (Covenants) Act 1995.

Kim Lewison Q.C. and **Jonathan Arkush** for the plaintiffs. When a landlord grants a lease to a tenant the parties are entering into a contract. In addition, the landlord is creating a legal estate. Thus, at the inception of the present lease, the liability of the tenant arose in two ways: (a) by privity of contract and (b) by privity of estate. Liability by privity of estate is transferred to a subsequent assignee of the leasehold estate created by the lease; liability by privity of contract cannot be transferred. These principles are well established in the law of landlord and tenant. Thus, upon the taking of the assignment by the first assignee, it assumed liability by privity of estate. This liability was an automatic consequence of taking the assignment, and came to an end

when the first assignee assigned the leasehold term to the second assignee. But in addition, by clause 2(i) of the licence, the first assignee assumed by an independent contractual liability to pay the rent and perform the tenant's covenants for the residue of the term. Liability of the surety arises under clause 5(1) of the licence. Since the surety acquires no estate in land, his liability is contractual only.

Liability by privity of estate and liability by privity of contract are not necessarily coextensive, either in duration or extent: see *City of London Corporation v. Fell* [1994] 1 A.C. 458, 464G-466A and *Friends' Provident Life Office v. British Railways Board* [1996] 1 All E.R. 336. It follows that the liabilities of the second and third defendants to the plaintiffs are independent of, and of a quite different nature to, the liability disclaimed by the liquidator. What the liquidator disclaimed was the estate. He could not disclaim liabilities imposed by other persons.

The effect of a disclaimer is to release the insolvent from liability in respect of the property disclaimed. Immediately before the disclaimer the second assignee, Prest Ltd., had the following liabilities in respect of the disclaimed property: (a) the liability to the landlord to pay the rent and perform the covenants in the lease; (b) the liability to indemnify the first assignee under the covenant for indemnity if the first assignee was called upon by the landlord under its own contractual liability; (c) the liability to indemnify the lessee under the rule in *Moule v. Garrett*, L.R. 7 Ex. 101, if the lessee was called upon by the lessor under its contractual liability; (d) the liability to reimburse the surety for the first assignee who, on payment to the lessor, would be subrogated to the landlord's rights. All these liabilities were discharged by the disclaimer.

It follows from the language of section 178(4) of the Insolvency Act 1986 that a disclaimer is not to affect the rights or liabilities of any person other than the insolvent company. The single exception to this rule is that rights and liabilities of third parties are affected so far as necessary to release the company. If, therefore, the foregoing liabilities were not automatically discharged by the disclaimer, the question arises: what third party rights is it necessary to interfere with to release the company? The

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answer is: only those rights which are directly enforceable against the company. These are (a) the right of the lessor to look to the company for payment of rent and performance of the tenant's covenants; (b) the right of the lessee to look to the company for an indemnity under the rule in *Moule v. Garrett*; (c) the right of the first assignee to look to the company for an indemnity under the covenants implied by section 77 of the Law of Property Act 1925; (d) the right of the surety to look to the company for an indemnity under the general principles of subrogation. This construction does least violence to third party rights and liabilities which it is the evident intention of Parliament to preserve.

If the lessee, the first assignee and the surety are all released, then in addition to the rights previously mentioned, the following third party rights will also be released: (a) the lessor's right to look to the lessee pursuant to the contractual liability contained in the lease for payment of the rent and performance of the tenant's covenants; (b) the lessor's right to look to the first assignee pursuant to the contractual liability contained in the licence for payment of the rent and performance of the tenant's covenants; (c) the lessor's right to look to the surety pursuant to his contract of suretyship to make good defaults in payment of rent and performance of the tenant's covenants. The release of these rights and liabilities, however, is incompatible with the general proposition that disclaimer is not to affect third party rights.

As to the position before 1869, the assignee of the bankrupt (in modern legislation, the trustee in bankruptcy) was called upon to elect whether or not to accept a leasehold interest. Section 19 of the statute 49 Geo. 3, c. 121 provided that if the assignee elected to accept the lease the bankrupt should not be liable to pay the rent accruing due after such acceptance. Nevertheless, a surety remained liable: see *Inglis v. MacDougal* (1817) 1 Moo.Rep. 196, 198. In *Taylor v. Young* (1820) 3 B. & Ald. 521 it was held that the provisions of the Bankruptcy Acts applied only as between landlord and tenant. The decision shows that a narrow

interpretation was given to the words of the statute. It was followed in *Manning v. Flight* (1832) 3 B. & Ad. 211, where it was held that the statute effected only a personal discharge of the bankrupt. *Tuck v. Fyson* (1829) 6 Bing. 321 is authority for the proposition that the statutory discharge of the bankrupt was a personal discharge only, and did not release the surety before the actual surrender of the lease. The case also shows that the liability of the surety may survive the personal discharge of the bankrupt.

As to the position after 1869, by section 23 of the Bankruptcy Act 1869 a provision was made for the first time to enable the trustee of an insolvent to disclaim leases and other onerous property. In *Ex parte Walton; In re Levy*, 17 Ch.D. 746 the Court of Appeal held that the deemed surrender had effect only as between the bankrupt and the landlord. From the observations of Sir George Jessel M.R., at p. 754, it is plain that (a) third party rights were not to be affected; (b) the persons injured by the disclaimer were those with direct (not indirect) rights against the bankrupt; and (c) Parliament adopted this formulation when it later amended the mechanism for dealing with a leasehold estate vested in an insolvent. To the question whether it could ever have been intended

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that the bankruptcy of the lessee should release the surety the answer of James L.J., at p. 757, was plainly negative. The approach of James L.J. was adopted by the Divisional Court in *Harding v. Preece*, 9 Q.B.D. 281, where it was held that both the original tenant and the surety for a bankrupt assignee of a lease continued to be liable for the rent of the lease after it had been disclaimed. The only case on the disclaimer of a lease to reach the House of Lords is *Hill v. East and West India Dock Co.*, 9 App.Cas. 448, where the majority of the House of Lords adopted a purposive construction of section 23 of the Act of 1869, and held that the deemed surrender took effect only as between the insolvent landlord. Great reliance was placed by the present defendants on the speech, at pp. 467-468, of Lord Bramwell, who dissented on the ground that the words of the section should be construed literally, but said that if the majority view was correct, the draftsman should have provided that the bankrupt should be discharged from all the obligations of the lease. The suggested form of words was indeed adopted in subsequent legislation. Moreover, it should also be observed that another reason which led Lord Bramwell to his conclusion was his view that the original tenant had no means of recovering possession of the property. This anomaly no longer arises because, under section 181(2) of the Insolvency Act 1986, a person who is under a liability in respect of any disclaimed property may apply to the court for a vesting order.

The current mechanism for dealing with a leasehold interest, where the tenant becomes bankrupt, was introduced by section 55 of the Bankruptcy Act 1883, and was repeated in section 54(2) of the Bankruptcy Act 1914, section 267(2) of the Companies Act 1929, section 323(2) of the Companies Act 1948 and section 178(4) of the Insolvency Act 1986.

In enacting the provisions dealing with the effect of a disclaimer, Parliament was codifying (or adopting) the construction placed upon previous legislation by the previous authorities. The legislation should therefore be interpreted as interfering with third party rights and liabilities to the minimum extent necessary to secure the contractual release of the insolvent. [Reference was made to *Warnford Investments Ltd. v. Duckworth* [1979] Ch. 127 and *W.H. Smith Ltd. v. Wyndram Investments Ltd.* [1994] 2 B.C.L.C. 571.]

