

WHAT COULD POSSIBLY GO WRONG? – GUARANTEES AND INDEMNITIES

by

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Introduction

1. The purpose of this paper is to consider issues arising in relation to guarantees and indemnities in a property context. This paper is split into three parts. The first part deals with definitions. The second part deals with guarantees in the context of leases and with particular regard to the principles governing the enforcement of guarantees in respect of tenants' covenants. The third part deals with indemnities in the context of settling litigation. The particular issue that will be considered is that of when a party can rely upon an indemnity to recover sums incurred in compromising a claim.

1 Definitions

2. The starting point is to try to distinguish guarantees on the one hand from indemnities on the other. A contract of guarantee is a contract whereby the guarantor (or surety) promises the creditor to be responsible, in addition to the principal, for the due performance by the principal of his obligations to the creditor in the event that the principal fails to perform those obligations.¹ The essential distinguishing feature of a contract of guarantee is that the liability of the guarantor is ancillary to that of the principal: there is no liability on the guarantor unless and until the principal fails to perform his obligations.² Whether a particular contractual promise is to be classified as a guarantee so as to attract the legal consequences which flow from that classification depends upon the words in which the parties have expressed the promise. The use of the word "guarantee" is not of itself conclusive.³
3. A contract of indemnity is a contract whereby one party agrees to keep the other harmless against loss.⁴ In its widest sense, a contract of indemnity might be said to include a contract of guarantee. However, more usually, to describe a contractual obligation as one of indemnity is to denote a contract by which the promisor undertakes an independent obligation to indemnify, as distinct from an ancillary contract in the nature of a guarantee by which the person undertakes to answer for the default of another person who is to be primarily liable to the promisee.⁵ The essential characteristic of a contract of indemnity, in contrast to a contract of guarantee, is that it gives rise to a primary liability.

¹ See *Halsbury's Laws*, Vol. 49 (5th ed., 2008) paragraph 1013, cited with approval by Phillips J in *Wardens and Commonalty of the Mystery of Mercers of the city of London v New Hampshire Insurance Company* (1991) 3 JIBFL 144; Andrews and Millet, *Law of Guarantees* (5th ed., 2008) at paragraph 1.04.

² *Lakeman v Moutstephen* (1874) LR 7 HL 17 at 24.

³ *Moschi v Lep Air Services Ltd* [1973] AC 331 at 349.

⁴ *Yeoman Credit Ltd v Latter* [1961] 1 WLR 828 at 830-831.

⁵ *Yeoman* (above) at 830-831.

4. The question of whether a contract is one of guarantee or indemnity has been described in the Court of Appeal as a “most barren controversy” with the potential (possibly overstated) to bring the law into “hatred, ridicule and contempt by the public”⁶. The distinction is, however, one that matters. As a matter of law, guarantees and indemnities are treated differently from one another. For instance, a contract of guarantee, unlike a contract of indemnity, is unenforceable unless it is in writing or some memorandum or note of it is in writing and signed by the guarantor.⁷ As a matter of practice, the contexts in which guarantees and indemnities appear can differ; so too can the particular problems to which they give rise.

2 Guarantees under leases

5. Leases commonly include clauses containing guarantees in respect of tenants’ covenants. For instance: “The tenant shall punctually pay the rents and perform the covenants contained in the lease and if at any time the tenant fails so to do the guarantor covenants that he shall pay and perform the same”. Thus, the guarantor’s obligations appear to mirror those of the tenant. As Lord Templeman famously put it in *P & A Swift Investments v Combined English Stores Group Plc* [1989] AC 632 at 638:

“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.”

However, such formulation risks oversimplifying the position. This is because the principles which apply in respect of the enforcement of guarantees in leases can place the guarantor in a substantially better position than that of the tenant whose default the guarantor is called upon to remedy. The main principles and points to keep in mind in such regard are as follows.

