CORPORATE GUARANTEES

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Definitions

The modern corporate enterprise is frequently undertaken by a group of companies. The corporate conglomerate consisting of a holding company and a number of subsidiaries is not an infrequent means by which modern business or commerce is undertaken. A concomitant of this development is the giving of guarantees by one company of the debts of another company in the group. Frequently the guarantee is by a subsidiary of the debts of the parent company. Guarantees can, of course, be given by companies in other circumstances. In this paper I propose to deal with questions arising out of the giving of guarantees by companies, be they members of a group or not.

As with any discussion on the topic of guarantees, it is important, at the outset, to distinguish between guarantees and indemnities. A guarantee is an accessory contract by which the promisor undertakes to be answerable to the promisee for the debt, default or miscarriage of another person, whose primary liability to the promisee must exist or be contemplated. (Halsbury, Laws of England, 4th Edition, Vol 20, para 101.) Expressing the obligations another way, a guarantor might be defined as one who contracts with an actual or possible creditor of another to be responsible to him by way of an additional security for the whole or part of the debt (Rowlatt on The Law of Principal and Surety (4th Edition) 1). The obligations arising out of a contract for guarantee are thus necessarily a collateral obligation, postulating the principal liability of another person (ibid). Unlike a guarantee, which is ancillary or subsidiary to another contract, an indemnity is a contract by which the promisor undertaken an original and independent obligation to discharge a liability. While a contract of guarantee may be described as a contract of indemnity in the wider sense of the term, it is to be distinguished primarily on the basis that the indemnity is a primary obligation whereas the guarantee is always a collateral obligation. In practice the distinction may be of little difference as the terms of guarantee quite often are couched in terms of a guarantee and indemnity.

It is not the purpose of this paper to review the law relating to guarantees but rather to point to some issues arising in the context of corporate guarantees.

Ultra vires abandoned

The erstwhile necessity to examine the objects of a company to determine whether the company had the capacity to grant a guarantee may no longer be required. Since 1st January 1984 companies have the rights and powers of a natural person. The terms of the new sections 67, 68 and 68A of the Companies Code substantially limit the doctrine of ultra vires in relation to companies. Although a company may in its Memorandum or Articles restrict or prohibit the exercise by the company of any of the powers referred to in section 67(1), the fact that a company acts in a way prohibited by its Memorandum does not, so far as third persons are concerned, render that act invalid: section 68A(4). While persons dealing with companies gain some protection under sections 67, 68 and 68A, the position of persons dealing with a company who have actual knowledge of limitations upon the powers of a company are not so clear. The question arises whether a person, who calls for a copy of the Memorandum and Articles of Association of the company for the purpose of perusing it prior to dealing with the company, might be in a worse position than a person who deals with the company without having examined its Memorandum and Articles of Association. The Memorandum or Articles may contain terms which restrict or prohibit the power of a company to give a guarantee. A person who peruses the Memorandum and Articles of Association will be deemed to have actual knowledge of them and may not be entitled to rely on the protections afforded by section 68A.

Guarantees by subsidiaries

In 1867, Mr JF Astley, QC, an experienced and skilled legal practitioner, noted (41 ALJ 368. The following notes are based on this article):

> "With the expansion and complexities of modern business, diversification of the activities of companies, and possibly for some reasons not unconnected with taxation, businesses are more and more being split up into a number of companies instead of departments of the one company. One finds at the top the parent company, often a mere holding company, and a number of wholly owned subsidiary companies, each of which probably owns important assets and carries on an important trade or business. Although the subsidiary companies are separate entities, there seems to be a strong tendency to regard them not as separate entities but still as departments of one business which is run by the parent company at the top, and to regard the subsidiaries as being subject in all things to the direction of the parent."

This trend does not appear to be any less prevalent today. The practice of regarding subsidiaries as departments of the one business sometimes extends to the giving of guarantees by subsidiary companies of the debts of the parent company. While for business and commercial reasons the need for this practice must be acknowledged, one question which exists in relation to this practice is whether it is necessary for the subsidiary to ascertain whether the giving of the guarantee is beneficial to

it, in the sense that the subsidiary will get something out of it.

