UK DEFENCE CLUB

Soundings

What type of guarantee is it?

There are two main types of guarantee: "see to it" guarantees, where the guarantor is only liable to pay out if the underlying debtor is found liable to the creditor, and "demand" guarantees, where the guarantor is liable to pay out against the creditor's demand, irrespective of whether or not the underlying liability is proven. The difference can clearly be crucial for the party seeking to draw down on the guarantee as demonstrated in the recent case of Shanghai Shipyard Co. Ltd. v Reignwood International Investment (Group) Company Ltd [2020] EWHC 803 (Comm).

In this case, the English Commercial Court was asked to consider whether a parent guarantee given to a shipyard in respect of the final instalment payable under a shipbuilding contract was a "see to it" or "demand" guarantee.

The Court's decision

The Court applied the well-established approach in relation to guarantees in English law, namely that there is a presumption that guarantees not issued by banks, insurance companies or other financial institutions are "see to it" guarantees unless there are "cogent indications that the instrument was intended to operate as a demand guarantee".

The guarantee in this case was a parent company guarantee, not a guarantee issued by a financial institution, and there were no "cogent indications" that it was a "demand"

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guarantee. The Court therefore held that the parent company guarantee was a “see to it” guarantee. It followed that the parent company was not liable on the guarantee unless and until the shipyard established that the subsidiary was liable to it under the shipbuilding contract.

Consequences for parent company guarantees in the charterparty context

Where a parent company guarantees its subsidiary’s obligations under a charterparty, it is not acting as a financial institution. Accordingly, it is unlikely that such a parent company guarantee will be interpreted as a “demand” guarantee unless there are “cogent indications” to that effect. The parent company is only likely to be required to pay out once it is proved that the subsidiary was liable under the charterparty. It is unlikely to be required to pay out against a mere demand.

“Cogent indications”

Determining whether a guarantee is a “demand” guarantee can be difficult because there is significant commonality in the language used in the two different types of guarantee. In this case, although the guarantee stated that it was payable on the shipyard’s “first written demand” and that the parent company was liable as “primary obligor and not merely as the surety”, it is well-established that such language alone is not sufficient to determine that the document is a “demand” guarantee. The courts will require more “cogent indications”.

The wording and the individual guarantee will need to be considered in each case, but “cogent indications” may be found where the guarantee states explicitly that it is intended to respond to a mere demand, irrespective of whether the underlying debtor is liable to the creditor (and perhaps in some limited other cases).

Was the parent company required to pay out in the event that arbitration was commenced between the subsidiary and the shipyard?

The Court also considered a further issue that may be of interest to Members. In this case, clause 4 of the guarantee provided that, in the event that a dispute between the subsidiary and the shipyard “is submitted for arbitration”, the parent company should only be required to pay out against an arbitration award against the subsidiary. Such terms are quite common in guarantees, especially in the shipbuilding industry.

The shipyard had commenced proceedings in the English Commercial Court against the parent company under the guarantee in 2018, but it was not until June 2019 that arbitration was commenced between the subsidiary and the shipyard. The parent company nonetheless argued that a dispute between the subsidiary and the shipyard had been submitted for arbitration, and that it was not, therefore, required to pay out under the guarantee unless and until there was an arbitration award against its subsidiary. The shipyard, by contrast, argued that clause 4 only applied where arbitration had been commenced before a demand was made under the guarantee.

The Court rejected the shipyard’s arguments, holding that clause 4 applied “regardless of when such arbitration is or may be commenced”. It brushed aside a number of practical objections, namely that the commencement of arbitration could be used as a tactical device to delay payment under the guarantee and that it would be impractical if the shipyard were required to refund the parent company if arbitration were commenced after payment had been made under the guarantee.

Although the interpretation of each guarantee will depend on its individual terms, it therefore appears that, at least for the moment, there is unlikely to be any particular deadline for the commencement of arbitration for the purposes of a term such as clause 4. However, in light of possible practical difficulties, this may be revisited by a future court.

Conclusion

In summary, guarantees that are not issued by a bank are likely to be interpreted as “see to it” guarantees, rather than “demand” guarantees, unless there are “cogent indications” to the contrary. At least for the moment, terms that defer payment under a guarantee where arbitration is commenced do not require arbitration to have been commenced at any particular time, although this will be dependent on the wording of the individual guarantee.

The interpretation of guarantees is a fertile ground for dispute. Readers will recall, for example, our October, 2019 Soundings where similar issues were discussed in the context of “The Rubicon Vantage” case. The message remains that clear drafting is of paramount importance when it comes to guarantees.

Please contact the Managers for further advice on any of the issues discussed above.

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