Client Update
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Dispute Resolution

Distinguishing Between Guarantees And Performance Bonds

Introduction

While guarantees and performance bonds are closely related branches grown from the same legal root, they are in fact very different instruments. Distinguishing between the two in terms of contractual wording is an exercise that is not without complications, but a failure to properly designate a provision as such can lead to serious practical implications. In the English case of *Wuhan Guoyu Logistics Group Co Ltd v Emporiki Bank of Greece SA* [2012] EWHC 1715 (Comm), the High Court examined the factors that may be used to discern whether a provision is a guarantee or a performance bond.

The instrument in question was described as a guarantee, but contained features of a performance bond in the wording of its provisions as well. The Court looked at the words of the provisions, and whether they were more in keeping with a guarantee or a performance bond. It also examined the nature of the obligation contained within the instrument, and whether it was a secondary obligation dependant upon a primary event. Eventually, the Court determined that the instrument was in fact a guarantee.

While a performance bond usually entitles the creditor to payment upon the simple presentation of a demand, a guarantee depends upon the liability of the primary debtor, and payment under the guarantee may be delayed until the existence of the liability is established in Court. It is thus important for performance bonds to be properly drafted in order for immediate payment. Otherwise, a creditor may find itself encountering a potentially long-drawn delay.

Brief Facts

(1) The claimant Seller entered into a shipbuilding contract with the Buyer. The contract price was payable in installments, upon receipt by the Buyer of a Refund Guarantee and a certificate of cutting of the first steel plate from the Seller.

(2) The defendant Bank financed the Buyer's purchase of the vessel. It issued what was described as a Payment Guarantee in respect of the second installment of the contract price. The Payment Guarantee stated that:

a. Clause 1: The Bank irrevocably, absolutely and unconditionally guarantees "as the primary obligor and not merely as the surety, the due and punctual payment by the [Buyer]" of the second installment.

b. Clause 2: The installment guaranteed comprises the second installment payable by the Buyer upon written notice of the cutting of the first steel plate and the corresponding certificate countersigned by the Buyer.

c. Clause 3: The Bank also guarantees the payment of the interest on the second installment "from and including the first day after the date of installment in default".

d. Clause 4: "In the event that the [Buyer] fails to punctually pay the second installment… then, upon receipt of your first written demand… we shall immediately pay" the unpaid installment and the interest.

(3) Eventually, the Buyer did not pay the second installment, and the contract came to an end. There was a dispute between the Buyer and Seller over whether the second installment was due from the Buyer, and the issue was referred to arbitration.

(4) In the meanwhile, the Seller made a written demand to the Bank for payment under the Payment Guarantee.

Issue

The Seller asserted that the Payment Guarantee was a performance bond, and that payment from the Bank was due upon the written demand. It thus sought to claim summary judgment for the second installment and the interest.

However, the Bank argued that the Payment Guarantee was a guarantee proper, and that its liability to the Seller could only be determined after the Buyer's own liability was settled in the arbitration.

The Court thus had to determine whether the Performance Guarantee was a guarantee proper or a performance bond.

Holding of the High Court

It was held that the Performance Guarantee was in fact a guarantee proper. Had it been a performance bond, the Court would have expected it not to describe itself as a "guarantee" and use the language and provisions habitually found in a guarantee, and would have instead expected it to use appropriate language to make it clear that it was a performance bond.

General Law

When examining a potential performance bond, the Court will look at the terms used to describe the instrument.

(i) Was the instrument described as a guarantee or a performance bond?

(ii) Was the guarantor described as a surety or a primary debtor?

(iii) Were the terms used consistent with those ordinarily found in a guarantee or did they indicate a bond payable upon demand?

While the language used is not conclusive, it is useful in indicating the parties' intentions. However, the Court must then look at the nature of the obligation in the instrument.

(i) The obligation in a guarantee is secondary, and depends on the existence of the primary debtor's liability to the creditor. The obligation in a performance bond is to make payment upon demand, and exists regardless of the underlying position as between the creditor and debtor.

(ii) The instrument may refer to an underlying liability, but this does not necessarily make the "guarantor's" liability secondary. If it is made clear that payment is required merely upon demand, the reference may be seen as just identifying the payment for which the "guarantor" is providing security.

(iii) Conclusive evidence clauses stating that written demand is conclusive evidence of the sum demanded are also strong indicators that the instrument is a performance bond.

Application

There were a number of factors which suggested that the Payment Guarantee may have been a performance bond.

(i) The undertaking was given as primary obligor and not merely as surety.

(ii) Clause 4 provides for immediate payment upon first written demand.

However, after analyzing the totality of the Payment Guarantee, the Court found that it was more in keeping with a proper guarantee.

(i) The instrument was continuously referred to as a guarantee.

(ii) Clause 1 set out the core obligation in the classic language of a guarantee.

(iii) The guaranteed "second installment" was defined in Clause 2, which introduced the new requirement of a certificate countersigned by the Buyer, indicating that the Bank would not be required to make payment merely upon demand by the Seller.

(iv) Clause 3 referred to interest from the date of "installment in default", which goes against a free standing obligation to pay interest from any given date following demand.

(v) Clause 4 indicated the primary event of the Buyer failing to pay the second installment. Taken with the rest of the clauses, it went well beyond what was needed for the purpose of identifying the obligation for which security was being given, making it instead an underlying condition to payment.

Concluding Words

The development of performance bonds as a form of payment guarantee has now become a well established practice. The terms of payment are simple – the creditor need only present a written demand and, if necessary, accompanying documents as specified in the provisions. In comparison, a proper guarantee depends on the liability of the primary debtor. The guarantor may avail himself of all the defences available to the debtor, and payment may thus be very much delayed.

Oftentimes, the creditor requires the money from the guarantee to keep going. Suppliers of goods or services, particularly in construction or ship building, may find the security of immediate payment extremely essential. It is thus important to draft performance bonds clearly, making certain that the terms used are in keeping with performance bonds.

As seen in this case, it is not enough to merely describe the instrument as a performance bond. Even the inclusion of the phrase "upon receipt of your first written demand… we shall immediately pay" was not sufficient to create a performance bond. It is thus critical that the obligation contained therein must be clearly defined as payment upon demand, and not upon the existence of any other liability.

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