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A Brief Introductory Guide to the English Law of Guarantees

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This is an introductory guide to aspects of the English law of guarantees. It is useful to note at the outset that the commercial usage of the term "guarantee" is not always aligned with the technical legal meaning of that term.

There are many different types of documentary instruments that are commonly referred to as guarantees. Almost invariably, any such instrument sets out a contractual assurance that a certain type of event (such as contractual performance or payment of money) will happen under a certain separate contract ("the underlying contract") or in relation to the obligations ("the underlying obligations") of one of the parties to the underlying contract ("the underlying obligor").

In fact, however, some such instruments are not true guarantees at all under English law. The legal significance of this is explained below. The explanations are largely based on general English law principles. It is important to note that general principles are not necessarily applicable to every case.

A "True Guarantee" Compared With an "Indemnity" (Such as "a Demand Guarantee")

As indicated above, sometimes, in the eyes of the law, it may be that a particular instrument, albeit named as a guarantee, is not a true contract of guarantee but a contract of indemnity, of which a demand guarantee is an example. As explained below, this has significant legal implications.

(1) From an English law point of view, of instruments that are guarantees and/or named as guarantees, it is important to distinguish between the following two types of instruments: (i) a true guarantee – a guarantee that is, in substance, a contractual promise to be responsible, in addition to and (typically) co-extensively with the underlying obligor, for the due performance by the latter of its obligations and is not an indemnity (as defined at (ii) below) (the technical name of which is "a see-to-it guarantee" or, less often, "a surety guarantee"); and (ii) an indemnity, especially one in the form of an undertaking that is, in substance, a contractual promise to be liable to pay a sum of money in relation to an underlying contract upon satisfaction of certain conditions but wholly independent[1] of any liability that may arise between the parties to the underlying contract ("an indemnity").[2] In English law, such an indemnity is not a true guarantee.

Confusingly, both a true guarantee and an indemnity are often referred to as "contracts of suretyship".[3] On this subject, it is useful to note the following explanation provided by Sir William Blackburne (sitting as a judge of the High Court) in *Vossloh Aktiengesellschaft v. Alpha Trains (UK) Limited* [2010] EWHC 2443 (Ch) at paragraph 25 in relation to the liability of an indemnifier:

'*… Unless (as is quite possible) he has undertaken his liability jointly with the principal, his liability is wholly independent of any liability which may arise as between the principal and the creditor. It will usually be implicit in such an arrangement that as between the principal and the giver of the indemnity, the principal is to be primarily liable, so that if the indemnifier has to pay first he has a right of recourse against the principal. (It will not be so if, for example, the indemnifier has not undertaken his indemnity obligation at the request of the principal.) It is this feature which leads to the person giving the indemnity to be described as a "surety" although, strictly, the contract of indemnity cannot itself be a contract of suretyship*.'

(2) As regards the legal concept of a see-to-it guarantee, Lord Justice Popplewell explained it as follows in *Shanghai Shipyard Co., Ltd v. Reignwood International Investment (Group) Co*:[4]

'*A traditional guarantee by way of suretyship is an undertaking by the guarantor to be answerable for the debt or obligation of another if that other defaults. Traditional guarantees by way of suretyship are sometimes called "see to it" guarantees, following the dictum of Lord Diplock in Moschi v Lep Air Services Ltd [1973] AC 331, 348 that the nature of the guarantor's obligation was "to see to it that the debtor performed its own obligation to the creditor". Where the debt or performance obligation arises under a contract between the obligor/debtor and obligee/creditor, the essential feature of such a guarantee, for present purposes, is that the liability of the guarantor depends upon there being a liability of the obligor/debtor. The guarantor's liability is secondary, in the sense that it is contingent upon the obligor's continuing liability and default. …*'

1 This means that the underlying obligor being actually liable under the underlying contract is not a pre-condition to the liability of the indemnifier, although there may be a situation in which the underlying obligor has assumed a joint liability with the indemnifier. The fact that the instrument refers to the underlying obligor's contractual breach or liability does not in itself necessarily mean that the instrument was intended to be a true guarantee rather than an indemnity.

