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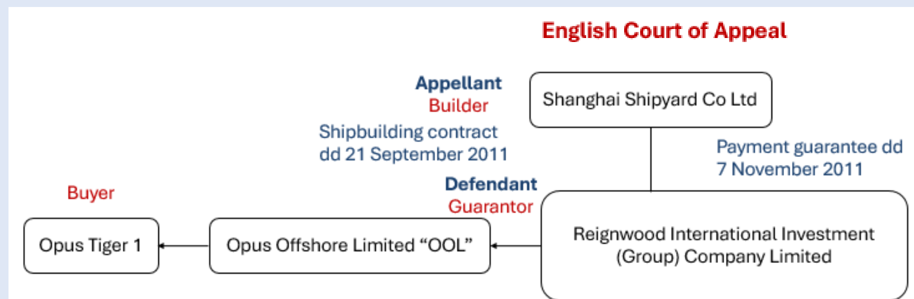
On demand vs. surety guarantee

__David Owens__ (Director) and __Cassandra Anum__, Trainee Solicitor at CJC, write about a recent Court of Appeal decision on the construction of a guarantee given to support the obligation of a buyer to pay the final instalment payment under a shipbuilding contract. The Court of Appeal overturned a previous High Court decision, and found that the guarantee was a demand guarantee not a surety guarantee, and that the guarantee could accordingly be enforced regardless of the fact there was an ongoing dispute as to liability to make payment of the sum guaranteed.

Background



The appellant Shanghai Shipyard Co Ltd (the "**Builder**"), a shipyard based in China, entered into a shipbuilding contract dated 21 September 2011 (the "**Shipbuilding Contract**") for a drillship (the "**Vessel**"). Following a novation, the buyer of the drillship in question became Opus Tiger 1 Pte Ltd (the "**Buyer**"). Reignwood International Investment (Group) Company Limited (the **"Guarantor"**), the owner of a 70% shareholding in Opus Offshore limited ("**OOL**"), the direct parent of the Buyer, guaranteed the Buyer's obligation to pay the final instalment of the purchase price (the **"Guarantee"**).

On 12 December 2016 the Builder gave notice of completion of the Vessel to the Buyer. On 11 January 2017, the Builder made a demand to the Buyer for the final instalment and other sums allegedly due under the Shipbuilding Contract. On 23 January 2017 the Builder sent a notice of default to the Buyer for non-payment of the sums allegedly due, and on 17 February 2017 the Builder sent a cancellation notice to the Buyer. On 23 May 2017 the Builder made a demand to the Guarantor for the final instalment under the Guarantee.

At some stage there arose a dispute between the Builder and the Buyer as to whether the Vessel was in a deliverable condition, with Buyer contending that the Vessel contained several major defects. An arbitration was commenced in the name of the Buyer against the Builder after a demand had already been made under the Guarantee.

The Builder commenced High Court proceedings against the Guarantor to enforce the guarantee. Two questions of particular importance arose. The first was whether the Guarantee was a "*see to it*" or surety guarantee, or a demand guarantee. If the former, the Guarantor's liability thereunder arose upon only if the Buyer was liable to pay for the final instalment under the terms of the Shipbuilding Contract. If the latter, the Guarantor was liable to make payment upon a valid demand being made, even if there was a dispute as to whether the Buyer was liable to pay the Builder in the sum demanded.

Secondly, there was a dispute as to whether the Guarantor was liable to pay the Builder before the conclusion of the arbitration between the Builder and the Buyer. The Guarantor relied upon clause 4 of the Guarantee, which contained a proviso that in case of a dispute between the Buyer and the Builder regarding payment of the final instalment, and that dispute was submitted to arbitration, the Guarantor would be entitled to withhold payment until an award was published, and pay only to the extent the award ordered.

The Builder argued that in order for the proviso to clause 4 to be triggered, there must be both be a dispute and the commencement of arbitration prior to a valid demand being made, as the wording of the Guarantee granted the Builder an accrued right to payment *"immediately upon a valid demand"*. As the arbitration between the Buyer and the Builder had been commenced after a demand had been made, the Builder claimed the Guarantor had no right to rely upon the proviso.

Procedural history

In the first instance, the Judge held in favour of the Guarantor that on true construction the Guarantee was a "*see to it*" guarantee or a conditional payment obligation.

