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Earthquakes, mortgagees and lessees

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with some problems from commercial leases

The Canterbury earthquakes have given rise to more than just seismic aftershocks. The legal consequences are only just beginning to be felt. Issues have been raised that have not been considered before and from which there are no easy answers.

GP 96 Ltd v FM Custodians Ltd HC Christchurch CIV-2011-409-627, 24 May 2011 is a case in point (the author appeared as junior counsel for the defendant). The case involved an application by the plaintiff, a lessee, to restrain the defendant, a mortgagee in possession purporting to act in place of the lessor, from asserting that the lease was cancelled because the premises were rendered untenantable after the earthquake of 22 February 2011. One of the reasons put forward by the defendant as to why an interim injunction should not be granted was that the balance of convenience did not lie in the plaintiff's favour. That was because the mortgagee had a right, under its mortgage, to take any insurance proceeds and apply them in reduction of its debt, at which point the premises might never be repaired. The defendant argued that its right had priority over any right of the lessee under the lease to have the insurance proceeds applied to repair the premises.

Although this was not addressed directly, Chisholm J did say at [51] "the defendant seems to be of the view that it can take the benefit of the lease but is not bound to honour the obligations arising under it". That leaves open two questions that have ramifications beyond Christchurch: what are the obligations of a mortgagee in possession under a lease; and, where a lessor owes conflicting duties to a mortgagee and a lessee, who takes priority?

Such questions do not seem to have been considered recently by the courts in New Zealand, and this article articulates the arguments from the mortgagee's and lessees' standpoints and draws some tentative conclusions.

MORTGAGEE IN POSSESSION

If a mortgagee has taken possession of mortgaged land under ss 137 and 139 of the Property Law Act 2007 (PLA), the mortgagee generally stands in the stead of the mortgagor. However, the right to stand in the place of the mortgagor arises from rights contained within the mortgage documentation (including the memorandum of mortgage) as well as from rights contained in the PLA. Specifically, the memorandum of mortgage and loan documentation generally gives the mortgagee the right to act in place of the mortgagor where necessary to protect the security, or where there has been a default. The PLA provides an overlay to such rights, and it limits the ability of a mortgagee to take possession of mortgaged land unless the procedure in the PLA has been followed.

The issue here is what the rights and obligations of a mortgagee in possession are where there is a lease to which the mortgagee has consented. Where no consent has been given, then the lease is of no effect as against the mortgagee, and it can exercise its powers as mortgagee in possession as if the lease did not exist (s 119 of the Land Transfer Act 1952). However, where a lease has been consented to, there is then a question as to the extent to which the mortgagee is bound by the terms of that lease, including when it enters into possession. As Somers J said in *Registered Securities Ltd v Christensen Potato Co Ltd* [1991] ANZ ConvR 57, at 58:

> At common law a lease by a mortgagor would be binding between him and his tenant by estoppel but as against the mortgagee's claim to possession the tenant has no defence unless the mortgagee recognises the lessee as tenant or is otherwise estopped from denying the tenancy.

Where do the mortgagee's rights under a lease consented to arise from? There is no contractual relationship between a mortgagee and a lessee. The rights of a mortgagee only arise from statute, primarily s 147 of the PLA:

> (1) A mortgagee in possession of mortgaged land that is subject to a lease may do the following as though the mortgagee were for the time being entitled to the reversion of the land:
>
> (a) exercise all the powers of the lessor; and
>
> (b) enforce by legal proceedings in the name of the mortgagee all rights and remedies of the lessor.
>
> (2) Subsection (1) applies—
>
> (a) whether the lease was entered into by the mortgagee or by the current mortgagor or by any other person; and
>
> (b) whether the lease was entered into before or after the mortgagee entered into possession.

