Briefing

BURGES SALMON

Corporate Turnaround and Insolvency

Director guarantees and the family home – does a spouse have an equity of exoneration

Quite often directors will guarantee their companies' debts without realising that their home mortgage (from the same bank) will be wide enough to secure that guarantee liability. The case of *Day v Shaw* and another [2014] EWCH 36 raises the possibility that a director's spouse has a right to have her "share" of the house protected in the event of a sale.

The facts

Mr Shaw and his daughter were directors of a company which had borrowed money from a bank. In return, the directors had given personal guarantees for the company's debt. At the same time, Mr Shaw and his wife executed a charge in which they covenanted to pay all sums owing to the bank by the company. The company later went into liquidation and the daughter was made bankrupt.

Mr Day had lent money to both directors (father and daughter) which was not repaid. Day obtained judgment against the father and a charging order over Mr Shaw's share (only) of the matrimonial home. This case arose from an application to enforce that charging order. The matrimonial home was sold and the bank repaid, but the county court judge ruled that the wife was entitled to an "equity of exoneration", meaning that the bank should be repaid out of Mr Shaw's share in the home before any of his wife's share of the proceeds could be touched. In effect this meant that Mr Day's charging order was worthless as Mr Shaw's share of the proceeds had been exhausted by the bank. He appealed against the county court judge's decision.

The issues

The High Court had to decide whether the county court was wrong in treating Mr Shaw as being a "principal debtor" for the purposes of apportioning the proceeds of sale of the house, given that it was the underlying company which was the true borrower.

What did the court decide?

The court decided that the directors were the primary guarantors of the company's debt (partly due to issues of ownership and control of the company). Because of the mortgage they had given, Mr and Mrs Shaw were "sub-sureties" (i.e. they were not on an equal footing with the directors, but were a "backup" guarantor). Ordinarily, if Mr and Mrs Shaw had been called upon to pay the company's debt, they would have been entitled to an indemnity from the company. However the company's indemnity was worthless due to its liquidation. As a result of that fact, and their position as sub-sureties, the Shaws were entitled to an indemnity from the father and daughter (as primary guarantors).

Given that the daughter was bankrupt, that meant Mrs Shaw's indemnity had to come from her husband only. That right was not merely personal, but attached to their rights to the matrimonial home with priority over Day's charging order, meaning that Mrs Shaw had an "equity of exoneration" – in other words, that the debt to the bank had to be discharged from the husband's share first.

The court observed that had Mr Shaw and his daughter not granted a guarantee, however, the husband and wife would have been liable on an equal footing due to the covenant to pay under the mortgage.

What does this mean for practitioners?

There are a number of cases where souses will have either signed up to a joint mortgage of their home to back up a personal guarantee given by one of them. It may also be that (where a company borrows from the same bank which provides the directors' residential mortgage), the residential mortgage is wide enough to cover personal guarantee liabilities from the director spouse. This case throws up the prospect that – where one mortgaging spouse is not a director, shareholder or guarantor the underlying company's liabilities should be met from the director spouse's share of the proceeds of sale first. We are interested to see whether this proceeds to a higher court for a more decisive ruling.

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