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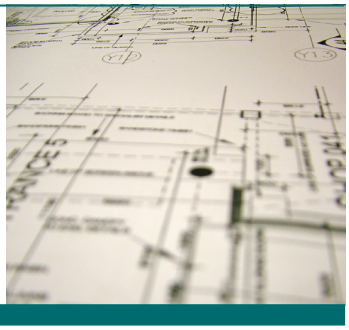
Review



Lease Guarantees – Risks For Landlords/ Opportunities For Guarantors

BACKGROUND

Last year, the decision of the High Court in the case of *Good Harvest Partnership LLP v Centaur Services Limited [2010] EWHC 330 (Ch)* surprised many in the real estate community. The case related to an unresolved question of interpretation of the Landlord and Tenant (Covenants) Act 1995 ("the Act").

The fundamental premise behind the Act is that, on an assignment of a lease granted on or after 1 January 1996, the outgoing tenant and its guarantor are released from all liability under the lease. There is one recognised exception to this principle. The Act expressly permits the landlord to require the assigning tenant to guarantee the performance of the lease covenants by the assignee. This guarantee is referred to as an authorised guarantee agreement or "AGA" and it can only be required as a lawful condition of the landlord giving its consent to assign. The Act contains wide-ranging anti-avoidance provisions in section 25 to prevent the frustration of these provisions.

Where it has been necessary for a guarantor to support the covenant of the outgoing tenant by providing a guarantee, the commercial reality is that the value of any AGA given by that tenant is limited. The question left unanswered by the Act is whether, on an assignment of a lease, the guarantor of the assigning tenant can also effectively guarantee the performance of the lease covenants by the assignee.

In practice, this can be achieved in a number of ways. The guarantor can enter into a sub-guarantee. Under this, the guarantor guarantees the tenant's liability under any AGA it may give on assignment (as well as the tenant's liability under the lease itself). Since the Act came into force, landlord and tenant practitioners have generally been optimistic that the sub-guarantee represents a valid means of providing a landlord with additional security. In some cases, the guarantor may offer to provide a freestanding direct guarantee for the assignee's performance under the lease. This often happens on inter-group assignments and has also been regarded as permissible under the Act.

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THE GOOD HARVEST DECISION

In the Good Harvest case, the High Court decided that a requirement for any direct guarantee to be given by the assigning tenant's guarantor in respect of the assignee is void - which did not come as a great surprise. However, the Court also cast doubt on the effectiveness of sub-guarantees and went on to suggest that if the guarantor of an assigning tenant *volunteers* to provide a direct guarantee for the assignee, then this falls foul of the Act. These obiter comments caused considerable consternation since the Act had not generally been interpreted in this way. The consequences of the Good Harvest decision for landlords and indeed tenants, in assignment situations where covenant strength is weak, have been significant. The decision has made inter-group transactions particularly troublesome.

An opportunity for the higher courts to consider the issues was eagerly anticipated. That arose for the first time in the case of ***K/S Victoria Street v House of Fraser (Stores Management) Limited & others [2011] EWCA Civ 904*** and the Court of Appeal has now handed down its judgement. The Court has sought to address the issues which it recognised have caused great uncertainty in the field of landlord and tenant law. Leave to appeal has not (so far) been requested so it would appear that the judgement will represent the law for some time to come.

COURT OF APPEAL DECISION

The Court has confirmed that a guarantor of an assigning tenant cannot validly guarantee the liability of the immediate assignee. Even where the guarantor of the assigning tenant *volunteers* to provide a guarantee for the immediate assignee, that spontaneous agreement is void. The Court acknowledged that this strict interpretation of the Act produces commercially unrealistic results but it felt there were compelling reasons why it should adopt this approach.

The following are two examples of the practical effects of this ruling: if the assigning tenant and its assignee are unrelated but both are customers of a bank which has acted as guarantor for the assigning tenant, then the bank cannot provide a guarantee for the assignee. Likewise, if both are subsidiaries of the same parent company, the parent cannot guarantee the assignee where it has already guaranteed the assigning tenant.

The Court has also decided that any arrangement, whether in the lease or entered into before or after the date of the lease, which obliges the guarantor of a tenant (or someone who will become the tenant's guarantor) to guarantee any future assignee is void.

To counter the strict interpretation which it has put on the provisions of the Act, the Court of Appeal has allowed two concessions:

- First, it has sanctioned the use of sub-guarantees. This is good news. It means that, when considering an application for consent to assign, a landlord can look back to the assigning tenant's guarantor for a sub-guarantee of any AGA obligations. The landlord does not have to procure other forms of security to counterbalance a weak AGA provided by the outgoing tenant.
- Secondly, the Court has decided that a tenant's guarantor can validly guarantee the liability of an assignee on a future assignment PROVIDED there has been an intervening assignment of the lease during which the guarantor was released from liability. Assume that the original tenant A is guaranteed by X. On assignment by A to B, X is released from all liability. B then assigns to C. The alienation covenant in the lease allows for X to stand again as guarantor for C. This is acceptable. The key is that the chain of X's liability was broken on the A to B assignment. The same would apply if there was a re-assignment from C back to A.

The Court of Appeal's judgement contains one unexpected sting in the tail. When examining the meaning of section 25 of the Act and applying a strict interpretation to its terms, the Court said, "it would appear to mean that the lease could not be assigned to the guarantor even where both tenant and guarantor wanted it". Although this comment is obiter, it has caused great concern as the judgement was handed down by the Master of the Rolls, with a view to clarifying the uncertainty which had arisen following the Good Harvest case.

IMPLICATIONS

The judgement has a number of ramifications for landlords, in terms of assessing transactions which have taken place in the past and lessons to learn for the future:

- It confirms that, in the worst case scenario, landlords may find that guarantees which they have already taken, in good faith and in accordance with the law as it was understood at the time, are effectively worthless. This may have a significant effect on value and prompt the need for revaluations. In relation to inter-group assignments, where a parent company has acted as guarantor on each assignment, some guarantees will be void (but intriguingly, landlords may still be able to rely on others!)
- In the light of the doubts which the Court has raised over the validity of assignments by tenants to their guarantors, landlords may find in certain situations that the current tenant's title to a lease is founded on a void transaction so that good title has not passed. This could present considerable difficulties for landlords.
- In relation to leases/licences to assign already granted, obligations upon guarantors to provide direct guarantees for future assignees are void and unenforceable. Landlords will need to consider what protection they may lawfully seek instead as a condition of giving consent to assign. When considering any application by a tenant for consent to assign, landlords must refuse to accept a guarantee for the assignee proffered by the tenant's guarantor.
- In terms of how transactions should be structured from now on, landlords must review their documentation to ensure that this is Act compliant and to take advantage of the concessions which the Court has allowed. The Court has purposefully framed its decision to permit schemes to be set up which will be useful in structuring inter-group transactions. Any scheme of this nature needs to be extremely carefully drafted.

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Landlords would be well advised to review their portfolios to identify void guarantees and assignments and we would be delighted to assist in this. We can also provide advice on how best to draft documentation for the future so that a landlord's interests are protected to the fullest extent permitted by the Court of Appeal's decision.

For corporate tenants, particularly those accustomed to moving property around their group, there may be real opportunities for guarantors who have assumed liabilities under guarantees now deemed to be void, to lose those liabilities. Again, we can help to identify these opportunities and also provide advice as to how companies can retain maximum flexibility when negotiating provisions which allow inter-company transactions within lease alienation clauses. In the future, these clauses are likely to be drafted very differently, as a result of this decision.

FURTHER INFORMATION

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