Practical Considerations In Dealing With Lease Guarantees

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When a prospective Tenant does not have sufficient financial strength or business experience for a Landlord to rely on as the sole source of securing the Tenant’s lease obligations, one of the most common forms of additional security is a personal or corporate guaranty of the Tenant’s lease obligations. A guaranty reduces the Landlord’s risk of entering into a lease with a Tenant by providing the Landlord with an additional source of recourse, i.e., against the guarantor, in the event of a Tenant default. In addition to providing fiscal security to the Landlord, the guarantor may be a source of additional pressures on the Tenant to see that the Tenant performs the lease.

If the Landlord is requiring a guaranty and the Tenant is willing and able to secure a guarantor to guarantee its obligations, the next step in the negotiations is to determine the scope of the guaranty. There are many practical considerations in negotiating the form and scope of a guaranty. Obviously, the Landlord wants to obtain the greatest assurances it can get that all of the Tenant’s obligations under the lease will be met, while the guarantor will want to take on as little risk and potential liability as possible. This article will discuss some of the considerations you should consider when negotiating a guarantee.

Payment Versus Performance

A primary concern of the Landlord, but not the only one, is the Tenant’s timely payment of rent. To protect itself against a Tenant payment default under a lease, the Landlord is looking for the maximum assurance that not only will the default be cured, but also after the cure that the lease shall continue under its agreed upon terms and conditions. Consequently, most guarantees demanded by Landlords are guarantees of both payment and performance. Under a payment and performance guaranty, the guarantor is agreeing not only to cure a monetary default, but to perform all other defaulted obligations of the Tenant as if the guarantor were the Tenant, including for example, maintaining required insurance, indemnifying the Landlord pursuant to indemnification provisions, and even continuing the business operations in the premises if the tenant abandons them.

An initial consideration therefore, is whether the guaranty is to be one of payment and performance, or one of payment only. From the guarantor’s point of view, limiting the guaranty to payment only is an extremely important concession to obtain from the Landlord, particularly if the guarantor is an individual or an entity not affiliated with or engaged in the business of the Tenant. While most defaults can be cured in one way or another by the payment of money, Landlords are reluctant to give up a performance guaranty, especially in retail situations where the ongoing business is important to the Landlord. If the guarantor is an individual not familiar with the business of running a restaurant for example, that individual is not likely to want to step in and run the business, or be responsible to find someone to continue to run the business, in the event the Tenant abandons the premises. On the other hand, if the Tenant is a franchisee of a national retail chain and the guarantor is the corporate franchisor under a retail lease, the guarantor is in a better position to cause the performance of all obligations of a Tenant in default no matter what the default. Therefore, the Landlord is more likely to insist upon a guarantee of
performance in this scenario since the guarantor is much more likely to be able to perform in the shoes of the Tenant.

**Limited Guaranty**

Often, a Landlord wants a guaranty because the Tenant is a start-up entity or otherwise has an unknown track record. For the same reasons, a guarantor may not be readily available to guarantee against the risk of default. A possible solution to this situation is to limit the guaranty for a fixed period during the early years of the lease term. This compromise gives the Landlord the additional security it is looking for during what are usually the riskiest years of a new lease and allows the Tenant to obtain the experience, grow its business, and establish a history with the Landlord while reducing the time frame for the guarantor’s liability. A typical example would be that the guaranty would expire by its own terms after a set number of years, provided there had been no Tenant default. The logic of this limited guaranty from the Tenant’s perspective is that if the Tenant has not been in default and the Landlord has not had to look to the guarantor during the first several years of the lease term, then the Landlord’s risk has been sufficiently reduced to rely thereafter on the Tenant alone to perform under the Lease. From the Landlord’s perspective, although the risk may have been reduced by a history of timely payment and compliance, there is no assurance that the Tenant’s financial situation will be significantly greater at the end of the guaranty period. A history of past performance may not be a truly reliable gauge of future performance. One technique to address this issue from the Landlord’s perspective is to condition the release of the guaranty on the Tenant’s attaining a certain level of sales or net worth.

Another way to limit a guaranty, but without having to look solely to the Tenant for security after a set period of time, is to limit or cap the dollar amount of liability of the guarantor. Under this form of limited guaranty, the guarantor would remain liable for the entire term; however, the monetary liability of the guarantor would be capped at a specific dollar amount or limited to the amount of rent due under the lease for a specific period of time. This type of guaranty provides the Landlord with some additional security and another party to look to in the event of a Tenant default for the life of the lease, while giving the guarantor a known cap on its exposure. Because the guarantor knows its maximum potential liability regardless of the default, this is a good compromise for a Landlord to consider when the guarantor is very desirable (such as a parent corporation) but reluctant otherwise to guaranty the Tenant’s obligations.

**Rolling Guaranty**

Another option is some combination of reducing or limiting the liability of the guarantor over a period of time. A rolling guaranty can often address the security concerns of the Landlord without requiring the guarantor to be fully exposed to all liability from a Tenant’s default. A rolling guarantee is a form of limited guaranty in which the liability of the guarantor is reduced over time provided the Tenant does not default under the terms of the Lease. This type of guaranty provides the most flexibility in negotiating an agreement that meets the security concerns of the Landlord and limits the liability exposure of the guarantor.
As an example, suppose an established regional corporation has created a new limited liability company to pursue a separate but related business venture. Although the new company is backed by a corporation with a long history and strong financials, the corporation does not want to take on all the potential liabilities of the new venture and this is why the corporate parent created a new entity. The Landlord wants this Tenant because it will be leasing a significant amount of space and based on the history of the corporation, expectations are that the new venture will be successful. Nonetheless, because this is a newly formed limited liability company, without any established cash flow or the assets of the parent corporation, it would not be unreasonable for the Landlord to require a corporate guaranty from the parent corporation. In order to induce the Landlord to take the risk of leasing a significant portion of its space to this unproven entity, while not taking on the full liabilities of the startup venture, the parent corporation may agree to a rolling guarantee. With a rolling guarantee, as an example, the parent is fully liable for any default of the Tenant during the first five years of a ten year lease; for the following five years, if the Tenant has not been in default, the liability of the guarantor would be reduced to an amount equal to three years worth of rental payments due to Landlord; and for any option or extension years, the liability of the guarantor would be reduced further to an amount equal to one year’s worth of rental payments.

Under this scenario, the Landlord gets the full security of the established, parent corporation during the startup phase of the venture that is as good as having the parent company as the Tenant, and a reduction in security during the remainder of the Lease, but still significant security backed by the parent. The limited liability company gets the space it needs, presumably at a lower rate than it would be able to obtain without the guaranty, and the guarantor has a declining risk exposure as the new venture grows and establishes itself.

Conclusion

The intent of this article was to give you an idea of some of the primary considerations involved in negotiating the terms of a guaranty. There are many other considerations and legal nuances that are beyond the scope of this article (such as defenses of enforcement, subrogation, local law issues, etc.) that should be considered and addressed by Landlords, Tenants and guarantors before entering into any guaranty.

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