Determining the extent of guarantor’s obligation

6. First, in determining whether a guarantor is liable for the particular defaults of a tenant, the starting point is to identify the precise scope of the guarantor’s obligation. This is a matter of construction. Historically, the courts have adopted the approach that in cases of ambiguity a guarantee should be strictly construed in favour of the guarantor. As stated by Hilbery J in *Eastern Counties Building Society v Russell* [1947] 1 All ER 500 at 503:

“... the court [will] in case of doubt lean in his [i.e. the surety’s] favour. Neither equity nor law will put a construction on the document which results in imposing on the surety any more than, on the strictest construction of the instrument, he must be said expressly to have undertaken, or so as to detract from

⁶ *Yeoman* (above) at 835.

⁷ Section 4 of the Statute of Frauds 1677.

the right given to the surety by the proviso defining the circumstances in which the surety is to be held discharged.”

Sometimes this rule of construction has been expressed in more liberal terms, with an emphasis not on the strictest possible construction but rather on a “fair but strict reading of the language of the guarantee”.⁸

7. This strict approach to construction can give rise to particular issues in the landlord and tenant context. For instance, it has been held that, in the absence of clear words to the contrary, the obligation of a guarantor under a lease will not extend beyond the contractual term of a lease into a period during which the tenancy in question is continuing by virtue of Part II of the Landlord and Tenant Act 1954 (“LTA 1954”).⁹ Nor will a guarantor be obliged to pay interim rent in excess of the contractual rate under section 24A LTA 1954 unless there is an express provision to such effect.¹⁰ Also, a guarantor’s liability will not ordinarily extend to obligations contained in documents other than the lease itself, such as a rent deposit deed¹¹ or an agreement to surrender¹².
8. As against the above, in considering the traditional strict approach to the construction of guarantees it is now important to keep in mind the principles enunciated in the judgment of Lord Hoffman in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896. The position as set out in *Investors* suggests that the proper approach to construing a contract of guarantee is no different from that applicable in relation to the construction of any other commercial agreement; that is to say, the document in question should be given a reasonable, business meaning taking into account any relevant background.
9. In the circumstances, the current position as regards the historical approach that guarantees be construed strictly is one of uncertainty. Acknowledging the analysis contained in *Investors*, the Court of Appeal has recently suggested that it may be that “the concept that a guarantee should be ‘strictly construed’ now adds nothing”.¹³ On the other hand, there has been no clear judicial decision to the effect that the historic approach to construing guarantees should be formally abandoned.¹⁴ It remains prudent, therefore, to be cautious when considering the extent of any liability imposed by a guarantee under a lease.

⁸ *First National Finance Corp Ltd v Goodman* [1983] BCLC 203 at 213.

⁹ *Plessner & Co v Davis* [1983] 2 EGLR 70.

¹⁰ *City of London Corporation v Fell* [1993] QB 589.

¹¹ *Jaskel v Sophie Nursery Products* [1993] EGCS 42.

¹² *BSE Trading Ltd v Hands* 75 P&CR 138.

¹³ *Static Control Components (Europe) Ltd v Egan* [2004] EWCA Civ 392 at paragraph 19.

¹⁴ *Investec Bank (UK) Ltd v Zulman* [2009] EWHC 1590 (Comm) at paragraph 57.

