

## Lease Guaranties: Assignments, Releases and Related Issues

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The economic downturn has resulted in many tenant defaults, bankruptcies and other attempts to shift obligations to third parties through assignment or sublease. Many commercial leases require that a third party guarantee the tenant's lease obligations. Tenants are often surprised to discover that an assignment alone does not release them from liability on the lease. Guarantors are perhaps more surprised to discover that neither an assignment nor a tenant bankruptcy necessarily releases them. This discovery often leads to an examination of traditional theories of relief for guarantors, such as release through material modification, novation and impairment of collateral or recourse. This article briefly reviews these theories as they relate to lease assignors and guarantors.

### **Lease Guaranties Generally**

Guaranties come in two basic forms: guaranties of payment/performance and guaranties of collection. Guaranties of performance generally allow the "creditor" to pursue the guarantor immediately upon the "debtor's" default. Conversely, guaranties of collection require a creditor (1) to pursue the original debtor to judgment, (2) to obtain a deficiency upon the sale of any collateral and (3) to

still have an unsatisfied debt. In addition, creditors often insist on "absolute" and "unconditional" guaranties that include waivers of notice, waivers of impairment of recourse and collateral, and provisions that extend the guarantee to cover obligations incurred after the execution of the original lease or guarantee.

In major retail lease situations, the tenant is often a corporate operator owned by a holding company or other conglomerate. In other situations, the tenant may be owned wholly or partially by a high net worth individual. In either case, if the landlord determines that the tenant is not sufficiently creditworthy, or if it simply has the leverage, the landlord will require a personal or corporate guaranty by the tenant's creditworthy owner or affiliate.

Guarantors, as secondary parties to the underlying lease transaction, must take care to understand and control their exposure. If the guarantor has substantial and meaningful control over the operations of the tenant, then it can control the extent of the guaranteed debt. However, if the guarantor does not have the ability to control the tenant or at least obtain accurate and timely information regarding its activities and financial health, the guarantor's liability could grow

through the tenant's actions and inactions. In this latter situation, the guarantor should require the landlord to provide the guarantor with notice of defaults and opportunities to cure.

This is especially true where the lease contains acceleration of rent provisions that could greatly expand the guarantor's liability without the guarantor's having a chance to mitigate the exposure. The guarantor should also require that the landlord obtain the guarantor's consent to material modifications to the lease, such as increases in the term, rent payments, assignments and subletting. Often, as a business venture fails, the relationship between the co-venturers, who may also be personal guarantors of the lease, becomes frayed. The landlord may enter into lease workout negotiations with some of the co-venturers, which are detrimental to the excluded guarantors. Without the right to receive notice of, and consent to, such negotiated changes, the guarantors may lose control of their exposure.

### **Impact of Lease Assignments**

Consistent with traditional contract principles of novation and substituted contract, an assignment of obligations without a specific release in favor of the assignor will not release the assignor. Restatement Second of Contracts, § 280. Most leases prohibit assignment or subletting without the consent of the landlord. Even if the assignment or sublease is approved, it does not necessarily release the assignor or any third-party guarantors. However, some tenants/guarantors negotiate provisions that automatically release them upon assignment to a "credit-worthy" assignee, with specific objective qualifications included to define "credit-worthy." Absent such a provision, a tenant or guarantor that is not released must understand how the guaranty language will

affect its continuing liability. For example, a guarantor signs an unconditional and absolute continuing guarantee with a waiver of notice; the actions of the assignee/new tenant increase the tenant's lease obligations or create lease defaults that may, in turn, increase the guarantor's liability; the guarantor has no idea of its increased exposure until the landlord makes a demand on it. For many local tenants that are required to provide a personal guaranty or that of a more creditworthy relative or friend, this result is often unexpected and potentially devastating.

