Leon v Kensington Mortgage Company Ltd & Anor (2023) and the concept of subrogation

Introduction to subrogation

A surety (i.e. someone who has agreed to be liable for the obligations of a third party) will often be "jointly and severally" liable with the borrower for amounts outstanding under a set of finance documents. The secured parties can therefore sue the surety for the full amount outstanding under the finance documents.

If a surety has to make such a payment then it has the right to require the principal debtor to reimburse it for that payment. To assist in this, the surety also has a right to be "subrogated" to any security interest held by the secured parties against the principal debtor. In effect, the benefit of the security held by the secured parties against the principal debtor is assigned to the surety.

This right is based on the common law and on Section 5 of the Mercantile Law Amendment Act 1856.

Introduction to bona vacantia

When a company is dissolved, any property that the company owned (as beneficial owner) immediately before the dissolution will pass to the Crown under the Companies Act 2006. This property is known as *bona vacantia*. The Crown will not usually want to take on any of the liabilities associated with the bona vacantia property. So, the Crown will usually disclaim this property and must do so within three years from the date when the Crown receives notice that the property has passed to it.

What happens if the principal debtor no longer exists?

The concept of "subrogation" was recently discussed in in the case of Leon v Kensington Mortgage Company Ltd & Anor [2023] EWHC 121 (Ch) (06 February 2023) (bailii.org)

On this transaction, C provided a loan to two co-debtors – A and B. A and B provided security as co-mortgagors over a property. Subsequently, this security was replaced through a deed of substituted security, under which A provided security over a lease with D. A was then dissolved because of a failure to comply with statutory filing requirements. The lease then vested in the Crown bona vacantia. The Crown then disclaimed the lease, which terminated the rights of A under the lease. Eventually, following litigation the lease was vested in C. D and B remain in dispute as to who owns the lease.

Key questions which emerge from this are:

1. Can B have a right of recourse (or indeed any ongoing rights and remedies) against A despite A no longer existing?
2. Can the security granted in respect of A's debts be subrogated from C to B despite A no longer existing?

What did the court decide?

The court accepted that B was no longer a co-debtor with A – A no longer existed and could not therefore be sued for a debt. However, the court did find that if B repaid the loan then the security would be subrogated to them.

The court gave the following reasons for this decision:

1. The security created for the loan survived the dissolution and ensuing disclaimer of the lease by the Crown;
2. The charge initially granted was over the property of A, then a co-debtor with B;
3. Even if A was the sole debtor, the Crown coming to hold the lease and subsequent disclaimer do not end the proprietary rights of third parties who hold derivative interests – with the security held by C still being in place.

4. Just as a secured creditor can use security to recover what is owed to it even if the security provider has been dissolved, the subrogated party can use security to recover what is owed to it, despite the principal debtor having been dissolved.

5. C and D were inconsistent in their approach to whether Mr Leon could obtain the charge through subrogation in the previous court proceedings and this undermined their opposition to B having the right to subrogation in relation to the charge over the lease.

6. The fact that C cannot pursue A for the loan is not a sufficient reason to deny B the right of subrogation in relation to the security over property. There is no conceptual reason why B cannot step into the shoes of C in terms of inheriting the security over the lease.

7. If B did not have the right of subrogation then C could either:

   (a) sell the lease through an enforcement process without asking B to make any payments at all; or

   (b) require B to pay all amounts outstanding – thus leaving B "high and dry" without any means of revering his expenditure from the security over the lease.

   The court noted that it would be "most quirky" if different courses of action available to C could result in such different outcomes for B.

8. In prior litigation, the Court of Appeal had supported the idea that B had a right of subrogation.

What lessons can secured parties take from this case?

1. A secured party would only want rights of subrogation to apply once they have been repaid in full. This avoids sureties gaining rival claims and supporting security against the principal debtor before the secured party has been repaid in full. This should be explicit in the finance documents.

   English law is, in general, protective over sureties and they have numerous rights which arise automatically. It is therefore essential that guarantee documents are well-drafted and carve-out these rights to ensure that they don't disrupt an enforcement by a secured party.

2. The issue at the heart of this matter was A being dissolved due to a failure to meet statutory filing requirements. Well drafted finance documents contain the following provisions to protect against such an occurrence:

   (a) a repeating representation that each obligor is "validly existing" in the relevant jurisdiction;

   (b) a general undertaking on obligors to comply with all laws to which they are subject where failure to comply has or is likely to have a material adverse effect; and

   (c) an event of default if an obligor suspends or ceases to carry on its business.

3. At first glance, subrogation should arise after the secured parties have been repaid in full and should not therefore concern secured parties. However, in this case C was reluctant to enforce its security because it did not know whether any surplus remaining after the sale of the lease should be sent to B or D. It did not want to get caught up in the dispute between B and D. Well drafted finance documents can help reduce the risks of such disputes arising (in this case by requiring A to comply with its statutory filing requirements). The finance documents should also give secured parties clear rights of enforcement in relation to any such breaches.