

# GUARANTEES AND INDEMNITIES: RELYING ON THE TWELFTH MAN

by

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## **THE IMPORTANCE OF GUARANTEES**

1. In hard-pressed times, the commercial landlord who is unable to recover rent arrears or damages for breach of covenant from his tenant, is bound to cast around for alternative sources of redress. The prospect of recovery from sureties (e.g. parent companies or individual directors) presents an attractive and straightforward option. Where there are rent arrears, the landlord envisages a simple demand for the rent from the surety – and an uncomplicated debt action if the surety does not capitulate. Further protection for the landlord is also provided by the fact that modern leases which include a surety covenant will also provide (in the form of a separate and primary obligation) for the surety to take a new lease in the event of disclaimer<sup>1</sup>.
2. This talk is intended as a brief look at: (1) some of the more common defences that the surety may try to rely on when claims are brought against him either for arrears/breach of covenant; (2) the obligation on the surety to take a lease following disclaimer. I shall not deal with overriding leases; 'AGAs' or other matters arising from the Covenants Act 1995 other than in so far as the Act affects the 'standard' guarantee covenant.

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<sup>1</sup> In authorised guarantee agreements s.16(5)(c) of the L and T (Covenants) Act 1995 specifically authorises such a term.

3. The title for this 'mini bite' comes from some well known words of Lord Templeman<sup>2</sup> (in the case that established that guarantee obligations are enforceable by successors to the reversion) who described the surety for the tenant as follows:  
*'A surety for a tenant is a quasi tenant who volunteers to be a substitute or twelfth man for the tenant's team and is subject to the same rules and regulations as the player he replaces'*.
4. But this is perhaps something of an over-simplification, if read out of context. In very many respects, as is apparent from what follows, the surety remains in a better position than the tenant – not least because of the range of defences that a surety can sometimes advance when called upon by the landlord to act as 'twelfth man'.

### **GUARANTEE/INDEMNITY- WHAT IS THE DIFFERENCE – DOES IT MATTER IN THE LEASE CONTEXT?**

5. First: what is the difference between a guarantee obligation and an obligation to indemnify? Put very simply, the obligation to guarantee the tenant's obligations is a secondary obligation – whereas the obligation to indemnify is a primary obligation. A simple surety contract is thus an 'accessory' contract only – although the distinction is often in practice difficult to draw<sup>3</sup>.
6. In the ordinary lease the distinction is often an artificial one – and often the lease will include wording that is appropriate to both guarantees and indemnities - i.e. the phrase '*provided that as between the landlord and the surety the surety shall be deemed principal debtor ..*' is not uncommon. Although each surety covenant must be interpreted in its own specific context, probably the effect of this 'hybrid' wording is that the surety's obligations are genuinely secondary whilst the tenant remains liable under the lease covenants – but, once the tenant has been discharged from his lease obligations for whatever reason, the surety's obligations become primary obligations<sup>4</sup>.

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<sup>2</sup> **P & A Swift Investments v Combined English Stores Group plc** [1989] AC 632

<sup>3</sup> See e.g. **Actionstrength Ltd v International Glass Engineering Spa** [2002] 1 WLR 566

<sup>4</sup> See e.g. **General Produce Co v United Bank Ltd** [1979] 2 Lloyds Rep 255

7. However, it can still be important to distinguish between guarantee obligations and indemnities. The main practical consequences of an obligation being construed as a 'secondary' rather than a primary obligation are as follows:

- Where the main contract is void or unenforceable a guarantee is also unenforceable – but an indemnity may not be;
- A guarantee is dependent on the liability of the principal debtor – so that the discharge of the debtor (for whatever reason) will discharge the guarantor – the indemnifier will not be discharged in these circumstances – hence the importance of the 'principal debtor' clause;
- An obligation to indemnify is not capable of being discharged following an accommodation reached between the landlord and a subsequent holder of the term<sup>5</sup>
- A guarantee must comply with s.4 Statute of Frauds 1677 - no formality is required for an indemnity<sup>6</sup>.

## **PRINCIPAL DEFENCES ON WHICH THE GUARANTOR MAY RELY**

8. The guarantor's defensive armoury includes the following:

### Strict Construction of the Obligations

(1) The authorities frequently state that a guarantee should be construed 'strictly' to ensure that it covers the '*nature extent and circumstances of the principal debt sought to be recovered from the surety*<sup>7</sup>'. Thus, for example, in the absence of clear words, the surety's liability will not extend beyond the contractual term into the period of 'holding over' under Part II of the 1954 Act. Even where the guarantor's liability is so extended, further clear words are required to make the tenant liable for interim rent.<sup>8</sup> Equally, unless there are clear words, the obligations of the surety will not extend to tenant obligations contained in documents other than the lease (e.g. rent deposit deeds<sup>9</sup>).

