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A simplified approach to distinguishing between guarantees and bonds?

By Jonathan Choo and Shaun Lee

The English Court of Appeal has sought to re-establish in *Wuhan Guoyu Logistics Group Co Ltd & Anor v Emporiki Bank of Greece SA*, [\[2012\] EWCA Civ 1629](#), a simpler and more streamlined test (presumption) for determining whether a so-called "Payment Guarantee" is actually a proper guarantee or more in the nature of an on demand bond.

In the decision below (see *Wuhan Guoyu Logistics Group Co Ltd & Ors v Emporiki Bank of Greece SA* [\[2012\] EWHC 1715](#) (Comm)), the learned judge decided that the payment guarantee was in fact a guarantee. It was thus open to the defendant bank to argue that it was not liable to make payment to the plaintiffs on the basis that no payment had become due pursuant to the underlying contract and therefore the bank not liable to make payment under the guarantee (see paragraph [1]).

The English Court of Appeal allowed the appeal by the plaintiffs.

There is an important distinction between a proper guarantee and an on-demand bond matters. If the so-called guarantee is in fact an on demand bond, then upon the presentation of the necessary documents,

"the [b]ank is obliged to pay, unless there is fraud. This is so even if there is a dispute as to whether the instalment is truly due. Liability arises from the instrument rather than the underlying contractual arrangement. An instrument of this kind is akin to a letter of credit in that the bank is concerned only to see whether or not the documents produced are those for which the instrument calls" (see paragraph [26] of the High Court decision).

The High Court noted in footnote 1 that should the bank refuse to make payment on an on-demand bond, the beneficiary is entitled to seek summary judgment for the sums due under the bond. The bank could only avoid a summary judgment against it if it could demonstrate that there was a real prospect that it could establish at trial that the fraud exception applied i.e. the only realistic inference was that the demand by the beneficiary was made fraudulently, see *Enka Insaat Ve Sanayi A.S. v Banca Popolare Dell'Alto Adige SPA* [\[2009\] EWHC 2410 \(Comm\)](#) per Teare J.

As the learned judge explained at [27], the commercial fight underlying the distinction is as follows:

"It is in the interest of a seller to secure a demand bond. He will then be assured of payment from the bank even though there is a dispute about whether the money is due. It is, or may be, in the interest of the bank - and the buyer who is being financed by the bank (who will probably have given it an indemnity) - to give a guarantee and not a bond. It will then only have to pay if the buyer should have paid; and it will avoid the risk, which may be

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significant, of paying a seller in a foreign country from whom it may in practice be difficult to secure repayment. This is particularly so if there is not in place an operative refund guarantee from another reputable bank. At the same time a guarantee may put the bank in difficulty because it may not be able to pay out safely if there is any dispute as to the existence of the obligation guaranteed".

The Problem

The English Court of Appeal noted that that the decision of the learned judge below was "an exhausting document. Entirely understandably he found it necessary, in order to resolve this question of construction, to cite no less than 20 authorities and deliver a judgment of 93 paragraphs. Beatson J needed to cite a similar number of authorities in Meritz v Jan de Nul [2011] 1 AER (Comm) 1049" (see paragraph [22]).

The Court of Appeal unanimously considered that "something ha[d] surely gone wrong if this comparatively simple question of construction require[d] such lengthy consideration" (see paragraph [22]). The problem as the learned law lords saw it was that "[i]t [wa]s a problem of our system of precedent, that as more and more cases g[ot] decided, it seem[ed] to be necessary for judges at first instance to consider each case and determine how near or how far the document in question differ[ed] from the document [which had been] construed in each past case".

The Facts

The plaintiffs jointly operated a shipyard and entered into a contract with two buyers for the construction, sale and purchase of two bulk carriers. Payment for the bulk carriers was to have been made by instalments. The defendant was a Greek bank which provided the buyers with the necessary financing for the purchase of the carriers. The defendant had also issued what was termed a "Payment Guarantee" to secure the payment of the second instalment by the buyers.

The material terms of the payment guarantee were as follows,

"DETAILS OF GUARANTEE

Dear Sirs,

1) In consideration of your entering into a Shipbuilding Contract dated 29th November 2006 ("the Shipbuilding Contract") with Tamassos Navigation Ltd as the buyer ("the BUYER") and WUHAN Guoyu Logistics Group CPM LTD and Yangzhou Guoyu Shipbuilding Co. Ltd as the seller ("the SELLER") for the construction of one (1) 57,000 Metric Tons Deadweight OEC known as YANGZHOU GUOYU SHIPBUILDING COMPANY LTD. HULL NO. GY404 ("the VESSEL"), we, EMPORIKI BANK OF GREECE SA, hereby IRREVOCABLY, ABSOLUTELY and UNCONDITIONALLY guarantee, as the primary obligor and not merely as the surety, the due and punctual payment by the BUYER of the 2nd

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instalment of the Contract Price amounting to a total sum of United States Dollars 10,312,500.00 (Ten million three hundred twelve thousand five hundred only) as specified in (2) below.

(2) The Instalment guaranteed hereunder, pursuant to the terms of the Shipbuilding Contract, comprises the 2nd instalment in the amount of U.S. Dollars 10,312,500.00 (Ten million three hundred twelve thousand five hundred only) payable by the BUYER within five (5) New York banking days after completion cutting of the first 300 MT of steel plate in your Seller's workshop and written notice thereof along with certificate of cutting of steel plate countersigned for approval by the Buyers representative.

(3) We also IRREVOCABLY, ABSOLUTELY and UNCONDITIONALLY guarantee, as primary obligor and not merely as surety, the due and punctual payment by the BUYER of interest on the second Instalment guaranteed hereunder at the rate equal to the three months US\$ LIBOR quoted on page no. 3750 of Telerate, 2 days before the date from which interest becomes effective, plus 1% margin, from and including the first day after the date of instalment in default until the date of full payment by us of such amount guaranteed hereunder.