That was a new section in the PLA, and repealed s 108(1) of the LTA. The Law Commission report on the proposed Property Law Act noted that the effect of it was to place "the mortgagee in the same position as the mortgagor" (Law Commission *A New Property Law Act* (NZLC R29 1994) at 328) when it came to enforcing rights and remedies under the lease. Clearly, the existence of those two sections is statutory recognition that, absent an express conferral of the ability to exercise rights under the lease, no such right exists at law. Given the lack of a contractual relationship, and that the lease confers no benefits on the mortgagee, that is certain to be the case.

Section 147 is worded so that it will apply regardless of whether or not the mortgagee consented to the lease in question, but in practice its operation will be limited to situations where a mortgagee has consented to a lease. That is because, where no consent was given, then a mortgagee has a right to enter into physical possession of the land under ss 137 and 139 of the PLA. In contrast, where a mortgagee has consented to the lease, then under s 138 a mortgagee may

only take physical possession of the land by using one of the powers under s 147 of the PLA, in other words, under the lease. Clearly, if a mortgagee did not consent to a lease and did not see value in it, then it would be preferable that it "cut to the chase" and take physical possession.

If the mortgagee can enforce the rights of the lessor, that raises the question of to whom the lessee looks to enforce the obligations of the lessor. From the lessee's perspective the section creates an asymmetrical relationship: the mortgagee in possession has power without responsibility. It was concern at such a situation that no doubt drove the comment of Chisholm J in *GP 96 Ltd* at [51]. But, in the absence of a contractual relationship and where the rights of the mortgagee are specifically conferred by statute, can the relationship be anything but asymmetrical?

From the lessee's perspective the answer would be "yes". A lessee could point to the difficulty inherent when the mortgagee in possession could, for example, attempt to seek payment of rent but ignore the covenants relating to quiet enjoyment. In such circumstances, any relief sought against the lessor would be of limited practical use given the inability of the lessor to control the behaviour of the mortgagee.

There is also an argument relating to what it means if the mortgagee has "consented" to the lease. The lessee could argue that the mortgagee, in consenting, has effectively agreed to be bound by the provisions of the lease. When a mortgagee consents was considered by the Supreme Court in *Cashmere Capital Ltd v Caroll* [2009] NZSC 123, [2010] 1 NZLR 577 but it did not deal with the effect of consent.

From the mortgagee's standpoint, the answer would be no. When consenting to a lease, a mortgagee would almost certainly not consider that it would be taking on any obligations to the lessee, such as an obligation to repair the premises, which would actually require it to take action or expend funds. Such an obligation would have to be specifically included in the lease, unless the lessee could rely on the covenants implied in all leases under the PLA, such as that the lessor may not derogate from the grant. From the mortgagee's standpoint, all that occurs is it acknowledges that there is another registered interest, and if it was to sell the freehold then it must do so subject to the leasehold. If a mortgagee was taking on positive obligations by consenting to a lease and entering into possession, then mortgagees would either not consent or seek to enter into side agreements with lessees so as to avoid that outcome.

The statutory overlay is also important here. As there is no contractual relationship between the lessee and the mortgagee, the only relationship between the two is that created by the PLA. For example, the right of a mortgagee to enter into possession physically is only curtailed when it has consented to a lease by virtue of s 138 of that Act. That implies it is only by operation of statute that that ancillary right is curtailed. In the same way, the only manner in which the mortgagee in possession can act against the lessee is by virtue of s 147, which refers to the mortgagee having the right to exercise powers, and makes no reference to the mortgagee having any of the obligations of the lessor.

Absent specific statutory provision, the mortgagee only acquires the rights, but not the obligations, of the lessor. That does lead to an asymmetrical relationship, but there is a separate question as to what requirements need to be met in the event that a mortgagee in possession seeks to exercise those powers. The preferable result may be for the operation of s 147 to be viewed more as an assignment. When assignments of choses in action occur, it is well accepted that they are subject to equities (*Phipps v Lovegrove* (1873) LR 16 Eq 80 at 88, and *Downers v Bank of New Zealand* (1895) 13 NZLR 723). So, for example, when an assignee attempts to enforce a debt it does so subject to any claim from the creditor against the debtor that could affect the enforcement.