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<sup>5</sup> **Scottish & Newcastle Plc v Raguz** [2003] EWCA Civ 1070

<sup>6</sup> Note the position as regards variations to a guarantee is less clear – it is arguable that a guarantee may be varied orally: **Re a Debtor (no 517 of 1991)** TLR 25/11/91.

<sup>7</sup> **Associated Dairies v Pierce** [1983] 1 EGLR 45

<sup>8</sup> **City of London Corp'n v Fell** [1993] QB 589

<sup>9</sup> **Jaskel v Sophie Nursery Products** [1993] EGCS 42.

## Variations to the Principal Contract

(2) The surety will be discharged by *any* substantial variation in the terms of the contract between creditor and the principal debtor made without the surety's consent – even if the variation was beneficial to the surety<sup>10</sup>. The rule is strict – so for example the surety was released where the tenant had been permitted to retain unauthorised structural alterations<sup>11</sup>. Whilst almost all modern leases will provide for the surety to remain liable despite any giving of time or immaterial variation<sup>12</sup> to the terms of the lease, consistent with (1) above, such provisions will be construed strictly – and if at all ambiguous, will not preserve a guarantor's liability following a variation.<sup>13</sup> Furthermore, any discharge will extend to all obligations – including the obligation to take on a new lease – (except where the discharge is as a result of disclaimer by a liquidator.)

This 'variation' principle applies where the tenant enters into a binding composition with his creditors including his landlord – because it is a *voluntary* act of the creditor/landlord to agree to such. But it has also been held to apply where the composition is a statutory composition – i.e. a tenant CVA or an IVA.<sup>14</sup> Thus even though the composition is created by statute, because the wording of the statute *deems* a consent, the creditor/landlord is to be treated as if he has voluntarily consented to the composition<sup>15</sup>.

## Release of Securities and of Co-Sureties

(3) The surety is entitled on discharging the indebtedness, to be subrogated to the creditor's rights against the debtor and to any securities held by the creditor – this is so whether or not the surety knew of the existence of the securities or rights when giving his guarantee, and it applies to securities taken by the creditor after as well as before the guarantee. Contribution rights exist between sureties to the same degree. But any act or omission of the creditor which impairs those rights/securities or which leads them to be realised at less than a proper price, potentially injures the surety's interest. The law is very protective of sureties in this regard, and any culpable act or omission of the creditor which alters or affects those rights is likely to discharge the surety either wholly or in part. Thus for example if one of several sureties or the tenant himself has charged other property as security for the lease obligations and that security is released or not

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<sup>10</sup> Rowlatt: *Principal and Surety* (5<sup>th</sup> ed. 1999 para 5-14)

<sup>11</sup> *Selous Street Properties v Oronel Fabrics* [1984] 1 EGLR 50

<sup>12</sup> It is common for the tenant to insist that only immaterial variations should not result in release – which represents a fair compromise between the tenant and landlord's rights. But what constitutes an 'immaterial' variation is often a nice question

<sup>13</sup> E.g. *Howard de Walden Estates Ltd v Pasta Place Ltd* [1995] 1 EGLR 79

<sup>14</sup> *Johnson v Davies* [1999] BCC 275. This C.A. decision overturned a number of first instance decisions – but has been criticised – see e.g. Gabriel Moss QC – 'Landlord's Position in a CVA' Lecture to the Property Bar Association, July 2008.

<sup>15</sup> But the landlord can exclude the result of *Johnson v Davies* [1999] by the express terms of the surety covenant, as was the effect of the terms of the guarantees in *Prudential Assurance Co Ltd v PRG Powerhouse Ltd* [2007] BCC 500.

registered, any surety who is jointly liable and who is potentially prejudiced by the failure will be discharged 'in toto'. Where the surety is severally liable (i.e. where there are co-sureties but it is not part of the surety's contract that the co-sureties should join in) the discharge of one will discharge the other 'pro tanto' to the extent that his contribution rights are prejudiced. Although the effects of these strict rules can often be overcome by a suitable worded 'principal debtor' clause, such a clause will of course be strictly construed.

The surety (if he is a 'consumer') can also potentially rely on the provisions of the Unfair Contract Terms Act 1977 as regards any limitation or exclusion of liability. UCTA 1977 also applies to any guarantee on standard written terms of business; and, for the consumer, there is also the additional protection provided by the Unfair Terms in Consumer Contracts Regulations 1999.

#### Variations and s.18 Covenants Act 1995

(4) Statute has intervened to provide further protection for the surety in two important ways.