(4) In the event that the BUYER fails to punctually pay the second Instalment guaranteed hereunder or the BUYER fails to pay any interest thereon, and any such default continues for a period of twenty (20) days, then, upon receipt by us of your first written demand stating that the Buyer has been in default of the payment obligation for twenty (20) days, we shall immediately pay to you or your assignee the unpaid 2nd Instalment, together with the Interest as specified in paragraph (3) hereof, without requesting you to take any or further action, procedure or step against the BUYER or with respect to any other security which you may hold.

(5) We hereby agree that at your option this Guarantee and the undertaking hereunder shall be assignable to the Bank of China Limited, Hubei Branch, 65 Huangshi Road, Wuhan City, Hubei 430013, the People's Republic of China.....

....
(7) Our obligations under this Guarantee shall not be affected or prejudiced by any disputes between you as the SELLER and the BUYER under the Shipbuilding Contract or by the SELLER's delay in the construction and/or delivery of the VESSEL due to whatever causes or by any variation or extension of their terms thereof or by any security or other indemnity now or hereafter held by you in respect thereof, or by any time or indulgence granted by you or any other person in connection therewith, or by any invalidity or unenforceability of the terms thereof, or by any act, omission, fact or circumstances whatsoever, which could or might, but for the foregoing, diminish in any way our obligations under this Guarantee.

...

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IN WITNESS WHEREOF, we have caused this Letter of Guarantee to be executed and delivered by our duly authorised representative the day and year above written."

The English Position

The English Court of Appeal noted that the confounding issue (as in all such cases) was that different factors in the payment guarantee pointed in different directions. Some pointed in favour of a reading that it was a guarantee (see paragraph [23]) and others in favour of a reading that it was in fact an on demand bond (see paragraph [24]).

However, the test for determining the nature of a guarantee could not be a checklist, i.e. just because there were 6 factors in favour of a guarantee reading and only 4 factors in favour of an on demand bond did not mean that the guarantee was in fact a proper guarantee as opposed to an on demand bond (see paragraph [25]).

Therefore, in the interest of lending "assistance" to "commercial men...in determining their obligations", the English Court of Appeal held that "while everything must in the end depend on the words actually used by the parties, there is nevertheless a presumption that, if certain elements are present in the document, the document will be construed in one way or another".

This presumption is stated by the learned authors of Paget's Law of Banking (11th ed.) (see paragraph [26]),

"Where an instrument (i) relates to an underlying transaction between the parties in different jurisdictions, (ii) is issued by a bank, (iii) contains an undertaking to pay "on demand" (with or without the words "first" and/or "written") and (iv) does not contain clauses excluding or limiting the defences available to a guarantor, it will almost always be construed as a demand guarantee.

...

In construing guarantees it must be remembered that a demand guarantee can hardly avoid making reference to the obligation for whose performance the guarantee is security. A bare promise to pay on demand without any reference to the principal's obligation would leave the principal even more exposed in the event of a fraudulent demand because there would be room for argument as to which obligations were being secured."

The English Court of Appeal went on to explain that this presumption was fully justified on the basis of various Court of Appeal authorities (see paragraphs [27] to [28]). Furthermore, the presumption in Paget's Law of Banking had also previously been approved by the Court of Appeal in *Gold Coast Ltd v Caja de Ahorros* [\[2002\] 1 Lloyd's Rep 617](#) (see paragraph [28]).

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Critically, in allowing the appeal, the Court of Appeal noted that such guarantees would be "*almost worthless if the [b]ank [could] resist payment on the basis that the foreign buyer is disputing whether a payment is due. That would be all the more so in a case such as the present when the [b]uyer can refuse to sign any certificate of approval which may be required by the underlying contract*" (see paragraph [29]).

Accordingly, the Court of Appeal held that the trial judge had erred by construing the guarantee as a proper guarantee and failed to "*have had much more regard to the presumption than he did*" (see paragraph [31]). The Court of Appeal also stressed that adopting the presumption was "*extremely important*" as it would promote "*a consistency of approach by the Courts, so that all parties know clear where they stand*".

Singapore Position

The position in Singapore appears to be simply stated, but is very much fact specific. In *JBE Properties Pte Ltd v Gammon Pte Ltd*, [2011] 2 SLR 47; [\[2010\] SGCA 46](#), the Court of Appeal held at [17] that,

"The threshold question for the purposes of ascertaining the nature of the Bond is whether, on a true construction of that instrument, the Bank was liable to pay on demand, or only later, upon proof of breach by Gammon and loss by JBE. The construction process looks to the substance of the parties' rights and obligations under the Bond; the label adopted by the parties is inconclusive".

It is also worth noting that in contrast to their counterparts in England, the courts in Singapore admit an additional ground to prevent or injunct a call on an on demand bond. It would also appear that the Singapore courts have long accepted unconscionability as a ground to restrain a call on a performance bond in addition to fraud whether as against the bank or the beneficiary claiming under the bond, see *Bocotra Construction Pte Ltd & Ors v A-G (No 2)* [\[1995\] 2 SLR 733](#) and *GHL Pte Ltd v Unitrack Building Construction Pte Ltd* [\[1999\] 4 SLR 604](#).

Conclusion

Cash flow is the life blood of commerce and businesses, and courts are anxious to strike the right balance between on the one hand, upholding and promoting the instruments that facilitate such commerce, and on the other hand, concurrently ensuring that parties are held to their bargains and do not obtain a free lunch by obtaining the benefits of an on demand bond without paying for it. It is hoped that this decision will lend greater guidance and certainty to commercial parties in determining the nature of the "guarantee" that they have given or have in hand.

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