MAKING DEMANDS OF PARENTS – INTERPRETING SEE-TO-IT AND ON-DEMAND GUARANTEES

4 JUNE 2020 • ARTICLE

Guarantees are a significant feature in almost all transactions involving international trade. They may be given by banks, parent companies or other third parties. Whether these instruments should be "see-to-it" or "on-demand" guarantees ought to be given careful consideration when negotiating a transaction. This is particularly important where a business depends upon good cash flow, where a party is taking on sizeable credit exposure and/or contracting with a special purpose company. As set out below, while these considerations are especially relevant in a shipbuilding context, they also apply to many other businesses.

On-demand guarantees arguably provide more effective security for taking on risk, as access to the funds guaranteed is, in theory, relatively straightforward. The reason for this is that on-demand guarantees are autonomous of the underlying contract and impose a primary liability upon the guarantor to make payment when a demand is made that complies with the formalities under the guarantee. By contrast, see-to-it guarantees impose only a secondary liability contingent upon the extent to which the principal is liable under the underlying contract.

> "The principal issue in this case was whether the guarantee was characterised as an on-demand or a see-to-it guarantee."

Determining which category a guarantee falls into has been the subject of much judicial consideration over the years, and the latest English judgment on this matter is *Shanghai Shipyard Co. Ltd. v Reignwood International Investment (Group) Company Limited & Ors*[1], in which the Commercial Court revisited the principles established in *Wuhan Guoyo Logistics Group v Emporiki Bank of Greece*[2]. Of particular interest in this latest decision was the emphasis given to the question of whether the instrument was issued by a financial institution to determine whether it was an on-demand guarantee.

BACKGROUND

Shanghai Shipyard Co. Ltd, as Builder, was the beneficiary of a "guarantee" provided to it by Reignwood International Investment (Group) Company Limited ("the Guarantor") dated 17 November 2011. The guarantee was provided in relation to a shipbuilding contract entered between the Builder and the Buyer, an indirect subsidiary of the Guarantor, who was an SPV. The purpose of the guarantee was to secure payment of the final instalment for the vessel due from the Buyer to the Builder of US$170m.

The guarantee provided that in the event of such default, the Builder could demand the sum from the Guarantor, who was obliged to pay it immediately on receipt of the demand. However, the guarantee also provided that if there was a dispute between the Buyer and Builder as to the Buyer's liability to pay the final instalment, and the dispute was referred to arbitration, the Guarantor could withhold payment of the guarantee until the outcome of the arbitration.

The Buyer refused to take delivery of the vessel or to pay the final instalment. A dispute ensued between the Builder and the Buyer over whether the final instalment was payable, and the Builder proceeded to make a demand under the guarantee. The Guarantor refused payment pending the outcome of arbitration between the Builder and the Buyer.

The principal issue in this case was whether the guarantee was characterised as an on-demand or a see-to-it guarantee.

THE PRESUMPTION ESTABLISHED IN WUHAN LOGISTICS

The Court of Appeal decision in *Wuhan Logistics* is the leading judgment on characterising on-demand guarantees. Longmore LJ explained that determining this issue ultimately depends upon the language used within the instrument, but that if the relevant instrument satisfies four criteria then there will be a presumption that the guarantee is on-demand (referred to by Longmore LJ as "Paget's presumption" as the criteria had already been suggested in Paget's Law of Banking). The four criteria require that the instrument:

- relates to an underlying transaction between the parties in different jurisdictions;
- is issued by a bank;
- contains an undertaking to pay 'on demand' (with or without the words 'first' and/or 'written')[3]; and
- does not contain clauses excluding or limiting the defences available to a guarantor.

THE DECISION

In *Shanghai Shipyard* Robin Knowles J highlighted the importance of approaching the language of the guarantee in line with the guidance given by the Court of Appeal in *Wuhan Logistics*. In particular, he reiterated that a consistency of approach by the courts would allow all parties to know where they stand. However, he also emphasised that "Paget's presumption" was not intended to be a tick box exercise against each of the four elements but should instead be used to help reach an understanding of the nature of the instrument in question.

