Disclaimers by Liquidators – How Secure is Your Guarantee?

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Introduction

The 1995 decision of Bainton J in the Supreme Court of New South Wales in *Sandtara Pty Ltd v Abigroup Ltd*[1] serves as a reminder of the special treatment accorded to guarantors and of the fact that bankers, financiers and other creditors may sometimes find that a guarantee is not as secure as was first thought. Bainton J at first instance in *Sandtara* decided that the disclaimer of a lease by a liquidator of a lessee company discharged a guarantor of its obligations, notwithstanding the existence of a relatively comprehensive guarantee and indemnity.

That decision by Bainton J, the judgments delivered on 1 May 1996 in the successful appeal[2] against it, and the comments made by judges involved in the recent English case of *Hindcastle Ltd v Barbara Attenborough Associates Ltd & Ors*[3] highlight the difficulties which the judiciary encounter in endeavouring to accommodate the particular principles relating to guarantors with insolvency laws.

The issue of the impact of disclaimer on, amongst others, *guarantors*, has been commented upon as giving rise to a *"puzzling conundrum"*.[4]

The potential impact of disclaimer on guarantees is of concern not only to creditors and guarantors, but also to insolvency practitioners who are involved in both situations. In either situation, an insolvency practitioner may find himself or herself to be at the centre of a controversy and possibly the subject of complaints or legal action.

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1 (1995) NSW ConvR 55-754.

2 *Sandtara Pty Ltd v Abigroup Ltd & Ors* (1996) 14 ACLC 888, Supreme Court of New South Wales, Court of Appeal. Special leave to appeal to the High Court of Australia was refused on 13 February 1997.

3 [1995] QB 95, House of Lords [1996] 2 WLR 262.

4 *Hindcastle Ltd v Barbara Attenborough Ltd* [1996] 2 WLR 252 at 272 per Lord Nicholls of Birkenhead.

Disclaimer

Relevant Guarantee Principles

Two principles relating to guarantees are of particular relevance in relation to the impact of disclaimer, they being as follows:

- The accessory nature of guarantees and
- The guarantor's right to an indemnity from the principal debtor.

As outlined by Dixon J in *McDonald v Dennys Lascelles*:

> ... the extinction of the principal obligation necessarily induces that of the surety; it being of the nature of an accessory obligation, that it cannot exist without its principal; therefore, wherever the principal is discharged, in whatever manner it may be, not only by actual payment or compensation, but also by release, the surety is discharged likewise...[5]

This principle was reinforced by Lord Nicholls in *Hindcastle Ltd v Barbara Attenborough Associates Ltd & Ors*:

> ... a guarantor's right to be indemnified by the principal debtor is inherent in the relationship between them. His right of indemnity arose at the moment of creation of the guaranteed liability, and is to be regarded as inseparable from it.[6]

How then, can these principles be accommodated with disclaimer?

Effect of disclaimer – the "Puzzling Conundrum"

Section 568D of the *Corporations Law* provides as follows :

> (1) A disclaimer is taken to have terminated, as from the day on which it is taken because of subsection 568C(3) to take effect, the company's rights, interests, liabilities and property in or in respect of the disclaimed property, but does not affect any other person's rights or liabilities except so far as necessary in order to release the company and its property from liability.
> (2) A person aggrieved by the operation of a disclaimer is taken to be a creditor of the company to the extent of any loss suffered by the person because of the disclaimer and may prove such a loss as a debt in the winding up.

Provisions similar to s.568D(1) have been found in Australian and English legislation since 1883.[7]

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5 (1933) 48 CLR 457 at 479-480.
6 [1996] 2 WLR 262 at 277.
7 The first legislative provision of this nature was s.55 *Bankruptcy Act* 1883 (UK). More recent Australian equivalents have included s.568 (3) *Corporations Law* and s.296 (2) *Companies Act* 1961.

As noted earlier, the effect and application of disclaimer provisions has been described as giving rise to a *"puzzling conundrum"*. This is particularly so in endeavouring to accommodate the principles previously mentioned relating to guarantors. The conundrum and the endeavours of judges to overcome it is perhaps best exemplified and explained by reference to a number of cases, in particular *Stacey v Hill,*[8] *Sandtara Pty Ltd v Abigroup Ltd*[9] and *Hindcastle Ltd v Barbara Attenborough Associates Ltd & Ors.*[10]

(a) Stacey v Hill[11]

In *Stacey v Hill* a lease of premises from Stacey to Chapman was guaranteed by Hill. Chapman became bankrupt and a trustee of his estate was appointed. The trustee disclaimed the lease. Stacey then sued the guarantor to recover rent due and owing under the lease.