Variations of the lease

10. Another issue that arises in the context of considering whether a guarantee can be enforced relates to variations of the lease. A material variation of the terms of the lease between the landlord and the tenant for which the guarantor does not give his consent will discharge the guarantor from his obligations. An example of such a situation would be if the tenant were to surrender part of the property subject to the lease without consulting with the guarantor;¹⁵ or if the tenant were to grant the landlord more extensive rights of entry than those contained in the unvaried lease.¹⁶ However, an immaterial variation will have no effect on the guarantor's liability, and a guarantor's liability will usually (see below) survive if the guarantor consents to the variation. Also, it is common in modern leases for the covenant of guarantee to seek to make express provision limiting or excluding the application of the common law rule that a guarantor will be discharged from liability on variation of the lease. Such express provisions are effective provided the formal requirements of section 4 of the Statute of Frauds 1677 are met.¹⁷ Section 4 requires that a contract of guarantee be in writing or some memorandum or note of it be in writing and signed by the guarantor.
11. The caveat to the basic position that a guarantor's liability will survive a variation to a lease if the guarantor consent to the variation is that the situation is affected by section 18(3) of the Landlord and Tenant (Covenants) Act 1995 ("LTCA 1995"). Section 18 applies regardless of whether the lease in question is an old lease or a new lease for the purposes of LTCA 1995 but only applies in respect of variations effected on or after 1 January 1996. Section 18 provides (in part):

"(1) This section applies where a person ("the former tenant") is as a result of an assignment no longer a tenant under a tenancy but—

(a) (in the case of a new tenancy) he has under an authorised guarantee agreement guaranteed the performance by his assignee of any tenant covenant of the tenancy; or

(b) (in the case of any tenancy) he remains bound by such a covenant.

(2) The former tenant shall not be liable under the agreement or (as the case may be) the covenant to pay any amount in respect of the covenant to the extent that the amount is referable to any relevant variation of the tenant covenants of the tenancy effected after the assignment.

(3) Where a person ("the guarantor") has agreed to guarantee the performance by the former tenant of a tenant covenant of the tenancy, the guarantor (where his liability to do so is not wholly discharged by any such

¹⁵ *Holme v Brunskill* (1878) 3 QBD 495.

¹⁶ *West Horndon Industrial Park Ltd v Phoenix Timber Group plc* [1995] 1 EGLR 77.

¹⁷ *Goodaston Ltd v FH Burgess Plc* [1999] L&TR 46.

variation of the tenant covenants of the tenancy) shall not be liable under the agreement to pay any amount in respect of the covenant to the extent that the amount is referable to any such variation.

(4) For the purposes of this section a variation of the tenant covenants of a tenancy is a “relevant variation” if either—

(a) the landlord has, at the time of the variation, an absolute right to refuse to allow it; or

(b) the landlord would have had such a right if the variation had been sought by the former tenant immediately before the assignment by him but, between the time of that assignment and the time of the variation, the tenant covenants of the tenancy have been so varied as to deprive the landlord of such a right.

(5) In determining whether the landlord has or would have had such a right at any particular time regard shall be had to all the circumstances (including the effect of any provision made by or under any enactment).”

12. Thus, the effect of section 18(3) is that where a variation of a lease to which section 18 applies does not wholly discharge from liability the guarantor of a former tenant, the guarantor will not be liable to pay any amount in respect of the tenant’s covenants to the extent that the amount is referable to any such variation. (Sections 18(1)-(2) have a similar effect to section 18(3) in respect of a tenant who has entered into an authorised guarantee agreement¹⁸, or who is liable as the original tenant under an old tenancy.) Therefore, by way of example, if the lease contains a clause which enables the landlord to vary its terms without releasing the guarantor and the landlord agrees with the assignee to permit the premises to be used for additional purposes on payment of an increased sum, when the assignee defaults, the guarantor will only be liable for the original amount of rent. It is important to note that section 18(3) is confined to variations which the landlord has or would have had an absolute right to refuse (section 18(4)(a)). Also, section 18(3) does not apply to the guarantor for the assignee of the former tenant: he must rely on the common law rules as to the variation of the principal contract.

¹⁸ An authorised guarantee agreement within the meaning of section 16 LCTA 1995 is subject to all the rules of law applicable to any other guarantee (section 16(8)).