There are differences between the position of a surety and that of the original tenant. The original tenant takes on the primary liability under the lease. At that stage he has no right of indemnity against anyone. The surety has no benefit under the lease: he guarantees any loss. The original tenant is a property owner and a contributing party. At the outset, the surety has a right of indemnity against the principal debtor. The original tenant only has a notional right of indemnity if he can find an assignee. There are therefore real conceptual differences between the two positions. Even if the liquidator or trustee of an insolvent original tenant disclaims a lease, a surety for the insolvent will remain liable. *Stacey v. Hill* [1901] 1 K.B. 660 may be said to controvert this proposition. But in that case the guarantee was limited to payment of rent which was actually in arrear. It was not the more usual form of combined guarantee and indemnity under which the guarantor

covenants that the tenant will perform his obligations and that the guarantor will indemnify the landlord if the
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guarantor fails to perform. A. L. Smith M.R. held that, on the authority of *In re Finley, Ex parte Clothworkers' Co.*, 21 Q.B.D. 475, the court was bound to conclude that on the disclaimer the lease came to an end. It followed that no rent could become due under it, and there could be no rent in arrear. As to the observations of Lindley L.J. in *In re Finley, Ex parte Clothworkers' Co.*, 21 Q.B.D. 475, 485 which were applied, (a) *Stacey v. Hill* was not a case in which there was nothing more than a lease; there was a lease and a guarantee; (b) the legislation did not (and does not) provide for the lease itself to come to an end; where there is a leasehold interest without an owner, it vests in the Crown as bona vacantia (*In re Sir Thomas Spencer Wells; Swinburne-Hanham v. Howard* [1933] Ch. 29); (c) it is not necessary for the lease to be brought to an end in order to release the insolvent from liability; the insolvent's liability under the lease has ex-hypothesi been terminated by the disclaimer himself; (d) *Stacey v. Hill* has not been followed in Ireland; the criticism of Keane J. in *Tempany v. Royal Liver Trustees Ltd.* [1984] B.C.L.C. 568, 579-584 is justified. If and to the extent that *Stacey v. Hill* decides that a disclaimer by the trustee in bankruptcy or liquidator of an insolvent original tenant does discharge a person standing surety for the performance of the obligations under the lease, it should be overruled.

As to the right to prove, any person sustaining loss or damage in consequence of the operation of a disclaimer is deemed to be a creditor of the company to the extent of the loss or damage and therefore may prove for the loss or damage in the winding up: see section 178(6) of the Insolvency Act 1986. Accordingly, if an original tenant or a surety suffers loss because of the loss of his right to indemnity against the insolvent, he may prove for that loss in the winding up. This provision is neutral as between the opposing arguments. The true effect of section 178(4) is not dependent on an attempt to quantify what loss might be the subject of proof by the landlord, on the one hand, and the original tenant or surety on the other. If the landlord can put himself in a position to relet, the original tenant or a surety can put himself in the same position by applying for and obtaining a vesting order.

Oliver Q.C. in reply. Section 55 of the Bankruptcy Act 1883 may be described as the parliamentary draftsman's revenge for the courts' interpretation of section 23 of the Bankruptcy Act 1869. The later Act set up a completely new framework, and therefore the early cases are of little moment.

Stacey v. Hill [1901] 1 K.B. 660 was applied in *D. Morris & Sons Ltd. v. Jeffreys* (1932) 49 T.L.R. 76, and it was referred to without disapproval in *In re A.E. Realisations* (1985) Ltd. [1988] 1 W.L.R. 200. It was applied in *Murphy v. Sawyer-Hoare* [1994] 2 B.C.L.C. 59. [Reference was also made to section 7 of Deasy's Act 1860 (23 & 24 Vict. c. 154); section 210 of the Companies Act 1948; section 469 of the Companies Act 1985; section 178(4) of the Insolvency Act 1986; *In re Finley, Ex parte Clothworkers' Co.*, 21 Q.B.D. 475; *In re Thompson and Cottrell's Contract* [1943] Ch. 97; *In re Fenton, Ex parte Fenton Textile Association Ltd.* [1931] 1 Ch. 85; *In re Katherine et Cie. Ltd.* [1932] 1 Ch. 70 and *In re I.W. Yarmarine* [1992] B.C.L.C. 276.]
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Their Lordships took time for consideration.

22 February 1996. LORD KEITH OF KINKEL My Lords, for the reasons given in the speech to be delivered by my noble and learned friend, Lord Nicholls of Birkenhead, which I have read in draft and with which I agree, I would dismiss this appeal.

LORD GRIFFITHS . My Lords, I have had the advantage of reading in draft the speech prepared by my noble and learned friend, Lord Nicholls of Birkenhead. For the reasons he gives I would dismiss this appeal.

LORD BROWNE-WILKINSON . My Lords, for the reasons given in the speech of my noble and learned friend, Lord Nicholls of Birkenhead, I, too, would dismiss this appeal.

LORD LLOYD OF BERWICK . My Lords, I agree that the appeal should be dismissed for the reasons to be given by my noble and learned friend, Lord Nicholls of Birkenhead. I add a short speech of my own only because I have found the case to be one of some difficulty.

At an early stage of the hearing I formed the view that *Hill v. East and West India Dock Co.* (1884) 9 App.Cas. 448, and *Stacey v. Hill* [1901] 1 K.B. 660, could not well stand together, despite Sir Robert Megarry V.-C.'s attempt to reconcile the decisions in *Warnford Investments Ltd. v. Duckworth* [1979] Ch. 127, and Millett L.J.'s further attempt at reconciliation, on rather different grounds, in the court below. If the decisions cannot be reconciled, the question becomes which of the two decisions should be preferred.

For much of the hearing I was attracted by Mr. Oliver's argument that the reasoning in *Stacey v. Hill* was the more convincing. The key feature of that decision, as Mr. Simon Goldblatt Q.C. pointed out in his remarkable extempore judgment at first instance, is that both A. L. Smith M.R. and Collins L.J. regarded the case as being concluded by the passage which the former quoted from the judgment of Lindley L.J. in *In re Finley; Ex parte Clothworkers' Co.* (1888) 21 Q.B.D. 475, 485:

"Now the operation of those clauses in the simple case of a lease is not very difficult to ascertain. If there is nothing more than a lease, and the lessee becomes bankrupt, the disclaimer determines his interest in the lease under subsection (2). He gets rid of all his

liabilities, and he loses all his rights by virtue of the disclaimer. There is no need of any provision for vesting the property in the landlord, but the natural and legal effect of subsection (2) is that the reversion will become accelerated."

A. L. Smith M.R. put the point as follows in *Stacey v. Hill* [1901] 1 K.B. 660, 664:

"In other words, the effect of the subsection is that in such a case the lease is put an end to altogether as between the lessor and the bankrupt lessee, the intention being that the bankrupt shall be altogether freed from any obligation arising under or in relation to it;

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and, consequently, no other person being interested in the lease, it ceases to exist. As the lease is determined, no rent can, subsequently to the disclaimer, become due under it: the reversion on the term is in effect accelerated; and the lessor gets back his property, and can let it to another tenant, for aught I know, at a higher rent."