The same principle should logically apply in the case of mortgagees in possession attempting to enforce the rights of a lessor, so that if there is any breach of the lease by the lessor that could be used to prevent the lessor from enforcing the lease, such a claim could be used as a defence to an action by a mortgagee. Such an approach avoids the injustice of a completely asymmetrical relationship while not placing positive obligations on the mortgagee, which existing mortgagees will not have bargained for. It also recognises the intention of Parliament more closely, namely the exercise of rights cannot be separated from obligations, and so a defence to enforcement by a lessor should be available when a mortgagee is standing in the place of the lessor.

CONFLICTING INSURANCE OBLIGATIONS

There can be conflicts between mortgagees and lessees even when a mortgagee is not in possession. *GP96 Ltd* highlighted what occurs when a mortgagor owes conflicting obligations in relation to insurance proceeds.

The PLA implies certain covenants into mortgages over land (s 95(1) and Part 1 of Sch 2, notably cll 2 and 3). Those covenants apply unless a contrary intention is expressed in the memorandum of mortgage. The most relevant implied covenants are:

(a) an obligation of the mortgagor to insure the property to the extent possible, including against loss or damage from natural disaster, to the full insurable value and on normal replacement terms;

(b) an obligation that the insurance be in the joint name of the mortgagee and mortgagor; and

(c) a right on the part of the mortgagee to choose whether insurance proceeds received be put towards rebuilding or repairing the building or towards repayment of the principal amount, interest and other amounts secured by the mortgage, even if the payments are not yet due.

If a mortgagee chooses to use the insurance proceeds to reduce the amounts owed to it, then the mortgagor gains a right to pay off all amounts owing under the mortgage at any time within two months thereafter.

It is worth noting that s 76 of the PLA 2007 says that the covenants in question only apply to mortgages that come into operation on or after 1 January 2008. It is unclear what that phrase means. If a mortgage was registered before that date and a loan only advanced after that date, when does the mortgage 'come into operation'? In any event, the PLA 1952 contained similar covenants, except the insurance coverage was limited to fire insurance. Further, a mortgagee typically buttresses its position by way of the memorandum of mortgage which will almost always include an obligation to insure the property with the mortgagee able to take the benefit of the policy. Some policies state that the mortgagor holds proceeds on trust for the mortgagee and even absent such a provision, the Privy Council has held that the effect of the implied covenants as to insurance creates a charge in the mortgagee's favour over the insurance proceeds *Colonial Mutual General Insurance Co Ltd v ANZ Banking Group (NZ) Ltd* [1995] 3 NZLR 1.

However, where a mortgagor enters into a lease it is not uncommon for the lease to include a covenant that insurance proceeds are to be applied in repair of the premises, presumably so that the lease can continue. The standard form ADLS leases contain such clauses. Of course, if the premises are totally destroyed then under those leases the lease terminates due to untenantability. But, what if the premises are damaged such that the lease is not terminated? Does the mortgagee still have a right to proceeds, or does the mortgagee's consent to the lease restrict its rights?

The arguments in favour of the lessee's position include that by consenting to the lease the mortgagee has consented to all of the covenants in the lease, including those that extend beyond the simple grant of an estate in the freehold title. Accordingly, the mortgagee has effectively restricted its rights of its own accord. Further, the position of the mortgagee is protected either way, in that repair of the premises will restore the value of its security. It is really the lessee that faces economic risk given that, if the mortgagee takes the money, the lessor may not have the substance to repair, leaving the lessee in a difficult position.

In contrast, the mortgagee would point to the fact that its right to insurance proceeds is a covenant implied by statute, whereas the rights of a lessee in relation to insurance are based on the lease. Indeed, the PLA at ss 268 to 270 provides protection to a lessee from an action by the lessor if the premises are damaged or destroyed and the lessor is insured, but it does not create an obligation on the part of the lessor to expend insurance funds to repair the premises. That suggests that Parliament recognised that, for policy reasons, it is preferable that the rights of a mortgagee to insurance proceeds be codified, as opposed to the rights of a lessee to have a building repaired, because the rights of a mortgagee should prevail. In addition, a mortgagor can only lease the estate it has — that means the lessee takes the estate subject to any restrictions upon it, including any covenants relating to insurance agreed with the mortgagee.

