Spotting the difference between guarantees and demand bonds

Introduction

Guarantees, demand bonds and letters of credit play a vital role in the smooth running of international and domestic trade agreements. However, although sometimes perceived as interchangeable, the precise nature of such instruments can have significant financial, commercial and credit implications for those that are party to them, and the fact that they are defined in a certain way will not always be conclusive.

A significant difference between these instruments relates to the circumstances under which the third party becomes liable and the conditionality of the instrument. Under a guarantee, for example, the third party guarantor is responsible for the payment of a debt. However, they will only be liable under the guarantee if the original debtor is liable – the liability of the guarantor is a secondary one. Establishing the original debtor’s liability may well take time, leading to delayed recovery by the creditor.

By contrast, under a demand or performance bond the third party’s liability to make payment is simply dependent on presentation of a demand and, in some cases, other documentation that will typically certify that certain events have taken place. Once the presentation has been made, the third party is obliged to make payment unless there is fraud. The question of whether the payment should rightly be made pursuant to the underlying contract is irrelevant and payment will be made immediately (subject to the terms of the bond). Fundamentally, determining the true nature of the instrument is a question of construction of the instrument in its commercial and contractual context.

The Commercial Court’s recent decision in the case of Wuhan Guoyu Logistics Group Co & Anr v Emporiki Bank of Greece SA [2012] EWHC 1715 (Comm) is the most recent judicial guidance on the subject. Taking that case as our reference, this briefing will consider the differences between these instruments, what practical implications these differences have to those
using them, and how to identify the true nature of such an instrument in its relevant context.

**Background**

The background to the decision concerned a shipbuilding contract under which the claimants, joint operators of a shipyard in the People’s Republic of China, had agreed to construct a bulk carrier. The contract price of the vessel was to be paid in instalments, with the second instalment payable on receipt by the buyer of a “Refund Guarantee” issued by the claimant’s bank, together with a certificate of the cutting of the first steel plate of the vessel. In turn, the buyer was to give a “Payment Guarantee” in respect of the second instalment.

At the end of December 2007 the Payment Guarantee was issued by the defendant bank (the Bank), which provided finance to the buyer and to which the buyer had assigned all claims under the shipbuilding contract and the refund guarantee. The first cutting of steel was said to have taken place in April 2009 and the claimants’ bank issued a Refund Guarantee. However, the buyer disputed whether the steel cutting had taken place and did not make the second instalment. The issues relating to whether the second instalment was in fact due will be determined at an arbitration later this year. In the meantime, the claimants made a demand for payment under the Payment Guarantee.

**A guarantee or a demand bond?**

Before Mr Justice Christopher Clarke, the claimants contended that, despite its label, the Payment Guarantee was in the nature of a demand or performance bond, whereas the Bank argued the instrument was properly called a guarantee. The labels attached to such instruments are often confusing and not necessarily accurate – in addition to those used in this case, these instruments may also be referred to as demand guarantees, performance guarantees (which are frequently used in construction projects) or independent guarantees. In some cases these labels are used interchangeably.

Standby letters of credit operate in a similar manner to demand or performance bonds, and in the UK are mainly used in relation to international trade. They can be distinguished from documentary credits, which are more commonly used as a means of making payment rather than as a form of security.

Although it is possible to identify from previous authority certain criteria that may indicate whether an instrument is a guarantee or demand bond, in this case Mr Justice Christopher Clarke warned that the answer to the question cannot be given by a tick box approach. The same factors may have different significance from case to case and few factors are likely to be decisive if taken in isolation.

Nevertheless, the judge did consider the authorities in this area, from which a number of conclusions can be drawn, including:

- The use of the word “guarantee” to describe the instrument is not determinative;
- If the undertaking of the bank is to pay on “first written demand” supported by a particular declaration as the only condition of payment, the instrument is likely to be treated as an obligation to pay regardless of the underlying position (ie, as a demand bond);
- Although there is a presumption that, if performance is conditional on documents rather than facts, the instrument will be construed as a demand bond, that presumption is not irrebuttable;
Reference to the purpose of the instrument does not necessarily mean that the instrument will be construed as a guarantee;

A clause providing that certain evidence will be “conclusive evidence” that the sum demanded was due, may be decisive that the instrument is a demand bond and no further enquiry into liability is required;

There is a strong presumption against deeds of guarantee being treated as demand bonds outside the banking context; accordingly, a parent company’s support of its subsidiary is more likely to be construed as a guarantee creating secondary liability, allowing the guarantor to rely on all the defences and rights of its subsidiary to challenge the claim being made by the beneficiary of the guarantee, than a bank’s obligation to meet an obligation on demand, especially where the bank has no other connection with the transaction; and

The existence of an “as primary obligor and not merely as surety” clause does not automatically mean that an instrument is not a guarantee.

Decision
In this case, Mr Justice Christopher Clarke found in favour of the Bank, concluding that the Payment Guarantee was, in law, a guarantee.

Carefully analysing the language of the instrument, the judge noted that it was continuously referred to as a guarantee, and used the classic language of a guarantee. The Bank’s undertaking under the instrument was the liability of a guarantor in respect of the second instalment, and not simply to agree to pay on demand the second instalment if not paid by the buyer. Although the instrument did have some features of a demand bond, including a provision for immediate payment on first written demand, in the context of the rest of the instrument this was not inconsistent with it being construed as a guarantee. Further, the instrument’s phraseology in referring to the obligation for which security was being given (ie, the purpose of the instrument) went far beyond what was needed to simply identify the obligation for which security was being given.

In considering the contractual context, Mr Justice Christopher Clarke did not find that this provided any particularly sure guide to the correct interpretation of the instrument in question. As the defendant submitted, there may be a spectrum of circumstances in which such instruments fall to be considered, with instruments called guarantees issued by persons other than banks and financial institutions being commonly regarded as guarantees and instruments issued by banks being more readily construed as demand bonds. However, the judge pointed out that while banks may be used to providing demand bonds, they also provide guarantees. Although banks may be more likely to issue demand bonds in circumstances where they have little knowledge of the underlying transaction and the court should not be surprised to find that a bank accepts those obligations, in this case the Bank was closely linked with the underlying contract and thus it could not be said that the Bank would not have wanted to be concerned with whether the second instalment was truly due.

Conclusion
As Mr Justice Christopher Clarke stated, it is "of critical importance to decide into which category any given instrument falls". The fact that, in this case, the instrument was determined to be a guarantee rather than a demand bond means that the claimants will have to wait until they can establish that the second instalment on the vessel fell due before being able to recover against the Bank. That may well take some time, and in the current economic climate it is all too obvious what the risks of delaying recovery are.
Such instruments play a common role in both domestic and international trade, and this case emphasises the great importance of ensuring that the instrument’s terms are sufficiently clear and that parties do not simply rely on the presumption that banks will normally be more likely to enter into demand bonds than guarantees. Some helpful words of advice can be taken from Mr Justice Christopher Clarke’s final comments on the issue: “[if the claimants] wanted the additional security of a demand bond I would have expected it (i) not to use what was (a) described as, (b) took the form and used the language of, and (c) included provisions habitually found in, a guarantee; and (ii) to have used, instead, appropriate... language to make it clear that that was so.”

Should you like to discuss any of the issues raised in this briefing, please get in touch with a member of our team below, or your regular contact at Watson, Farley & Williams.

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