NOTES

GUARANTEES OF LEASES: THE PROBLEM OF ASSIGNMENTS

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INTRODUCTION

Commercial tenancies and property leases are usually created for substantial terms with options to renew or extend the period. The parties anticipate that the lessee may wish to assign the lease for the balance of the current term and insert express provisions requiring the lessee to obtain the consent of the lessor to the assignment. There are seldom any express provisions governing the lessor's right to assign the reversion as this is seen as one of the normal incidents of ownership.

Often the lease itself contains a guarantee of the lessee's obligations, but sometimes a separate guarantee is executed. The impact of an assignment of the lease or the reversion upon the rights and obligations of the parties to the guarantee is rarely considered at the time the lease is drafted. Yet recent cases highlight some of the pitfalls for lessors who wish to enforce a guarantee of a lease which has been assigned.

ASSIGNMENT OF THE LEASE

1. Where the lease does *not* contemplate an assignment

There is an apparent inconsistency between the rule that the right to assign is incidental to every leasehold interest and the principle that contrac-

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tual liabilities cannot be assigned without the consent of the obligee.[1] In leases, drafters avoid this inconsistency by expressly requiring the lessee to obtain the lessor's consent to an assignment of the lease. Thus, if the lessee purports to assign his obligations arising from the lease without seeking the consent of the lessor, the assignment will be ineffective. The guarantor, however, should still remain liable, although he will be discharged if a third party (the purported assignee) discharges the principal obligation by payment to the lessor.[2]

If the lessee and the lessor agree to an assignment of the lease by the lessee (without notifying the guarantor) so as to make the assignment effective, the guarantor will probably be absolutely discharged because this will constitute a variation of the principal contract, namely, the lease. Such a variation will discharge the guarantor, unless the variation is obviously immaterial or for the benefit of the guarantor. The introduction of another principal debtor (the new lessee) cannot be regarded as an immaterial change or a variation which is clearly for the benefit of the guarantor. If there is a condition of the guarantee that the guarantor shall be notified of any assignment and there is no such notification, the guarantor will be discharged on the alternative basis of the lessor's failure to comply with a condition of the guarantee.[3]

If the guarantee contemplates that an assignment may take place, although the lease itself does not, the guarantor will not be absolutely discharged in the event of the lessor and the lessee agreeing between themselves to an assignment. The guarantee has provided for the variation of the principal contract and clearly contemplates that the guarantor's liability will continue notwithstanding the assignment of the lease. However, even in this case the guarantor will not be responsible for the debts of the new lessee unless they are specifically brought within the ambit of the guarantee.

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1. *Tolhurst v Associated Portland Cement Manufacturers Ltd* [1902] 2 KB 660, 668; *Keeves v Dean* [1924] 1 KB 685, 691. See generally, G H Treitel *The Law of Contract* 8th edn (London: Stevens & Sons, 1991) 603–604. Notice Professor Treitel's criticism of the expression "assignment of liabilities".
2. A creditor cannot object to vicarious performance unless he is prejudiced by the fact that the debtor does not perform personally. See Treitel id, 657 and *British Waggon Co & the Parkgate Waggon Co v Lea & Co* (1880) 5 QBD 149.
3. Alternatively, the assignment may involve the creditor in breach of other conditions of the guarantee, eg, that possession of the goods shall remain with the original principal: *Ankar Pty Ltd v National Westminster Finance (Aust) Ltd* (1987) 162 CLR 549.

2. Where the lease contemplates an assignment

The lease may provide that the lessee may assign his interest in the lease with the consent of the lessor. In this situation the English Court of Appeal in *Johnson Brothers (Dyers) Ltd v Davison*[4] held that the guarantor remained liable when the lease was assigned and the assignee was unable to pay the rent. The Court stressed two factors: first, that the principal contract contemplated an assignment, so that it could not be said that there was a variation of the principal contract discharging the guarantor; and secondly, that the guarantor knew of the terms of the lease. However, even in the absence of any actual knowledge by the guarantor of the clause in the principal contract permitting assignment, the guarantor should remain liable: the guarantor should be deemed to be aware of the possibility of the assignment and should be regarded as having consented to it.

But it is possible that on its proper construction the guarantee may still relate only to the obligations of the named lessee whilst that lessee is solely responsible for the obligations arising under the lease. In this case the guarantor would not be liable for defaults subsequent to the assignment.

In order to guard against the possible assignment of the lessee's interest in the lease without reference to the guarantor, the lessor should specify in the guarantee itself that the lessee may assign his interest under the lease and that the guarantor shall be responsible not only for the obligations of the original lessee but also the obligations of the assignees.