Ultimately, the answer lies in what the effect of a mortgagee consenting to a lease is. In *Tattley v Wagstaff* [1924] NZLR 813, a mortgagee consented to a lease but its consent was "without prejudice" to its remedies and rights. The Court held at 815:

> The consent of the mortgagee to a lease does not in any way prejudice or affect his rights and remedies under his mortgage, except that, if he exercises his powers under the mortgage, he can only do so without derogation to the lease to which he has consented.

However, it has also been held that a mortgagee's consent to personal covenants in the lease is not necessary, rather consent is only needed to covenants that grant an estate or interest in the land (*Driver v McDonald* (1888) 6 NZLR 557). That means that, when consenting to a lease, the mortgagee is only consenting to some of the covenants.

Such an approach is supported by the PLA. The ancillary right of a mortgagee to take physical possession of mortgaged property is restricted by that Act. In the absence of similar provisions relating to other ancillary rights (such as the right to insurance proceeds) it could be presumed that consenting to the lease does not necessarily affect those other ancillary rights. That is particularly the case given that the right to possess the premises held by the lessee over the mortgagee arises from a covenant relating to an estate or interest in the land rather than from a personal covenant.

There are two further points to consider. The first is whether the right of the mortgagee to insurance proceeds is a right that arises under the mortgage. The answer to that question is that "yes", although that does not prevent a mortgagee from relying on ancillary rights, such as those granted under a General Security Agreement.

The second is whether the obligation of a lessor to apply insurance proceeds to repair is a covenant granting an estate or interest in the land. The answer to that question would seem to be no, given that the covenant does not allow a greater interest in the land, and is best viewed as ancillary to it. That strongly suggests that the covenant as to repair is a personal covenant, by which a mortgagee is not bound.

So where does that leave matters? It would appear that a mortgagee is able to exercise its rights to insurance proceeds, regardless of having consented to a lease that contains a term that the proceeds are to be used in the repair of the premises. There are a number of reasons for this.

First, consenting to a lease does not appear to mean that a mortgagee consents to all the covenants in a lease, only those that grant an estate or interest in the land, which the covenants relating to insurance do not.

Second, there is the recognition by Parliament that the interests of a security holder need greater protection than those of a lessee. Arguably that should flow through to how such a conflict of rights is approached by the courts.

Third, there are difficulties with effectively making the mortgagee a party to the lease and preventing it from exercising what is effectively a right ancillary to its mortgage, or rights that it has acquired as either an insured or owner under the insurance policy. What would the legal basis be for turning consent to a lease into an agreement that insurance proceeds the mortgagee is entitled to as a policy owner be employed in a certain way? Knowing of the existence of a conflicting obligation owed to a third party does not prevent you from enforcing an obligation owed to you.

Fourth, there are practical difficulties with any other approach, given that a mortgagee could simply circumvent the situation by relying on rights created under another document, such as a General Security Agreement, to the insurance proceeds.

The one outstanding issue is whether it matters if the mortgage came on to the title after the lease had been granted. The answer to that question could well be "no". If it is accepted that a lessor's obligation to use insurance proceeds to repair is a personal covenant, then it will not necessarily bind those behind the lease on the title, depending on precisely what has been registered. If the full lease is registered then the position of the lessee is considerably strengthened but, again, there is a difficulty in that merely being aware of a conflicting personal covenant owed to another party does not mean that party is prevented from taking the benefit of an obligation owed to it.

CONCLUSION

Although this area of the law has received only scant attention in recent years, it is an important area, given the potential for conflict where one party has made promises to two others, both of which simply cannot be kept. Notwithstanding the lack of modern judicial attention, both the statutory framework and the limited case law suggests that the answer is that, all things being equal, the rights of a mortgagee are extensive and often greater than those of a lessee. ❐