JONES DAY

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WHY SOME LEASE GUARANTEES ARE NOT ENFORCEABLE

Following the landmark decision of the High Court in *Good Harvest Partnership LLP -v- Centaur Services Limited*[1] on 23 February 2010, any attempt by a landlord to insist that an existing surety of an outgoing tenant enters into an authorised guarantee agreement ("AGA") to guarantee the incoming tenant's obligations under a post-1995 lease will be void and unenforceable, as will any other new guarantee of the incoming tenant given by the outgoing tenant's surety, even if entered into voluntarily.

BACKGROUND

When the Landlord and Tenant (Covenants) Act 1995 (the "1995 Act") originally introduced a new regime of tenant liability, there was some debate as to whether it was permissible under the 1995 Act for a lease to require a surety to stand behind the outgoing tenant's AGA.

The 1995 Act provides for a tenant to be automatically released from its covenants in a post-1995 lease following a lawful assignment. The only exception to this is that the 1995 Act permits the outgoing tenant to guarantee the obligations of its immediate assignee under the lease by way of an AGA. Although the 1995 Act also makes it clear that any surety of an outgoing tenant is released when the tenant being guaranteed is released as tenant, it does not deal specifically with whether the AGA exception also applies to the surety, *i.e.* can the surety be required to remain "on the hook" under the AGA for the obligations of the tenant's immediate assignee under the lease, just as the tenant can?

Over time, most people seem to have accepted the view that it cannot have been the intention of Parliament to prohibit a surety from guaranteeing the tenant's obligations under an AGA; if that were the case, where there is a weak tenant and a strong surety (which, of course, is usually the case) an AGA becomes virtually worthless. It was certainly not considered problematic for a surety to voluntarily directly guarantee the obligations of an assignee, for example on an intra-group assignment. That is, until now.

FACTS

The case in question concerned a 10-year lease granted in 2001 to the tenant, Chiron CS Limited ("Chiron"), at a current rent of £245,000 per annum. The defendant, Centaur Services Limited ("Centaur"), was a party to the lease as surety for the tenant.

The lease provided that "upon or before any assignment… the Tenant making the application for licence to assign and its guarantor…shall enter into an authorised guarantee agreement."

In 2004 the lease was assigned and both the tenant, Chiron, and the surety, Centaur, entered into an AGA whereby both Chiron and Centaur covenanted with the landlord that the assignee would pay the rent and perform the tenant covenants under the lease.

The assignee subsequently failed to pay the rent and the landlord sought to recover the arrears of rent from Centaur under the terms of the AGA.

DECISION

The High Court held that:

- Only a former tenant (and not its surety) can give an AGA.

- An existing surety for the assignor of a lease cannot give a direct guarantee for the assignee. This is the case, even if such a direct guarantee is given *voluntarily*. The judge quoted an example of a parent company guaranteeing a subsidiary's obligations under a lease, and wishing to transfer the lease to another subsidiary. The judge confirmed that the 1995 Act would "prevent the parent company from giving any guarantee for the second subsidiary however much it wished to and however commercially desirable that was".

- In all likelihood, an assignor's surety cannot guarantee the assignor's AGA. In *Good Harvest*, the surety had agreed in the AGA to guarantee the performance of the tenant covenants by the assignee. Many leases are, however, drafted so that the surety instead guarantees the outgoing tenant's obligations under the AGA. Although a rather fine distinction, in such circumstances the assignor's surety is not giving an AGA; rather, it is guaranteeing the AGA, otherwise known as a sub-guarantee. Although, on the facts, the judge did not have to decide the point, he did say that it is not "by any means clear" that the 1995 Act permits an assignor's surety to sub-guarantee the assignor's obligations under the AGA in such a way. When considered in light of the judge's interpretation of the anti-avoidance provisions in section 25 of the 1995 Act (as discussed below), it would seem likely that any such sub-guarantee is also unenforceable.

The decision is principally based around section 25 of the 1995 Act and its inter-relationship with sections 16 and 24.

Section 24 provides that any surety for a tenant is released from its obligations at the same time as the tenant is released from its obligations. In other words, the judge said, any obligations undertaken by a person as surety for a tenant come to an end on the assignment of the lease.

Section 16 provides that a tenant can give a guarantee for an assignee (*i.e.* an AGA), but there is no equivalent provision dealing with sureties. Section 16 represents an exception to a general prohibition against the obligations of the tenant or its surety continuing after a lawful assignment. The court took the view that, had Parliament intended a tenant's surety to be able to guarantee the obligations of an assignee, it could have been expected to say so explicitly.