ASSIGNMENT OF THE REVERSION

There is no general restriction upon the creditor assigning the principal contract which is guaranteed. This is not a positive act to the prejudice of the guarantor because it is immaterial, from the guarantor's point of view, to whom the guarantor owes the obligation. It is possible that if the principal contract prohibits an assignment and the creditor and the principal alter its terms to permit an assignment, the guarantor may be discharged on the basis that there has been a variation of the principal contract, but even here it is arguable that the variation is immaterial so that the guarantor will remain liable.

Generally, therefore, it is clear that if a lease is assigned and the benefit of the guarantee is also assigned, the assignee may enforce *both* the lease and the guarantee.[5] The assignor (the original lessor) will not, of course, then be

4. (1935) 79 SJ 306.

5. *International Leasing Corp (Vic) Ltd v Aiken* [1967] 2 NSWR 427 Jacobs JA, 439;

able to enforce the guarantee.[6] An exception to this general rule is where the guarantee is construed as a guarantee of the performance of the obligations under the main contract only so long as those obligations are owed to the original creditor.[7] The guarantee will then be unenforceable by the assignee of the principal transaction, but it will be unusual for a contract of guarantee to be construed in this way.[8] In order for the assignee to enforce the guarantee no notice of the assignment of the lease need be given to the guarantor,[9] but if notice is not given the guarantor may satisfy his obligations under the guarantee by paying the original lessor.[10] Notice to the guarantor of the assignment of the guarantee[11] will usually be necessary to make the assignment effective[12] but is otherwise unnecessary.[13]

Where the lease is assigned without the benefit of the guarantee it is unlikely that the assignor can enforce the guarantee.[14] The High Court of Australia in *Hutchens v Deauville Investments Pty Ltd*[15] referred with approval to comments by Jacobs JA in *International Leasing Corporation (Vic) Ltd v Aiken*,[16] outlining the incongruous result which would occur if the position were otherwise:

> If the debt is assigned but the guarantee is not assigned then the right in the original creditor to recover under the guarantee must at least be suspended so long as the debt is assigned. There cannot be two persons entitled to recover the amount of the same debt, one from the principal debtor, and so long as the principal debtor was in default, another from the surety. Let it be assumed otherwise and suppose that the original creditor, the assignor of the principal debt, could show that it was overdue and thereupon sued the surety. Let it be assumed that the surety paid. Then, the assignee sues the principal debtor. He must be entitled to succeed unless there are some special circumstances of estoppel in the particular case, a factor which I place to one side. The assignee under an absolute assignment could not be deprived of his right to recover

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Asprey JA, 450–451; *Wheatley v Bastow* (1855) 7 De GM & G 261; 44 ER 102.

6. *International Leasing Corp (Vic) Ltd v Aiken* [1967] 2 NSWR 427 Jacobs JA, 439.
7. Id, Moffitt AJA, 453.
8. Id, Moffitt AJA, 454. As an example of a guarantee being construed as personal to the original creditor, see *Sheers v Thimbleby & Son* (1897) 76 LT 709.
9. *Wheatley v Bastow* (1855) 7 De GM & G 261; 44 ER 102, 109; *Bradford Old Bank Ltd v Sutcliffe* [1918] 2 KB 833 Pickford LJ, 841–842. But in order for the principal contract to be effectively assigned notice will usually have to be given to the principal.
10. *Wheatley v Bastow* (1855) 7 De GM & G 261; 44 ER 102, 109.
11. See the relevant statutory provisions regarding assignment: eg Property Law Act 1969 (WA) s 20.
12. Ibid.
13. See supra n 10 and its interpretation in *Sacher Investments Pty Ltd v Forma Stereo Consultants Pty Ltd* [1976] 1 NSWLR 5, 11.
14. This may occur because there is no express assignment of the guarantee.
15. (1986) 68 ALR 367.
16. Supra n 5, 439.

from the debtor because the assignor had recovered from the surety.[17]

For similar reasons, in *Hutchens v Deauville Investments Pty Ltd*[18] it was held that a guarantee (or the security for it) cannot be assigned without the benefit of the principal transaction.[19] Hence a guarantee (or the security for it) cannot be assigned without the benefit of the lease itself.

In a series of recent cases the courts have considered whether it is possible for the assignee of a reversion to enforce a guarantee of the lease even if there was no specific assignment of the guarantee. The basic argument in these cases is that the guarantee is a covenant that "touches and concerns" land and runs with the land.

In *Lang v Asemo Pty Ltd*,[20] the Full Court of the Supreme Court of Victoria drew heavily upon the earlier decisions of the English Court of Appeal in *Kumar v Dunning*[21] and the House of Lords in *P & A Swift Investments v Combined English Stores Group plc*.[22] The defendants were the directors of a company which was the lessee of a strata title unit in a medical centre. They executed a deed of guarantee to secure the lessee's covenants when the lease was granted. On the same day that the lease and the guarantee were executed the lessor sold the unit to Asemo Pty Ltd, which later sought to enforce the guarantee.

