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It's an on-demand bond, isn't it?

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What's in a name?

It has been said that a name is an artificial and meaningless convention. What matters is what something is, not what it is called. The same is true in the world of guarantees and on-demand bonds.

In our client alert of 17 May 2011, we looked at the need for demands to comply strictly with the terms of on-demand bonds. This alert considers the fundamental question as to whether the security instrument you thought was an on-demand bond is actually a guarantee or vice versa.

To recap, the idea is that with guarantees, particular conditions, such as the seller's default, need to be established before the secondary obligation to pay has to be fulfilled, whereas, with on-demand bonds payment has to be made if the demand is in compliance with the terms of the bond.

Although labels given by parties to an instrument may be indicative of their intentions, the substance of the obligations will depend upon the actual words used to express them. Two English High Court cases from last year, one of which has recently been affirmed by the Court of Appeal, emphasise the risks to parties of imprecisely worded guarantees and on-demand bonds, and highlight the approach adopted when construing such documents.

Vossloh Aktiengesellschaft v Alpha Trains (UK) Ltd [2010] EWHC 2443 (Ch)

The facts of the case

Vossloh Aktiengesellschaft ("VAG") was a manufacturer and supplier of trains. Alpha, a train operator, entered into a series of contracts with VAG's subsidiaries, under which those subsidiaries would manufacture, operate and service trains in accordance with Alpha's orders. VAG gave a parent company guarantee ("PCG") to Alpha in relation to the obligations of its subsidiaries.

Alpha complained that a large number of trains supplied were defective. VAG and its subsidiaries denied the defects, which became the subject of separate legal proceedings in which both liability and quantum were in issue. Alpha submitted a claim in excess of €17 million under the PCG to VAG in respect of losses which it claimed it had suffered as a result of the defects. Approximately €2.5 million of that sum was found to represent amounts actually incurred by Alpha in buying alternative trains or making compensation for payments to customers. The balance of €14.5 million represented an estimation of Alpha's costs of repairing the trains.

The parties' arguments

Alpha sought this money from VAG under the PCG on the basis that VAG's liability under it was in the nature of an on-demand bond, in that it constituted an unconditional independent promise to pay on demand all amounts demanded. Alpha placed reliance on the fact that: (i) VAG's contractual obligations under the PCG were entered into *"as a principal debtor and not merely as a surety, as a separate, continuing and primary obligation..."* which showed it was a primary and not secondary obligation; (ii) the payment clause of the PCG uses the phrase "all sums payable hereunder shall be paid on demand"; and (iii) save for manifest error, the beneficiary's certificate of the amount due is to be *"conclusive evidence of such amount"*.

VAG's argument in response was that key provisions of the PCG were expressed as secondary obligations which assumed there has been a default on the part of one of VAG's subsidiaries in performing the underlying contract. Therefore, the PCG cannot be construed as giving rise to any liability to pay against a mere assertion of breach. VAG further argued that little significance should be attached to the phrase *"all sums payable hereunder shall be paid on demand"*, which related to the liability which arises under the PCG. By contrast, in on-demand bonds, the demand is critical because it is that which triggers liability. The relevant clause does not seek to do this.

The court's decision

The question for the court was whether the liability assumed by VAG for its subsidiaries under the PCG was triggered by the demand or whether, in addition to the demand, it was necessary to demonstrate the existence of a default by its subsidiaries. The court found "context" was important when deciding the particular nature of the obligation in the guarantee, as even minor variations in language, plus a different context, could produce different results.

An on-demand bond was a particularly stringent contract, developed by the banking world for its commercial customers, which the courts have accepted as equivalent to irrevocable letters of credit. In a case outside the banking context and in the absence of language which contained an overt indication of an intention to create an on-demand bond, a strong presumption arose against the existence of such an obligation.

The court held that the presumption against the finding of an on-demand bond applied in favour of VAG. There was nothing in the context or the wording of the PCG which was sufficient to rebut that presumption.

One of the critical factors which the court found supported the presumption that the PCG was not an on-demand bond, was that all of VAG's obligations were premised upon a failure of performance of an underlying obligation on the part of its subsidiaries. It found that the intention of the guarantee was to make good the loss suffered by Alpha as a result of breaches of VAG's subsidiaries. The payment obligation under the PCG was, therefore, conditional upon proof of that loss and not merely on-demand.

Meritz Fire & Marine Insurance Co Ltd v Jan de Nul NV [2010] EWHC 3362 (Comm)

The facts of the case

Jan de Nul, a dredging company, entered into three shipbuilding contracts with Korean shipbuilding company, Huen Woo Steel Co Ltd ("HWS"). The contracts required HWS to provide advance payment guarantees ("APGs"). Meritz, an insurance company, issued the APGs to Jan de Nul.

HWS subsequently merged with Xxien Environmental Company ("XEC"). The merged company was renamed Buyoung Heavy Industries Co Ltd ("Buyoung"). Buyoung informed Meritz and Jan de Nul of the merger, stating that all HWS's rights and obligations under the three shipbuilding contracts *"are to be transferred"*. Buyoung subsequently partitioned its business and transferred its shipbuilding to a newly incorporated company, Asia Heavy Industries Co Ltd ("Asia Heavy").

Asia Heavy ran into financial difficulties. Jan de Nul terminated its contracts and sought the refund of all advance payments made, and the return of all owner-supplied items, to Asia Heavy. Asia Heavy was subsequently declared bankrupt. Jan de Nul demanded payment from Meritz under the APGs, whilst informing Buyoung it was under a joint and severable liability in respect of the shipbuilder's obligations to repay under the contracts.

