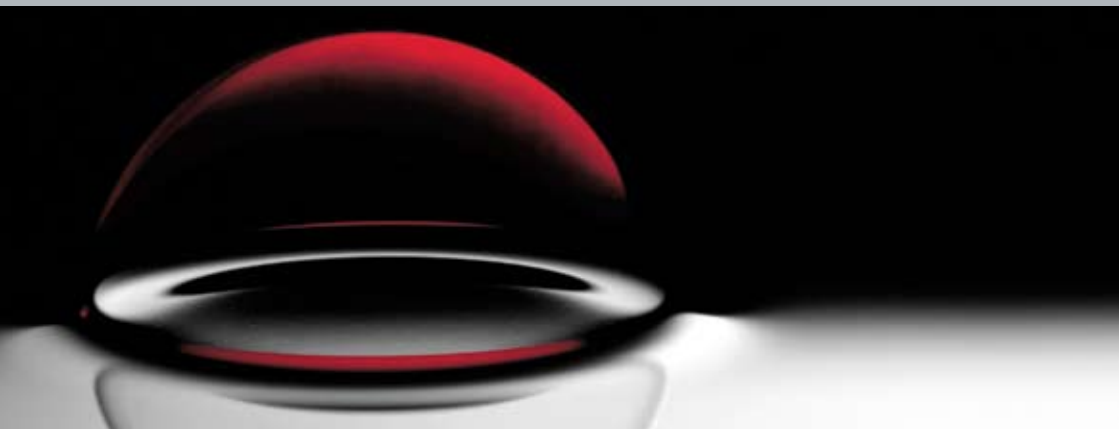


CLAYTON UTZ

Restructuring & Insolvency
Third party guarantees



What are they?

Guarantees are binding promises to be answerable for the obligation of another (the principal) if that other defaults. Most guarantees are given in relation to the payment of a debt, but it is equally possible to guarantee the performance of a contractual obligation which does not involve the payment of money. A guarantee differs from an indemnity. A guarantee is usually only a collateral undertaking to answer for non-performance of a primary obligation. This means that if the primary obligation cannot be legally enforced, the guarantee is discharged.

By contrast, in a contract of indemnity, a primary liability is assumed and is enforceable whether or not some other person is liable or makes default. The distinction between the two is important for several reasons:

- the statutory provisions in certain jurisdictions, requiring certain types of contracts to be evidenced in writing, in general apply to guarantees but not to indemnities
- as the guarantor's liability is co-extensive with that of the principal, the guarantor's liability will be affected by the discharge of the principal or by the fact that the principal's contract is found to be unenforceable – not so with an indemnifier's liability, if the indemnity is carefully worded
- the liability of a guarantor can be discharged by certain types of conduct of the lender, not all of which will discharge an indemnifier.

Who needs them and who gives them?

Who needs them?

A guarantee can be used in conjunction with the provision of credit in almost any form. Thus, it can be used in:

- direct lending
- any kind of financing arrangement
- the provision of goods or services on credit.

In appropriate circumstances it can be used in relation to the performance of obligations other than monetary ones.

Who gives them?

Any adult person, who is not mentally incapacitated, can give a guarantee.

A company has the same capacity as a natural person, and can also give a guarantee.

A legal person with limited capacity, such as a statutory body, can do so provided it is permitted by its constitution or other document defining its powers. Care should therefore be taken where the guarantor's capacity could be limited, as with:

- a statutory body
- an incorporated or unincorporated association
- a trustee.

In practice, a guarantor will be interested in or connected with the business or undertaking of the principal. It is common for obligations of a company to be guaranteed by, for example:

- related bodies corporate
- directors and spouses of directors
- company officers.

How are they made?

As a guarantee is a contract separate from the contract creating the principal obligation, the usual principles relating to the creation of contracts apply to it. In particular, unless made under seal, there must be consideration. Something needs to be given or promised to the guarantor in return for the guarantee promise. Usually the making of the loan or extension of credit to the principal at the request of the guarantor is sufficient but, if this has already happened, problems of consideration arise.

Some States and Territories have a statutory provision requiring all guarantees to be in or evidenced by writing signed by the guarantor. Furthermore, consumer credit legislation may apply to a guarantee to the extent that it guarantees obligations under a consumer credit contract. Such legislation contains complex provisions applicable to guarantees falling within its ambit governing formation, variation, termination and enforcement. The local laws of each jurisdiction in which the form is to be used should be considered in the drafting of a standard form of guarantee.