In many cases when money is required to be borrowed for the purposes of some company or companies in the group, the borrowing is done by the parent, not by the company or companies which require the money. One of the difficulties of this practice which might otherwise be very sound is that the principal assets of the group are held not by the parent, but by the subsidiaries. The problem of how to make those assets available for repayment of the money borrowed is resolved by taking guarantees from the subsidiaries for repayment of the money borrowed. Thus subsidiaries join in trust deeds as guarantors and the trust deeds contain a covenant by the parent to procure a guarantee from any wholly owned subsidiary, including an after acquired one, if called upon by the trustee. As a consequence it is not uncommon to join all existing wholly owned subsidiaries in the trust deed.

The granting of guarantees by subsidiaries might have serious implications for creditors of the subsidiary. A claim made under the guarantee might result in the guarantor's trade creditors getting nothing if the guarantor should become insolvent.

It is arguable, therefore, that a subsidiary should not give a guarantee of the debts of the parent company, even though the parent is the only shareholder, unless the directors of the subsidiary are of the opinion that it will be for the benefit of the subsidiary to give the guarantee. In reaching this conclusion, the directors should endeavour to form an independent opinion without regard to the individual interests of the parent. The guarantee should not be automatically given. In other words the directors of the subsidiary should recognise that the subsidiary is a separate entity with its own assets and its own liabilities. Furthermore, they must recognise that they have liabilities cast upon them as directors of the subsidiary company and make their own judgment as to whether the guarantee should be given.

While the directors of a company have a clear duty to the shareholders of the company to act in the best interests of the company as a whole, that does not necessarily mean that the interests of the creditors of a company are to be disregarded or that the interests of the shareholders are to be considered at the possible expense of the creditors. The directors of a company owe a duty to its creditors: Walker v Wimborne (1976) 137 CLR 1; Ring v Sutton (1980) 5 ACLR 546. In Walker v Wimborne, Mr Justice Mason drew attention to the fact that the directors of a company, in discharging their duty to the company, must take account of the interests of both its shareholders and its creditors.

> "Any failure by the directors to take into account the interests of creditors will have adverse consequences for the company as well as for them."

It seems that it is arguable that this duty is qualified where there are a number of companies in a group, associated by common

or interlocking shareholdings, so that it may be necessary to have regard to the interests of the group as a whole. No doubt there are many cases in which the granting of a guarantee by a subsidiary might be entirely proper. However, the directors of a subsidiary cannot entirely disregard the interests of their creditors. If creditors could demonstrate that the giving of a guarantee could not, in all the circumstances, be justified, the guarantee might be invalidated: Reid Murray Holdings Limited (In Liquidation) v David Murray Holdings Pty Ltd (1972) 5 SASR 387, 403-404. In other words if directors decide that the company should give a guarantee when they are not bona fide of opinion that it will be in the interests of the company to give it, not merely that it will be in the personal interests of their one and only shareholder, it is arguable that the directors have acted in excess of their powers. These questions should not be considered to be merely hypothetical. The collapse of a group of companies quite often reveal interlocking arrangements which would be assailable as having been entered into contrary to the interests of the creditors of a subsidiary: Reid Murray Holdings Limited (In Liquidation) v David Murray Holdings Pty Ltd.

Schemes of arrangement

Two questions in connection with Schemes of Arrangement are, is the surety discharged when the principal debtors' liability is discharged under the Scheme and, second, what is the consequence for guarantors if the Scheme contains a moratorium on the enforcement of debts of the principal debtors?