Statutory limitation period in respect of fixed charges

13. A further issue that can arise when trying to enforce a guarantee in respect of a tenant's covenant is that of whether the necessary steps to enforce the guarantee have been taken with sufficient speed. In such regard, LCTA 1995 imposes a significant procedural limitation upon the right of a landlord to recover certain fixed sums (including rent) from the guarantor of a former tenant who has assigned his lease. Section 17(3) LCTA 1995 Act effects a six month limitation period within which the landlord must notify the guarantor of his liability to pay the sum in question. This limitation period applies regardless of whether the tenancy in question is a new lease or an old lease for the purposes of LCTA 1995. Section 17 provides (in part):

“(1) This section applies where a person (“the former tenant”) is as a result of an assignment no longer a tenant under a tenancy but—

(a) (in the case of a tenancy which is a new tenancy) he has under an authorised guarantee agreement guaranteed the performance by his assignee of a tenant covenant of the tenancy under which any fixed charge is payable; or

(b) (in the case of any tenancy) he remains bound by such a covenant.

(2) The former tenant shall not be liable under that agreement or (as the case may be) the covenant to pay any amount in respect of any fixed charge payable under the covenant unless, within the period of six months beginning with the date when the charge becomes due, the landlord serves on the former tenant a notice informing him—

(a) that the charge is now due; and

(b) that in respect of the charge the landlord intends to recover from the former tenant such amount as is specified in the notice and (where payable) interest calculated on such basis as is so specified.

(3) Where a person (“the guarantor”) has agreed to guarantee the performance by the former tenant of such a covenant as is mentioned in subsection (1), the guarantor shall not be liable under the agreement to pay any amount in respect of any fixed charge payable under the covenant unless, within the period of six months beginning with the date when the charge becomes due, the landlord serves on the guarantor a notice informing him—

(a) that the charge is now due; and

(b) that in respect of the charge the landlord intends to recover from the guarantor such amount as is specified in the notice and (where payable) interest calculated on such basis as is so specified.

(4) Where the landlord has duly served a notice under subsection (2) or (3), the amount (exclusive of interest) which the former tenant or (as the case may be) the guarantor is liable to pay in respect of the fixed charge in question shall not exceed the amount specified in the notice unless—

(a) *his liability in respect of the charge is subsequently determined to be for a greater amount,*

(b) *the notice informed him of the possibility that that liability would be so determined, and*

(c) *within the period of three months beginning with the date of the determination, the landlord serves on him a further notice informing him that the landlord intends to recover that greater amount from him (plus interest, where payable).*

(5) *For the purposes of subsection (2) or (3) any fixed charge which has become due before the date on which this Act comes into force shall be treated as becoming due on that date; but neither of those subsections applies to any such charge if before that date proceedings have been instituted by the landlord for the recovery from the former tenant of any amount in respect of it.*

(6) *In this section—*

“fixed charge”, in relation to tenancy, means—

(a) *rent,*

(b) *any service charge as defined by section 18 of the Landlord and Tenant Act 1985 (the words “of a dwelling” being disregarded for this purpose), and*

(c) *any amount payable under a tenant covenant of the tenancy providing for the payment of a liquidated sum in the event of a failure to comply with any such covenant;*

“landlord”, in relation to a fixed charge, includes any person who has a right to enforce payment of the charge.”

14. As well as applying to guarantors, section 17 also applies to former tenants (sections 17(1)-(2)), but it is not necessary for a landlord to serve notice on a former tenant before making a claim against a guarantor.¹⁹ It is now settled that for the purposes of section 17(3) “due” means “payable” and an unascertained sum (such as rent due on conclusion of a rent review) will not become “due” until it is ascertained.²⁰

¹⁹ *Cheverell Estates v Harris* [1998] 02 EG 127.

²⁰ *Scottish & Newcastle v Raguz* [2008] 1 WLR 2494.

