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COMMERCIAL & RETAIL LEASING UPDATE

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ALTERNATE WAYS OF SECURING A TENANT'S LEASE OBLIGATION

Offices at:

Brisbane
Level 28 Central Plaza One
345 Queen Street
Brisbane

Beenleigh
99 George Street
Beenleigh

Caboolture
9 Elliott Street
Corner Morayfield Road
Caboolture

Cleveland
141 Shore Street West
Cleveland

Gold Coast
64 Marine Parade
Southport

Ipswich
55 Limestone Street
Ipswich

Telephone
Freecall 1800 652 969

mail@quinnscattini.com.au
www.quinnscattini.com.au

The topic "security under a lease" relates to the landlords ability to cover its losses if the tenant goes out of business and breaches the Lease.

These monetary losses usually include:-

- The legal and other costs of Lease enforcement and tenant eviction;
- The lost rental revenue while the premises are vacant; and
- Any rent shortfall if the replacement tenant negotiates lower rent than the outgoing tenant.

Security under a Lease normally takes the form of a cash-based security (eg cash bond or bank guarantee) and/or personal guarantors for a corporate tenant.

1. THE LEASE SECURITY COMPROMISE

The perfect scenario for a landlord would be an enormous bank guarantee (eg. equal to all of the rent that would be payable for the entire Lease) combined with personal guarantees from the business owners plus their wealthier relatives.

This would allow the landlord an abundance of options to cover its losses if the tenant defaults.

On the other hand, the perfect scenario for a tenant would be a \$2.00 Pty Ltd company as tenant (with no assets) and no cash or personal securities given. This would allow the tenant to "cut its losses and run" with few consequences if the business fails.

In most commercial leases a compromise between these two extremes is met. It is common to see a bank guarantee for a dollar amount equal to between two and six months rent and/or personal guarantees from the directors of a corporate tenant.

The different security options are discussed in more detail below.

2. PERSONAL GUARANTEES / DIRECTOR'S GUARANTEES

"Personal Guarantee" and "Directors Guarantee" mean the same thing:-

A human being signs a document to say *"I will pay for the corporate tenant's obligations under the lease if the tenant does not"*.





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Personal guarantees normally relate to Pty Ltd company tenants. If the tenant takes out the Lease in his/her own name, a personal guarantee is not normally required.

The exception would be a landlord who wished to make extra people liable for the tenant's obligations. For example, if the lease is in the name of the husband but the husband and wife clearly own and run the business together and hold most of their personal assets in both names then a landlord may require the non-tenant wife to give a personal guarantee.

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Advantages of personal guarantees

The advantages of personal guarantees as Lease security are as follows:-

- They are usually not capped with a monetary limit. This means that as long as the guarantor has deep enough pockets, the landlord can sue the guarantor for all of its losses.
- There is usually a psychological imperative on the guarantor to ensure that the corporate tenant does not default (or, failing that, to ensure the landlord is paid out so that the guarantor's liability can be finalised). Most people find being sued and going bankrupt to be a stressful and inconvenient exercise and they will take steps to avoid this wherever possible.

Disadvantages of personal guarantee

From the landlord's point of view, the disadvantages of personal guarantees as Lease security include the following:-

- The delay, cost and uncertainty of enforcement. It is beyond the scope of this article to discuss this area in detail however the starting costs for legal proceedings against a person are \$5,000.00 - \$10,000.00 or more and 8-12 months to obtain an enforcement or bankruptcy type result. There is also the chance of losing in court due to a technicality.

Of course once you commence proceedings against a person they will sometimes settle the matter early if they have the money, thereby avoiding the full cost and delay of the full enforcement process. The landlord will not usually be able to predict the outcome unless he/she "rolls the dice" and pursues the guarantor.

- As mentioned above; a guarantor needs to have "deep pockets" (significant assets) to be worth pursuing as a guarantor. The first part of this equation is the landlord's "Due Diligence" enquiries into the guarantor's assets in initial lease negotiation phase. Unfortunately many landlords do not spend enough time and resources on guarantor Due Diligence when there is a hurry to "get the deal done".