A. L. Smith M.R. then went on to consider the position of a guarantor for the original lessee. He gave two reasons for rejecting the argument that the guarantor remained liable, even though no more rent could fall due from the bankrupt lessee. The first depended on the need to release the bankrupt from liability to indemnify the guarantor. I do not find that ground convincing for the reasons to be given by my noble and learned friend, Lord Nicholls. But the second ground was a straightforward application of the ordinary law of principal and surety. If the lease has ceased to exist, to use the language of A. L. Smith M.R., how could the surety be liable for rent which has not yet fallen due? A surety is normally only liable for the defaults of the principal debtor. But the lessee cannot make default after disclaimer, for he is no longer liable to pay the rent. The lease has come to an end by operation of law.

Collins L.J. said, at p. 666:

"I think that what the legislature intended in such a case as this was that the lease should be determined by the disclaimer as between the lessor and the lessee, and therefore incidentally as regards the surety, with the result that the bankrupt lessee is discharged and incidentally the surety also: ..."

A little later he said: "If disclaimer under the present law operates in the language of Lindley L.J. to 'accelerate the reversion,' the condition of the surety's liability in this case must necessarily fail ..."

Perhaps the clearest exposition of the point is to be found in the short judgment of Romer L.J., at p. 667. He regarded the release of the guarantor as "necessary for the purpose of releasing the bankrupt" because that is the inevitable result in law of bringing the lease to an end. If the lease has ceased to exist as between lessor and lessee, it cannot be treated as if it continued to exist for the purpose of making the surety liable. So to hold would be to impose on the surety a different kind of liability.

"For the defendant has only agreed to be liable as surety for the payment of rent by a lessee under a lease: and yet the appellant seeks to make him liable to pay money, though there is no rent payable, no lease, and no person in the position of lessee."

The next step in Mr. Oliver's argument was that if the surety for the original lessee is released by a disclaimer on the part of the original lessee's trustee in bankruptcy, the same must apply where the lease has been assigned, and it is the assignee who has become bankrupt. If the assignee's trustee in bankruptcy disclaims the lease, it ceases to exist just as surely as if it is disclaimed by the trustee in bankruptcy of the original lessee; and if the lease has ceased to exist, the assignee's guarantor must necessarily also be released under the ordinary law of principal and surety, since to hold him liable would be to impose on him a different kind of liability.

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Mr. Oliver accepted that it would be possible to devise a form of guarantee under which the surety would undertake an independent liability in the event of disclaimer. Clause 5(2) in the licence dated 22 April 1987 is just such a provision. But it is clear from the language of clause 5(2) that the parties contemplated such independent liability as arising under a *new* lease on the same terms as the old, which was to take effect on the date of the disclaimer, and was to be delivered to the lessor after execution by the surety. It is difficult to see how a new lease could be brought into existence unless the old lease has ceased to exist.

Finally, Mr. Oliver returned to consider the position of the original lessee, where it is the assignee's trustee in bankruptcy who disclaims. Mr. Oliver argued that the original lessee's position must be the same as that of the surety of the bankrupt assignee. If the lease has ceased to exist, it must have ceased to exist for all purposes. The original lessee cannot be liable for rent if there is no lease. By the same token, the original lessee's guarantor, and the guarantor of any intermediate assignee would also be released.

If Mr. Oliver's argument be correct, it would follow that *Hill v. East and West India Dock Co.*, 9 App.Cas. 448 was wrongly decided. Alternatively, Mr. Oliver sought to distinguish *Hill v. East and West India Dock Co.* on the ground that section 23 of the Bankruptcy Act 1869 (32 & 33 Vict. c. 71) is in very different terms from section 55 of the Bankruptcy Act 1883 (46 & 47 Vict. c. 52), as the Court of Appeal in *Stacey v. Hill* [1901] 1 K.B. 660 were at pains to emphasise.

It will be apparent from this inadequate account of Mr. Oliver's argument that it all depends on his underlying proposition that disclaimer has a dual effect. It determines the rights, interests and liabilities of the bankrupt tenant. But it also determines the leasehold estate, not only in the case of the original lessee's bankruptcy, but also in the event of any subsequent assignee becoming bankrupt. The question is thus whether this dual effect is indeed the consequence of section 178(4) of the Insolvency Act 1986. In order to answer this question it helps to go back to the language of the Act of 1869.

Section 23 of the Act of 1869 provided:

"When any property of the bankrupt acquired by the trustee under this Act consists of land of any tenure burdened with onerous covenants ... the trustee may ... disclaim such property, and upon the execution of such disclaimer the property disclaimed shall ... if the same is a lease be deemed to have been surrendered on the same date ..."

In *Ex parte Walton; In re Levy* (1881) 17 Ch.D. 746, Sir George Jessel M.R. held that the words "deemed to be surrendered" were to be given a narrow construction. He said, at p. 754:

"Therefore it seems to me that the section must be read as meaning that the property is to be disclaimed inter se, so as not to interfere with the rights of third parties, and only for the benefit of the bankrupt and his estate; so far, that is, as respect any rights and liabilities in relation to it as between the trustee and the person who is entitled to the benefit of those obligations which attach to the

property; so far only as is necessary in order to relieve the bankrupt and his estate and the trustee from liability."

James L.J. said, at pp. 756-757:

"That being the sole object of the statute, it appears to me to be legitimate to say, that, when the statute says that a lease, which was never surrendered in fact (a true surrender requiring the consent of both parties, the one giving up and the other taking), is to be deemed to have been surrendered, it must be understood as saying so with the following qualification, which is absolutely necessary to prevent the most grievous injustice, and the most revolting absurdity, 'shall, as between the lessor on the one hand, and the bankrupt, his trustee and estate, on the other hand, be deemed to have been surrendered.'"

James L.J. went on to ask, rhetorically, whether it could ever have been intended that the bankruptcy of the lessee should release the surety, the very question which, contrary to the clear implication of the question, was answered in favour of the surety in *Stacey v. Hill* [1901] 1 K.B. 660.

In *Hill v. East and West India Dock Co.*, 9 App.Cas. 448 it was argued that *Ex parte Walton* was wrongly decided, and was, indeed, inconsistent with an earlier decision in which James L.J. had said that the effect of the disclaimer was that the lease was to be deemed to have come to an end "for all purposes:" the term "was gone." However, the House, by a majority, held that *Ex parte Walton* was correctly decided. Earl Cairns quoted extensively from the judgment of James L.J. Lord Blackburn held, at p. 459, that the narrow construction put upon the section by James L.J. was "more natural and more reasonable and more correct than the construction for which the appellant contends ..."

Hill v. East and West India Dock Co. is thus clear authority of your Lordships' House that, despite the "deemed surrender" of the lease by the assignee's trustee in bankruptcy, the lease does not come to an end for all purposes. The original lessee's liability survives, and so presumably does the liability of his surety. This would, I think, be almost enough to persuade me that *Stacey v. Hill* was wrongly decided, and ought to be overruled. But what carries the day to my mind is the intervention of the legislature between the date of the decision in *Ex parte Walton* and the decision of your Lordships' House in *Hill v. East and West India Dock Co.* For the reference to the "deemed surrender" of the lease - the phrase which caused all the difficulty in *Hill v. East and West India Dock Co.*, and which does indeed lend some support to Mr. Oliver's argument that the lease comes to an end for all purposes - is no longer to be found. Instead, section 55 of the Act of 1883 substitutes the narrow construction favoured by the Court of Appeal in *Ex parte Walton*; *In re Levy*, 17 Ch.D. 746 and adopts language very similar to that used by Sir George Jessel M.R. in that case. In the light of that legislative history, I do not think it was open to A. L. Smith M.R. in *Stacey v. Hill* [1901] 1 K.B. 660 to disregard, as he did, the cases decided under the Act of 1869 on the ground that the language was very different. Since the legislature had, in effect, adopted the narrower construction favoured by the Court of Appeal in *Ex parte Walton*, and subsequently approved by the House in *Hill v. East and West India Dock Co.*, 9 App.Cas. 448 the Court of Appeal in

Stacey v. Hill ought to have held that the surety was not released. It follows that, for the same reasons, none of the three defendants were released in the present case. Despite Mr. Oliver's persuasive argument to the contrary, I would dismiss the appeal.