At first instance, Phillimore J found for the guarantor, and the lessor appealed.

The lessor argued that section 55 of the English *Bankruptcy Act 1883*,[12] which was in comparable terms to section 568D of the *Corporations Law*, had the effect of determining the lease so far as concerned the liability of the bankrupt and his property, and also the trustee, but did not destroy the liability of third parties such as a surety.[13]

In considering s.55, the attitude of judges of the Court of Appeal[14] was that:

(i) The disclaimer had the effect of determining the lease with the result that no rent could subsequently become due under it; thus a guarantor could not be liable for such rent;
(ii) The termination of the principal debtor/lessee's obligation resulted in a discharge of the guarantor
(iii) The release of the insolvent lessee necessitated the release of the guarantor because of the guarantor's right of indemnity against the principal debtor.[15]

Collins LJ, in agreeing with AL Smith MR, said:

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8 [1901] 1 QB 660.
9 (1995) NSW ConvR 55-754 (Bainton J) and (1996) 14 ACLC 888 (Court of Appeal).
10 [1995] QB 95 (Court of Appeal) and [1996] 2 WLR 262 (House of Lords).
11 [1901] 1 QB 660.
12 Section 55 (2) *Bankruptcy Act* 1883 read as follows :

> The disclaimer shall operate to determine, as from the date of disclaimer, the righs, interests, and liabilities of the bankrupt and his property in or in respect of the property disclaimed, and shall also discharge the trustee from all personal liability in respect of the property disclaimed as from the date when the property vested in him, but shall not, except so far as is necessary for the purpose of releasing the bankrupt and his property and the trustee from liability, affect the rights or liabilities of any other person.

13 [1901] 1 QB 660 at 661.
14 AL Smith MR, Collins and Romer LJJ.
15 [1901] 1 QB 660 per AL Smith MR at 664, Collins LJ at 665 and Romer LJ at 667.

> The effect of the disclaimer in such a case is stated by him to be that the bankrupt lessee gets rid of all his liability... The result being that the liability of the lessee for future rent under the lease is determined, the obligation of the surety under his guarantee in respect of such rent can never arise, because no such rent can ever become an arrear.[16]

Romer LJ, in agreeing that the guarantor was no longer liable as a result of this disclaimer observed:

> For the defendant has only agreed to liable as surety for the payment of rent by a lessee under a lease: and yet the appellant seeks to make him liable to pay money, though there is no rent payable, no lease, and no person in the position of lessee.[17]

A L Smith MR stated:

> If the surety is liable to pay rent in futuro on his guarantee, he would be entitled to indemnity against the bankrupt or his property. It is therefore necessary, in order to release the bankrupt and his property from liability under the lease subsequently to the disclaimer, that the words at the end of the sub-section should be brought into play in such a case.[18]

Subsequently, the decision has been criticised,[19] distinguished[20] and circumvented,[21] however, it was a decision of the English Court of Appeal which stood for over 90 years.[22]

(b) Sandtara Pty Ltd v Abigroup Ltd – the Decision at First Instance

In 1995, the decision in *Stacey v Hill* was followed and applied by Bainton J in the Supreme Court of New South Wales in *Sandtara Pty Ltd v Abigroup Ltd*.[23]

In *Sandtara*, the landlord, Sandtara Pty Ltd, leased premises to Cenrin Pty Ltd for a period of 10 years. Article 18 of the lease contained a guarantee and indemnity, whereby the guarantor (Abigroup Ltd) guaranteed to the landlord the payment of all moneys due and payable under the lease, and indemnified the landlord against all

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16 *Ibid* at 665.
17 *Ibid* at 667.
18 *Ibid* at 664.
19 See for example *Rowlatt on Principal and Surety* (4th ed) 1982 at 174.
20 See for example *Re Ice Rinks (Timaru) Ltd* [1955] NZLR 641; *Warnford Investments Ltd v Duckworth* [1979] Ch 127.
21 For example, the High Court of Ireland declined to follow the decision in *Maurice Tempany v Royal Lever Trustees Ltd* (1984) BCLC 568.
22 See for example *Re Katherine et Cie Ltd* [1932] 1 Ch 70; *Teller Home Furnishers Pty Ltd (in liq); Electronic Industries v Horsburgh* [1967] VR 313; *Hindcastle Ltd v Barbara Attenborough Associates Ltd* [1996] 2 WLR 262 per Lord Nicholls at 278.
23 (1995) NSW ConvR 55-754.

actions, claims, and other expenses which could be incurred by the landlord as a result of any breach or non-observance by the tenant of its obligations under the lease.