The liability of the surety will be discharged should the principal debtor be discharged from liability to the creditor (Halsbury Vol 20, para 284 and cases there cited). This is a necessary consequence of the fact that a guarantee is essentially an accessory obligation: McDonald v Dennys Lascelles Limited (1933) 48 CLR 457, 480. However where the liabilities of the principal debtor have been discharged for the purpose of liquidating his affairs or transforming the rights of the creditor against him into rights against or in respect of his assets, the liability of the guarantor is not discharged: McDonald v Dennys Lascelles Limited. Thus, in the case where a company enters into a Scheme of Arrangement approved by the court under section 317 of the Code, the Scheme of Arrangement does not in itself result in any discharge of the liability of the guarantor notwithstanding that the scheme may compromise debts of the principal debtor: Re Garner's Motors Limited (1937) Ch 594; Hill v Anderson Meat Industries Limited (1982) 2 NSWLR 704. The rule obtains even in the case where the guarantee is in respect of a debt due to a creditor who has voted in favour of the scheme: Hill v Anderson Meat Industries Limited (1972) 2 NSWLR 704. Where a Scheme of Arrangement proposes that the liability of the debtor will be discharged in the circumstances contemplated by the Scheme, those corporate guarantors, who seek a discharge in the event that the principal debtor should be discharged, should seek to include in the scheme an express provision to this effect. On the other hand, banks and others seeking to keep the guarantees on foot might wish to prevent this by a provision in guarantees binding guarantors not to seek the inclusion of such clause in Schemes of Arrangement.

There is a division of judicial opinion as to the effect of a moratorium upon the capacity of the creditor to enforce the guarantee during the period of the moratorium. In Stramit Industries Limited v Gardner [1970] 2 NSWLR 450, it was held that the creditor could not proceed against the guarantor during the moratorium period. However, a contrary view has been expressed in Hill v Anderson Meat Industries Limited (1972) 2 NSWLR 704, 708 and Commercial Banking Co of Sydney Limited v Gaty [1978] 2 NSWLR 271, 277. The better view would appear to be that a moratorium does not prevent the surety from enforcing the guarantee.

Section 230 of the Companies Code

Certain kinds of corporate guarantees are prohibited by section 230(1) of the Code. This section prohibits companies, other than exempt proprietary companies, from making loans or providing guarantees to directors, spouses of directors and relatives of either directors or their spouses. The prohibition extends further so that it is useful to set out its terms in full:

> "230(1) [Prohibition of loans and guarantees] A company shall not, whether directly or indirectly -
>
> (a) make a loan to -
>
> (i) a director of the company, a spouse of such a director, or a relative of such director or spouse;
>
> (ii) a director of a corporation that is related to the company, a spouse of such a director, or a relative of such a director or spouse;
>
> (iii) a trustee of a trust under which a person referred to in sub-paragraph (i) or (ii) has a beneficial interest being a loan made to the trustee in his capacity as trustee; or
>
> (iv) a corporation, where a person referred to in sub-paragraph (i) or (ii) has, or 2 or more such persons together have, a direct or indirect beneficial interest in shares in the corporation the nominal value of which is not less than 10% of the nominal value of the issued share capital of the corporation; or
>
> (b) give a guarantee or provide security in connection with a loan made or to be made by another person to a natural person or corporation referred to in paragraph (a)."

The rationale for the rule appears to be that it is undesirable that a director should borrow from his company. If he could offer good security, it would be no hardship to him to borrow from other sources. If he could not offer good security, he should not borrow from the company: see report of the Cohen

Committee cited in Ford, Principles of Company Law (3rd Edition) para 1519.

Section 230 contains a number of exceptions to this prohibition, for example, where the loan is in the interests of a company and does not prejudice the interests of its creditors and in the case of a company whose ordinary business includes moneylending. This is not the place to discuss the full operation of section 239. However, it is relevant to note that where there has been a failure to comply with the terms of section 230, any person who has made a loan in relation to which the company has given a guarantee or provided security cannot enforce the guarantee or security unless an exemption certificate signed by a director and secretary of the company has been supplied to him before the loan was made: section 230(8). The Code provides for two kinds of certificates. The first certifies that the company is an exempt proprietary company. The second certifies that the company was not prohibited by section 230 from giving guarantees or providing the security. This certificate must be furnished before the loan was made and the lender did not know or had no reason to believe that the certificate was incorrect. Plainly, where the lender has no knowledge or means of knowledge of the true position, it is desirable for the lender to obtain the appropriate certificate.