LORD NICHOLLS OF BIRKENHEAD . My Lords, this case arises out of the recession in the property market. It raises a much vexed question about the liability of a guarantor when the tenant becomes insolvent and the lease is disclaimed.

In times of recession the rent payable under a lease may exceed the current rental value of the property in the open market. The rental value of the property may have fallen since the lease was granted or the rent was reviewed. This is especially likely where the rent review is upwards only. So long as the tenant remains solvent, the fall in property values leaves the tenant out of pocket, not the landlord. The tenant is out of pocket by paying more for the property than its current worth.

The picture changes if the tenant gets into financial difficulty. If the insolvent tenant was the original tenant and there was no guarantor, there is nothing the landlord can do. He can forfeit the lease and recover his property, but the shortfall between the current rental value of the property and the rent reserved by the lease is a loss he has to bear. The loss resulting from the falling market will be his loss. He has a right to prove in the tenant's insolvency, for however much or little that may yield.

The picture changes again if the landlord has protected himself against the risk of the tenant's insolvency by requiring a guarantor to join in the lease. When the rent payable under the lease is higher than the rental value of the property at the time of the tenant's default, the landlord's financial interests may be better served by looking to the guarantor than by taking possession of the property and reletting it. Similarly, if the impecunious tenant is not the original tenant but a person to whom the lease has been assigned, the landlord may look to the original tenant for payment. When the lease was granted the original tenant covenanted with the landlord to pay the rent and to do so throughout the whole term of the lease. This included any increased rent payable under the rent review provisions. In these cases the loss falls on the guarantor or the original tenant, not the landlord.

Sometimes, in post-assignment cases, the landlord's protection may be achieved at an unreasonably high price to others. The insolvency may occur many years after the lease was granted, long after the original tenant parted with his interest in the lease. He paid the rent until he left, and then took on the responsibility of other premises. A person of modest means is understandably shocked when out of the blue he receives a rent demand from the landlord of the property he once leased. Unlike the landlord, he had no control over the identity of assignees down the line. He had no opportunity to reject them as financially unsound. He is even more horrified when he discovers that the rent demanded exceeds the current rental value of the property.

Mounting public concern at this post-assignment state of affairs led to the enactment of the Landlord and Tenant (Covenants) Act 1995. In future, where a tenant lawfully assigns premises demised to him he will be

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released from the covenants falling to be complied with by the tenant of the premises.

However, the principal provisions of the new Act do not apply to tenancies granted before the Act came into force on 1 January 1996. So this amelioration of a tenant's lot does not apply in the present case. In the

present case the three defendants are the original tenant, a first assignee which entered into direct covenants with the landlord covering the rest of the term, and a guarantor for the first assignee. A subsequent assignee, Prest Ltd. ("Prest"), became insolvent. Because of the fall in property values, the lease had no value. It was unsaleable. The liquidator of Prest wished to have nothing to do with it. He disclaimed the lease as onerous property. The defendants are liable for non-payment of the rent and service and other charges unless the *liquidator's* act in disclaiming the lease ended *their* liability. That depends upon the proper interpretation of the disclaimer provisions in the Insolvency Act 1986.

The lease and the proceedings

In 1983 the plaintiff, Hindcastle Ltd., leased second floor office premises at 297, Oxford Street in the West End of London to the first defendant, Barbara Attenborough Associates Ltd. The lease was dated 20 October 1983 and was for 20 years. The initial rent was £13,626 per annum, with periodic rent reviews, upwards only.

In May 1987 the lease was assigned to the second defendant, CIT Developments Ltd. ("CIT"). On that occasion, by a licence dated 22 April 1987 CIT covenanted with the landlord to pay the rent and perform the lessee's covenants during the residue of the term. The third defendant, Mr. Patrick Whitten, was a director of CIT. He guaranteed performance of CIT's obligations for a period of 10 years from the date of the lease.

CIT was not tenant for very long. Two years later, in May 1989, CIT assigned the lease to Prest Ltd. Thereafter the rent was reviewed upwards to £37,500 per annum, nearly three times the amount of the original rent. The increase was backdated to Christmas Day 1988. None of the defendants took any part in the negotiations with the landlord. On 31 October 1992 Prest went into creditors' voluntary liquidation, and on 8 December its liquidator gave notice of disclaimer of the lease. No one applied for a vesting order.

In 1993 the plaintiff landlord brought proceedings against all three defendants for unpaid rent and other money falling due both before and after the date of the disclaimer. On applications for summary judgment Mr. Simon Goldblatt Q.C., sitting as a deputy judge of the High Court, gave judgment for the plaintiff for just over £50,000. The original tenant, Barbara Attenborough Associates Ltd., then went into compulsory liquidation and took no further part in the proceedings. The first assignee, CIT, went into creditors' voluntary liquidation and its liquidator disclaimed CIT's liability, if any, in respect of the lease. The Court of Appeal, comprising Sir Stephen Brown P., Rose and Millett L.J.J., dismissed an appeal by CIT's liquidator and Mr. Whitten. The court applied the decision in *Hill v. East and West India Dock Co.*, 9 App.Cas. 448 and distinguished the decision in *Stacey v. Hill* [1901]

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1 K.B. 660. The tension between these decisions lies at the heart of this appeal

The rights, interests and liabilities of a tenant

Before turning to the statute I should set the scene in one further respect. I must refer briefly to some basic propositions concerning the typical rights, interests and liabilities of a tenant in respect of property leased before the coming into force of the Act of 1995. A tenant is under a *liability* to the landlord to pay the rent and perform the tenant's other covenants under the lease. This obligation arises by virtue of privity of contract, in the case of the original tenant. An assignee is under a similar liability so long as he holds the lease, by virtue of privity of estate. If the assignee enters into a direct covenant with the landlord his liability will also be by virtue of privity of contract, in the terms of his covenant. That was the position of CIT in the present case.

A tenant enjoys *rights* under a lease as well as being subject to liabilities. The landlord covenants that the tenant will enjoy the property free from disturbance. The landlord may undertake repairing obligations, or obligations to provide services. The rights of a tenant under these covenants will be enforceable by him against the landlord, either by virtue of privity of contract, or privity of estate, or both.

Each of the liabilities of the tenant has a reverse side. A tenant is under a liability to the landlord to pay the rent. The reverse side is that the landlord has a right to be paid the rent. Similarly with the rights of a tenant: a tenant has a right to quiet enjoyment. The reverse side is that the landlord is under a liability to the tenant to afford quiet enjoyment.

A tenant may enjoy rights, and be subject to obligations, against other persons as well as the landlord. If he has sublet the property he will be entitled to rights and subject to liabilities vis-à-vis the subtenant. The reverse side of these rights and liabilities of the tenant as sub-lessor will be liabilities and rights of the subtenant.