Release of guarantor and disclaimer

15. The liability of a principal debtor and his guarantor is co-extensive. Accordingly, as a general rule, a guarantee in respect of a tenant's covenants will cease when the tenancy in question is determined, although this will not affect any liability on the part of the guarantor that has already accrued²¹. However, this general rule that the guarantor is released on termination of the tenancy does not apply where a lease is disclaimed. If a tenant who is an individual becomes bankrupt, his trustee in bankruptcy may disclaim the lease under section 315 of the Insolvency Act 1986 ("IA 1986"). A similar right is given to the liquidator of an insolvent company under section 178 IA 1986. Following the decision of the House of Lords in *Hindcastle v Barbara Attenborough Associates* [1997] 1 AC 70 it is clear that a guarantor of an original tenant will not be released by the disclaimer even though the lease ceases to exist. It is also clear from *Hindcastle*²² that the guarantor loses his right to an indemnity from the insolvent tenant, albeit that statute provides him with a right to prove as a creditor of the insolvent tenant's estate.
16. A lease may include a provision requiring the guarantor to take on a new lease for the remainder of the term in the event of a disclaimer by the liquidator or trustee in bankruptcy of the original tenant. Because such a provision constitutes a primary obligation as between guarantor and landlord it survives the disclaimer of the lease. The benefit of such an obligation runs with the notional reversion which survives post-disclaimer as between landlord and guarantor.²³ The position is different, however, if the landlord takes possession. If the landlord takes possession of the property in question then he is no longer merely the involuntary recipient of a disclaimed lease, and he loses both the right to claim rent from the guarantor for the future and the right to require the guarantor to take on a new lease for the remainder of the term.²⁴

3 Indemnities and settlement

17. The third part of this paper concerns indemnities. As set out earlier, a contract of indemnity is one whereby the party providing the indemnity promises to hold the other party harmless against a particular liability. For instance, a party, A, might agree to indemnify another party, B, against "any loss, damage, expense or liability due to or resulting from any breach of obligation" on the part of A. An indemnity, therefore, is unlike a guarantee in that the former, in contrast to the latter, gives rise to a primary rather than ancillary obligation.

²¹ *Torminster Properties v Green* [1983] 1 WLR 676.

²² *Hindcastle* (above) at 94.

²³ *Scottish Widows Plc v Tripipatkul* [2004] BCC 200 at 204.

²⁴ *Andrews and Millet* (above) at paragraph 18.13; *Scottish Widows* (above).

18. One context in which the enforceability or otherwise of an indemnity can be of importance is in the context of the settlement of litigation. The particular question that arises is that of when a defendant to proceedings can compromise a claim safe in the knowledge that an indemnity in respect of which he has the benefit, and which appears to bite in respect of the settlement reached, does in fact do so. This question is not peculiar to property litigation, but does arise in the context of various types of property dispute, including, for instance, dilapidations claims (Can the head tenant recover from the sub-tenant the cost of compromising proceedings brought against the head tenant by the head landlord?) and construction-related litigation. An example of the latter type of case is as follows.
19. A construction company, A, builds a new office building. The company enters into a contract with another company, B, in relation to the supply of a sprinkler system for the building. B in turn enters into a sub-contract with C in respect of the installation of the sprinkler system. Under the contract between B and C, C indemnifies B against any loss arising from any breach of contract by C. After the building has been built and the sprinkler system has been supplied and installed, a valve for the storage tank in relation to the sprinkler system fails. Flooding and damage occur in the basement of the building. The lessee of the building sues A, B and C. The supplier of the sprinkler system, B, settles the claim for half of its full value and then seeks to recover the settlement sum from C. B asserts that it is entitled to recover the settlement sum from C in circumstances where C has provided B with an indemnity and C was responsible for the installation of the valve and such installation was deficient. C resists B's claim. C asserts that both B's decision to settle the claim and the quantum of settlement were unreasonable. C denies that its installation of the valve was defective and points to shortcomings in relation to the maintenance of the building as affecting the chain of causation. In considering whether a party in B's position would be entitled to recover the settlement sum under C's indemnity, the relevant principles are as follows.²⁵

