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Defining the difference between on-demand bonds and guarantees

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Bonds, guarantees, performance security or whatever they are called form an important part of every major international contract. Despite this, there are a regular number of cases, in many different jurisdictions, where the courts are asked to decide what the nature of the particular project security actually is. Is the security an on-demand bond or guarantee? An on-demand security bond is an unconditional obligation to pay when a demand has been made. A surety bond or performance guarantee requires certain conditions to be met before payment is made.

Some contracts provide standard form security documents. For exmaple, the Annexes to the FIDIC Red Book 1999 set out seven recommended forms of security, of which six relate to different types of security which the Contractor might be required to provide. Of these, five are securities which are callable on demand. These standard securities incorporate the Rules produced by the International Chamber of Commerce. One advantage of incorporating these rules is that it will mean that there can be no argument over which laws govern the security or which jurisdiction will be competent to hear disputes in connection with it.

One reason why FIDIC has chosen to annex particular forms of security to the contract is that the terms "performance bond" and "guarantee" are often used synonymously in the construction industry but they are in fact quite different forms of security. Just because a document is headed a "guarantee" does not mean that it actually is one. In the case of *Vossloh Aktiengesellschaft v Alpha Trains (UK) Ltd*[1], Alpha argued that the guarantee given by Vossloh was in the nature of an "on-demand" bond in that it constituted an unconditional independent promise to pay on demand all amounts demanded, i.e. Vossloh's liability was triggered by a demand alone. Vossloh, on the other hand, argued that liability under the guarantee was conditional, being triggered upon proof of a breach of contract by a member of the Vossloh group.

In reaching his decision, the Judge, Sir William Blackburne, provided a helpful summary of the law in this area, as follows:

> *"there is in this field of law a spectrum of contractual possibilities ranging from the classic contract of guarantee, properly so called, at the one end, where the liability of the guarantor is exclusively secondary and will be discharged if, for example, there is any material variation to the underlying contract between principal and creditor, to the performance or demand bond (or demand guarantee) at the other end, where liability in the giver of the bond may be triggered by mere demand and without proof of default by the principal (and indeed where it may be apparent that the principal is not in default).*
>
> *There may be little to distinguish (and it may not matter) whether the obligation undertaken is in the nature of a guarantee (strictly so called) or an indemnity. Where it does matter, the question is whether the liability to be enforced is secondary (or ancillary) to that of the principal (however qualified that liability may be), in which case the obligation is in the nature of a guarantee, or primary, in which case it will be in the nature of an indemnity and, if the latter, may be enforceable merely on demand (as with a performance or demand bond) or conditional on proof of default by the principal or on satisfaction of some other event or requirement."*

This question arose again in the English courts at the end of 2012 in the case of *Wuhan Guoyu Logistics Group Co Limited & Others v Emporiki Bank of Greece SA*[2] where the Court of Appeal reversed the first instance decision of the Commercial Court that a security document was a guarantee rather than an on-demand bond. However, neither the first instance judge nor the Court of Appeal found the case particularly easy and so the guidance given by the Court of Appeal will be helpful in distinguishing on-demand bonds from guarantees in the future.

1. [2010] EWHC 2443 (Ch) (05 October 2010)
2. [2012] EWCA Civ 1629 and [2012] EWCA 1715 (Comm)

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The claimant sellers operated a shipyard in Yangzhou in the People's Republic of China. They entered into a shipbuilding contract with the buyer, and payment was made in five instalments. The shipbuilding contract required the second instalment to be payable within five New York banking days of receipt by the buyer of a refund guarantee, together with a certificate confirming the cutting of the first steel plates of the vessel. The seller was to:

> *"notify with a telefax notice to the Buyer stating that the 1st 300 mt steel plate has been cut in its workshop approved by the Buyer's representative and demand for payment of this instalment."*

The shipbuilding contract then contained the form of words for an irrevocable letter of guarantee, referred to as a "Refund Guarantee". There was also a separate irrevocable letter of guarantee in respect of the second instalment of the price. A "Payment Guarantee" was issued by a bank.

An invoice for the second instalment dated 4 May 2009 and a written demand for payment, together with a certificate stating that in April 2009 the steel had been cut, were then issued. There was a dispute about whether the steel cutting had taken place. A demand for payment under the Payment Guarantee was made on 22 June 2011. The demand stated that the steel plates had been cut.