A tenant may also owe obligations to persons who have no proprietary interest in the property. Under general principles of subrogation a tenant will be obliged to indemnify a person who has guaranteed payment of the rent. If a tenant is an assignee of the lease he will normally be under an obligation to the assignor to pay the rent and perform the tenant covenants in the lease, by virtue of the covenant implied by section 77(1)(c) of the Law of Property Act 1925. These liabilities of the tenant have, as their reverse side, a right enjoyed by the guarantor of assignor against the tenant.

Finally, a tenant has a proprietary interest in the property, namely the lease. This is a legal estate, of which the tenant is the owner. The landlord owns the reversion, expectant on the determination of that estate.

The statutory disclaimer provisions

Sections 178 to 182 of the Insolvency Act 1986 are a group of sections governing the disclaimer of onerous property by a liquidator of a company that is being wound up. Similar provisions, in sections 315 to 321, apply to trustees in bankruptcy. The differences between the two sets of

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provisions are not material for the purposes of this appeal. The ancestor of the disclaimer provisions in their present form is the Bankruptcy Act 1883, replaced subsequently by the Bankruptcy Act 1914. Disclaimer in corporate insolvencies was introduced in the Companies Act 1929. Again, and save as mentioned below, the differences between the Act of 1883 and its successors and the current statutory provisions are not material for present purposes.

Section 178(2) empowers a liquidator to disclaim any onerous property. Onerous property means any unprofitable contract, and any other property of the company which is unsaleable or not readily saleable or such that it may give rise to a liability to pay money or perform any other onerous act. Subsection (4) sets out the effect of a disclaimer. This is the crucial provision. It reads:

"A disclaimer under this section - (a) operates so as to determine, as from the date of the disclaimer, the rights, interests and liabilities of the company in or in respect of the property disclaimed; but (b) does not, except so far as is necessary for the purpose of releasing the company from any liability, affect the rights or liabilities of any other person."

Subsection (6) spells out a further consequence of disclaimer:

"Any person sustaining loss or damage in consequence of the operation of a disclaimer under this section is deemed a creditor of the company to the extent of the loss or damage and accordingly may prove for the loss or damage in the winding up."

Where a liquidator has disclaimed property an application may be made to the court for an order vesting the disclaimed property in the applicant, or for an order for the delivery of the property to the applicant. Under section 181(2), an application may be made by:

"(a) any person who claims an interest in the disclaimed property, or (b) any person who is under any liability in respect of the disclaimed property, not being a liability discharged by the disclaimer."

The court cannot make an order under (b) except where it would be just to do so for the purpose of compensating the person subject to the liability in respect of the disclaimer. The effect of such an order is to be taken into account in assessing, for the purposes of section 178(6), the extent of any loss or damage sustained by any person in consequence of the disclaimer.

If an underlessee or mortgagee of leasehold property takes a vesting order he is, in short, required to stand in the shoes of the company. An underlessee or mortgagee who declines to do so is excluded from all interest in the property. If there is no underlessee or mortgagee willing to do so, the court may vest the company's estate or interest in the property in "any person who is liable ... to perform the lessee's covenants in the lease." and may do so freed and discharged from all estates and incumbrances created by the company: see section 182(3).

The fundamental purpose of these provisions is not in doubt. It is to facilitate the winding up of the insolvent's affairs. There is a further purpose in personal insolvency cases. A bankrupt's property vests

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automatically in his trustee. The disclaimer provisions operate to discharge the trustee in bankruptcy from all personal liability in respect of the property: see section 315(3) (b).

Equally clear is the essential scheme by which the statute seeks to achieve these purposes. Unprofitable contracts can be ended, and property burdened with onerous obligations disowned. The company is to be freed from all liabilities in respect of the property. Conversely, and hardly surprisingly, the company is no longer to have any rights in respect of the property. The company could not fairly keep the property and yet be freed from its liabilities.

Disclaimer will, inevitably, have an adverse impact on others: those with whom the contracts were made, and those who have rights and liabilities in respect of the property. The rights and obligations of these other persons are to be affected as little as possible. They are to be affected only to the extent necessary to achieve the primary object: the release of the company from all liability. Those who are prejudiced by the loss of their rights are entitled to prove in the winding up of the company as though they were creditors.

I turn next to consider the application of these provisions to the principal types of landlord and tenant

situations. I do so initially without reference to the decided cases.

Disclaimer: (1) where only a landlord and tenant are involved

The simplest case is of a landlord and an insolvent tenant. No third parties are involved. Disclaimer operates to determine all the tenant's obligations under the tenant's covenants, and all his rights under the landlord's covenants. In order to determine these rights and obligations it is necessary, in the nature of things, that the landlord's obligations and rights, which are the reverse side of the tenant's rights and obligations, must also be determined. If the tenant's liabilities to the landlord are to be extinguished, of necessity so also must be the landlord's rights against the tenant. The one cannot be achieved without the other.

Disclaimer also operates to determine the tenant's interest in the property, namely the lease. Determination of a leasehold estate has the effect of accelerating the reversion expectant upon the determination of that estate. The leasehold estate ceases to exist. I can see no reason to question that this is the effect of disclaimer when the only parties involved are the landlord and the tenant.

Disclaimer : (2) where others have liabilities in respect of the lease

Thus far I have addressed the case where, apart from the insolvent tenant, the only person involved is the landlord. In such a case there is no scope for any rights or liabilities to be preserved by paragraph (b) of section 178(4). In order to achieve the statutory objective of releasing the insolvent from liability, it is necessary to determine all the rights of the landlord.

The matter stands differently where the landlord has the benefit of covenants from a guarantor. In this situation the liabilities of the insolvent tenant to the landlord are ended, but not so as to affect the obligations of

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the guarantor to the landlord. That is the effect of paragraph (b) of section 178(4). Similarly, where the insolvent tenant is an assignee and the landlord has the benefit of the covenants of the original tenant: the original tenant's obligations to the landlord are not affected.

Also ended is the obligation of the insolvent tenant to indemnify the guarantor but, here again, not so as to affect the mutual rights and obligations of the landlord and the guarantor. Termination of the liabilities of the insolvent does not carry with it any legal necessity to determine the guarantor's obligations to the landlord. The right of recourse of the guarantor against the insolvent can be effectually determined without, at the same time, releasing the guarantor from his liability to the landlord. His liability to the landlord can survive extinguishment of his right of recourse. Similar considerations apply to the liabilities of the original tenant where the insolvent tenant is an assignee.

I shall have to enlarge upon these points later when considering the decision in *Stacey v. Hill* [1901] 1 K.B. 660. But there is a recondite point which must be faced and resolved here as part of the process of interpreting the sections as a whole. It concerns what happens to the lease in this tripartite situation. The point may be stated shortly. A lease either exists, or it does not. If disclaimer has the effect of ending the lease, no further rent can become due, and so the guarantor and original tenant cannot be called upon. It is a contradiction in terms for rent to accrue for a period after the lease has ended. If, however, disclaimer does not end the lease, so that rent continues to accrue, what happens to the lease, bearing in mind that the insolvent's interest in the property has been ended? Possibilities are that the lease vests in the Crown as

bona vacantia, or that it remains in being but without an owner, or that it remains vested in the tenant but in an emasculated form. Each of these possibilities raises its own problems.

The starting point for attempting to solve this puzzling conundrum is to note that the Act clearly envisages that a person may be liable to perform the tenant's covenants even after the lease has been disclaimed. A vesting order may be made in favour of such a person: see section 182(3), and see also section 181(2)(b). The proper legal analysis has to be able to accommodate this conclusion. The search, therefore, is for an interpretation of the legislation which will enable this to be achieved as well as fulfilling the primary purpose of freeing the insolvent from all liability while, overall, doing the minimum violence to accepted property law principles.

