

Article Information

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Bank guarantees - are they as effective as we think?

Many commercial and retail leases contain provision for a bank guarantee to be provided by the tenant as security for the tenant's obligations under the lease. Bank guarantees are sometimes provided in addition to, or in substitution for, other forms of security such as personal guarantees and payment of a security bond. A bank guarantee is an unconditional promise by the bank to pay the landlord an amount of money (up to a maximum sum) upon the occurrence of certain events, commonly, when the tenant breaches an obligation under the lease.

Bank guarantees are a popular and convenient alternative to holding a security deposit during a lease term for many landlords. However, care must be taken to ensure that the bank guarantee provisions in any lease are appropriately drafted so that a landlord is able to use the bank guarantee for its intended purpose and call on the funds secured by the bank guarantee in the event of a breach (without having the landlord's entitlement to damages authoritatively determined by a court).

There is a line of judicial authority that supports the proposition that a landlord should have immediate access to the guaranteed funds and should not have to wait for a determination from a court that the lessee has, as a matter of law, breached the lease. The cases assert that generally a landlord cannot be restrained from calling on a bank guarantee so long as the landlord claims in good faith that it is entitled to do so and the words of the lease do not inhibit a landlord from calling on the bank guarantee.

The decision in *Universal Publishers Pty Ltd v Australian Executor Trustees Ltd* [2013] NSWSC 2021 casts doubt on this line of authority. The case rejects the proposition that there is a default position allowing a landlord to call on a bank guarantee relying solely on a good faith claim (in certain circumstances, allowing a tenant to dispute a landlord's access to the bank guarantee, until a court determines whether a breach has actually occurred). In this decision, the court asserted that the landlord's ability to claim under a bank guarantee will depend on the terms of the lease which are applicable to the bank guarantee (and not a "good faith" entitlement).

The decision places a burden on landlords to ensure that the bank guarantee clause of a lease is appropriately worded to provide for an allocation of risk as to who should be out of pocket whilst a dispute as to a tenant's asserted breach is determined. To enable a landlord to call upon bank guarantees in circumstances where a tenant disputes a landlord's entitlement, the bank guarantee clause should provide that the landlord simply needs to claim an entitlement in good faith (i.e. that an actual breach of the lease is not necessary). This will generally permit the landlord to have unrestrained access to the bank guarantee where the landlord's entitlement is being disputed so long as the landlord is acting in good faith.

If a bank guarantee clause provides that the bank guarantee may only be called upon in the event of a default or breach of the lease by the tenant, the landlord may find itself restrained from having recourse to the bank guarantee. The landlord will need therefore to exercise caution unless it is confident of its entitlement to call on the bank guarantee as the landlord may be liable for damages where it has called upon a bank guarantee without justification.

We recommend landlords include the following provision in their leases where a bank guarantee is used as a form of security:

The Landlord may use the bank guarantee to recover its loss if the Tenant (in the sole opinion of the Landlord acting in good faith) does not comply with any obligation under the Lease. The Landlord may (without notice to the Tenant and

provided that the Landlord acts in good faith) demand payment by the bank of an amount equal to its loss. For clarity, it is not a precondition to the exercise of the Landlord's rights under this clause that a Court determines whether an actual breach has occurred.

In addition, it is important that the wording of the bank guarantee is suitable. Accordingly, the bank guarantee clause in the lease should ensure that the bank guarantee is in a form that is acceptable to and first approved by the landlord. It would be appropriate for the landlord to request a draft copy of the bank guarantee to ensure that it is suitably worded.