Cenrin Pty Ltd was placed in liquidation, and liquidator disclaimed the lease under s.568 of the *Corporations Law.* The critical question which then arose was whether the guarantor was liable to the landlord in accordance with the terms of the guarantee.

The provisions of the Corporations Law dealing with disclaimer were revised by the *Corporate Law Reform Act* 1992. Section 568 (3), the subject of dispute in *Sandtara*, was in similar terms to section 568D in its present form.[24]

Bainton J held that no part of the amount claimed was recoverable by Sandtara from Abigroup.[25] His Honour was of the view that a relatively comprehensive guarantee and indemnity was insufficient in its terms to render the guarantor/ indemnifier still liable after disclaimer. This was so even though the guarantee and indemnity, amongst other things, contained provisions to the effect that the guarantor would remain liable notwithstanding:

- The exercise by the landlord of its rights, including its rights of re-entry;
- Winding up of the tenant; and
- The unenforceability in whole or in part of the guarantees and indemnities.[26]

Bainton J concluded that there was no reason to doubt the validity of the reasoning in *Stacey v Hill*, and accordingly the case should be followed.[27] In the view of his Honour, once the lease had been disclaimed by the liquidator,

- no moneys for rent or otherwise were payable by the lessee, nor were there any obligations required to be performed by the lessee for which the guarantor was liable;[28] and
- there were no covenants, terms, provisions or conditions which the tenant was obliged to observe, and for which Abigroup was liable in terms of its indemnity.[29]

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24 Section 568 (3) provided:

> This disclaimer operates to terminate, as from the date of the disclaimer, the rights, interests and liabilities of the company and the property of the company in or in respect of the property disclaimed but does not, except so far as is necessary for the purpose of releasing the company and the property of the company from liability, affect the rights and liabilities of any other person.

25 (1995) NSW ConvR 55-754 at 55,811.

26 For full details of the Guarantee and Indemnity, see *Sandtara Pty Ltd v Abigroup Ltd* (1995) NSW ConvR 55-754 at 55,810-55,811.

27 *Ibid* at 55,813.

28 *Ibid* at 55,814.

29 *Ibid.*

It should be noted that the disclaimer considered in that case was effected under s.568 of the *Corporations Law* which provided that the disclaimer would take effect as from the *date of the disclaimer*. Since the amendment to the legislation by the *Corporate Law Reform Act* 1992, the time from which the disclaimer takes effect has been altered – the relevant date is the day on which the disclaimer is *taken* to take effect by the operation of s.568C (3).[30]

(c) Hindcastle Ltd v Barbara Attenborough Associates Ltd

While *Sandtara Pty Ltd v Abigroup Ltd* was under consideration by the New South Wales Supreme Court, another case, *Hindcastle Ltd v Barbara Attenborough Associates Ltd*,[31] was before the courts in England. This case in particular highlighted the odd results created by the disclaimer provisions and their effect on third parties.

The facts of *Hindcastle* echo other cases dealing with disclaimers of lease and guarantees. Hindcastle Ltd had granted Barbara Attenborough Associates a lease of office premises for a term of 20 years. As part of a transaction whereby Barbara Attenborough Associates assigned the lease to the second defendants, CIT Developments Ltd, the third defendant, Patrick Whitten, guaranteed the performance of the obligations of CIT Developments under the lease. CIT Developments assigned the lease in turn to a company which went into voluntary liquidation. The liquidator disclaimed the lease under section 178 *Insolvency Act 1986 (UK)*, which is in substantially similar terms to section 568D *Corporations Law*.[32]

At first instance the court found in favour of the lessor. The guarantors then appealed to the Court of Appeal.

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30 Section 568C (3) provides that an effective disclaimer will be taken to have taken effect on the day after:

(a) if:

(i) the liquidator gave to a person notice of the disclaimer because of paragraph 568A (1)(b); or

(ii) notice of the disclaimer was published under subsection 568A (2);

before the end of 14 days after the liquidator lodged notice of the disclaimer – the last day when the liquidator so gave such notice or such notice was so published; or

(b) otherwise - the day when the liquidator lodged notice of the disclaimer.

For further discussion of this provision, see Mourell and Willoughby, "Disclaimer of Onerous Property under s 568 of the Corporations Law" (1994) 4 *Australian Journal of Corporate Law* 63 at 79, and Australian Law Reform Commission, *General Insolvency Inquiry* AGPS Canberra 1988, pp260-261. Doubt appears to exist as to whether a 14 day period of grace exists as to the time of taking effect if no application is made to set aside the disclaimer.