If the problem is approached in this way, the best answer seems to be that the statute takes effect as a deeming provision so far as other persons' preserved rights and obligations are concerned. A deeming provision is a commonplace statutory technique. The statute provides that a disclaimer operates to determine the interest of the tenant in the disclaimed property but not so as to affect the rights or liabilities of any other person. Thus when the lease is disclaimed it is determined and the reversion accelerated but the rights and liabilities of others, such as guarantors and original tenants, are to remain *as though* the lease had continued and not been determined. In this way the determination of the lease is not permitted to affect the rights or liabilities of other persons. Statute has so provided.

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The vesting order provisions do not run counter to this analysis. If a vesting order is made, the court order operates by virtue of the statute to vest the lease in the person named on the terms fixed by the court. That the lease may have ceased to exist meanwhile is neither here nor there. If necessary, there will be a statutory recreation.

If no vesting order is made and the landlord takes possession, the liabilities of other persons to pay the rent and perform the tenant's covenants will come to an end as far as the future is concerned. If the landlord acts in this way, he is no longer merely the involuntary recipient of a disclaimed lease. By his own act of taking possession he has demonstrated that he regards the lease as ended for all purposes. His conduct is inconsistent with there being a continuing liability on others to perform the tenant covenants in the lease. He cannot have possession of the property and, at the same time, claim rent for the property from others.

The result is not without artificiality. Unless a vesting order is made, after disclaimer there will be no subsisting lease, and the property will be vacant and empty. But if the landlord enters upon his own property, he will thereby end all future claims against the original tenant and any guarantor, not just claims in respect of the shortfall between the lease rent and the current rental value of the property. It must be recognised, however, that awkwardness is inherent in the statutory operation: extinguishing ("determining") the lease so far as the bankrupt is concerned, but leaving others' rights and liabilities in respect of the same lease affected no more than necessary to achieve the primary purpose.

Disclaimer: (3) where other persons have an interest in the property

In both instances considered so far no person had acquired a proprietary interest under the lease before disclaimer. The third typical case is where a third party has acquired such an interest. The prime example is a subtenant. I can deal with this very shortly. In order to free the tenant from liability, it is necessary to extinguish the landlord's rights against the tenant and also the subtenant's rights against the tenant. The tenant's interest in the property is determined, but not so as to affect the interest of the subtenant. Determination of the subtenant's interest in the property is not necessary to free the tenant from liability. Hence the subtenant's interest continues. No deeming is necessary to produce this result. Here the deeming

relates to the terms on which the subtenant's proprietary interest continues. His interest continues unaffected by the determination of the tenant's interest. Accordingly the subtenant holds his estate on the same terms, and subject to the same rights and obligations, as *would* be applicable *if* the tenant's interest had continued. If he pays the rent and performs the tenant covenants in the disclaimed lease, the landlord cannot eject him. If he does not, the landlord can distrain upon his goods for the rent reserved by the disclaimed lease or bring forfeiture proceedings. In practice, matters are likely to be brought to a head by one of the parties making an application for a vesting order.

The earlier legislation and the authorities: before 1869

I turn next to the earlier legislation and the decided cases, with particular reference to the position of guarantors. Before 1869 the

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assignees of a bankrupt, who were the statutory predecessors of the trustee in bankruptcy, had to elect whether or not to accept a leasehold interest. The statute 49 Geo. 3, c. 121, section 19, provided that if the assignees elected to accept the lease, "the bankrupt shall not be ... liable to pay the rent accruing due after such acceptance ...". In *Inglis v. MacDougal* (1817) 1 Moo.Rep. 196 the court held that, notwithstanding this discharge of the principal debtor, a surety remained liable. Gibbs C.J. said, at p. 198:

"The very object of taking sureties is to provide against the insolvency of the principal; and the object of the insolvent acts and statutes applying to bankrupts is to discharge debtors and bankrupts from obligations, but not to disturb the claims of creditors on other persons, as sureties, from the failure of such debtors or bankrupts."

In *Tuck v. Fyson* (1829) 6 Bing. 321 the same approach was adopted to the language of the later Act of 6 Geo. 4, c.16, section 75.

From 1869 to 1883

The Bankruptcy Act 1869 introduced machinery enabling the trustee, for the first time, to disclaim leases and other onerous property. Section 23 stated the consequences of disclaimer. If the property disclaimed was a contract, it was deemed to be determined. If the property was a lease, it was "deemed to have been surrendered". If the property comprised shares in a company, they were deemed to be forfeited. Any person "interested in any disclaimed property" could apply to the court for an order for delivery up of the property.

From an early date the court robustly declined to give effect to the literal construction of these words. On ordinary principles, if a lease is surrendered no further rent is payable. But in *Smyth v. North* (1872) L.R. 7 Ex. 242 the Court of Exchequer held that section 23 affected only the relationship of the bankrupt and the lessor, and not third parties. So where the bankrupt was the assignee of a lease, disclaimer did not affect the liability of the original tenant.

The Court of Appeal took the same view in *Ex parte Walton; In re Levy*, 17 Ch.D. 746. Sir George Jessel M.R., at p.753, considered the results of a literal construction of the section would be so monstrous that such a construction must be considered absurd. He stated, at p. 754:

"the section must be read as meaning that the property is to be disclaimed inter se, so as not to interfere with the rights of third parties, and only for the benefit of the bankrupt and his estate; so far, that is, as respects any rights and liabilities in relation to it as between the trustee and

the person who is entitled to the benefit of those obligations which attach to the property; so far only as is necessary in order to relieve the bankrupt and his estate and the trustee from liability." (Emphasis added.)

The words I have emphasised may well be the source of the express provision to the same effect included in all the disclaimer legislation from 1883 onwards. The precise words in section 55(2) of the Bankruptcy Act 1883 were: "but shall not, except so far as is necessary for the purpose of

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releasing the bankrupt and his property and the trustee from liability, affect the rights or liabilities of any other person."

James L.J. adverted to the position of a surety of a disclaimed lease. He posed a question, at pp. 755-756, in terms which made plain his unstated answer: "Take the case of a lease with a surety for the payment of rent. Could it ever have been intended that the bankruptcy of the lessee was to release the surety?"

This question had to be answered in *Harding v. Preece* (1882) 9 Q.B.D. 281. The Queen's Bench Divisional Court held that both the original tenant and the surety for a bankrupt assignee of a lease remained liable for the rent of the lease after it had been disclaimed.

In *Hill v. East and West India Dock Co.*, 9 App.Cas. 448 your Lordships' House considered section 23. The assignee of a lease had become bankrupt and his trustee had disclaimed the lease. Your Lordships decided that the original tenant remained liable for rent notwithstanding the deemed surrender of the lease. Lord Bramwell disagreed vigorously. He adhered to the dissenting opinion he had expressed in *Smyth v. North*, L.R. 7 Ex. 272. He was oppressed by the injustice of a construction of the Act which meant that the original tenant had to continue paying rent and yet never be able to benefit from the property. The original tenant could not apply for possession under the statute because, no longer having a proprietary interest, he ceased to be "interested" in the property.

