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Tenant Restructuring Plan Does Not Relieve Third-Party Guarantor of Payment Obligation, English Court Rules

Go-To Guide:

- The case deals with the obligations of guarantors of a tenant which has obtained approval of a restructuring plan under Part 26A of the Corporate Insolvency and Governance Act, 2020
- It has implications for both real estate investors and their lenders

On 15 August 2022, Deputy Master Arkush handed down **judgment** in the case of *Oceanfill Limited v Nuffield Health Wellbeing Limited and Cannons Group Limited* [2022] EWHC 2178.

The case, which arises out of Virgin Active Limited's restructuring plan under Part 26A of the Companies Act 2006, is relevant to real estate investors and their lenders. Part 26A was one of the measures introduced under the Corporate Insolvency and Governance Act 2020 to facilitate the rehabilitation of businesses affected by the COVID-19 pandemic.

The Facts

Oceanfill Limited owned a property in Leeds. In September 1998, Oceanfill let part of the premises for a 25-year term to Vardon Health and Fitness Limited (the previous name of Nuffield Health Wellbeing Limited) to be used as a gym. Cannons Group Limited guaranteed Nuffield's payment obligations under

the lease. In 2000, Nuffield assigned the lease to Virgin Active Limited and entered into an authorised guarantee agreement (AGA) promising the performance of Virgin's obligations under the lease. Cannons guaranteed Nuffield's obligations under the AGA.

In 2021, Virgin obtained High Court approval in respect of a restructuring plan, necessitated by the disruption to its business caused by the COVID-19 lockdown.

Under the restructuring plan and in accordance with its terms, Virgin did not have to pay its landlords, a significant constituency of its creditors, rent and other amounts under its leases. In return, the landlords were entitled to payment prescribed under the restructuring plan, described as a "Restructuring Plan Return".

The terms of the restructuring plan were binding upon Virgin's landlords by order of the court, notwithstanding their opposition. However, the restructuring plan did not make provision for the position of any third-party guarantors that provided credit enhancement for Virgin's payment obligations.

Oceanfill sought to claim the rent and other amounts owed to it by Virgin under the guarantee. Nuffield and Cannons resisted this claim. Oceanfill applied for summary judgement.

The Arguments

Nuffield and Cannons argued that the restructuring plan had varied the terms of the lease with Virgin, releasing Virgin's obligation to pay, and that, by virtue of this rewriting, Cannons was no longer bound by its obligations as guarantor.

Oceanfill countered this defence by arguing that the restructuring plan had not resulted in the terms of the lease being re-written but rather gave Virgin a legal protection from having to honour its obligations. Even though the obligation to pay rent, for example, fell due, Oceanfill claimed the obligation was not payable by virtue of the restructuring plan.

While in commercial terms there is little difference between the two arguments, in legal terms the difference is significant: Nuffield and Cannons posited the guarantee should come to an end; Oceanfill claimed the guarantee continued to be effective.

The Judgment

Oceanfill persuaded the court, which held that while Virgin was, by operation of law, relieved from the obligations it owed Oceanfill under the lease, Oceanfill still was entitled to make a claim under the guarantee. The court's analysis was, at least in part, based on the fact that third parties such as guarantors did not benefit from the legal protection arising out of the restructuring plan, which was for Virgin's benefit. In his judgment, Master Arkush stated:

...if there are any third parties by whom the rent is payable, such as guarantors who are not parties to the [restructuring plan], the rent has fallen due. Nothing has happened which would have the effect of discharging the rights or liabilities against such third parties....

Though it did not change the reasoning described above, the court also found that under the terms of the assignment of the lease, the guarantee would continue to be effective notwithstanding any variations to the lease, save where the landlord expressly released the guarantee under seal. Even though the

restructuring plan included a provision which deemed it to take effect as a deed, the formal release condition was not satisfied.

The Commercial Implications

Landlords require that tenants obtain third-party guarantees precisely because tenants may become subject to financial distress during the term of a lease, and as a result may be unable to pay amounts owed. It would be contrary to this commercial objective if a guarantor was relieved from its obligations under the very circumstances it was supposed to provide protection, and in the case of banks providing guarantees, for which they would have been paid.

Guarantors may qualify their obligations under guarantees. For example, a guarantor could seek to include a term in a guarantee stating that its obligation to make payment under the guarantee will be limited to the amount the tenant is obliged to pay the landlord, or words to that effect (i.e., the guarantor's obligation would be restricted to the amounts payable by the tenants rather than the amounts due). That would, in effect, mean the landlord would be no better off as a result of having the guarantee; therefore, landlords and their legal advisors should be vigilant in respect of such matters.

The position of a landlord's lender is more nuanced. One of the ways a lender measures the quality of a real estate loan is through an interest cover test or a debt yield test. Both these tests involve measuring rental income which is of "good quality" and comparing this to the landlord's obligation to pay interest (in the case of interest cover) or the amount of the loan (in the case of debt yield). Rent payable by a tenant that is subject to an "insolvency proceeding", which would include proceedings to obtain approval of a restructuring plan, is not regarded as good quality rent and will be excluded from the calculation, making the tests harder to satisfy. However, even if a tenant is subject to insolvency proceedings, the landlord will, nonetheless, be able to claim credit for the amount of rent due from that tenant if the tenant's obligation to pay rent is guaranteed by a guarantor which is not subject to insolvency proceedings. Lenders may wish to add words to the definition of "passing net rental income" to the effect that the guarantor also has not denied its obligation to make payment under the guarantee, in order to bolster the "good quality" requirement. Where a guarantor has denied its obligations under the guarantee, a lender should be allowed to take this into account and not treat the guarantee as providing the necessary credit enhancement.

The case also highlights the importance of the drafting in licences to assign and guarantees, such that any variation of the tenant's obligations can only be effected by way of a formal deed under seal.

Conclusion

The case has implications that go beyond the position of the landlord and its lender. After a guarantor makes payment under the guarantee, it may be entitled to seek recovery from the tenant based on its rights of subrogation. Cannons may consider an appeal. It is, on any view, an interesting addition to the jurisprudence being generated as a result of the use of restructuring plans.

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