31 [1995] QB 95.

32 Section 178 (4) read:

A disclaimer under this section -

(a) operates so as to determine, as from the date of the disclaimer, the rights, interests and liabilities of the company in or in respect of the property disclaimed; but

(b) does not, except so far as is necessary for the purpose of releasing the company from any liability, affect the rights or liabilities of any other person.

Millett LJ, in considering the impact of a disclaimer on a guarantor, referred to a guarantors right of indemnity by the principal debtor and indicated that in his view a provision similar to s.568(1) of the *Corporations Law* was not sufficient to deprive a surety of his right of indemnity. His Lordship commented:

> It would, in my judgment, require very clear statutory language to deprive a surety of his right to indemnity while leaving his liability unimpaired. No such language is to be found in sub-section (4)(b)...[33]

The Court regarded itself as bound by the previous decision of the Court of appeal in *Stacey v Hill*. However, it did not have to consider identical circumstances. Rather, the Court was of the view that before it was a situation involving the liability of entities which had assigned a lease and a guarantor of such entities.

The Court held that assignors of a lease and a guarantor of one of the assignors, remained liable, notwithstanding disclaimer of the lease by a liquidator of the ultimate lessee company. In so holding, the Court applied an earlier decision of the House of Lords – *Hill v East and West India Dock Co.*[34]

The Court of Appeal indicated it regarded an original or assignor lessee as liable notwithstanding disclaimer as the liability of such an entity was a primary and direct liability; not dependant on the continued liability of an assignee. In contrast, in the situation involving a guarantor of the lessee company, there was only one obligation, namely that of the lessee, but two different parties liable in respect of it; with the result that the statutory determination of that obligation necessarily discharged the liability of both.[35]

From this result, the guarantors appealed to the House of Lords.[36]

In hearing the unsuccessful appeal from that decision in the House of Lords, Lord Nicholls of Birk enhead[37] indicated his desire to sort out the confusing legal situation and do away with the "tortuous distinctions"[38] which would continue to exist if disclaimers continued to have such an impact. In the course of his judgment Lord Nicholls commented:

> According to *Stacey v Hill*, a surety's liability is discharged when the principal debtor's obligation to indemnify him is determined by disclaimer of the lease ... So the end result, on this footing, would be that disclaimer operates to discharge a guarantee if the disclaimer is in the insolvency of the principal debtor, but not if the disclaimer is in the insolvency of an assignee.
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> This would make no sort of legal or commercial sense. This would mean that directors who guarantee their company's obligations would not be liable if their own company

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33 [1995] QB 95 at 105.
34 (1884) 9 App Cas 448.
35 [1995] QB 95 at 102.
36 [1996] 2 WLR 262.
37 With whom the other members of the House of Lords agreed.
38 [1996] 2 WLR at 279.

> became insolvent whilst tenant, but they would be liable if an assignee from their company encountered financial difficulties whilst tenant ... What sort of law would this be? ... I am unable to accept that this is, or should be, the state of the law. It would lack any rational or practical basis. It would defy coherent explanation. It would defeat the parties intentions.[39]

Accordingly, the House of Lords overruled the decision of the Court of Appeal in *Stacey v Hill*.[40]

In contrast to the views previously expressed in the Court of Appeal, Lord Nicholls indicated that in his view the provision equivalent to s.568D(1) of the *Corporations Law* preserved the obligations of a guarantor to a landlord and ended the obligation of an insolvent tenant to indemnify a guarantor. He pointed out that whilst a guarantor would consequently lose his right to an indemnity from the insolvent tenant, the statute, in its place, gave him or her a right to prove as a creditor of the insolvent tenant's estate. Consequently, in his view, there was no question of the guarantor's right to indemnity being confiscated.[41]

He also pointed out that a guarantor could take steps to obtain some return from the property by applying to the court for a vesting order.[42]

Lord Nicholls decided that the "best answer" to the problem was to interpret the statute as taking effect as a deeming provision so far as other persons preserved rights and obligations were concerned.[43]

(d) Sandtara Pty Ltd v Abigroup Ltd & Ors – the Appeal

Whilst the *Hindcastle* case was in the process of determination in England, the decision of Bainton J in *Sandtara Pty Ltd v Abigroup Ltd & Ors*[44] was under appeal in Australia.[45]

The lessor argued that a disclaimer under s.568[46] terminated only the liabilities of the lessee, and did not affect the rights or liabilities of any other party to the lease, other than to the extent necessary for the release of the lessee from its liabilities under the lease. The New South Wales Court of Appeal upheld the appeal.