2 There are other forms of indemnities under English law, such as, for example, a contract of insurance.

3 See *Law of Guarantees*, 7th ed., by The Hon. Mrs. Justice Geraldine Andrews DBE and Richard Millett, QC, para. 1-003.

4 *Shanghai Shipyard Co., Ltd v. Reignwood International Investment (Group) Company Limited* [2021] EWCA Civ 1147 at paragraph 22. Although the judgment of the Court of Appeal in the *Shanghai Shipyard* case has been appealed to the Supreme Court, which remains pending as at the date of this article, this explanation by Lord Justice Popplewell is unlikely to be affected by the outcome of that appeal.

(3) The most obvious example of an indemnity is a guarantee that promises to comply with any written payment demand from the beneficiary, provided that the payment demand complies with the provisions of the guarantee related to such a demand (such as provisions that stipulate what such demand should state) (which is normally called "a demand guarantee", "an on-demand guarantee" or "a first demand guarantee").

(4) Certain formalities need to be satisfied before an enforceable true contract of guarantee can come into existence, which are set out in section 4 of the Statute of Frauds Act 1677, although there may be situations in which the courts would be justified to disallow the guarantor from relying on the provisions of section 4.[5]

(5) As briefly mentioned below, there are English law principles that are designed to protect guarantors who have issued see-to-it guarantees but are not applicable to indemnities. Where those principles apply, depending on the circumstances, the guarantor may be discharged completely from its obligations under the guarantee, unless the application of those principles has been validly excluded by contractual agreement.

(6) It is possible that a particular documentary instrument contains both a see-to-it guarantee and an indemnity. Such instrument is often used in relation to financing transactions that involve financial institutions.

(7) Determining whether a particular documentary instrument is a see-to-it guarantee or an indemnity (such as a demand guarantee) is often difficult – sometimes even for judges. There have been a number of English court cases where an issue arose as to whether a particular guarantee was a see-to-it guarantee or a demand guarantee. Sometimes, such an issue arises because the wording of the guarantee contains a mixture of wording only appropriate or necessary for a see-to-it guarantee and a demand guarantee, respectively. There have been instances of a demand guarantee being issued when the issuer's subjective intention was to issue a true guarantee instead. As to each of the cases referred to above, the value of the relevant court judgment as an authority is quite limited, except in relation to cases where the wording of the guarantee in question is materially identical or similar to that which was the subject matter of the judgment.

There are further important differences between true guarantees and indemnities. Some of them are explained below.

True Guarantees – the Instance and Scope of Liability

Under a see-to-it guarantee, the guarantor is normally liable if, and simply because, the underlying obligor has committed a breach of contract in relation to the guaranteed obligations and is liable under the underlying contract, although there may be a see-to-it guarantee that provides for the service of a payment demand by way of a condition precedent to the guarantor's liability. This means that the liability of the guarantor is secondary (rather than primary) to that of the underlying obligor and is, subject to the terms of a particular guarantee, co-extensive with that of the underlying obligor. For this reason, where a documentary instrument of guarantee refers to the guarantor as "primary obligor", it is often regarded as an indication (although often not determinative in itself) that the instrument was intended to be an indemnity as opposed to a true guarantee.

As noted above, in the case of a see-to-it guarantee, there are situations in which the operation of certain English law principles can make the guarantee unenforceable and of no real value. Although explaining those principles in detail is out of the scope of this article, by way of example, the guarantor under a see-to-it guarantee could be discharged from its obligations if a "material" amendment is made to the underlying contract without the consent of the guarantor.

Indemnities – the Instance and Scope of Liability

The liability under a contract of indemnity is (as further explained below in the context of discussing demand guarantees) wholly independent of the liability (if any) that arises between the parties to the underlying contract.[6]

A demand guarantee is a good example of a contract of indemnity. It is a type of payment bond (similar, in some sense, to a letter of credit). Under a demand guarantee, the guarantor's liability arises when (and simply because) the beneficiary serves a "compliant" payment demand. Usually, a demand guarantee requires the beneficiary to refer to the relevant liability of the underlying obligor in any payment demand to be served, although the underlying obligor actually having such liability is not a pre-condition to the validity of such demand.