First, S.18(3) of the Covenants Act 1995 – which applies to 'old' and 'new' tenancies, has the effect that the guarantor cannot be liable for post 1/1/1996 variations to the lease effected *after* an assignment by the tenant whose obligations the guarantor guaranteed – probably even if the guarantor expressly consents to the variation.<sup>16</sup> Thus the guarantor will only remain liable to the extent of the un-varied (i.e. pre-assignment) obligation, but he is not released altogether. So even if the lease contains provisions which mean that the surety is bound by variations effected while the principal debtor remains tenant, the lease draftsman cannot provide for the guarantor to remain bound *after* an assignment by the principal debtor, and any provision that purports to have that effect will be void. Note however that s18(3) does not apply to the guarantor for the assignee of the former tenant – he must rely on the common law rules as to variations of the principal contract (see (2) above), and is at the mercy of the landlord's draftsman who will of course, in a modern lease, usually have excluded the common law rules, as we have seen above.

(Note: S.18(2) of the Covenants Act has a similar effect to s.18(3) in respect of a tenant who has entered an authorised guarantee agreement, or, who is liable as original tenant under a pre-Covenants Act tenancy.)

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<sup>16</sup> **Woodfall** (Vol 1, para 5.154.1) considers the point unclear – but that the better view is that the anti-avoidance provisions in the Act (s.25) will mean that the guarantor will not be bound – even after express consent. The practical answer to the problem is for landlords to refuse to enter into variations unless the surety agrees to enter a new guarantee – but query if this also offends s.25?

### Covenants Act 1995 - s.17 Notice Provisions

(5) The second statutory intervention is in respect of the 'limitation period' for recovery from lease guarantors. The notice provisions in s.17(3) of the Covenants Act 1995 are wide in their application. They provide, in respect of old and new leases, that where the guarantor has guaranteed the performance by a former tenant the guarantor is not liable for any 'fixed charge' unless the guarantor has been served with a s.17 notice within six months of the charge becoming due. (The same applies under s.17(2) to the former tenant who (under a 'new' tenancy) guarantees the obligations of the assignee under an AGA or, who is contractually liable as a former tenant under an 'old' tenancy.) The notice requirements in each case are strict<sup>17</sup> – and arguably, illogical in their operation. (Note that the provisions do not of course apply to a guarantor of a current tenant – where the limitation period remains 6 years.)

Until very recently, a familiar 'trap' for the landlord arose when he failed to serve notices on the guarantor of a former tenant whilst there is a rent review outstanding, and, again, once a rent review has been determined<sup>18</sup>. In **Scottish & Newcastle v Raguz** [2007] 15 E.G. the Court of Appeal came to the completely anomalous conclusion that s.17(2) requires a landlord to serve notice on a former tenant within six months of each rental quarter during the period in which a rent review remains outstanding, even where, at the time of service, the current tenant was not in arrears, and the amount that he was then due to pay for the reviewed rent was 'nil' because it will not become payable until the reviewed rent is actually determined. Furthermore a further notice under s.17(4) was needed (said the Court of Appeal) within three months of the determination of the new rent, informing the former tenant/his guarantor that that greater amount may be recovered from him. The Court's view was that the policy of the Act was to ensure that the former tenant/guarantor of the former tenant received prior notice of the *possibility* that it would be looked to for the recovery of rent under a lease that might have been assigned many years previously.

Fortunately the position has been reversed recently by the House of Lords. In **Scottish & Newcastle v Raguz** [2008] UKHL 65 the House of Lords restored sense to this area of law. They decided that s.17 notices were only required once the review had actually been determined and there were actually arrears of rent.

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<sup>17</sup> There is a 'pro forma' notice that needs to be completed and served – see The Landlord and Tenant (Covenants) Act 1995 (Notices) Regulations 1995 (SI 1995 No. 2964)

<sup>18</sup> See **Scottish & Newcastle v Raguz** [2007] 15 E.G. 148

Particular s.17 traps may still be presented where, for example, a *Jervis v Harris* clause is operated by the landlord who seeks to recover the cost of repair as a debt – i.e. a ‘fixed charge’. The repairs may take an extended period to complete and it may be unclear when the ‘debt’ is incurred by the current tenant. The landlord may have to make the decision whether to serve the s.17 notices on the guarantor (or former tenant) on an on-going basis as the debt mounts up during the repairs period, or, when the final bill is determined on completion of the works. This may require a careful scrutiny of the building contract and the *Jervis v Harris* clause.

