Ensuring that Your Lease Guarantee Remains in Force

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It is common for a lease to contain a guarantee, from a third party connected with the tenant, who guarantees to the landlord that the tenant will pay the rent and comply with the tenant's covenants under the lease. A lay landlord might assume that it would have no difficulty in pursuing the guarantor if the tenant defaults. He could hardly be more wrong. The law relating to guarantees is complex, and it is only too easy for a landlord to commit some innocent act that will mean that he loses the benefit of the guarantee. Even worse, it may be a predecessor of the current landlord who committed the act that means the guarantee cannot now be relied upon. This article will shed some light on the problems and possible escape routes for landlords.

The basic rule

The basic rule was set out in *Holme v Brunskill* (1878) 3 Q.B.D. 495. A variation to the guaranteed obligation made without the guarantor's consent will lead to the guarantee being discharged, unless the rule has been excluded by agreement with the guarantor. In the leasehold context, that means that the landlord and the tenant must not agree to vary the lease without the guarantor's consent.

The variation need not be material. The guarantor is discharged if the landlord agrees with the tenant to vary the terms of the lease, unless it is self-evident that the variation is insubstantial or one that cannot be prejudicial to the guarantor. The court does not examine whether, in fact, there is actual prejudice or damage. The burden of showing that there is no prejudice is on the landlord.

A recent example

A very recent example of this rule in operation is *Topland Portfolio No.1 Ltd v Smiths News Trading Ltd* [2013] EWHC 1445 (Ch); [2013] 25 E.G. 109 (C.S.). In 1981, the then landlord (L1) granted a lease to the tenant, guaranteed by S. It contained, among the usual tenant covenants, an absolute covenant against structural and external alterations. In 1987, L1 granted consent to T to construct a new building, on terms under which the covenants contained in the lease were expressed to apply to the permitted works and to the leased property as altered. L1 sold the reversion to L2, who claimed against S in 2011 when the tenant became insolvent.

The court held that, because the scope of the tenant's covenants (and thus the contingent liability of S) was necessarily increased by the permitted works, S was discharged completely from its guarantee. The judge commented tersely (at [41] and [51]):

> "[41] [It] is clear from the textbooks, and not disputed by [L2], that under the … rule in *Holme v Brunskill* a [guarantor] is discharged *entirely* where the risk … increases.

> The rule does not operate so as to effect a discharge in part of the [guarantor's] obligation …
>
> [51] The rule and its effect are clear and arguably have been for many years. I do not understand there to be a general discretionary jurisdiction in this court in circumstances such as these. As some of the cases show, it is indeed possible to draft clauses which maintain the [guarantor] on the hook. There was no such clause in the materials before me."

One might say that the landlord should have been put on notice here, by the landlord and the tenant entering into the licence for alterations without joining in the guarantor. Wherever this situation is encountered, it is vital to consider whether the guarantee might have been discharged in some way. In this case, the variation of the lease was effectively concealed and would only have been revealed by comparing the works permitted by the licence for alterations against the alterations covenant in the lease.

There are occasions on which it is very difficult, or even impossible, to persuade a guarantor to enter into a variation, some of which are considered below.

Possible protections for a landlord

It is not all bad news for landlords. First, it is clear from the decided cases that it is possible to contract out of the rule in *Holme v Brunskill*, as alluded to by the judge in the second extract above. The wording of the guarantee can allow the landlord and the tenant to vary the lease without reference to the guarantor, without affecting the validity of the guarantee.

However, there are also cases that makes the position less certain. In *Triodos Bank NV v Dobbs* [2005] EWCA Civ 630; [2005] 2 Lloyd's Rep. 588 a guarantor guaranteed a company's obligations to the lender under two loan agreements. The guarantee contained a provision allowing the lender "without reference to the guarantor" to "agree to any amendment, variation, waiver or release in respect of an obligation of the company under the loan agreements". The Court of Appeal held that this did not permit the lender to lend a much larger sum than the original loan, as it would lead to the borrower being more likely to default, and so the lender would be more likely to call upon the guarantor. So these contracting-out provisions have to be treated with some caution.

The second is that the rule in *Holme v Brunskill* is thought not to apply where the obligation assumed by the guarantor is not a true guarantee (which is a secondary obligation) but a primary obligation. This is the reason for the inclusion of the words "as primary obligor" in standard guarantee provisions. However, there is obiter comment from Cresswell J. in *Marubeni & South China Ltd v Government of Mongolia* [2004] EWHC 472 (Comm); [2004] 2 Lloyd's Rep. 198 that this is not an invariable consequence of structuring the obligation by way of a primary obligation. Perhaps more importantly, it is often difficult to tell whether an obligation constitutes a guarantee or a primary obligation (see, for example, *Associated British Ports v Ferryways NV* [2009] EWCA Civ 189; [2009] 1 Lloyd's Rep. 595, in which an agreement was held to be a guarantee and so was discharged by a variation to the principal agreement to which the guarantor had not assented).

Other problems for landlords

So far we have considered the key danger for landlords who accept guarantees—the risk that the guarantee may have been discharged by a variation to the lease to which the guarantor did not assent. There are four other concerns that are worthy of mention, all of which are to the landlords' disadvantage as well.