In the course of arriving at their decision, the Court of Appeal Judges[47] adopted similar reasoning to Lord Nicholls in relation to many of the arguments put forward on behalf of the guarantors.[48] The court also pointed out that whilst there is a general

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39 *Ibid* at 279-280.
40 *Ibid* at 280.
41 *Ibid* at 272 and 278.
42 *Ibid* at 278.
43 *Ibid* at 272 and 278.
44 (1995) NSW ConvR 55-754.
45 (1996) 14 ACLC 888.
46 Now s.568D.
47 Meagher, Handley and Cole JJA. The primary judgment was delivered by Cole JA, with whom Meagher JA and Handley JA agreed.
48 See for example (1996) 14 ACLC 888 at 890 per Handley JA and at 896-897 per Cole JA.

principle that the release of a principal debtor by the act of a creditor discharges the surety; where the release of the principal debtor is effected by operation of law, such as by the operation of bankruptcy or liquidation law, that is not so.[49] In particular, Cole JA relied upon comments by Dixon J in *McDonald v Dennys Lascelles* where his Honour stated:

> It results from the definition of a surety's engagement, as being accessory to a principal obligation that the extinction of the principal obligation necessarily induces that of the surety; it being of the nature of an accessory obligation, that it cannot exist without its principal; therefore, wherever the principal is discharged, in whatever manner it may be, not only by actual payment or a compensation, but also by a release, the surety is discharged likewise ... As a general principle, subject to similar qualifications and exceptions, it appears to be well recognised in English law, although it is evidenced by decisions giving it particular applications and by dicta rather than by formal pronouncements ... It does not extend to a discharge of the principal debtor's personal liability by operation of law when the discharge is for the purpose of liquidating his affairs or transforming the rights of the creditor against him into rights against or in respect of his assets.[50]

The judges preferred this interpretation of the continued liability of guarantors, and in any event noted that *Stacey v Hill* had been overruled by the House of Lords in the *Hindcastle* case.[51] Accordingly, and notwithstanding the previous decision of Bainton J, the Court of Appeal held that the guarantee and indemnity was sufficient to preserve the guarantor's liability despite the disclaimer by the liquidator of the debtor company.

Conclusion

Notwithstanding the decision of the New South Wales Court of Appeal in *Sandtara Pty Ltd v Abigroup Pty Ltd*, it is interesting to speculate whether the issue as to a guarantor's liability where disclaimer occurs has been finally decided. Although special leave to appeal to the High Court in respect of the *Sandtara* decision was refused, it should be noted in that regard that the decision of the House of Lords in *Hindcastle Ltd v Barbara Attenborough Ltd & Ors* was only reported after conclusion of argument in the New South Wales Court of Appeal.

Further arguments could also continue as a result of comments made by Lord Nicholls in *Hindcastle Ltd v Barbara Attenborough Ltd* as follows:

> If no vesting order is made and the landlord takes possession, the liabilities of other

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49 *Ibid* at 896 per Cole JA. In support of this proposition, his Honour cited a number of cases including *McDonald v Dennys Lascelles Ltd* (1933) 48 CLR 457 at 480; *Jowitt v Callaghan* (1938) 38 SR (NSW) 512 at 518-519; and *Citicorp Australia Ltd v Hendry & Ors* [1984] 4 NSWLR 1 at 16.

50 *McDonald v Dennys Lascelles Ltd* (1933) 48 CLR 457 at 479-480.

51 (1996) 14 ACLC 888 at 890 per Handley JA; and at 897 per Cole JA.

> persons to pay the rent and perform the tenant's covenants will come to an end as far as the future is concerned. If the landlord acts in this way, he is no longer merely the involuntary recipient of a disclaimed lease. By his own act of taking possession he has demonstrated that he regards the lease as ended for all purposes. His conduct is inconsistent with there being a continuing liability on others to perform the tenant covenants in the lease. He cannot have possession of the property and, at the same time, claim rent for the property from others. ... But if the landlord enters upon his own property, he will thereby end all future claims against the original tenant and any guarantor, not just claims in respect of the shortfall between the lease rent and the current rental value of the property.

Handley JA in *Sandtara Pty Ltd v Abigroup Pty Ltd* addressed these comments and indicated that in his view a guarantor in such circumstances could remain liable for damages, if not debt, depending upon the terms of the guarantee and any indemnity.[52]

52 *Ibid* at 890.