Section 129 of the Companies Code

The rule prohibiting the purchase by a company of its own shares must also be considered: Trevor v Whitworth (1887) 12 App Cas 409. The rule is now contained in section 129 of the Code which prohibits a company from directly or indirectly giving any financial assistance for the purpose of or in connection with the acquisition of its shares. The provision of financial assistance is deemed by section 129(2) to include the giving of a guarantee. The prohibition extends to any kind of acquisition of shares whether the acquisition be by way of purchase, subscription or otherwise: section 129(16).

This is not the occasion to discuss the scope and ambit of section 129. Rather the purpose is to focus attention on the need to direct attention to the operation of section 129 whenever members of a group of companies are involved in the acquisition of shares. The Code expressly prohibits in section 129(1) financial assistance in connection with the acquisition of shares by a subsidiary in its holding company. Section 129 provides for some exceptions.

Reference should be made to the terms of section 129 and to the various texts and other commentaries for the full operation of the exemptions. One of the exclusions which might be noted is that contained in section 129(9) which exempts from the operation of section 129 the making of a loan by a company whose business includes moneylending where the loan is made in the ordinary course of its business. If the company is aware the loan is made for the purpose of the acquisition of or in connection with the acquisition of its own shares, it is unlikely to be a transaction in the ordinary course of the company's ordinary business:

Steen v Law [1964] AC 287; Fowlie v Slater (QBD) 5 April 1979, noted at 54 ALJ 602.

An illustration of how breaches of sections 129 and 230 of the Code might occur in a takeover situation is provided by the decision in Re Myer Retail Investments Pty Ltd (1983) 8 ACLR 102. In that case an injunction was sought to restrain Myer Retail Investments Pty Ltd ("Myer Retail") from sending offers to shareholders in Grace Bros Holdings Limited for the acquisition of their stock units. Myer Retail was a wholly owned subsidiary of Wybalena Limited, a shelf company acquired as a vehicle for the takeover of Grace Bros by the Myer group. Wybalena was in turn owned as to 50% by subsidiaries of Myer Emporium Limited ("Myer") and 50% by non-executive directors of Myer. Shares in Wybalena Limited were held by three individuals who were also directors of Myer, which was also related to Wybalena. In addition, each individual's share constituted not less than 10% of the nominal value of the issued share capital of Wybalena. Another company in the Myer group, Myer Finance Limited ("Myer Finance") also had the same shareholding. Myer Finance was going to finance the takeover by lending funds to Wybalena. Although the breaches of section 230 were relatively clear, the alleged breach of section 129 was not so clear. But it was held that there was a prima facie breach of the section. However, given the urgency of the matter (it had been intended to send the offers to the holders of stock units in Grace Bros the day before the hearing), the court invoked section 129(10) of the Code and the breaches of each of section 129 and section 230 were overcome by undertakings given on behalf of the defendants. The terms of the undertakings required additional information to be provided to the stockholders in Grace Bros.

A cautionary tale

Directors of a company will usually have power to bind the company by a guarantee given by them: Halsbury, Vol 20, para 137. They may also bind themselves personally by guarantee which they sign or adopt. Directors should, of course, exercise care when drafting the guarantee if the intention is that the guarantee is to bind the company and not the directors personally. One example of an imperfectly worded guarantee is Re Fletcher; ex parte Hanimex Pty Ltd (1984) 9 ACLR 30. Mr Fletcher, a director of five companies in a group, gave guarantees on behalf of the companies in the group. The letter continued:

> "Furthermore, the directors of all these companies hereby give directors' guarantees for all debts incurred by the above listed companies."

Fletcher signed the letter as director of the five companies. Four of the companies subsequently went into liquidation and the question arose whether Fletcher had given a personal guarantee. The trustee in bankruptcy took the view that they were not personal guarantees because the use of the adjective "directors" in the phrase "directors' guarantees" in the letter did not constitute a personal guarantee. However, it was held that they did amount to personal guarantees. The decision is instructive

also in that it indicates that even relatively uncertain language might nevertheless bind a guarantor.

Stock Exchange listing requirements

Stock Exchange listing requirements require information concerning guarantees: see, for example, section 2B(15a), the requirements for property trusts and sections 2C and 2E.