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- The second part of the “deep pockets” equation is the guarantor’s assets at the time when the tenant defaults (which could be years later).

If a tenant has gone out of business, its guarantor owners could have exhausted their personal resources trying to keep the business afloat and not be worth suing.

- Asset protection measures! Some tenants will take assets out of their own name and into (for example) their spouses name, their family trust or some other structure. The landlord will not be able to “*get blood from a stone*” if the guarantor has squirreled away his/her assets in other entities.

These asset protection steps may have been taken before the person signs the guarantee (particularly if the landlord has not done any Due Diligence) or after the guarantee is signed. The net result could be a landlord contemplating whether to sue/bankrupt a guarantor at considerable expense for no monetary return. Litigation “for the principle of the matter” is seldom a sensible exercise.

3. CASH-BASED LEASE SECURITY

Cash-based Lease security normally takes the form of a cash bond, bank guarantee or, more rarely, a lease bond. Usually it is for an amount calculated with reference to the rent (eg. equal to three months rent plus GST and outgoings).

Cash Bonds

A cash bond is usually an amount of money held in the bank account of the landlord or its agent.

Bank Guarantees

A bank guarantee is a written undertaking by a bank to pay the landlord an amount of money in the event of default by the tenant.

We recommend that landlords insist on bank guarantees rather than cash bonds. This is because cash bonds run the theoretical risk of being “clawed back” by a liquidator if the corporate tenant goes out of business. A bank guarantee is under no such disability because it is a promise from the bank to pay the landlord (and the insolvent tenant has little to do with that).

Lease Bonds

A third category of cash-based security is a Lease bond. A lease bond can be described as a form of insurance policy where the bond provider promises to pay the landlord in the event of default.

Lease bonds sometimes provide practical inexpensive options for lease security, particularly between developers and the initial tenants of a new development. A Lease bond is theoretically not as good as a bank guarantee from one of the major banks. *Who is the entity providing the bond anyway?* The landlord needs to find out if the Lease bond provider is a reputable long-term prospect.

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A landlord would need to make a business decision about accepting a Lease bond instead of a bank guarantee.

Advantage of Cash Based Security

Immediacy & certainty. The landlord has cash-in-hand now to cover its costs of tenant default and does not need to sue anyone to obtain that money.

Disadvantage of Cash-Based Security

Cash-based security is finite. Although the landlord has cash to cover its losses now that cash will run out. In a healthy rental market, the landlord may be able to obtain a replacement tenant before its cash security runs out. On the other hand, in a slow rental market the landlord could use up its cash security before locating a suitable replacement tenant.

4. RECOMMENDATIONS

We usually recommend to our tenant clients that, given the choice, they should seek to remove any personal guarantees from their draft Lease, offering a larger bank guarantee in exchange if necessary.

When acting for landlords, of course we recommend that the landlord attempt to obtain as much security as possible (eg. a suitable bank guarantee plus personal guarantees) however negotiation circumstances will often not permit this. While every tenancy situation is different, if a choice must be made we often recommend that landlords pursue larger bank guarantees over personal guarantees for the reasons discussed in this article.

There are also numerous technical issues and recommendations which relate to the particular lease circumstances and are beyond the scope of this article.

Landlords and tenants should get legal advice early in the negotiation process as security matters are often decided at the "Agreement to Lease" stage.

Julian Creagh
Solicitor
Quinn & Scattini

This update is for your information and interest only. It is not intended to be comprehensive, and it **does not constitute and must not be relied on as legal advice**. You must seek specific advice tailored to your circumstances.

If you would like to ask any questions about this or any other leasing issue Julian may be contacted on (07) 3221 1838 between 8:00am and 5:30pm Monday to Friday or on email jcreagh@quinnscattini.com.au

The partners and staff of Quinn & Scattini Lawyers extend to you the compliments of the season. The firm will be open over Christmas and the New Year 8.00am—5.30pm Monday to Friday (excluding public holidays).

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