Section 25 provides that any "agreement relating to a tenancy is void to the extent that it would apart from this section have effect to exclude, modify or otherwise frustrate the operation of any provision of" the 1995 Act. Section 25 was described in *Avonridge Property co Ltd -v- Mashru*[2] as "a comprehensive anti-avoidance provision" which is "to be interpreted generously, so as to ensure that the operation of the 1995 Act is not frustrated, either directly or indirectly". In *Good Harvest*, the judge found that if a surety is required to enter into a further guarantee when the lease is assigned, that further guarantee can fairly be said to "frustrate the

operation of any provision of" the 1995 Act, in that it would, if valid, impose on the surety obligations equivalent to those from which section 24 was designed to secure his release.

CONSEQUENCES

For **landlords**, the consequences of the court's decision are as follows:

- If a post-1995 lease has been assigned and a guarantee of the assignee's lease obligations has been given by the surety of a former tenant (either under an AGA or as a direct guarantee), then that guarantee is now unenforceable.

- If, as is more common, the surety has guaranteed the former tenant's AGA (a sub-guarantee, as referred to above), then it is still arguable that the guarantee is valid, although this is unlikely to be the case. Only a future court case will decide for certain.

- Going forward, landlords may well be reluctant to accept a weak or newly constituted tenant with a strong surety, bearing in mind the likely inability to ensure that the strong surety remains on the hook after assignment of the lease.

- Where a tenant with a surety seeks landlord's consent to assign the lease, the landlord will need to be more careful in considering this. Firstly, without the benefit of its surety, the security given by the outgoing tenant's AGA will be much weaker that would have been thought previously. Secondly (as explained above), it may well be reasonable for the landlord to reject a weak incoming tenant with a strong surety.

- Consideration will need to be had to the drafting of any standard form lease. Any wording requiring the surety of an outgoing tenant to give an AGA or a direct guarantee for the incoming tenant will not now be effective. Care should be taken, however, in amending these provisions, as the decision in *Good Harvest* may be overturned in the future (leave to appeal has been granted). For the time being, it is worth changing to or retaining drafting that requires a surety to guarantee any AGA given by the outgoing tenant, although as explained above even this wording may not work going forward.

- Where the landlord has the benefit of an AGA given by both a former tenant and a surety and the current tenant is in arrears, for the time being we would recommend that a Section 17 notice is still served on both parties within the requisite six-month period, as *Good Harvest* was a first instance decision that may be overturned in the future. Please bear in mind, however, that if the former tenant or its surety does pay the arrears due under a section 17 notice, it will be entitled to claim an overriding lease under section 19 of the 1995 Act.

For **tenants**, the consequences of the court's decision may not necessarily be positive:

- A weak or newly constituted tenant will find it more difficult to take/assign a lease.

- Tenants will need to think carefully when offering a parent company guarantee in circumstances where they may want to assign the lease intra-group in the future. Thought needs to be had as to whether there is any other company of suitable financial strength within the group that could stand as surety for any group assignee, as the original surety will not be able to do so. Leases are often drafted so as to prohibit group assignments unless a package of equivalent financial strength is on offer, which may not be possible if the strongest group company is offered as surety under the original lease.

Any surety of a former tenant who has given any guarantee for a period after the tenant has assigned the lease and has already paid out under that guarantee may now try to bring an action against the landlord for reimbursement on the basis that payment was made under a mistake of law[3]. Certainly, going forward, such sureties should look carefully at the terms of their guarantee before making any payment under it.

CONCLUSION

Any guarantee given by the surety of an outgoing tenant in respect of the incoming tenant's obligations under a post-1995 lease is void and unenforceable, whether given under an AGA or via a new guarantee and even if this is given voluntarily. The court did not decide whether a surety could guarantee the outgoing tenant's obligations under an AGA (*i.e.* a sub-guarantee, rather than a direct guarantee of the assignee), but it is likely that they would have also found this to be unenforceable had this been the issue.

The case only applies to leases granted on or after 1 January 1996 (unless granted pursuant to an earlier agreement for lease), and old pre-1996 leases are not therefore affected.

The case does not affect the validity of an AGA given by the outgoing tenant or a guarantee for the current tenant (unless this was given by the surety of a former tenant).

LAWYER CONTACT

For further information, please contact your principal Firm representative or the lawyer listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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ENDNOTES

1. *Good Harvest Partnership LLP -v- Centaur Services Limited* [2010] EWHC 330 (Ch).

2. *Avonridge Property Co Ltd -v- Mashru* [2005] UKHL 70.

3. *Kleinwort Benson Ltd -v- Lincoln City Council* [1999] 2 AC 349.