

Letting with security

This article covers the types of security that a landlord can take if there are doubts about the tenant's financial strength when taking a commercial lease.

Introduction

The purpose of a guarantee is to enable the landlord to claim against a third party if the tenant does not pay the rent or breaks the other terms of the lease.

The landlord will want the guarantee to be unlimited, but the guarantor may insist that there is a maximum amount, or that it will end if the business generates acceptable profits (for example, when its net pre-tax profits are at least 3 times the annual rent for 3 years in a row). This is a matter of negotiation.

Most guarantees specify that, if the tenant goes into liquidation (or is made bankrupt in the case of an individual) and the lease is terminated, the landlord can force the guarantor to take a new lease for the remaining period.

The following is a summary of the main types of guarantee.

Personal Guarantees Limited companies

Most leases are taken in the name of a limited company. Provided the directors have acted properly, they will not personally be responsible for the company's debts. A guarantee from the directors removes this barrier.

Landlords should check the directors' financial situation in order to assess whether the guarantee is worth having. References should be taken from the directors' own bank, and from their accountants if they have one.

When assessing what the directors are worth, it is their net worth that will be important, so landlords will need to know the extent of any mortgages and other debts.

Other guarantees – landlords will want to know whether the directors have given personal guarantees to the company's bank and how much is covered. It is common practice for banks to secure the guarantees by taking a second charge against the directors' homes. If the guarantees have been secured, the bank and mortgage company will have first call on the sale proceeds before the landlord and most other creditors.

Limited liability partnership ("LLP")

Some businesses (mainly solicitors and surveyors) have traditionally operated as a partnership of individuals rather than as a limited company. In recent years many partnerships have converted into LLP status. Although not identical to a limited liability company, an LLP shares the same basic purpose, namely to limit the partners' personal liability. Landlords should treat an LLP in the same way as a limited company and take guarantees from the partners where necessary.

Group company guarantees

Personal guarantees tend to be taken where the business is run through one company. However, many businesses operate two or more companies within a group.

Where the tenant company is not considered strong enough on its own, a guarantee from another group company rather than from the directors may be offered. That company may be another trading company in the group or the ultimate “parent” company.

Landlords should check the financial strength of that company in the same way as the tenant company.

Bank guarantees

The risk to the landlord of a personal or group company guarantee is that there is no absolute certainty that it will be effective throughout the lease.

An alternative is a guarantee from the company’s bank. The benefit to the landlord is that it will hopefully be solid. However, banks will almost always insist that the amount of the guarantee is limited, for example to 6 months’ rent.

It will not be an available option in all cases, as the bank may not be willing to provide a guarantee. Even if it is willing to do so, the bank will usually charge the tenant a fee and may require the tenant to lodge money as security.

Guarantees from previous tenants

We have looked at guarantees at the time when the landlord is about to grant the lease to a tenant. The same issues apply during the term of the lease when the tenant wishes to transfer it to another tenant. Landlords will want to check the financial strength of the proposed tenant and consider whether additional security is needed.

The position here is not quite the same as before the lease started, as the landlord will not be free to insist on whatever it wishes. Leases usually say that the tenant must obtain the landlord’s consent to transfer the lease, and if so it will be implied that the landlord must act reasonably when considering the tenant’s request for a transfer. This is a topic that we will cover in more detail in future articles.

If the lease is transferred, the landlord may still be able to pursue a previous tenant if the current tenant fails to comply with its obligations. The position will generally depend on whether the lease was granted before 1 January 1996, which is when the law in this area changed, or afterwards:

Leases granted before 1996 – unless the lease says otherwise, all previous tenants under the lease will remain liable to the landlord for the rest of the term, however many times it may change hands. This is sometimes called “privity of contract”.

Leases granted during and after 1996 – if the lease specifies, the outgoing tenant may have to guarantee the incoming tenant until the lease is transferred again, and if not transferred then for the rest of the term. This is known as an “authorised guarantee agreement”. Most leases will allow for such a guarantee, although some will only permit it where it is reasonably required by the landlord.

Which is better - rent deposit or guarantee?

There is no golden rule, as it will depend on the tenant's circumstances and on the strength of the landlord's bargaining position. Each has its own advantages and disadvantages:

- Rent deposit – the funds can be accessed quickly. However, they may not completely cover the amount owed.
- Personal guarantee – the existence of a guarantee may give the owners of the business added incentive to comply with the lease. However, it may take time to enforce the guarantee and there is no certainty that the landlord will recover all or any of the amount owed.
- Bank guarantee – may be considered stronger than a personal guarantee, but it will usually always be limited.

Please do not hesitate to contact us if you would like any advice or assistance.

If you are having problems with a tenant, and need advice on what action to take and on how to enforce a guarantee, please contact Andrew Olins of our Real Estate Dispute Resolution team at andrew.olins@ibblaw.co.uk