The "purview" of the guarantee

From time to time, the courts raise the concept of the "purview" of a guarantee, meaning the subject matter of the obligation being guaranteed. It is logically possible for the obligations being guaranteed to change to such an extent that the guarantee no longer applies to them. A recent example is *CIMC Raffles Offshore (Singapore) Ltd v Schahin Holdings SA* [2013] EWCA Civ 644. In that case, C contracted to build an oil rig on the basis that certain payments were due from the buyer during the construction period and others only on and after delivery. The guarantor guaranteed payment of the sums due after delivery (but not those due before delivery). There was then an agreement (to which the guarantor was party) that some of the sums originally payable before delivery should be payable after delivery. Could those sums be demanded from the guarantor?

The Court of Appeal held that they could not, despite the guarantor being a party to the variation agreement and the guarantee containing wording that would exclude the rule in *Holme v Brunskill*. The reason was that the sums demanded were no longer within the "purview" of the guarantee, meaning its reasonably contemplated scope. The Court did not need to decide on this appeal whether the wide wording of the guarantee itself was enough to exclude the concept of purview, as there has to be a trial on disputed issues of fact and the issue may not be relevant. This seems to be another reason for joining in the guarantor in any variation of the underlying obligations.

Undue influence

The landlord needs to make sure that a guarantor understands the obligations that he is undertaking. In the relatively recent case of *Trustees of Beardsley Theobalds Retirement Benefit Scheme Trustees v Yardley* [2011] EWHC 1380 (QB), Mr Yardley added his signature to a lease when requested to do so by one of the directors of the company for whom he worked. He was accustomed to witnessing the director's signature, but in this case the document—a lease of the company's new office—contained a personal guarantee from Mr Yardley, entirely without his knowledge.

Mr Yardley did not know of the personal guarantee until the company became insolvent and the landlord demanded rent from him. He successfully raised the defence of undue influence, on the basis that the landlord had had constructive knowledge of the director's undue influence upon him. The landlord was aware of the company's precarious financial position before granting the lease, which was one of the reasons why the guarantee had been required. It was, therefore, incumbent upon the landlord to ensure that the guarantor understood the extent of the commitment he was entering into.

Fortunately, this is not going to be a common occurrence, but it would be sensible for a landlord to ensure that it understands the reason for a guarantor to be providing a guarantee. A director who is a major shareholder in the company would be expected to provide a guarantee. An employee with no interest in the company would not.

Guarantors not connected with the tenant

As explained above, it is clear from *Holme v Brunskill* that it is wise to join in guarantors to any variation, to ensure that their guarantees are not discharged. This includes guarantors who are not connected with the tenant. There are three reasons why a guarantor may not be connected with the tenant:

- it guaranteed the obligations of the person that used to be the tenant, at the time it was the tenant (e.g. the original tenant's parent company),but the lease has since been assigned to a new tenant
- it was connected with the tenant at the time when the lease was granted, but is connected no longer (perhaps because the parent company has now sold the tenant company out of the group)
- it may be a former tenant who is the guarantor of the current tenant under an authorised guarantee agreement (AGA), or that former tenant's guarantor under what is often called a guarantee of an AGA, or GAGA (also called a parallel guarantee)

In any of these cases, when the landlord is contemplating a variation of the lease with a tenant, it will wish to join in the guarantor. But the guarantor, having no interest in the building any longer, will see no purpose to joining in to confirm the guarantee. In fact, its interest is exactly the opposite. It wants the guarantee to be discharged by a variation to which it is not a party. A landlord in this position is in a particularly difficult position, wanting to do a deal with the current tenant (perhaps to improve the rent it receives) but at the same time putting at risk the guarantee.

Section 18 of the Landlord and Tenant (Covenants) Act 1995

Section 18 of the Landlord and Tenant (Covenants) Act 1995 provides that, if there is a variation of a lease, a former tenant is not liable for any additional obligations that have been agreed since that former tenant assigned the lease. For example, assume that, by agreement between the current tenant and the landlord, the rent has been doubled in exchange for a relaxation of the user clause. A former tenant will only be liable for the original amount of rent.

Section 18 also protects guarantors of former tenants, in the same way. It is often believed that this supplants the rule in *Holme v Brunskill*, in that a guarantor of a former tenant remains liable even without agreeing to a variation, but only to the extent of its former obligation. This is incorrect. First, you have to apply the rule in *Holme v Brunskill*, and only then (if the guarantor of the former tenant is still liable) do you operate the protection in s.18. This is made clear by the inclusion of the wording "(where his liability to do so is not wholly discharged by any such variation of the tenant covenants of the tenancy)" in s.18(3) of the 1995 Act.

Section 18 applies to all leases, whether "new tenancies" or not, but only to variations made on or after January 1, 1996 and where the variation is one that the landlord has an absolute right to refuse. It should be remembered that it does not apply to current tenants or guarantors of current tenants.

Conclusion

A landlord entering into a variation of a lease with the tenant, or—now confirmed by the *Smiths News Trading* case, allowing the tenant to carry out an activity that would not normally be permitted by the lease—is at risk of losing a guarantee unless it joins the guarantor into the variation. Wording that purports to exclude the operation of the rule in *Holme v Brunskill* should be included where possible, but even then there are cases that show that it is not 100 per cent effective. Joining in the guarantor—assuming that the tenant can procure this (see above)—avoids the need to have that argument in the first place.

The law is stated as at June 20, 2013.