### **Impact of Bankruptcy on Guarantor Obligations**

Section 365 of the Bankruptcy Code provides special rules for unexpired leases, pursuant to which a debtor-tenant has two options: First, it can reject the lease, which is then terminated, giving rise to a breach of the lease and a claim for damages by the landlord that may ultimately be discharged. Alternatively, the debtor-tenant may elect to assume and/or assign the lease if (1) the obligations of the tenant are brought current and (2) the landlord is given adequate assurance of future performance by the assignee. 11 U.S.C. § 365(b)(1)(A). Once these requirements are satisfied, the lease may be assigned and the debtor is relieved of future obligations under the lease. 11 U.S.C. § 365(k). If the trustee does not assume or reject an unexpired lease within 60 days of the bankruptcy petition, or within such additional time as the court, for cause, within such 60-day period, fixes, then such lease is deemed rejected, and the trustee shall immediately surrender the premises to the lessor. 11 U.S.C. § 365(d)(4). Regardless of the rejection or assumption of the lease, if there is a guarantor and a default under the lease, the landlord may pursue the guarantor

under applicable state law, even if the debtor's obligation to the landlord is discharged in bankruptcy. 11 U.S.C. § 524(e).

### **Impact of Illegality, Fraud or Duress**

Traditional principals of contract formation also have an impact on the validity of a lease guaranty. If the lease is the product of illegal conduct, fraud, duress, lack of capacity or consideration, and is thus void, then the guaranty, being derivative of the lease, is also void. However, guarantees often contain provisions waiving any defense based on those claims. Guarantors should certainly try and remove those waivers.

### **Some Traditional Guarantor Defenses**

Courts routinely state that guarantors are a favorite of the law and are entitled to strict construction of their guaranty; consequently, their liability should not be extended beyond the express terms of the original agreement. *Levenson v. Haynes*, 123 N.M. 106, 934 P.2d 300 (1997). However, such favoritism may be of little consequence if the express terms include waivers of impairment of collateral and recourse and a waiver(s) of notice, and are unconditional and absolute continuing guaranties. Most retail leases prepared by sophisticated landlords contain these provisions as a matter of course.

In general, impairment of collateral occurs when the secured party fails to perfect a security interest, releases a security interest for unreasonable consideration or disposes of collateral in an unreasonable manner. Restatement (Second) of Contract § 42. Some states provide a landlord with a statutory floating lien on all tenant property located in the leased premises. Some leases also include a specific security interest in tenant property. Conversely, many sophisticated tenants will either negotiate for a specific waiver by the landlord of any such

security interest or at least a subordination of such interest in favor of its purchase-money creditors and bank lenders. Regardless, to the extent the landlord has a security interest in tenant property and engages in conduct that diminishes its value as security for the lease, a guarantor may argue that its obligation should be proportionately diminished.

Traditionally, impairment of recourse occurs when the obligor takes some action that has the effect of impairing the guarantor's ability to pursue the primary obligor for restitution or reimbursement, or makes it more likely that the guarantor will have to satisfy the primary obligation. Restatement Second Guaranty & Suretyship § 44. In the lease context, this could occur if the landlord has released one or more tenants or guarantors without receiving adequate compensation. The landlord can include a waiver of impairment of recourse and also a clause in the release that specifically preserves the guarantor's recourse against the tenant, regardless of a release. If an effective reservation of rights clause is included in the release, the tenant may still be liable to the guarantor.

### **Effect of Modifications on Guaranty**

If the landlord and tenant agree to material modifications of the guaranteed lease, those modifications could have the effect of releasing the guarantor. Perhaps the most effective argument a guarantor has against the landlord's enforcement of the guaranty is that there has been a material and prejudicial modification of the lease without the consent of the guarantor. Typically, these claims involve an extension of the lease term, an increase in the rent or some other monetary obligation.

Landlords must take care when negotiating "workouts" with a non-performing

tenant that the workout does not materially prejudice the rights of the guarantors. While many lease guarantees contain standard waivers of the right to consent to or receive notice of extensions, amendments, substitutions and other modifications, the landlord should always try to obtain the guarantors' signature to any modification.

