Doubts over alternative mechanisms

Guarantees offer landlords security on the grant or assignment of a lease – or do they? *Joanna Sykes* considers their enforceability

When a landlord grants a new lease or consents to an assignment of an existing lease to a company with a weak financial covenant, it will generally insist on some form of security. Landlords have historically asked for third-party guarantees or rent deposits, but in the current economic climate tenants are offering alternative forms of security, such as letters of credit or bank guarantees.

This issue is sensitive for landlords following *Good Harvest Partnership LLP* v *Centaur Services Ltd* [2010] EWHC 330 (Ch); [2010] 14 EG 114. The court held that any attempt by the landlord to require a guarantor to enter into an authorised guarantee agreement would be void: see also *EG* 3 April, p74, and *EG* 10 April, p107.

This article discusses the alternative security mechanisms and focuses on issues of enforceability.

Letters of credit and bank guarantees

A letter of credit generally operates as a contract under which the bank agrees to pay the landlord directly. Under the terms of a bank guarantee, the bank agrees to pay a sum of money to the landlord should the tenant default on payments due under the lease.

Generally speaking, letters of credit and bank guarantees relate only to the financial obligations in the lease and do not cover any other tenant covenants. The arrangement is usually supported by an indemnity from the tenant to the bank; the tenant will agree to repay the bank any sums that the bank is required to pay to the landlord under the terms of the guarantee. In order to underpin its indemnity, the tenant will often be required to deposit cash equal to the maximum liability of the bank. If not, the latter will enforce the indemnity against the tenant if the tenant defaults and the landlord's rights are exercised.

The bank must pay the amount owed to the landlord even if the tenant's indemnity is found to be worthless, for example, in the event of the tenant's insolvency. It is therefore an advantageous arrangement for a landlord.

Sale by the landlord

If, on the acquisition of an investment interest that is subject to occupational leases secured by bank guarantees and letters of credit, where good records have not been kept, the benefit of those documents will not always be expressly assigned to the purchaser. Similarly, investment properties are often owned by special-purpose vehicles, which will be wound up or dissolved following the sale of the investment asset and would be unable to assign the benefit of such documents retrospectively.

Do guarantees automatically pass to the purchaser?

If a landlord assigns the reversion but does not expressly assign the benefit of a surety's covenant, the assignee will have neither privity of contract nor privity of estate with the surety.

The assignee of the reversion cannot rely on section 141 of the Law of Property Act 1925 because the surety's covenant is not a covenant by a lessee. Instead, it must rely on the common law principle set out by the House of Lords in *P&A Swift Investments (a firm)* v *Combined English Stores Group Ltd* [1988] 43 EG 73.

Before this case, doubts were expressed as to whether the benefit of guarantees given to the landlord in respect of obligations under leases automatically transfer where the reversion has been transferred.

The common law principle is that guarantees are enforceable by any assignee of the reversion of the lease to the extent that they touch and concern the land

Swift established that the benefit of a surety covenant could be enforced by an assignee of the reversion without any express agreement or assignment if the covenant "touched and concerned the land". Moreover, a covenant in respect of the obligation to pay rent would also fall into such category. It was further held that, where the underlying obligation of the tenant touches and concerns the land, the obligation of the surety will also do so, even if the only obligation is to pay money.

In *Swift*, Lord Oliver formulated a three-tier test to determine whether, in any case, a covenant would touch and concern the land, namely the covenant:

- benefits only the reversioner for the time being, and if separated from the reversion will cease to be of benefit to the covenantee;
- affects the nature, quality, mode of user and value of the land to the reversioner; and
- is not expressed to be personal.

This means that any assignment of a reversionary interest in a lease automatically carries with it the benefit of a related guarantee.

This case pre-dated the Landlord and Tenant (Covenants) Act 1995. However, that Act does not change the common law rule, which applies equally to old and new tenancies.

Guarantee in letter form

Will the position be any different where the guarantee is provided in the form of a letter rather than a deed? Usually, such letters are expressly stated to benefit successors in title. However, if the guarantee is in the form of a letter rather than a deed does it fall within the common law principle or would it need to be expressly assigned? This issue has not been tested.

A further problem with the drafting of such letters is that they often refer to the addressee of the letter as "you". Notwithstanding an express provision that successors in title should be able to benefit from the letter of guarantee, the use of "you" can cause difficulties, particularly where any demand must be served by "you", and/or the new person entitled to the benefit of the guarantee must be identified and confirmed by "you" or any loss incurred by "you". Such letters are often difficult to negotiate with banks' lawyers, which treat them as standard documents to be accepted in the form provided or rejected.

Questions of reliance

When acquiring an investment property, the purchaser may be unsure about the enforceability of guarantees that purport to benefit the landlord from time to time. The common law principle is that they are enforceable by any assignee of the reversion of the lease to the extent that they touch and concern the land.

Landlords should think carefully about whether they can rely on this argument where the guarantees are in the form of a letter. This is especially so in the current climate, where the strength of guarantees is material to the value of the asset.

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