The defendants argued that the plaintiff could not enforce the guarantee because there was no privity of contract between them and the plaintiff, and the plaintiff was neither the lessor referred to in the guarantee nor the assignee of the benefit of the guarantee. However, the Full Court held that the guarantee was enforceable by the plaintiff as a covenant touching and concerning the land. Gobbo J, with whom Murphy and Phillips JJ concurred, applied the "satisfactory working test" propounded by Lord Oliver of Aylmerton in *P & A Swift Investments v Combined English Stores Group plc*[23] for determining whether in any given case a covenant touched and concerned the land:

(1) The covenant benefits only the reversioner for the time being, and if separated

17. But the High Court did acknowledge that the legal consequences would be less clear if the assignee of the debt had rights of recourse against the original creditor in the event of default by the principal debtor.
18. Supra n 15.
19. This was the factual situation in *Hutchens v Deauville Investments Pty Ltd* (1986) 68 ALR 367.
20. [1989] VR 773.
21. [1987] 2 All ER 801.
22. [1988] 2 All ER 885.
23. Id, 891.

> from the reversion ceases to be of benefit to the covenantee. (2) The covenant affects the nature, quality, mode of user or value of land of the reversioner. (3) The covenant is not expressed to be personal (that is to say neither being given only to a specific reversioner nor in respect of the obligations only of a specific tenant). (4) The fact that a covenant is to pay a sum of money will not prevent it from touching and concerning the land so long as the three foregoing conditions are satisfied and the covenant is connected with something to be done on, to or in relation to the land.[24]

Gobbo J declared that there was "no reason in principle why the decision of the House of Lords should not be followed by this court."[25] This appears to discount the analysis of a surety's covenant in the joint judgment of Dixon and Evatt JJ in *Consolidated Trust Co Ltd v Naylor*:[26]

> A surety's obligation stands in a different relation to the dealing. His liability is introduced by way of additional security. It is personal and, except as a result of subrogation, does not directly or indirectly affect the land.... A guarantee is thus collateral to the mortgage transaction...[27]

Gobbo J distinguished this case as one involving a guarantee of a mortgage debt, as distinct from a guarantee of the performance of tenants' covenants: only the latter touched and concerned the land.[28] Moreover, his Honour did not refer to the Privy Council decision in *Hua Chiao Commercial Bank Ltd v Chiaphua Industries Ltd*[29] where it was held that at the end of the term of a lease the assignee of the reversion was under no obligation to refund a security deposit given to support the tenant's covenants. In the Privy Council, Lord Oliver examined the relationship between the deposit and the land:

> It is bound up with the tenant's covenant only as it were, at one remove, as being an obligation correlative to a contractual obligation which is itself connected with the performance of covenants touching and concerning the land.[30]

By parity of reasoning, it could be argued that a guarantee to secure a tenant's obligations is not a covenant that touches and concerns the land.

Nevertheless, these arguments did not prevail. Applying Lord Oliver's "satisfactory working test" to the facts of the case, Gobbo J found first that the surety's covenant benefited only the lessor for the time being; once separated from the reversion, it ceased to be of any benefit to the covenantee.

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24. Ibid.
25. *Lang v Asemo Pty Ltd* [1989] VR 773, 776.
26. (1936) 55 CLR 423.
27. Id, 434–435.
28. Supra n 20, 775, applying the distinction in *Kumar v Dunning* supra n 21, Browne-Wilkinson VC, 811.
29. [1987] AC 99.
30. Id, 111.

Presumably the surety's covenant was also beneficial to the tenant in that it enabled it to obtain and retain the tenancy, but this was not fatal.[31] Secondly, the surety's covenant affected the land of the reversioner since the existence of the surety was an additional source of recovery and would therefore only add to the value. With respect, it is difficult to see how the existence of a guarantee enhances the value of the land per se. Indeed, in *Re Distributors & Warehousing Ltd*,[32] the guarantor's payment of the tenant's arrears of rent did not discharge the tenant's obligation to pay rent; the tenant continued in default and the landlord was entitled to forfeit the lease. Hence, the existence of a guarantee, and indeed payment by a guarantor, did not prevent the lease being forfeited. How then could the guarantee enhance the value of the land as such?