Termination of the lease or repossession and re-letting of the premises for the account of the tenant are material modifications to the landlord-tenant relationship. Many state laws provide that, unless the lease states otherwise, the lease will terminate upon repossession by the landlord. In that case, the landlord's monetary damages would not include future uncollected rents and, thus, the landlord could not pursue the guarantor for them. However, many leases contain provisions that allow for the acceleration of future rents upon default. Many leases also specifically provide that the lease does not terminate upon repossession, but that the landlord may make such modifications to the premises as it deems necessary to re-let them for the account of the tenant. The cost of such modifications and the difference between the contractual rent and the re-let rent are charged against the tenant and are charges for which the guarantor would also be liable. Finally, many leases contain "termination damages"—provisions that specify how the landlord's damages will be calculated. In each of these situations, the guarantor will be liable to the same extent as the tenant is liable and neither the termination of the lease nor repossession of the premises in compliance with the express terms of the lease changes the original obligation of the tenant or the guarantor.

*Green Leaves Restaurant v. 617 H Street Associates* contains an interesting discussion of the reservation of rights doctrine as well as other guarantor defenses in the context of

a defaulted lease. 974 A.2d 222 (2009). In that case, three investors formed a corporation to operate a restaurant in Bethesda, MD. All three guaranteed the lease for the restaurant. Shortly after acquiring the premises, fire destroyed the restaurant. Unfortunately, the tenants did not obtain insurance adequate to cover the loss or comply with the lease. The strain of the situation estranged one of the partners, who ceased communications with his co-guarantors and the landlord. Eventually, the landlord and the corporate tenant entered into a termination agreement whereby the premises were surrendered, monetary termination damages were stipulated and the corporate tenant was released from further liability.

The estranged guarantor sought to terminate his guaranty on the grounds, among others, that the settlement agreement was a material modification of the lease and, alternatively, that by recovering possession and seeking to re-let the premises, the landlord had terminated the lease and thus the guaranty. The court rejected these arguments because the lease provided the landlord with the right to take possession of the premises upon default and re-let them for the account of the tenant. In other words, the lease contemplated the remedies that the settlement agreement confirmed, and, therefore, the guarantors' liability was not expanded beyond the parties' original expectations.

The estranged guarantor also argued that because the landlord had released the corporate tenant from some liabilities, then he, as a guarantor was also released—that is, his liability was merely derivative of the tenant's liabilities. In rejecting this argument, the court relied on the doctrine of "reservation of rights." In this case, the landlord included in the settlement agreement,

language providing that it retained the right to seek judgment against any guarantor of the corporate tenant pursuant to the lease. While the court noted that this was the traditional method of reserving rights against secondary obligors, it also noted that the Restatement of Suretyship & Guaranty required additional language or facts indicating the landlord's intent not only to retain its rights against the guarantor but also to retain the guarantor's rights of recourse against the tenant. Despite the fact that the settlement agreement did not recite the proper formula from the Restatement (notifying the tenant that it was not released from recourse), the court still ruled that the settlement agreement did not release the guarantor. The court reasoned that the guarantor suffered no loss from the reservation of rights because the corporate tenant was insolvent and recourse against it had no value to be impaired.

### **Conclusion**

In reviewing any lease guaranty, the guarantor must assess the tenant's primary liability under the lease to determine the extent of its guaranteed debt. Next, the guarantor must determine whether by waiving impairment of collateral, recourse, notice and modification, it has consented to pay for any renovations, lease commissions and other "termination damages" over which it has no control. Finally, the guarantor must monitor the performance of the underlying lease. To do so, the guarantor may need to include periodic reporting and access covenants in an agreement between it and the tenant. Ultimately, the ability of a guarantor to obtain these benefits depends on its leverage; however, even if the guarantor does not have the leverage to remove the more onerous provisions of the guarantee, it can at least be prepared for their consequences when trouble arises.

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