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GOUGH SQUARE CHAMBERS' CONSUMER CREDIT COLUMN: JANUARY 2017

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In the January column, Ruth Bala considers the interaction between guarantees and the consumer credit regime.

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INTERACTION BETWEEN GUARANTEES AND THE CONSUMER CREDIT REGIME

Guarantees are not "consumer credit agreements" in their own right, even where the guarantor is an "individual". However, where guarantees are given in relation to consumer credit agreements, the consumer credit regime may come into play.

Nature of suretyship

A contract of suretyship is an agreement by one party (known as the surety or guarantor) to guarantee the performance of the obligations of another party. In the context of credit, the party whose performance is guaranteed will be the debtor. This arrangement allows the creditor to look to the surety for payment in the event that it is unable to enforce its debt against the debtor, thereby reducing the lending risk for the creditor. The contract of suretyship may either be tripartite (with the creditor, debtor and surety all parties) or bipartite. If it is bipartite, the contract may either be between surety and debtor, or between surety and creditor.

Technically, only guarantees are contracts of suretyship, but the term "suretyship" is frequently used to cover both guarantees and indemnities. This looser approach is adopted by the Consumer Credit Act 1974 (CCA), which defines the term "surety" as covering "the person by whom any security is provided"; "security" is defined in turn as including both guarantees and indemnities (*section 189(1), CCA*).

The distinction between guarantees and indemnities is that in a contract of guarantee the surety assumes a secondary liability to answer for the debtor who remains primarily liable, whereas in a contract of indemnity the surety assumes a primary liability, either alone or jointly with the principal debtor (see, for example, *Marubeni Hong Kong and South China Ltd v Mongolia [2005] 1 W.L.R. 2497, at [20]*). In general, proof of default by the principal debtor is required before a guarantor becomes liable.

Often this distinction will be immaterial. However, the correct classification is important where an attack is made on the enforceability or extent of the obligations of the primary debtor. This is because the liability of a guarantor is normally co-extensive with the liability of the principal debtor, so that if the debtor is discharged the surety will also be discharged, whereas if the contract is one of indemnity, the surety is not necessarily discharged, depending on the drafting of the contract of suretyship.

Where a contract of suretyship falls outside the consumer credit regime, the only drafting formalities are that a guarantee must be in writing and signed by the guarantor (*section 4, Statute of Frauds Act 1677*). It can be deduced

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that these requirements only apply to guarantees, as section 4 refers to the primary liability lying with another person.

Guarantees are not themselves credit agreements

The contract of suretyship itself is not a credit agreement. In *Encyclopaedia of Consumer Credit Law (Sweet and Maxwell, Vol 1), 2-010*, the position is summarised thus:

> "...if A, at the request of B, guarantees the payment of B's debt (whether actual or prospective) to C, this does not constitute the provision of credit by A to B - even though, in a popular sense, A might be said to provide "financial accommodation" to B. There is no deferment of B's indebtedness to A and such is the case even though B undertakes to reimburse or indemnify A in the event that A is called upon to pay under the guarantee. In any event, the Act makes separate provision (Pt VIII) for security, including contracts of guarantee."

Accordingly, FCA authorisation is not required to enter into personal guarantees, as this activity does not constitute entering into regulated credit agreements.

Types of guarantees within scope of consumer credit regime

Certain types of contracts of suretyship are made subject to Part VIII of the CCA and are, to that extent, subject to the consumer credit regime.

Whether a guarantee is within scope of Part VIII depends on the classification of the principal agreement that the guarantee supports. The term "surety" incorporates the defined term "security" and this is limited to instruments that relate to "consumer credit agreements, consumer hire agreements or linked transactions" (*section 189(1), CCA*).

The reference to "consumer" credit agreements excludes guarantees supporting credit agreements where the debtor is a company, or another entity that is not an "individual" (cross-reference the definition of a "consumer credit agreement" in section 8 of the CCA). However, there is nothing to exclude guarantees supporting credit agreements with individual debtors where the guarantor is a corporate entity: the definition of "surety" uses the term "person" rather than "individual".

The definition of "security" does not refer to "regulated" agreements and therefore may catch a guarantee supporting an unregulated consumer credit agreement. The restraint on the application of the consumer credit regime is found instead within the individual sections of Part VIII, which impose obligations in respect of "securities provided in relation to regulated agreements".

Broadly speaking, therefore, guarantees supporting regulated credit agreements, regulated hire agreements or linked transactions will fall within the scope of Part VIII, whether or not the guarantor is a corporate entity.

Guarantees not provided at the "request" of the debtor (express or implied) are excluded from the regime (this is an element of the definition of "security"). It follows that if the creditor can prove that the principal debtor was unaware of the guarantee at the time it was entered, it will fall outside the scope of Part VIII.