The first instance decision of the High Court of December 2010 was appealed to the Court of Appeal whose decision was delivered last month.

The parties' arguments at first instance

Meritz argued that it was not liable to Jan de Nul under the APGs on the basis that: (i) the APGs were contracts of suretyship rather than on-demand bonds; (ii) it had been discharged from liability under the APGs as a result of material variations in the contracts and changes in the corporate identity of the shipbuilder; and (iii) as a result of the corporate changes, Jan de Nul was unable to make a contractual demand which triggered liability under the APGs.

In response, Jan de Nul argued that on a true construction of the instruments, the APGs were on-demand bonds and it was irrelevant which corporate entity failed to make the refund or whether there have been material variations to the shipbuilding contracts. It was further argued that even if the APGs were classic contracts of suretyship, in which Meritz's obligation as guarantor was secondary to the primary obligation of the principal debtor, there were no material variations in the shipbuilding contracts because those contracts expressly provided for changes in the delivery time of the vessels.

The High Court's decision

The court found that the APGs were in fact on-demand bonds on the basis they had three of the four attributes which would lead an instrument to be almost always construed as an on-demand bond. The three attributes were that: (i) the underlying transactions were between parties in different jurisdictions; (ii) the APGs did not contain clauses excluding or limiting the defences available in a classic guarantee where the surety's liability was secondary; and (iii) the undertaking was to pay on demand. Although the fourth attribute, namely, that an instrument was issued by a bank was not met, as Meritz was an insurance company, it was still providing financial instruments in return for a fee.

The court also found that because the APGs were subject to the Uniform Rules for Demand Guarantees of the International Chamber of Commerce ("URDG"), this was an indication that the parties regarded them as on-demand guarantees. Furthermore, the fact that the obligation to pay under the APGs was conditional upon the presentation of a specified document, rather than proof of the underlying facts, was an indication of primary liability under on-demand bonds.

The parties' arguments on appeal

The parties' arguments focused on the precise terms of the APGs and the effect of the transfer of the rights and obligations from HWS to Buyoung and then to Asia Heavy.

Meritz argued that: (i) it had guaranteed only the obligation of HWS to make repayment and, therefore, once the obligation of HWS had disappeared, the APGs no longer had any application; (ii) no demand in conformity with the underlying contract could be made, as required by the APG, once the "builder" was no longer HWS; and (iii) in reliance upon *Commercial Bank of Tasmania v Jones* [1893] AC 313, once a debtor has been released by the transfer of rights and obligations, the guarantor is discharged.

Jan de Nul argued that: (i) Meritz had promised to repay sums advanced to HWS, where HWS failed to do so; (ii) Meritz was bound to pay where, in the absence of fraud, the contract documents had been presented; and (iii) the principle in the *Commercial Bank of Tasmania* case did not apply, as it concerned a "see-to-it" guarantee (where proof of default under the underlying contract is required) and, in any event, only applied when the beneficiary was a voluntary party to the transfer of the rights and obligations.

The Court of Appeal's decision

The court observed in passing that Meritz's argument that the APGs were "see-to-it" guarantees was, as a result of the incorporation of the URDG, rightly rejected by the judge at first instance.

The court rejected Meritz's argument that it took on the risk of HWS's default, not the defaults of any persons who might be its successors. Under Korean law, Meritz had six months after HWS's transfer to Buyoung within which to object to the merger and the transfer of rights and obligations, but it failed to do so. In light of this, the court found that the APGs required a literal construction on the basis that they are to be operated against documents without regard to the underlying contract. Unless a notice of arbitration was served pursuant to the APG, which it was not, Jan de Nul was entitled to a refund of the advance payments. In the absence of that refund being made by HWS, repayment had to be made by Meritz.

The court also rejected Meritz's argument that Jan de Nul failed to make a demand in conformity with the underlying shipbuilding contract and the APG. It found that payment under the APG is to be made against documents and there is no requirement that any assertion in the documents is correct in law. The APGs simply required Jan de Nul to certify that the demand was made in conformity with the underlying contract and that the refund had not been made by HWS.

The court further found that the principle in the *Commercial Bank of Tasmania* case did not assist Meritz. That case was authority in relation to a traditional "see-to-it" guarantee, however, the questions whether the debtor is liable under the underlying contract are irrelevant to documents such as the APGs, where payment is to be made against documents. In such cases, if the documents are in order, the guarantor must pay.

For the above reasons, the Court of Appeal affirmed the first instance decision and dismissed Meritz's appeal.

What can we learn from these cases?

Whether a guarantee is in fact an on-demand bond, or vice versa, depends upon its wording. It is the substance of an instrument and not the terminology used to describe it that determines its nature.

Context is also important in determining the nature of the obligation under consideration. As a note of caution, even minor variations in language, plus a different context, can produce different results.

Where a guarantee is not given in a banking context and there is no clear wording indicating an intention to create an on-demand bond, there will be a presumption that the obligation under the particular document does not constitute an on-demand bond.

However, where a guarantee is expressed to be subject to the URDG, a court is likely to treat this as an indication that the parties regarded it as an on-demand bond.

The fact that the instrument makes reference to the contractual performance for which it is security, and the circumstances which constitute default, do not of themselves prevent it being an on-demand bond.

Finally, where payment under a guarantee is required to be made solely against the documents, there is no requirement that any assertion in the documents be correct in law.

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