

UNCLEAR SURETY INSTRUMENTS GUARANTEE TROUBLE?

12 OCTOBER 2017 • ARTICLE



AUTORIDAD DEL CANAL DE PANAMÁ V SACYR, SA & ORS (1)

Guarantees and on demand bonds are the lifeblood of international trade, and nowhere is this truer than in the construction sector, where cash flow is critical. Therefore the courts' approach to the interpretation of such instruments will be of interest to all potential issuers and beneficiaries.

In its recent judgment in the case of *Autoridad del Canal de Panamá v Sacyr, SA & Ors*, the Commercial Court revisited the principles which will be used to determine how these instruments are construed. Here, an employer's application for summary judgment rested on the English court's interpretation of certain "advance payment guarantees" and its decision as to whether they should be construed as on demand bonds (by which the issuer assumed a primary obligation to pay the beneficiary on demand) or see to it guarantees (whereby the issuers' obligations were contingent on liabilities actually arising out of the underlying contract).

This briefing note will examine the reasoning behind the Commercial Court's judgment and its significance for the drafting of surety documents, particularly in complex construction projects.

BACKGROUND

In 2009, a Panamanian public corporation engaged in the widening of the Panama Canal (the "Employer") contracted with a consortium of mostly European companies (the "Defendants") to design and construct a set of locks (the "Contract"). The Defendants later assigned their obligations under the Contract to a Panamanian vehicle (the "Contractor").

The Contract was subject to Panamanian law and provided for disputes to be resolved by ICC arbitration seated in Miami. The Defendants also entered into joint and several guarantees of the Contractor's obligations under the Contract, which were, again, governed by Panamanian law and subject to Miami-seated ICC arbitration provisions.

Unfortunately, the Contractor experienced cash flow difficulties and so the Employer made various payment advances to it, secured by instruments described as advance payment guarantees from the Defendants. Again, the guarantees were subject to Panamanian law and Miami-seated ICC arbitration.

In June 2015, the Contractor and the Employer entered into a further advance payment agreement. However, in contrast to the previous occasions, the latest advance payment guarantees (the “APGs”) procured by the defendants were subject to English law and the exclusive jurisdiction of the English courts. The final repayment date for the advance payments secured by the APGs was 31 December 2016, although the underlying advance payment agreement incorporated in the Contract envisaged the possibility of a further extension to that deadline upon the provision of further security (namely, a letter of credit).

The Contractor was unable to obtain a letter of credit and the Employer brought English Commercial Court proceedings against the Defendants, seeking a declaration that it was entitled to make demands for circa US\$290m (plus interest) under the APGs in the event that the advance payments remained unpaid after the 31 December 2016 deadline, contending that the APGs should be construed as on demand bonds.

THE DIFFERENCE BETWEEN ON DEMAND BONDS AND SEE TO IT GUARANTEES IN THE CONTEXT OF CONSTRUCTION PROJECTS

On demand bonds and see to it guarantees (also referred to as conditional bonds) are common in construction projects. Their purpose is to protect the Employer against a contractor’s non-performance of the underlying contract.

The main difference between on demand bonds and see to it guarantees is that the liabilities under the latter are coextensive with the liabilities of the principal debtor. The beneficiary of a see to it guarantee must therefore evidence the contractor’s breach of the underlying construction contract and the loss suffered as a consequence in order to have recourse to the funds which are the subject of the guarantee.

By comparison, an on demand bond places a primary obligation on the issuer to pay. Importantly, the beneficiary of the bond does not need to prove any breach of contract or loss in order to obtain recourse to the funds. All that is customarily required to trigger immediate payment under the bond is a demand by the beneficiary made in accordance with the bond stating that the contractor is in breach of the underlying contract. A call, and the requisite payment under an on demand bond, will be very difficult for the contractor to restrain or the issuer to resist except in cases of fraud. The purpose of such bonds is to provide a readily accessible source of funds to the beneficiary.