After 1883

When your Lordships' House heard the appeal in *Hill v. East and West India Dock Co.*, 9 App.Cas.448 the act of 1883 had already received the Royal Assent. At the beginning of his speech Earl Cairns described the new statute as much more explicit. He said, at p.453, that the question raised by the appeal was therefore not one which could very well occur again. And it is to be noted, in passing, that the injustice which so troubled Lord Bramwell under the earlier legislation did not arise under the new disclaimer provisions. Under the Act of 1883 applications for vesting orders were not confined to persons having a proprietary interest. Under the Act of 1883 and all subsequent Acts, such an application might be made by a person who was under any liability in respect of the disclaimed property which was not discharged by the Act.

It is now over a century since the disclaimer provisions in their present form were first enacted. In that time reported decisions on the legislation have been few. I mention the leading cases. In *In re Finley, Ex parte Clothworkers' Co.*, 21 Q.B.D. 475 the Court of Appeal held that the landlord of a disclaimed lease which had been mortgaged by the bankrupt was entitled to apply for an order vesting the lease in the mortgagee. The court comprised Lord Esher M.R., Lindley and Bowen L.JJ. Delivering the judgment of the court, Lindley L.J. analysed the effect of the Act in similar terms to those set out above in my categories (1) and (3).

A case in category (2), concerning the liability of a guarantor, came before the Court of Appeal, comprising

A.L. Smith M.R., Collins and Romer L.JJ., in *Stacey v. Hill* [1901] 1 K.B. 660. The defendant had guaranteed payment of the rent by the tenant. The tenant became bankrupt and his trustee disclaimed the lease. The landlord did not resume

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possession. The court held that the guarantor was not liable for rent after the lease was disclaimed. I shall examine the reasoning of this decision below.

In recent years the most common circumstance in which landlords insist on guarantors is when the tenant is a company. The directors are required to assume personal liability in case the company defaults. It was not until 1929 that liquidators of companies were given power to disclaim onerous property. Under the Companies Act 1929 the liquidator required the leave of the court in all cases before he could disclaim. In 1932 Maugham J., in *In re Katherine et Cie. Ltd.* [1932] 1 Ch. 70, used this as a means of circumventing the decision in *Stacey v. Hill*. Disclaimer would have caused loss to the landlord, because it would have released the guarantor. So the judge refused to permit the liquidator to disclaim. Thereafter, as noted by Millett L.J. in the present case [1995] Q.B. 95, 100, the court normally refused leave to disclaim where this would prejudice the lessor by discharging the surety from liability. This practice continued until the Act of 1986 brought corporate insolvency into line with personal insolvency regarding leave to disclaim. Now the landlord generally has no opportunity to object.

Finally, in *Warnford Investments Ltd v. Duckworth* [1979] Ch. 127 Sir Robert Megarry V.-C. held that the original tenant remained liable after the liquidator of an insolvent assignee disclaimed the lease. He applied the decision in *Hill v. East and West India Dock Co.*, 9 App.Cas. 448 and distinguished *Stacey v. Hill* [1901] 1 K.B. 660.

The decision in *Stacey v. Hill*

Four different grounds have been put forward in support of the decision in *Stacey v. Hill*. None is satisfactory. The first, and broadest, ground is that on disclaimer the lease determines and no rent can subsequently become due under it. This is the first ground of the decision of A.L. Smith M.R. and Collins L.J.: see [1901] 1 K.B. 660, 664-665. If well founded, this ground would apply also to an original tenant. He would be discharged where an assignee becomes insolvent and the lease is disclaimed. That, indeed, was the primary argument of Mr. Oliver before your Lordships' House. Mr. Oliver submitted there is no logical distinction between the position of the original tenant and the position of a guarantor. The *Warnford Investments* case was wrongly decided. *Stacey v. Hill* is to be preferred to *Hill v. East and West India Dock Co.*

I agree that such differences as there are between an original tenant and a guarantor are not material on this point. Post-disclaimer, both are liable or neither. I also agree that either the Act of 1883 left the existing law clarified but unchanged, in which case both the original tenant and the guarantor remained liable notwithstanding disclaimer, or the Act changed the law and relieved original tenants and guarantors alike from liability post-disclaimer.

Where I am unable to agree is that the reasoning in *Stacey v. Hill* on this point is to be preferred. The difficulty I have is that this reasoning flies in the face of the plain language of the statute. The reasoning fails to give effect to paragraph (b) of section 178(4) and its evident purpose. The

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Act of 1883 made explicit what *Hill v. East and West India Dock Co.* held was implicit in the Act of 1869.

It must be recognised that underlying the Victorian decisions was a rigorous belief in the sanctity of contracts freely entered into. A century later there is more recognition of inequality of bargaining power, especially where consumers are involved. But the fact remains that Parliament incorporated the judicial interpretation of the Act of 1869 into the Act of 1883, in terms which have been continued by Parliament to this day, most recently in 1986.

The second line of reasoning advanced in support of the decision in *Stacey v. Hill* [1901] 1 K.B. 660 prays in aid the principle that the release of a debtor discharges his guarantor. Collins L.J. said, at p. 666, that "The liabilities of a surety are in law dependent upon those of the principal debtor..." As a general proposition this is true. But, here again, the conclusion sought to be drawn fails to take account of the saving word in paragraph (b) of subsection (4). Disclaimer operates to determine the insolvent's abilities under the lease, but subject to a qualification: not so as to affect the rights or liabilities of other persons. Parliament has provided that the general rule shall not apply. The release of the insolvent debtor is not to discharge a surety from his liabilities to the lessor.

The third ground is that the exception built into paragraph (b) applies in the case of a guarantor. This was relied upon by A. L. Smith M.R. and Romer L.J. In order to release the insolvent from all his liabilities in respect of the lease, it is necessary to release the guarantor from his obligations to the landlord. As already explained, I am unable to agree. In order to release the insolvent it is sufficient to extinguish the insolvent's liability to indemnify the guarantor. It is not necessary to go further, and release the guarantor from his liability to the lessor.

The fourth ground calls for fuller treatment. This ground was touched upon by Romer L.J., and developed more fully by Millett L.J. in the present case. I can summarise the reasoning as follows. Unlike an original tenant, who undertook liabilities without any right of recourse against anyone at that time, a guarantor's right to be indemnified by the principal debtor is inherent in the relationship between them. His right of indemnity arose at the moment of creation of the guarantee liability, and is to be regarded as inseparable from it. Millett L.J. said [1995] Q.B. 95, 105:

"It would ... require very clear statutory language to deprive a surety of his right to indemnity while leaving his liability unimpaired. No such language is to be found in subsection (4) (b)..."

Romer L.J. said [1901] 1 K.B. 660, 667: "The section does not operate so as to cast upon third persons liabilities different in kind from what they were under before the disclaimer."

The law, more specifically equity, has traditionally shown a tender regard for guarantors. The law has gone to great lengths to see that guarantors are not called upon to discharge burdens different from those they originally undertook. There are some who believe that on occasions the law has gone too far, attaching more importance to form than substance. In the present context it is essential to have in mind that the

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fundamental purpose of an ordinary guarantee of another's debt is that the risk of the principal debtor's insolvency shall fall on the guarantor and not the creditor. If the debtor is unable to pay his debt when it becomes due, his bankruptcy does not release the guarantor. The discharge of a bankrupt releases him from all his bankruptcy debts, but this does not release a guarantor for the bankrupt: see section 281(1) and (7) of the Act of 1986. The very object of giving and taking a guarantee would be defeated if the position were otherwise. So the guarantor remains liable to the creditor. The guarantor has a right of proof, for whatever that may be worth, as a creditor of the debtor's estate.