The Judge also held that the commencement of arbitration had triggered clause 4 of the Guarantee and so the Guarantor was entitled to refuse payment under clause 4 pending and subject to the outcome of the arbitration between the Builder and the Buyer.

The Judge granted permission to appeal on both issues, and the Court of Appeal reversed the Judge's decision on both issues.

Issue 1: Was the Guarantee a "*see to it*" guarantee or a demand guarantee?

The Guarantor submitted that the starting point when assessing whether a guarantee was an on demand or surety guarantee was to identify the nature of the institution providing the guarantee. It has been suggested in academic commentary that there would be a presumption a guarantee would be a demand guarantee if provided by a bank, but no such presumption if not provided by a financial institution (as was the case here). The Court rejected this argument. Whether a guarantee is a demand or surety guarantee is to be decided by the words used in the instrument, not the identity of the guarantor.

The Court held that the combination of wording throughout the Guarantee pointed strongly to it being a payment on demand. In particular:

1. the use of the words "*ABSOLUTELY*" and "*UNCONDITIONALLY*" in clauses 1 and 3 suggested the Guarantor's obligations were not dependent on a default by the Buyer;
2. in clause 1, the wording "*[as primary obligor] and not merely as the surety*" provided clear indication that the agreement was not a surety guarantee, and therefore the Guarantor's liability to make the final payment was an independent obligation not contingent upon the Buyer's default;
3. clause 4 of the Guarantee provided for payment to be made on demand, which the Court considered to be the "*hallmark*" of a demand guarantee;
4. clause 4 also provided for immediate payment, which would not be appropriate if the Guarantee were a surety, as the Guarantor would be entitled to investigate if there was an underlying liability;
5. subject to the proviso (discussed above and below, and the wording of which the Court also held to be indicative of a demand guarantee) the Guarantee was stated to be unaffected by any dispute under the Building Contract; and
6. clause 10 of the Guarantee limited interest payments to 60 days, which the Court considered envisaged prompt payment on demand, without any dispute as to the Buyer's own liability.

As such, the Court held the Guarantee was a demand guarantee.

Issue 2: Was the Guarantor entitled to refuse the final payment pending the arbitration award?

The Court agreed with the Builder that the natural meaning of the words in clause 4 required not only the existence of a dispute but also that the dispute be "*submitted*" to arbitration – both were expressed as the condition on which the Guarantor was "*entitled to withhold or defer payment*". Holding that the proviso to clause 4 would be triggered by the existence of a dispute alone (as the Guarantor argued) would lead to the indefinite suspension of the Guarantor' obligation to make payment on demand, as any failure to pay the relevant instalment could itself be considered a 'dispute'. The wording of the proviso to clause 4 was clear that to prevent liability arising on demand, the dispute had to be referred to arbitration before the demand was made.

The fact that there could be only a 15 day window for the Buyer to commence arbitration (being the minimum time between the Builder making a demand for the final instalment, and then making a demand under the Guarantee) did not change the position. The short time period for commencing arbitration was held to be not unreasonable but commercially sound, intended to protect cashflow and avoid considerable delay of payment for the shipyard.

CJC Perspective

1. This decision is an important reminder for all parties either giving or receiving a guarantee that the scope of their obligations will depend on a close consideration of the actual wording used, and that differences in wording can have very significant effects. If a guarantee is held to be a demand guarantee, then it may be called upon even where there is an underlying dispute as to liability – as was the case here. Further, any exception to a demand guarantee (as in here, the proviso relating to arbitration proceedings) must be strictly complied with to be relied upon.

2. The Court of Appeal held that whether or not a guarantee is a demand guarantee is not affected by the identity of the party giving it. Overall, the Court of Appeal's verdict in this case will be welcome to shipyards taking parent company guarantees – and accordingly less so for those giving such guarantees.

3. The case reminds parties drafting and issuing guarantees of the importance of ensuring that the wording should be chosen carefully to ensure that the guarantee correctly and clearly reflects the nature of the instrument and the obligations that are being undertaken, and that all necessary formalities are complied with when a demand is made or received. We accordingly recommend that legal advice is taken by all parties both when a guarantee is made, and when it is enforced.

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