The third element of Lord Oliver's "satisfactory working test" involved an analysis of the terms of the guarantee. There was nothing in the instrument itself suggesting that it was intended to be limited to the specific lessor and the specific lessee. In fact, the identity of the parties and the essential steps in related transactions rebutted any such suggestion:

> The lease was executed on the same day as the sale was completed in order to meet this requirement. The lessee was simply one of the two companies that were both lessors and vendors. It was not surprising that Asemo [the assignee] insisted on a guarantee being provided by the directors of the lessee company. Nothing in the content of progress of these related transactions suggests that the guarantee was not to benefit Asemo as assignee of the reversion which purchased the reversion *upon the basis of both the lease and the guarantee*.[33]

Nor was the guarantee limited to the period during which the lessee was in actual occupation of the premises, notwithstanding clause 4 of the guarantee which provided: "This guarantee shall continue to be binding as long as the lessee remains in occupation of the demised premises...". Gobbo J found that this clause was intended to cover a holding over of the lease at the conclusion of the term and suggested that the clause might be "equating occupation with entitlement to occupy and as merely providing confirmation of the fact that the guarantee ceased with the termination of the lease."[34] In any event, his Honour concluded that the trial judge was correct in rejecting the view that the guarantee was no longer binding once the lessee vacated the premises.

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31. R R Sethu "Surety Covenants: Privity of Contract or Estate?" (1989) 5 Aust Bar Rev 153, 166.
32. [1985] 1 BCC 99,570.
33. Supra n 20, 777–778 (emphasis added).
34. Id, 778.

In the result, the Full Court held that the guarantee enabled Asemo Pty Ltd, the assignee of the reversion, to recover from the guarantors unpaid rent and unpaid rates for the balance of the lease but not unpaid charges levied by the body corporate because they did not fall within the tenant's covenants.

Despite several first instance decisions to the contrary,[35] it appears that guarantees of a tenant's obligations under a lease may be enforced by the assignee of the reversion whether the guarantee is given upon the granting of the lease[36] or on assignment.[37] It is immaterial whether the guarantor has undertaken to be answerable for all the tenant's obligations under the lease or merely the obligation to pay rent.

While this conclusion is defensible where the surety undertakes that he will perform all the tenant's obligations under the lease if he fails to do so, it is less compelling where the surety merely covenants to pay rent or other monetary amounts if the tenant defaults. Only in the former case can the following be said to be true:

> A surety for a tenant is a quasi tenant who volunteers to be a substitute or twelfth man for the tenant's team and subject to the same rules and regulations as the player he replaces.[38]

CONCLUSION

The recent cases analysed in this note highlight several lessons for drafting guarantees of leases. First, the drafter of a guarantee of a lease should ensure that the liability of the guarantor is expressly preserved where the lease is assigned. The guarantee should therefore be drafted as a guarantee of the obligations of the lessee or any permitted assignee under the lease.

Second, the drafter should ensure that the debts and liabilities of the assignee, as the new lessee, are specifically included within the definition of "secured moneys" and "secured obligations" in the guarantee.

Third, from the lessor's point of view, the drafter should avoid provisions which create an obligation to notify the guarantor of any assignment of the lease as this may be construed as a condition of the guarantee.

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35. *Pinemain Ltd v Welbeck International* (1984) 272 E G 1166; *Re Distributors & Warehousing Ltd* supra n 32; *Coastplace Ltd v Hartley* [1987] 2 WLR 1289. See also *Blue Chip Investments Inc v Kavanagh* (1986) 60 Nfld & PEIR 85 and *Blue Chip Investments Inc v Hicks* (1983) 50 Nfld & PEIR 60; affirmed on other grounds (1985) 54 Nfld & PEIR 260.
36. *P & A Swift Investments v Combined English Stores Group plc* [1988] 2 All ER 885.
37. *Kumur v Dunning* supra n 21.
38. Supra n 36, Lord Templeman, 887.

Fewer problems arise where the lease itself contemplates an assignment but even here the drafter should make it clear that the guarantee is not restricted to the obligations of the named lessee while that lessee is solely responsible for the obligations arising under the lease. The guarantee should be expressed to cover not merely the obligations of the original lessee but also an assignee of the lease.

While it is generally desirable for a lessor to effect a specific assignment of the guarantee of the lease at the same time as he assigns the reversion, a specific assignment of the guarantee will not be necessary where the guarantee is properly classified as a covenant that touches and concerns the land and runs with the land. It appears to be immaterial whether the guarantee was given upon the granting of the lease or upon assignment. It is enforceable in respect of all the tenant's covenants under the lease. This result should be put beyond doubt by ensuring that the guarantee is drafted as an undertaking by the guarantor to perform all the tenant's obligations under the lease if the tenant fails to do so.

Most of the problems identified in this note can be avoided by careful drafting of the clauses in guarantees of leases. It is preferable to attempt to anticipate and resolve problems at this stage than to negotiate solutions when a default occurs. As always, prevention is better than cure.