THE DECISION

When assessing the proper interpretation of the APGs, Mr Justice Blair noted:

1. In contrast to a guarantee, an on demand bond is, in principle, autonomous from the underlying contract. For that reason, the courts have previously likened an on demand bond to a letter of credit;
2. The courts will pay greater attention to the substance rather than the form of instruments such as. Essentially the court will consider whether the instrument is effectively payable on demand. Mr Justice Blair noted that even terms such as “principal debtor” or “on demand” may be of limited value when determining their legal nature. Simply labelling an instrument in a particular way will not mean that the court will construe it accordingly;
3. The court will approach the task of construing an instrument by looking at it as a whole “without any preconceptions as to what it is”;

4. However, it was confirmed (following *Marubeni Hong Kong and South China Ltd v Mongolian Government* (2)), that the nature of the party giving the guarantee is In this case the judge noted that there is a presumption against construing an instrument as an on demand bond unless the issuer is a financial institution. Similarly, a presumption exists that instruments issued by financial institutions, relating to a transaction between parties in different jurisdictions and containing the words “on demand” will be construed as an on demand bond (*Wuhan Guoyu Logistics Group Co Ltd v Emporiki Bank of Greece SA* (3));
5. Whilst not necessarily a significant factor, the presence of “protective clauses” (i.e. which exclude or limit the defences available to a guarantor) have sometimes been treated as indicative of guarantee liability (because such clauses are unnecessary in on demand bonds). Equally, the absence of “protective clauses” may be a pointer to the instrument being an on demand instrument;
6. “Conclusive evidence” clauses which, if effective, require payment against certification by the beneficiary, are likely to be inconsistent with the need for the beneficiary to establish liability of the principal debtor in order to enforce the However, such clauses should be strictly construed with any ambiguity resolved in favour of the guarantor; and
7. Where they have been incorporated in the instrument, the ICC Uniform Rules for Demand Guarantees (URDG) are likely to be determinative in categorising surety instruments.

In this case the Defendants drew attention to the similarity in the drafting between the APGs and the earlier Panamanian law guarantees. There was no suggestion that the Panamanian guarantees were unconditional on demand bonds and Mr Justice Blair accepted that it was inherently unlikely that the objective intention of the parties was that the same language should create a radically different liability in the APGs.

Moreover, whilst the APGs labelled the Defendants as “primary obligor and not as surety”, the court questioned the substance of this primary liability and whether it amounted to on demand liability. Mr Justice Blair noted that the wording “payment... as and when due pursuant to the contract” was particularly convincing in determining that the Defendants’ liabilities were coextensive with the contract.

Additionally, the APGs provided that the Defendants would perform the Contractor’s obligations “in the same manner that [the Contractor is] required to perform such obligations according to the terms of the contract”. This language did not suggest an on demand liability but rather expressly referred the guarantors’ obligations to performance of the underlying contract by the principal debtor according to its terms. Thus, the APGs did not confer the right for the Employer to declare the Defendant’s repayments due on demand, and the summary judgment application failed.

EXCLUSIVE JURISDICTION UNDER SECTION 9 OF THE ARBITRATION ACT

The Defendants had also applied to stay proceedings under section 9 of the Arbitration Act 1996, on the basis that the primary issue under the APGs was whether the sums secured by the APGs were due and payable as a consequence of breach of the underlying contract, which was subject to arbitration under that contract and the Panamanian law guarantees. Section 9 provides that:

A party to an arbitration agreement against whom legal proceedings are brought ... in respect of a matter which under the agreement is to be referred to arbitration may ... apply to the court in which the proceedings have been brought to stay the proceedings so far as they concern that matter.

While the Defendants claimed that in order to rule on their APG liability, the court would inevitably have to look into the ‘matter’ of whether or not the payments were due, which was the subject of the arbitration, the Employer argued that the sole ‘matter’ at issue was whether the Defendants were liable under the English law APGs and so could be determined by the English court.