Scope of the indemnity

20. The first step is to determine the scope of the indemnity. The party seeking to invoke the indemnity must establish that the particular situation in which it finds itself is prima facie within the scope of the obligation undertaken by the indemnifying party. This is a matter of contractual construction. The traditional strict approach to the construction of guarantees (discussed earlier) does not apply in respect of indemnities. However, it has been suggested that if a contractual clause purporting to contain an indemnity is to be effective its terms must be clear and unambiguous.²⁶

²⁵ For a case involving similar facts, and summarising the applicable principles, see *Siemens Building Technologies FE Ltd v Supershield Ltd* [2009] EWHC 927 (TCC); [2010] EWCA Civ 7.

²⁶ See Lewison, *Interpretation of Contracts* (4th ed., 2007) at paragraph 12.15 and cases cited therein.

Strength of the claim in respect of which settlement reached

21. If the claim faced by the purportedly indemnified party is prima facie within the scope of the indemnity, the next issue is that of the degree of merit that such party must establish in respect of the settled claim if it is to recover any settlement figure under the indemnity. While it is not necessary for the party seeking to rely on the indemnity to establish on the balance of probabilities that it would have been found liable to the third party (i.e. in the above example that B would have been found liable to the claimant lessee), that party must be able to show that it was facing a “serious claim” and that there was “an appreciable risk of [the purportedly indemnified party] failing on the issue” in question.²⁷ Unless the party seeking to rely on the indemnity can establish that the claim was of sufficient strength reasonably to justify a settlement (and the particular amount paid in settlement (see below)), it will be unable to show that the loss which it has incurred has been caused by the particular eventuality which the indemnity, on its face, covers.
22. However, the height of this hurdle (i.e. as regards the seriousness of the claim faced) that the party invoking the indemnity must be able to clear should not be overstated. As stated by Colman J in *General Feeds v Slobodna Plovidba Yugoslavia* [1999] 1 Lloyd’s Rep 688 at 692²⁸:

“That [i.e. the requirement that the purportedly indemnified party establish that the claim was of sufficient strength reasonably to justify settlement] is not to say that unless it can be shown that that the claim is likely to succeed it will be impossible to establish that it was reasonable to settle it. There may be many claims which appear to be intrinsically weak but which common prudence suggests should be settled in order to avoid the uncertainties and expenses of litigation.”

Indeed it has been suggested that a claim may have to be “so weak as to be obviously hopeless”²⁹ before a court is likely to take the view that settlement of the claim was not reasonable.

Quantum of settlement

23. If the party seeking to invoke the indemnity can establish that the claim which it faced was in principle appropriate for settlement, there is then the issue of quantum. Here, again, the test is not one of balance of probabilities. Rather:

²⁷ *Comyn Ching & Co (London) Ltd v Oriental Tube Co Ltd* [1979] 17 BLR 56 at 83-84.

²⁸ See also *Biggin v Permanite* [1951] 2 KB 314.

²⁹ *John F Hunt Demolition Limited v ASME Engineering Ltd* [2008] 1 All ER 180 at paragraph 61.

“the test of whether the amount paid in settlement was reasonable is whether the settlement was, in all the circumstances, within the range of settlements which reasonable people in the position of the settling party might have made.”³⁰

Thus, in the example set out earlier, it would be up to B to establish that settling the claim for half of its full value was appropriate having regard to all the relevant circumstances. The question of whether a settlement is a reasonable one is to be assessed at the date of the settlement.³¹ The circumstances which it is likely that a court would pay regard to in considering the reasonableness of the quantum of a settlement would include, for instance, the strength of the claim; whether the settlement was the result of legal advice; the uncertainties and expenses of the litigation; and the benefits of settling the case as against disputing it.³²

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³⁰ *Siemens* (above) at paragraph 80.

³¹ *The Sargasso* [1994] 1 Lloyd's Rep 412 at 423.

³² *Siemens* (above) at paragraph 80.