A final point to note is that contracts of suretyship are expressly carved out of the definition of a "linked transaction" by virtue of the phrase "except [a transaction] for the provision of security" (section 19(1), CCA). This means that CCA provisions governing linked transactions are inapplicable to contracts of suretyship. However the definition of "security" includes guarantees provided in relation to linked transactions, for example, guarantees supporting the principal debtor's contract for the maintenance of goods. Such guarantees are not "linked transactions" in their own right, but they will still be "securities" for the purposes of the CCA.

For more information on linked transactions, see *Practice note, What is a regulated credit agreement?: Transactions linked to regulated credit agreements*.

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Formalities

I shall use the term "security" as shorthand for "a guarantee or indemnity provided in relation to a regulated credit agreement, a regulated hire agreement or a linked transaction". The form and content of securities is governed by section 105 of the CCA and the Consumer Credit (Guarantees and Indemnities) Regulations 1983 (*SI 1983/1556*). If a security is not expressed in writing in a form that complies with the Regulations, signed by the surety and provided together with the required copies, then it will be improperly executed and only enforceable on a court order (*section 105(4)-(7), CCA*).

If the application for an enforcement order is granted, the court may nonetheless reduce the sum payable by the surety (*section 127(2), CCA*). A much more severe sanction for non-compliance with formalities is also available: if an application for an enforcement order is dismissed on substantial grounds, then the security is treated as never having had effect and the creditor must repay any sums received on realisation of the security (*sections 105(8) and 106, CCA*).

To check compliance with formalities, the surety is able to obtain a copy of the regulated agreement, a copy of their contract of suretyship and a statement of account pursuant to sections 107-109 of the CCA.

Default notices

If the creditor wishes to enforce a contract of suretyship in relation to a regulated agreement, it must first serve a default notice on the principal debtor (*section 87(1)(e), CCA*). The creditor must also serve a copy of that default notice on the surety, otherwise the contract of suretyship will only be enforceable on a court order (*section 111, CCA*). On 19 January 2017, the FCA published final guidance (FG 17/1) on the circumstances in which it is necessary to serve a default notice on a guarantor before taking payment from them. Again, when granting an enforcement order, the court may reduce the sum payable by the surety (*section 127(2), CCA*). However, there is no provision here for the draconian "ineffective security" sanction in section 106 to be triggered.

If the creditor issues proceedings to enforce a regulated credit agreement, the surety must also be made a party, irrespective of whether the creditor is simultaneously seeking to enforce the contract of suretyship (*section 141(5), CCA*).

Control of unfairness

The "unfair relationship" provisions of the CCA are not confined to regulated credit agreements, but embrace most exempt credit agreements. As such, the "unfair relationship" provisions may also be of relevance to guarantees supporting unregulated credit agreements, even though such guarantees are outside the scope of Part VIII (*sections 140A(1) and (5) and 140C(6), CCA*).

Although contracts of suretyship are not "linked transactions", they are "related agreements" for the purposes of the "unfair relationship" provisions (*section 140C(4)(c), CCA*). This means that a relationship may be unfair because of any of the terms of the suretyship contract, or because of the way in which the creditor has enforced its rights thereunder (*section 140A(1), CCA*). Moreover, a surety may apply for an unfair relationship order in their own right and the relief granted by the court may involve the reimbursement of any sum paid by a surety, or the reduction of any sum so payable (*section 140B(1) and (2), CCA*).

However, the surety's limitation is that the court may only make an order under section 140B in respect of the principal credit agreement, and it is the relationship between the creditor and the debtor that must be unfair. If it is exclusively the relationship between the creditor and the surety that is unfair, then no order should be made.

Where the surety deals as a "consumer", an indemnity clause may also be attacked as an "unfair term" under the Consumer Rights Act 2015. This revokes and replaces section 4 of the Unfair Contract Terms Act 1977 for contracts of suretyship entered into after 1 October 2015. Whereas section 4 of the 1977 Act specifically addressed "unreasonable indemnity clauses", a surety has to rely on the general unfair terms provisions in the 2015 Act. If an indemnity clause is unfair, then it will not be binding on the surety and so the creditor will be unable to look to the surety for payment.

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KEY POINTS

- Guarantees are not consumer credit agreements in their own right, even where the guarantor is an individual. However, where guarantees are given in relation to consumer credit agreements, the consumer credit regime may come into play.
- FCA authorisation is not required to enter into personal guarantees, as this activity does not constitute entering into regulated credit agreements (see *Guarantees are not themselves credit agreements* above).
- Whether a guarantee is within the scope of Part VIII of the CCA depends on the classification of the principal agreement which the guarantee supports (see *Types of guarantees within scope of consumer credit regime* above).
- Broadly speaking, guarantees supporting regulated credit agreements, regulated hire agreements or linked transactions will fall within the scope of Part VIII of the CCA, whether or not the guarantor is a corporate entity (see *Types of guarantees within scope of consumer credit regime* above).=
- The consumer credit unfair relationship provisions may also be of relevance to guarantees supporting credit agreements with companies and other unregulated credit agreements (see *Control of unfairness* above).

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