Linklaters

August 2011

Court of Appeal decision on AGAs – *House of Fraser* case

In February last year, the *Good Harvest* case sent ripples through the real estate investment market when the High Court invalidated an authorised guarantee agreement ("AGA") in which a tenant and its guarantor both purported to guarantee the assignee's obligations following an assignment of the lease. The guarantee was held to be invalid on the basis that it was contrary to the provisions of the Landlord and Tenant Covenants Act 1995 ("the Act").

Now, *Good Harvest* has been upheld in the *House of Fraser* case on appeal, but it still leaves a number of questions unanswered. It is important for all those involved in property investment and financing, as well as those granting and taking new leases; it also has implications for some leases which have been already granted.

Contents

Rationale behind the Act

As a quick reminder, the Act abolished the old common law "privity of contract" position (i.e. that a tenant and its guarantor would remain liable for their lease obligations throughout the entire term of a tenancy) by providing for the automatic release of both parties on an assignment (Section 24). This unsurprisingly provoked a strong reaction from landlords, and lobbyists (including the BPF) succeeded in securing a qualification to the release in the form of Section 16 of the Act which provides for tenants to be required to give AGAs where appropriate. Perhaps unfortunately, section 16 did not address whether a guarantor's liability should extend beyond the first assignment to guarantee an assignor's AGA obligations. The *Good Harvest* case was the first judicial consideration of this issue.

House of Fraser case

The Court of Appeal's eagerly awaited judgment in the *K/S Victoria v House of Fraser* case was handed down on Wednesday 27 July, and the Court's findings will have far-reaching implications for the way in which corporates hold real estate and the long term security of guarantees given in respect of lease covenants. The Court of Appeal have gone out of their way to review the *Good Harvest* decision but most of the key findings of the Court, so far as guarantees and AGAs are concerned, are in fact *obiter dicta* (i.e. not strictly necessary for the decision itself). In *House of Fraser*, the key provision being scrutinised was contained in a sale agreement rather than a lease. The sale

agreement provided for the parent company (House of Fraser) to enter into a guarantee of the assignee's liabilities on a pre-ordained intra-group assignment (called by the Court in *House of Fraser* a "renewal obligation") The Court of Appeal upheld the *Good Harvest* decision, and ruled that such a renewal obligation was void; to construe it otherwise would have the effect of putting the guarantor back into the pre-Act position of continuing liability post-assignment thereby circumventing the automatic release under the Act.

Key principles

There are some key messages in the judgment (some of which were already clear from *Good Harvest*) as follows:

> **an existing or contracting guarantor cannot validly be required to commit itself in advance to guarantee the liability of a future assignee**. This stands from *Good Harvest*, but the *House of Fraser* decision has clarified that a guarantor cannot, even voluntarily, validly directly guarantee the liability of the assignee on a first assignment;

> **the only way in which a guarantor can validly guarantee the liability of an assignee on a first assignment is by "sub-guaranteeing" the assignor's obligations in an AGA** – i.e. expressly guaranteeing either in the guarantee clause of the lease and/or in an AGA the assignor's obligations under the AGA. Such a sub-guarantee will only be valid until the next assignment. Note this is not the same as joining in the AGA to *co-guarantee* the assignee's obligations. The Court expressly left undecided the question of whether this is permissible. The judgment does imply that a sub-guarantee is different from a co-guarantee but has the same effect; and

> **oddly, the judgment makes it clear that a guarantor <u>can</u> validly directly guarantee the liability of an assignee on further assignments after the first assignment**. This means that despite being automatically released from liability on a first assignment (in the absence of an obligation to sub-guarantee an AGA) the guarantor can still re-assume that liability for second (and subsequent) assignees.

Where are we now in practice?

This judgment is clearly the subject of hot debate, and there are still a number of unclear areas, but for now, the following points need to be borne in mind:

> **we can now be confident that the sub-guarantee route referred to above, works to keep original guarantors on the hook following a first assignment** (albeit via a sub-guarantee rather than a direct one)

> **"one volunteer is not worth ten pressed men"** – landlords approached for consent for assignment of "new leases" may not accept an offer by an assignor's guarantor to directly guarantee the assignee's obligations. Landlords can only benefit from an assignor's guarantor's covenant post assignment via a sub-guarantee of an AGA which can either be expressly required in the lease or given voluntarily. Landlords can, however, accept an offer by a guarantor who has been released

from liability on a previous assignment to reassume direct liability for a subsequent assignee (as long as there has been a break in liability) - see *conundrum* below.

> **conundrum** - it seems odd that an original guarantor cannot, even voluntarily, renew its direct guarantee on the first assignment but is free to do so on all assignments thereafter. It is doubtful whether it is possible to arrange/require in advance for the original guarantor to do so, but this can be given voluntarily, and as such its value may be limited commercially;

> **guarantor cannot become an assignee – effect on "two tier assignments"?** - The *House of Fraser* judgment makes it clear that a lease cannot be assigned to the current tenant's guarantor, even if both tenant and guarantor want that to happen. There has always been a question about whether "two tier assignments" (whereby insubstantial tenants are required to assign their leases to a third party via their parent company or other substantial covenant) are permissible under the Act. Following *House of Fraser*, this question remains but it is now clear that any requirement to assign via an original guarantor will not work

> **beware intra-group assignments** - it is clearly no longer valid, in respect of intra-group assignments, to pre-agree a "suitable" guarantor and to provide that such guarantor should guarantee all future intra-group assignments. However, it is still possible to require a parent company to "sub-guarantee" the AGA on first assignment. Beyond such first assignment that guarantor is free (in the light of *House of Fraser*) to re-assume direct guarantee liability for future group assignees, but as mentioned above, it is doubtful whether this can be contractually required.

Linklaters

Contacts

For further information please speak to your usual Linklaters contact or:

Anne Byrne
Head of UK Real Estate

(+44) 20 7456 4812

anne.byrne@linklaters.com

Authors: Kate Topping and Tracey Kennedy

One Silk Street

London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com

A13815292/0.2/03 Aug 2011