The buyer sought to avoid immediate payment being made by the bank to the seller under the Payment Guarantee, on the following grounds:

(i) There was no proof that the first 300 mt of steel had ever been cut;
(ii) The condition of approval of the buyer of the cutting had not been met; and
(iii) The seller did not provide the Refund Guarantee required under the ship-building contract. This was on the basis that the Payment Guarantee actually issued differed slightly from the Refund Guarantee set out in the shipbuilding contract.

Longmore LJ noted the following points that might be thought to favour a conclusion that the document was a traditional guarantee:

(i) The document was called a "payment guarantee" not an "on-demand bond";
(ii) Clause 1 said that the Bank guaranteed "the due and punctual payment by the Buyer of the 2nd instalment";
(iii) Clause 2 described the second instalment as being payable (in terms different from the Building Contract) 5 days after completion of the cutting of the first 300 metric tons of steel of which written notice was to be given with a certificate countersigned by the Buyer;
(iv) Clause 3 guaranteed the due and punctual payment of interest;
(v) Clause 4 imposed an obligation on the Bank to pay "in the event that the Buyer fails punctually to pay the second instalment"; and
(vi) Clause 7 said that the guarantor's obligation was not to be affected or prejudiced by any variations or extensions of the terms of the shipbuilding contract or by the grant of any time or indulgence.

Against that, Longmore LJ thought the following points favoured the conclusion that the document was an "on-demand" bond:

(i) Clause 4, the clause which required payment by the Bank, provided that payment was to be made: (a) on the Seller's first written demand saying that the Buyer has been in default of the payment obligation for 20 days; and (b) "immediately" without any request being made to the Seller to take any action against the Buyer;
(ii) Clause 7 provided that the Bank's obligations were not to be affected or prejudiced by any dispute between the Seller and the Buyer under the shipbuilding contract or by any delay by the Seller in the construction or delivery of the vessel;
(iii) Clause 10 provided a limit to the guarantee of US$10.3 million representing the principal of the second instalment plus interest for a period of 60 days. This meant that it was not envisaged that there would be any great delay in payment after default as there would be if there was a dispute about whether the second instalment ever became due.

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It was Clause 4 which turned out to be key.

The Court of Appeal also referred with approval to the 11th edition of *Paget's Law of Banking* which it noted was supported by judicial authority and which states as follows:

> *"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."*

This led the Court of Appeal to the view that the document here was an on-demand bond, despite the fact that it was actually called a payment guarantee. Reading the document as a whole, and in particular clause 4, it was clear that the Bank had to make payment on written demand by the Seller. Longmore LJ noted that guarantees of the kind before the court here would be almost worthless if the Bank could resist payment on the basis that the foreign buyer was disputing whether a payment was actually due. That would be all the more so in a case such as the one here where the Buyer was able to refuse to sign any certificate of approval which may be required by the underlying contract.

At the end of his judgment, Longmore LJ noted that it was important that there should be a consistency of approach by the courts, so that all parties know clearly where they stand. This would seem to be a clear policy statement and one reason why the Judge quoted, again with approval, from the judgment of Ackner LJ in the case of *Esal (Commodities) Ltd v Oriental Credit Ltd*:

> *"a bank is not concerned in the least with the relations between the supplier and the customer nor with the question whether the supplier has performed his contractual obligation or not, nor with the question whether the supplier is in default or not, the only exception being where there is clear evidence both of fraud and of the bank's knowledge of that fraud."*

Conclusions

There continue to be disputes about whether a security document is an on-demand bond, or a guarantee. An on-demand bond can be called immediately, and only fraud or very limited challenges have worked in the past (e.g. the bond has expired). A guarantee can only be called upon if a breach of the primary contract has been demonstrated, and the loss has properly crystallised but not been settled by the original contracting party.

The benefit, therefore, of an on-demand bond is that payment is made immediately, so improving cash flow, and without the need to demonstrate the full and proper loss under the primary contract. There is no need to pursue the original contracting party (who might be insolvent) in order to obtain a judgment or arbitration award.

Nonetheless, guarantees are common in the domestic UK construction market, because they are economic and they are usually readily available from most contractors. On-demand bonds, on the other hand, are much more common internationally, not just because of the nature of the cross-border risks involved, but also because the international contractors operating in those markets are more able to meet their bank's or bondman's requirements of counter-indemnity before issuing an on-demand bond.

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