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Project finance briefing

Van Der Merwe – A harsh case for guarantors

The recent case of **Van Der Merwe and another -v- IIG Capital LLC** [2007] EWHC 2631 (Ch) will be of interest to all projects sponsors who issue parent company guarantees. In it, the High Court held that a guarantee may, in certain circumstances, become a demand guarantee payable against a first demand, without reference to any defences which may exist in the underlying documentation.

Guarantees and performance bonds: What's the difference?

That has long been a somewhat tricky question to answer. The theory is straightforward – a performance bond (a.k.a. a demand guarantee or demand bond) is a direct undertaking to pay a specific amount to the beneficiary, conditional only on the occurrence of a certain event, which event is almost always conclusively "evidenced" by presentation of a document – typically a written demand or notice of default of the underlying debtor. In contrast, a guarantee is a promise to see that a contract is performed or to perform the contract following the default of the principal. If the principal has defences to liability, then those defences may equally be argued by the guarantor (unless the guarantor has agreed to their exclusion).

So far, straightforward. The practical problem is that guarantees are now rarely simple contracts of surety (i.e. secondary obligations under which the guarantor will perform if and when the principal has defaulted). Almost all modern contracts of guarantee now also include a direct contractual undertaking from the "guarantor" to indemnify the beneficiary against any loss suffered in relation to the principal contract. Additionally, almost all contracts of guarantee are expressed as being payable on demand and express the liability of the guarantor as being one of "principal debtor" – this is where the lines have become blurred.

This briefing does not go into all of the classic indicators of what distinguishes a performance bond from a true guarantee. It suggests, however, that in the case of **Van Der Merwe -v- IIG Capital LLC**, the courts have drawn the wrong conclusion. It is a surprising case since the weight of guarantee law over the years strongly favours guarantors; indeed guarantors are known as "*the darlings of the courts*". Guarantees are to be construed strictly so that no liability is imposed which is not clearly covered by the instrument. In cases of ambiguity, they are to be construed in favour of the guarantor. This case is hard to reconcile with those principles.

The facts

In 2006, IIG Capital LLC (IIG) entered into a loan agreement under which it provided finance to a company called Hurst Parnell Import & Export Limited (HPIE). The loan was secured by a debenture and also guaranteed by a Mr and Mrs Van Der Merwe, who were directors of HPIE. On 12 January 2007, IIG demanded $30,303,576 from HPIE, which was said to be due. HPIE did not pay and so, on 16 January 2007, IIG wrote to Mr and Mrs Van Der Merwe reciting HPIE's failure to pay, certifying the amount due under the guarantees and demanding payment within two days.

Mr and Mrs Van Der Merwe resisted payment on the basis that they were entitled to raise defences available to HPIE. The basic point to be decided was whether the guarantees were payable on presentation of a demand for payment of a certified amount – in which case no defences could be raised – or whether the Van Der Merwes had entered into true contracts of guarantee, which would permit them to raise the defences open to the principal (to the extent that those defences had not been effectively excluded).

Key terms of the guarantees

- The guarantees were expressed to be for "*all monies … due, owing, payable or expressed to be due, owing or payable*".
- Each guarantee was expressed to be given "*as principal obligor and not merely as surety*".
- The guarantees included a clause stating: "*if … any of the Guaranteed Monies are not paid in full on their due date … [the guarantor] will immediately upon demand unconditionally pay to the Lender the Guaranteed Monies…*".
- There was additional indemnity language: "*As an original and independent obligation the Guarantor shall indemnify … the Lender against any loss … incurred by the Lender…*".
- There was included a provision stating that: "*A certificate of the Lender stating the amount at any time due and payable by the Guarantor … shall, save for manifest error, be conclusive and binding on the Guarantor*".
- There was a typical preservation of guarantee clause (specifying no discharge following amendments to the principal contract, etc.).

All of the above terms are either entirely standard or, at least, not uncommon in a typical guarantee and we would not (prior to this case) have interpreted the above features as giving rise to interpretation as a "demand guarantee"; i.e. an instrument payable against presentation of documents only (i.e. presentation of demand).