A guarantee is a personal obligation of the guarantor. Providers of credit sometimes require that the obligation be supported by the provision of security by the guarantor. A creditor may thus take security from both principal and guarantor. Some potential guarantors are prepared to provide security without undertaking personal liability. This can be achieved by careful drafting.

Are they valid?

Grounds of invalidity

A contract of guarantee, like any other contract, can be nullified on a variety of grounds of invalidity affecting the formation of the contract. Two grounds of invalidity, of particular importance to lenders, are:

- unconscionability; and
- the rule in *Yerkey v Jones*.

Unconscionability

The principles of equitable relief against unconscionable contracts apply with equal force to contracts of guarantee. In general, two elements need to be satisfied:

- the guarantor must be under a special disadvantage, such as age, sickness, mental incapacity, illiteracy or lack of education, lack of assistance or explanation (where assistance or explanation is necessary), emotional dependence or lack of business acumen; and
- the creditor must have knowledge of the disability or disadvantage.

If these are shown, the burden of proof passes to the creditor to show that the transaction was fair, just and reasonable and ought not to be set aside.

Alternatively to relief on equitable principles, a guarantor may seek relief from unconscionability under certain statutory provisions.

The rule in *Yerkey v Jones*

The rule in *Yerkey v Jones* propounded by the High Court in 1939 still exists, notwithstanding that it has been severely tested.

The principle is that if a married woman's consent to become a guarantor has been secured by her husband without her understanding the essential nature of the guarantee, and the lender takes no steps to inform the wife of her obligations, and the wife receives no significant financial benefit for the transaction, the wife has a prima facie right to have the guarantee set aside. The rule has been criticised on the grounds that it is sexist and discriminatory, and that it is unnecessary having regard to the equitable remedies for unconscionability that have developed since the case was decided.

Despite these criticisms, the rule was affirmed by the High Court in the 1998 case of *Garcia v National Australia Bank Limited*. In that case, the High Court foreshadowed the possibility of the principle being applied to relationships other than marriage. Subsequently, the Supreme Court of Western Australia, in the case of *Commonwealth Bank of Australia v Ridout Nominees*, applied the principles of *Garcia* to a corporate guarantor, in a case where undue influence was presumed arising from a father's relationship to his son. The lesson from these decisions, and from the equitable rules about unconscionability, is that a lender must be sensitive to the possibility of there being a special relationship between guarantor and principal debtor. If there is any possibility of such a relationship, the lender must be very careful to ensure that the guarantor receives proper, independent advice about the legal effects of a guarantee, and the risks to the guarantor if the principal debtor defaults.

Safeguarding your guarantee

Formation

Apart from matters common to the formation and drafting of any contract with guarantees, particular attention needs to be given to:

- statutory requirements for writing and signature
- other statutory requirements relating to form
- consideration
- provision of independent advice to the guarantor.

During the credit relationship

The law of guarantees has a number of special rules, which may lead to the credit provider losing the benefit of the guarantee in part or in whole.

Examples are rules relating to:

- release of the principal debtor or other guarantors
- giving time to the principal debtor
- loss or impairment of securities.

Some of these rules may be dealt with in advance by provision in the guarantee contract itself. This requires some care in drafting.

Enforcement of the guarantee

Once the principal obligation has fallen due, the creditor can pursue remedies against the guarantor without first exhausting remedies against the principal debtor. Sometimes it is advisable to pursue remedies concurrently, as by lodging proofs in the insolvency both of the guarantor and of the principal debtor.

Restructuring & Insolvency group publications

The Restructuring & Insolvency group of Clayton Utz has prepared a series of brochures that provide an outline of the operation of relevant areas of law.

The complete set of brochures in the series comprises:

- Deed of company arrangement
- Company receivers and managers
- Third party guarantees
- Retention of title clauses
- Voluntary administration
- Liquidation
- Provisional liquidation
- Enforcing security rights

Treatment of the topic addressed in each brochure though comprehensive is not exhaustive. Moreover, a proper understanding of any particular situation demands an integrated approach. Clayton Utz is available to give advice over the whole range of issues relating to corporate restructuring and insolvency, including the position of secured and unsecured creditors, and the practical issues relating to enforcement of securities and debt recovery, structuring and restructuring transactions and litigation.

Copies of this brochure and the others referred to can be obtained free of charge from the Restructuring & Insolvency group of Clayton Utz.

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