The disclaimer machinery in the insolvency statutes achieves the same result in the case of guarantees of leases. The guarantor remains liable to the landlord. The guarantor loses his right to an indemnity from the insolvent tenant, but in place the statute gives him a right to prove as a creditor of the insolvent tenant's estate. Thus there is no question of the guarantor's right to an indemnity being confiscated. After disclaimer the guarantor's position is no different from the position of any unsecured guarantor of a debtor who becomes insolvent. Had there been no disclaimer the guarantor's right of indemnity would have led only to a right to prove against the insolvent's estate. The disclaimer provisions do not change this. The Act leaves the loss consequent upon the tenant's bankruptcy where the parties to the guarantee intended. In addition, the guarantor can take steps to obtain some return from the property by applying to the court for a vesting order, if necessary seeking an extension of time for this purpose. Or he may now be entitled to an overriding lease under section 19 of the Landlord and Tenant (Covenants) Act 1995, despite subsection (7). Section 19 is one of the few sections in the Act of 1995 which applies to existing leases.

The way ahead

There are three possible courses open to your Lordships. One is to depart from *Hill v. East and West India Dock Co.* and to decide that disclaimer discharges the original tenant and the guarantor. The second course is to overrule *Stacey v. Hill* and hold that disclaimer does not affect the obligations of original tenant or guarantor. The third course is to leave the two decisions standing side by side. I have given my reasons for rejecting the first course. The choice lies between the second and third courses.

This is the difficult part of the appeal. The decision in *Stacey v. Hill* is unsatisfactory. It has been much criticised. In *W.H. Smith Ltd. v. Wyndram Investments Ltd.* [1994] 2 B.C.L.C. 571, 576, Judge Paul Baker Q.C., sitting as a judge of the High Court, observed that the decision has failed to win universal acceptance. It has not been followed in Ireland: see *Maurice Tempany v. Royal Liver Trustees Ltd.* [1984] B.C.L.C. 568. In the textbooks it has been doubted or embraced with a marked lack of fervour: see, for instance, *Rowlatt on Principal and Surety*, 4th ed, (1982), pp. 173-174; *Gower, Modern Company Law*, 4th ed., (1979), p. 737, note 69; *Buckley on the Companies Acts*, 14th ed. (1981), vol. 1, pp. 753-754 and *Williams & Muir Hunter on Bankruptcy*, 19th ed. (1979), pp.388-389, 394.

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However, although criticised and distinguished and circumvented, the decision has stood as a decision of the Court of Appeal for over 90 years. This is a long time. The decision has been acted upon frequently after leases have been disclaimed. The disclaimer provisions have been re-enacted on several occasions, from the Bankruptcy Act 1914 to the Act of 1986, but Parliament has not intervened.

These are not important considerations, but they should be seen in perspective. Disclaimer is an intermittent rather than a constant problem, associated with period of recession when leases are unsaleable.

A further important factor is that it would not be right for your Lordships' House to overrule *Stacey v. Hill* [1901] 1 K.B. 660 if this would expose guarantors to more extensive liabilities than they reasonably anticipated when signing their guarantees. Prospective overruling is not yet a principle known in English law.

I do not believe that overruling *Stacey v. Hill* would have this consequence. I am not persuaded that people have been entering into guarantees in the expectation they will not be liable in the very circumstance at which the guarantee is primarily aimed: the insolvency of the person whose obligations are being guaranteed. Professionally drawn guarantees habitually include express provision protecting landlords if the lease is disclaimed. Those unversed in the finer points of bankruptcy law will not have had *Stacey v. Hill* in mind when undertaking their obligations. They would expect to have to pay the rent if the tenant, the principal debtor, became bankrupt.

Ultimately what has persuaded me and dispelled any lingering hesitation is the frankly absurd results produced if *Stacey v. Hill* and *Hill v. East and West India Dock Co.*, 9 App.Cas. 448 were left standing uneasily side by side. First, in practical terms, an original tenant guarantees that the tenants for the time being will perform their obligations. There is no practical justification for distinguishing his position from that of a formal guarantor.

Secondly, the present case is illustrative of the tortuous distinctions which would follow. According to *Stacey v. Hill*, a surety's liability is discharged when the principal debtor's obligation to indemnify him is determined by disclaimer of the lease. But this reasoning would not operate to release Mr. Whitten in the present case. He guaranteed the obligations of CIT, not Prest. The right of indemnity which then arose was against CIT. That right, which is the all-important right according to *Stacey v. Hill*, was not determined when the lease was disclaimed by the liquidator of Prest. The disclaimer operated to determine Mr. Whitten's right of indemnity against Prest, but that right arose after he had given the guarantee. Determination of a right of indemnity arising later does not bring down the guarantee, because it is not an inherent part of the guarantee. So the end result, on this footing, would be that disclaimer operates to discharge a guarantee if the disclaimer is in the insolvency of the principal debtor, but not if the disclaimer is in the insolvency of an assignee.

This would make no sort of legal or commercial sense. This would mean that directors who guarantee their company's obligation would *not* be liable if their *own* company became insolvent whilst tenant, but they [1997] A.C. 70 Page 96

would be liable if an assignee from their company encountered financial difficulties whilst tenant. Mr. Whitten, as guarantor of CIT's obligations, remains liable to the landlord. According to *Stacey v. Hill*, had he been a guarantor of Prest's liabilities, the disclaimer would have released him. What sort of a law would this be?

In the present case the liquidator of CIT disclaimed CIT's liabilities under the lease after the rents and other amounts had fallen due. The consequences of this disclaimer had it preceded the accrual of the liabilities were not explored in argument. But the possibility of a disclaimer by a non-tenant affecting the guarantor's position underlines the curious distinctions and evident anomalies arising if *Stacey v. Hill* and *Hill v. East and West India Dock Co.* were left standing together.

At the outset I drew attention to the practical mischiefs which can arise when former tenants are held liable for defaults by subsequent assignees. These mischiefs do not assist the appellants. *Stacey v. Hill* does not have the effect of striking down liabilities by reason of the acts of assignees over whose identity a guarantor has no control. *Stacey v. Hill* has the paradoxical effect of discharging the guarantee in a circumstance at which it was primarily aimed and when there are no such mischiefs, but of not discharging the guarantee in a more remote circumstance where the mischiefs following assignments may arise.

I am unable to accept that this is, or should be, the state of the law. It would lack any rational or practical basis. It would defy coherent explanation. It would defeat the parties' intentions. I would overrule *Stacey v. Hill*.

Conclusion

There remains one last point. The appellants contended that on the particular wording of the licence of 22 April 1987 neither CIT nor Mr. Whitten were liable once the lease had been disclaimed. CIT's obligation was to pay rent "during the residue of the term created by the lease," and Mr. Whitten's guarantee was to run

"during the continuance of the lease." Under clause 5 (2) Mr. Whitten could be required to take up anew lease in certain circumstances following a disclaimer. The submission was that the parties had contracted on the footing that on disclaimer the lease would end for all purposes, and that the quoted words should be construed accordingly. I cannot accept this. The put option in clause 5 (2) was exercisable after disclaimer or other event brought an end to the lease "so far as concerns the lessee for the time." This wording provides no support for the view that the parties thought that disclaimer would end the lease so far as CIT and Mr. Whitten were concerned. I would dismiss this appeal.

Appeal dismissed with costs.

Solicitors: Houghtons; Chethams.

J.A.G.