## **DISCLAIMER AND THE SURETY**

9. The effect of *Hindcastle Ltd v Barbara Attenborough Associates Ltd*<sup>19</sup> - a decision from the last property recession - is now well known for its onerous implications for the surety. The disclaimer of a lease does not put an end to the liability of a surety whether he is a surety for the insolvent tenant or for a predecessor in title. The surety’s position is particularly onerous because, following *Hindcastle* it is also clear that he is no longer entitled to an indemnity from the principal debtor. Thus the surety will remain liable unless:

- The surety would have been released any way (i.e. even if the lease had not been disclaimed)
- The landlord takes possession of the premises, so terminating the ‘statutory fiction’ that the lease remains alive
- The landlord requires the surety to take up a new lease, in which case the new lease will replace the ‘fiction’ that the old lease continues in existence.

### **Landlord Taking Possession**

10. A particular defence of the surety of which the landlord needs to be aware is that the landlord has taken possession. In *Hindcastle* Lord Nicholls made clear that, in these circumstances the landlord is no longer the involuntary recipient of a disclaimed lease. By his own act of taking possession he has demonstrated that he regards the lease as at an end. But this issue can present difficulties for the landlord – e.g.

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<sup>19</sup> *Hindcastle v Barbara Attenborough Associates* [1996] 1 All ER 737

where he secures the premises against intruders, or, takes possession proceedings against squatters, or attempts to re-let. Probably in each of these cases there will not have been a re-taking of possession, but the facts of individual cases are not always so clear.

11. A particular problem can arise where, before disclaimer, the landlord reaches an arrangement with a sister company of the troubled tenant, effectively allowing the sister company to occupy and pay the rent under the lease. Forfeiture and surrender of the lease can of course take place without the landlord intending such a result. This situation can lead to the inevitable argument, when the tenant goes into liquidation and the lease is disclaimed, that there had been an earlier surrender of the 'disclaimed' lease such that the guarantor was released from his obligation to take a new lease<sup>20</sup>. There are other circumstances where the argument can be raised – e.g. where, prior to disclaimer the tenant company has (unknown to the landlord) been dissolved but the rent is paid by a sister company. Here, the question will be whether the landlord has effected any act which is inconsistent with the continued existence of the original (now disclaimed) lease, and whether the landlord has consciously permitted the sister company to enter into possession as tenant<sup>21</sup>.

### The Obligation to Take a New Lease

12. The standard guarantor covenant in a modern lease will contain an obligation on the guarantor to take a new lease in the event of disclaimer. This is so despite the fact that the original purpose of the provision was to get around the rule in **Stacey v Hill** [1901] 1 QB 660 – i.e. that a guarantor was released upon disclaimer – even though this case was overruled in **Hindcastle**. The effect of the provision is that once the landlord serves notice on the guarantor it brings into existence a contract under which the executors are obliged to take a new lease. The notice itself does not therefore bring to an end the disclaimed lease – which remains in existence until the execution of the new lease<sup>22</sup>. Thus the clause is construed as a 'principal debtor' obligation and is usually in the form of a 'put' option – which has the effect that once the option is exercised an immediate binding contract arises, but, because it is in 'put' form, the surety cannot compel its grant – if the landlord does not want to make it.

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<sup>20</sup> For an example see: **Active Estates Limited v Parness** [2002] 36 E.G. 147. The landlord was saved in that case because, on the facts, it had plainly been agreed that the sister company would act as agent only for the tenant.

<sup>21</sup> See **Cromwell Developments Ltd v Godfrey** [1998] 2 EGLR 62 for an example of this situation.

<sup>22</sup> See **Basch v Stekel** [2000] 81 P & CR D1

13. The obligation is not discharged by the disclaimer therefore, and it carries no right of indemnity from the tenant<sup>23</sup>. It can be enforced by specific performance – but there is at least the potential in these circumstances, for ‘hardship’ defences to be raised by the guarantor.

### **WHY GUARANTEES ARE SO IMPORTANT**

14. The subject is important in the landlord and tenant context as we move into recession, because of the many unanswered questions. Just a few are listed below:

1. Where there is a standard ‘neglect or forbearance’ provision in the guarantee covenant – what about when rent is refused because L does not want to waive a ground for forfeiture – do the standard words include this? (Many lease guarantee covenants do not provide for this specific circumstance).
2. Where the guarantor of a former tenant expressly consents to a variation to the lease whilst it is held by an assignee – will the anti-avoidance provisions in s.25 of the Covenants Act 1995 prevent him being liable to the extent that the varied obligations increase the burden on him?
3. Similarly, if the guarantor enters a new guarantee in the situation in (2) above, rather than simply consenting to the variation – will the anti avoidance provisions of the Covenants Act 1995 operate to strike down the new guarantee?

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<sup>23</sup> *Re Yarmine (IW) Limited* [1992] BCLC 276