In this case, the guarantee was given by a parent company, albeit one which had described itself, in other proceedings in Singapore, as offering investment services. Further, at the hearing the Builder's counsel emphasised that in the shipbuilding industry, the function of a guarantee can be the same whether issued by a bank or a parent company. Although the judge accepted that there was some force in this submission, he focussed on the fact that the guarantee had not been issued by a bank and that as a result it fell outside of the presumption. He noted that the current edition of Paget's textbook has added the words "*or other financial institution*" to element (ii) of the presumption and that the presumption for an on-demand guarantee has been held to apply to a bond issued by an insurance company in the ordinary course of its business. However, Robin Knowles J did not consider that these "amplifications" of element (ii) applied in this case.

The judge went on to hold that the fact that an instrument was not issued by a bank, financial institution or insurance company in the ordinary course of its business was material and that this was underlined by the fact that the three remaining elements of the presumption did not necessarily form a powerful combination.

Lastly, applying further commentary from Paget's textbook, Robin Knowles J stated that where an instrument is not given by a bank or other financial institution, "cogent indications" that the instrument was intended to operate as an on-demand guarantee will be required. Robin Knowles J held that in this case the guarantee lacked indications of the strength or quality required to meet this "cogent indications" threshold.

COMMENT

"This case suggests that the bar has been raised for establishing that an instrument issued outside of the banking context is an on-demand guarantee."

This case suggests that the bar has been raised for establishing that an instrument issued outside of the banking context is an on-demand guarantee. The guarantee in this case was couched in language indicative of a primary obligation, with reference to the underlying contract arguably only inserted for indicating the circumstances pursuant to which the guarantee applies. It also had an undertaking to pay on demand. Yet, this wording did not play a significant part in Robin Knowles J's analysis.

Further, this case also highlights that it is not enough for an instrument to be issued by a "*bank or other financial institution*", but that such entity must be acting in the ordinary course of its business in doing so. As above, Robin Knowles J recognised that in another case a bond issued by an insurance company in the ordinary course of its business would satisfy element (ii) of the presumption. However, in this case, although the Guarantor had described itself as providing investment services, Robin Knowles J stated that "*even taking that into account the context here is not, or at least is not squarely, a banking context*". There may nevertheless exist some uncertainty as to what will be deemed a "banking context".

There are important consequences of this decision. Beneficiaries of parent company guarantees (or third party guarantees given by entities who are not banks or other financial institutions acting in the ordinary course of their business) may find that guarantees they consider to be payable on-demand do not in fact bestow a primary liability on the guarantor. This will be significant if credit exposure analysis has been premised upon there being an on-demand guarantee.

Going forward, if a party wishes to benefit from an on-demand guarantee, it should give careful consideration to whether the party issuing the guarantee should be a "*bank or other financial institution*" acting in the ordinary course of business. In the event that it is not possible or too costly for the guaranteed party to obtain a bank guarantee, then very careful drafting will be required to ensure that the parties' intentions are properly reflected in the documentation and efforts made to provide "cogent indications" that the instrument is an on-demand guarantee.

[1] [2020] EWHC 803 (Comm)

[2] [2014] 1 Lloyd's Rep 266

[3] As to which see our briefing on the decision in *Autoridad del Canal de Panama v Sacyr CA* [2017] EWHC 2228 (Ch), where it was observed by Blair J that: "What the instrument is labelled, the incorporation of terms such as a principal debtor clause, or terms imposing primary liability, both of which are very common in guarantees of all kinds, and the use of words such as "on demand", may be of limited value in determining its legal nature."

Trainee James Burgess also contributed to this article.

KEY CONTACTS

ANDREW HUTCHEON
PARTNER • LONDON

T: +44 20 7814 8049

ahutcheon@wfw.com

JEMMA DHILLON
SENIOR ASSOCIATE • LONDON

T: +44 20 7863 8943

jdhillon@wfw.com