Guarantees: draft carefully to survive unauthorised variations

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ON 20 APRIL 2009 THE NSW Court of Appeal in *Valstar v Silversmith* [2009] NSWCA 80 considered a guarantee given by two directors, which contained within a mortgage given by their company. The mortgage was varied, lengthening the term, increasing the principal and raising the interest rate, after the guarantors had resigned as directors. The lender, who suffered a shortfall on the sale of the security, sought to recover from the guarantors. Sackville AJA, with whom McColl JA and Basten JA agreed, gave important guidance for lenders seeking to draft guarantees so that they survive variations unauthorised by the guarantor.

The trial judge determined the lender should fail primarily because the variation constituted a novation of the original agreement. The Court of Appeal rejected this reasoning, holding that "for novation to occur, all parties to the old agreement must be parties to the new contract."[1]

Ankar

Argument then centred upon whether the principles flowing from *Ankar Pty Ltd v National Westminster Finance (Aust) Ltd* (1987) 162 CLR 549 at 558-560 applied, which the primary judge cited as an alternative basis for deciding in favour of the guarantors. The NSW Court of Appeal has previously summarised these: "A guarantee is discharged when the creditor's conduct has the effect of altering the surety's rights, unless the alteration is unsubstantial and not prejudicial to the surety."[2]

Counsel for the lender argued that the *Ankar* principle had no application since it is available only to sureties and the guarantors were liable as principals. In making this submission he relied upon a clause in the mortgage that read: "This mortgage shall take effect as if it was entered into by the guarantors ... as a further mortgagor, and are jointly and severally liable to the mortgagee under this mortgage ...".

The court rejected this on two grounds; first, because the argument was inconsistent with the pleaded case of the lender, which alleged the respondents were guarantors, and second, because the wording did not confer a primary obligation on the guarantors.

Sackville AJA quoted a reported note of Lord Denning's judgment in *Stadium Finance Co Ltd v Helm* (1965) 109 Sol J 471: "Lord Denning MR said that the test was whether, as between two people, one of the two was under a primary liability to perform the obligation, while the other's obligation was secondary only. If so, it was a contract of guarantee and not of indemnity. One always looked to see if there was a primary and a secondary obligation, or two primary obligations ... His Lordship did not think that these cases could be decided on a literal construction of these documents ... the whole burden of this document was that it was a guarantee, to come into force if the principal debtor defaulted and to the extent of his default."

Court view

Accordingly, on the *Ankar* argument the court concluded: "The variations ... altered the nature of the guarantors' obligations and that the alteration could not be regarded as unsubstantial or non-prejudicial ... By reason of the increase, the guarantors were exposed to a potentially greater risk of being called upon to meet a default by the company of its obligations under the mortgage. The guarantors were exposed to a greater risk, even if their liability was limited to the original sum lent to the company ($240,000) plus interest. The increased borrowing by the company may have made it more likely that the company would default and that the guarantors would be required to meet any shortfall (albeit up to a limit of $240,000). This is not a risk that can be dismissed as purely "theoretical."

In obiter dictum (at [43]) the court noted that it is possible to variation-proof a guarantee insofar as increases in principal are concerned: *Wood Hall Pty Ltd v Pipeline Authority* [1979] HCA 21; 141 CLR 443, at 455, per Gibbs J (with whom Barwick CJ and Mason J agreed).

Schoenhoff

Lenders should note that the Court of Appeal has considered this issue more broadly in *Schoenhoff v CBA* [2004] NSWCA 161 where the clause in question read: "[The bank's rights to call on the guarantee are not affected] "by any act or omission by us ... or by anything else that might otherwise affect them under law, including ... the fact that we vary or replace the borrower's obligations under this agreement ...".

Stein AJA, with whom Ipp JA and McColl agreed, held the clause "had the effect of varying or replacing the obligations of the borrower under the agreement. The appellants rely on the contract of guarantee being construed strictissimi juris so that any ambiguous provisions are construed in favour of the surety (*Ankar* at 561). But I cannot see any ambiguity ... and it was, as I have said, designed to overcome *Ankar*."

It is to be surmised that the lender in this case attempted to defeat *Ankar* by making the guarantors principals. This is as equally effective as the route taken in the *Schoenhoff* approach to variation-proofing a guarantee.

Sackville AJA noted that the following clause succeeded in *The Fletcher Organisation v Crocus Investments*:[3] "In order to give full effect to the provisions of this instrument the guarantor agrees and declares that the mortgagee shall be at liberty to act as though the guarantor were the principal debtor and the guarantor hereby waives all rights in connection with such provisions that it might otherwise be entitled to claim or enforce."

His Honour distinguished the case mainly because the guarantor waived all rights as surety. Accordingly, it would seem the safest way to variation-proof a guarantee is to adopt the *Schoenhoff* wording. ❑

ENDNOTES

1. At [26].
2. *Schoenhoff v CBA* [2004] NSWCA 161 at [5].
3. [1988] 2 Qd R 517. ❑

"The mortgage was varied, lengthening the term, increasing the principal and raising the interest rate, after the guarantors had resigned as directors."