> *"Many guarantees will now be open to the interpretation that they are payable on first demand irrespective of the true liability of the principal debtor."*

The judgment (Mr Justice Lewison)

The question which the judge considered apt was: what rights and obligations have the parties created by the words of the instrument construed in its factual and commercial context?

The key case considered was **Marubeni Hong Kong and South China Ltd -v- Government of Mongolia** [2005] EWCA Civ 395.

In **Marubeni**, Carnath LJ held that, outside a banking context (this should mean so long as the guarantor is not a bank/financial institution), there is a strong presumption against giving the words "on demand" the effect of creating an independent primary obligation. The question then becomes whether there are sufficient indications in the wording of the instrument to displace that presumption. Lewison J was satisfied that the **Marubeni** presumption had arisen. He then considered the relevant factors which might displace the presumption:

- The instrument is described as a "guarantee" and not a "demand guarantee" or "performance bond". This factor, which potentially supported the presumption, was given no weight. It is hard to argue with this in view of the often misleading/inconsistent names commonly given to instruments.
- The definition of Guaranteed Monies includes not only monies which HPIE actually owes to IIG but also monies "*expressed to be due, owing or payable*". Lewison J ascribed weight to this in terms of displacing the **Marubeni** presumption. These words do go further than the common language found in traditional guarantees but it is still very arguable that the intention is to displace the problems associated with the secondary obligation of guarantees and, in that sense, to create a primary obligation – but not one payable on presentation of a certificate only.
- The instrument includes the specific wording: "*it will immediately upon demand unconditionally pay to the Lender … the Guaranteed Monies*". Lewison J confirmed that the obligation to pay on demand was not enough on its own to displace the **Marubeni** presumption, but it did carry weight. Lewison J went on to say: "*The usual contract of suretyship is a promise that the principal debtor will perform his contract, whereas in the present case the promise is a promise to pay the Guaranteed Monies*". We would disagree with that statement in the context of a guarantee of a loan agreement.
- The promise is limited to the payment of Guaranteed Monies. It does not extend to the performance by HPIE of any of its other obligations under the loan agreement. Lewison J considered this to be consistent with an obligation to pay as a primary obligation. This ignored the fact that there were unlikely to be any obligations of significance

- under the loan agreement beyond the obligation to pay monies due. It also fails to distinguish between a primary obligation which retains the benefit of defences (to the extent that they have not been waived) and a primary obligation to pay on demand (which almost always is expressed as payable against presentation of a certificate of default of the principal).
- The promise to pay is "*as principal obligor and not merely as surety*". Lewison J acknowledged that this was not enough on its own to displace the **Marubeni** presumption, but it did carry weight. Again, this is standard guarantee language – aiming to mitigate the harsh effects of the secondary nature of the guarantee.
- The inclusion of a provision for conclusive certification of the amount due. Lewison J felt that this point clinched the argument for rebuttal of the presumption.

Ultimately, Lewison J was satisfied that the **Marubeni** presumption was rebutted. He declined to consider whether any of the points would have been sufficient on their own, since they were not on their own. The Van Der Merwes were obliged to make immediate payment under their guarantees.

Comment

This is a harsh case on guarantors and out of step with their typical treatment by the courts. It is especially surprising in view of the guarantors being private individuals, when the vast majority of performance bonds are issued by banks. The guarantee contained comprehensive waivers of defences (as is standard) and the Van Der Merwes may well have found that no defences were left open to them. In our view, they should have been able to argue such defences as they had left.

In any case, the practical impact is as follows:

many guarantees will now be open to the interpretation that they are payable on first demand, irrespective of the true liability of the principal debtor. Arguably, this will not make a huge amount of difference to many guarantors given the typically comprehensive waiver of defences. Nevertheless, given that guarantors do regularly raise defences, one would think that they would wish such remaining rights as they have to be preserved. Guarantors can, however, deal with the demand guarantee interpretation: rather than attempting to negotiate the removal of the cumulatively "problem" provisions identified above (which is unlikely to be a successful tactic in any case) we would recommend the inclusion of an express provision in the instrument along the lines of "*this instrument is not a demand guarantee or a performance bond and the guarantor shall be entitled to raise defences to its liability hereunder save where those defences have been expressly excluded by the terms of this instrument*".

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