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July 2011 / Special Alert

A legal update from Dechert's Finance and Real Estate Group

Court of Appeal Confirms "Sub-guarantees" Are Enforceable

In a landmark decision with important commercial implications, *K/S Victoria Street v House of Fraser (Stores Management) Ltd*, the Court of Appeal has affirmed the principle in the *Good Harvest* case that an assignor's guarantor may not guarantee the liability of an assignee. However, the court has placed important qualifications on that principle: a guarantee of the obligations of the assignor under an authorised guarantee agreement (an "AGA") is enforceable (that is a so-called "sub-guarantee"), as is a guarantee of the obligations of a later assignee.

Background

Last year, the High Court ruled, in *Good Harvest Partnership LLP v Centaur Services Ltd*, that it is unlawful for a landlord to require an assignee's obligations under a lease to be guaranteed not only by the outgoing tenant under an AGA, but also by the outgoing tenant's guarantor.

Such a guarantee is void and unenforceable because it falls foul of the anti-avoidance provision in Section 25 of the Landlord and Tenant (Covenants) Act 1995. That Act abolished the old rule that a tenant remained liable to pay the rent and comply with the tenant's other lease obligations throughout the whole term of the lease, even after the lease has been assigned. The Act provided that for leases granted after 1995 the tenant is automatically released from liability once the lease is assigned and any guarantee of the tenant's obligations will also fall away. The only exception to that blanket release is that the landlord may require the outgoing tenant to give an authorised guarantee agreement (commonly called an AGA) guaranteeing the liability of the assignee. Section 25 of the Act declares void any agreement to the extent that it would frustrate the operation of any provision of the Act.

In the *Good Harvest* case, the tenant's guarantor had joined in the AGA to guarantee the assignee's liability to the landlord. The court decided that allowing a guarantor to guarantee the assignee's obligations would frustrate the operation of the requirement that a guarantor's liability must end on an assignment. It was therefore caught by Section 25.

However, it is more usual for the guarantor not to guarantee the assignee's obligations directly, as in the *Good Harvest* case, but instead to guarantee the *assignor's* obligations under the AGA. This is sometimes described as a *sub-guarantee* and it is the way Dechert's leases are drafted. The *Good Harvest* decision did not affect sub-guarantees directly; however, the judge made comments which cast some doubt on their effectiveness.

The New Decision

The Court of Appeal has now clarified the position. It has affirmed the basic principle in *Good Harvest* that the outgoing tenant's guarantor may not guarantee the liability of an assignee. However, it has made clear that a sub-guarantee is not caught by Section 25 and is therefore enforceable. The judge said that requiring the assignor's guarantor to guarantee

the assignor's liability under the AGA is not inconsistent with the requirement of the Act that the guarantor should be released on an assignment "to the same extent as the tenant". The guarantor is released to precisely the same extent as the assigning tenant.

The court also pointed out that there is nothing to prevent a previous tenant's guarantor from guaranteeing the liabilities of a future assignee, as long as it is not the immediate assignee of the previous tenant. In other words, if tenant A assigns to assignee B, which in turn assigns to assignee C, A's guarantor cannot guarantee the liabilities of assignee B, but can guarantee the liabilities of assignee C.

Implications of the Decision

The decision has considerable commercial significance. For many reasons a lease may be granted to a single purpose vehicle with no other assets, which is acceptable to the landlord only because its liabilities are guaranteed by a parent company or a couple of directors. An AGA given by such a company would be worthless if not backed by the guarantor. Therefore, without the important clarification this case provides that the landlord may rely on a sub-guarantee, property subject to such a lease might have been devalued. Landlords would have had to refuse to accept weak tenants backed by substantial guarantors and that would have made it more difficult for tenants to dispose of their leases. Landlords could no longer allow a group re-structuring under which the property is moved between subsidiaries but the parent company guarantee remains in place.

The case has put beyond doubt the effectiveness of sub-guarantees. It is clear from the judgment that the obligation may be given either in the lease itself, as part of the original guarantee given when the tenant takes the lease, or in the AGA at the time of the assignment. The important point is that it must be a guarantee of the *assignor's* obligations, rather than the obligations of the *assignee*.

Lease assignment provisions which require the tenant's guarantor to give a direct guarantee of the assignee's obligations will not be enforceable. In most cases it will be possible to sever such a provision from the lease without compromising the enforceability of the remainder of the document. The landlord would then still be able to require a sub-guarantee as a reasonable condition of giving consent to an assignment. However, it is important to realise that the decision is not limited to future assignments—direct guarantees which have already been given cannot be relied on.

Practice group contacts

For more information, please contact the lawyers listed, or the Dechert lawyer with whom you regularly work. Visit us at www.dechert.com/real_estate.

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Steven A. Fogel
London
+44 20 7184 7444
steven.fogel@dechert.com

Andrew Hutchinson
London
+44 20 7184 7428
andrew.hutchinson@dechert.com

Barry J. Thorne
London
+44 20 7184 7413
barry.thorne@dechert.com

William Fryzer
London
+44 20 7184 7454
william.fryzer@dechert.com

Dechert LLP

www.dechert.com