In the absence of English precedent on the meaning of “matter” in section 9, Mr Justice Blair looked to other jurisdictions (4) advocating a “practical and common-sense inquiry” as to the “substance of the controversy” or “the essential nature of the claim”. On that basis, he held that in this case the “matter” in respect of which the proceedings were brought was the claim under the APGs. This matter fell within the English law exclusive jurisdiction clause and was not a matter which the parties had agreed to refer to arbitration, and accordingly the application under section 9 failed.

CONCLUSION

Although in this case the Employer was successful in establishing that the English court had jurisdiction, it was something of a pyrrhic victory in light of the decision that the APGs were seen to it guarantees rather than on demand bonds, which will thus necessitate it proving that the advance payments are due and payable pursuant to the underlying construction contract before being reimbursed.

The case highlights the importance of drafting surety instruments clearly and concisely. An aspiration for crystal clear drafting may be at odds with the commercial reality that surety instruments are likely to be heavily negotiated, increasing the scope for inconsistencies. However, parties should nevertheless be cognisant of the fact that if they intend to create on demand instruments, they should avoid any references to guarantees or underlying contracts and that, should uncertainty remain, the courts will look beyond the labelling of surety instruments to construe them in accordance with their substance as a whole.

Additionally this case demonstrates the care that needs to be taken in ensuring consistency in choice of law and jurisdiction clauses across all contract documents. Just because an underlying contract provides for disputes to be resolved by arbitration, it does not mean that future related claims and cross-claims subject to varying dispute resolution provisions will be bound by the initial preference for arbitration. Given that issues may overlap across different claims and forums there is potential for inconsistent decisions. Parties keen to resolve disputes by arbitration should therefore avoid making variations and subsequent agreements subject to alternative dispute resolution provisions. In large scale projects such as this, it is therefore advisable that parties agree uniform dispute resolution provisions at the outset and apply these consistently across all relevant contract documents.

1 [2017] EWHC 2228 (Comm)

2 [2005] 1 WLR 2497

3 [2012] EWCA Civ 1679, as to which see our briefing note of January 2013

4 Including the decision of the Singapore Court of Appeal in *Tomolugen Holdings Ltd v Silica Investors Ltd* [2015] SGCA 57 and the High Court of Australia in *Tanning Research Laboratories Inc v O'Brien* (1990) 91 ALR 180

KEY CONTACTS



REBECCA WILLIAMS

PARTNER • LONDON

T: +44 203 036 9805

rwilliams@wfw.com

DISCLAIMER

Watson Farley & Williams is a sector specialist international law firm with a focus on the energy, infrastructure and transport sectors. With offices in Athens, Bangkok, Dubai, Dusseldorf, Frankfurt, Hamburg, Hanoi, Hong Kong, London, Madrid, Milan, Munich, New York, Paris, Rome, Seoul, Singapore, Sydney and Tokyo our 700+ lawyers work as integrated teams to provide practical, commercially focussed advice to our clients around the world.

All references to 'Watson Farley & Williams', 'WFW' and 'the firm' in this document mean Watson Farley & Williams LLP and/or its affiliated entities. Any reference to a 'partner' means a member of Watson Farley & Williams LLP, or a member, partner, employee or consultant with equivalent standing and qualification in WFW Affiliated Entities. A list of members of Watson Farley & Williams LLP and their professional qualifications is open to inspection on request.

Watson Farley & Williams LLP is a limited liability partnership registered in England and Wales with registered number OC312252. It is authorised and regulated by the Solicitors Regulation Authority and its members are solicitors or registered foreign lawyers.

The information provided in this publication (the "Information") is for general and illustrative purposes only and it is not intended to provide advice whether that advice is financial, legal, accounting, tax or any other type of advice, and should not be relied upon in that regard. While every reasonable effort is made to ensure that the Information provided is accurate at the time of publication, no representation or warranty, express or implied, is made as to the accuracy, timeliness, completeness, validity or currency of the Information and WFW assume no responsibility to you or any third party for the consequences of any errors or omissions. To the maximum extent permitted by law, WFW shall not be liable for indirect or consequential loss or damage, including without limitation any loss or damage whatsoever arising from any use of this publication or the Information.

This publication constitutes attorney advertising.