As per Lord Justice Popplewell in the *Shanghai Shipyard Co* case referred to above, "*[A demand guarantee] may only be called on if the guarantor can assert in good faith that the secured obligation has arisen*."[7] This remark arises out of the so-called fraud exception. Where the beneficiary serves a *prima facie* compliant payment demand on the issuer of the demand guarantee, if the underlying obligor wishes to be able to obtain an injunction from an English court to prevent the issuer from complying with the demand, the underlying obligor needs (among other things) clear evidence of fraud that makes it "*seriously arguable on the material available that the only realistic inference is that [the beneficiary] could not honestly have believed in the validity of its [demand] under the guarantee*".[8] In general, evidence of fraud is only one of the pre-conditions to the granting of such an injunction.

5 See paragraphs 43 and 50 of the judgment of the House of Lords in *Actionstrength Limited (Appellants) v. International Glass Engineering In.Gl.En. SpA and others (Respondents)* [2003] UKHL 17.

6 See footnote 1 above.

7 *Shanghai Shipyard Co., Ltd v. Reignwood International Investment (Group) Company Limited* [2021] EWCA Civ 1147 at para 24.

8 See paragraph 37 of the judgment of Mr. Justice Fraser in *Tetronics (International) Limited v. HSBC Bank Plc, BlueOak Arkansas LLC (intervener)* [2018] EWHC 201 (TCC).

Practical Recommendations

Below are some considerations when proposing an English law guarantee or making or handling payment demands in respect of English law guarantees.

Drafting an English Law Guarantee

When a guarantor drafts a guarantee, the guarantor would be well-advised to ask itself at least the following question at the start of the drafting process: Does the guarantor wish to be contractually obliged to become liable regardless of whether or not the underlying obligor is actually in breach of contract and liable under the underlying contract?

Where the guarantor does not want the guarantee to be akin to a letter of credit, the guarantor would be well-advised to take extreme care to ensure that its intention is adequately and clearly reflected in the wording of the guarantee.

Making or Handling Demands for Payment Under English Law Guarantees

As regards any guarantee, where a guarantor has received a payment demand (or even where a breach of contract or an alleged breach of contract has occurred on the part of the underlying obligor), it will be important for the guarantor to consider whether the guarantee is a see-to-it guarantee or an indemnity, or (where appropriate) whether the guarantee is a see-to-it guarantee or a demand guarantee, which is a type of indemnity. Failure to determine the true legal nature of the guarantee may result in serious adverse consequences for the guarantor. By way of example, such consequences may occur if the guarantor misjudges the true legal nature of the guarantee and complies with the payment demand on the basis that the guarantee is a demand guarantee when, in fact, the underlying obligor is not liable at all (or at least not liable to the extent alleged by the beneficiary) under the underlying contract.

Where the guarantee contains stipulations about any payment demand that the beneficiary may make, regardless of the fundamental legal nature of the guarantee, it is normally advisable for the beneficiary to ensure that such stipulations are strictly complied with. Generally, strict compliance is of extreme importance, especially where the guarantee in question is a demand guarantee.

Serving a non-compliant payment demand could cause a serious problem for the beneficiary if, for instance, no further payment demand is permitted – because, for example, there is a time limit for making demand for payment and the time limit has already passed.

In making or handling a payment demand made under a demand guarantee, it is important to consider whether the beneficiary's assertion set out in the payment demand can be, or has been, made in good faith, rather than whether the assertion is correct. Although a payment demand can be a compliant demand even if the underlying obligor is, in fact, not liable under the underlying contract contrary to the beneficiary's assertion set out in its payment demand, as briefly explained above, the beneficiary might face legal problems if there is evidence that the beneficiary cannot have made such assertion in good faith.

Final Words

As explained above, it is important to understand that English law distinguishes between a see-to-it guarantee (a true guarantee) and an indemnity (such as a demand guarantee), and that this distinction can sometimes have serious legal implications. Failure to understand the potential implications of such distinction could result in catastrophic consequences for at least one of the parties involved. An instrument that is described as a guarantee may be a see-to-it guarantee, an indemnity or both. Further, it is sometimes difficult to determine whether a particular instrument is a see-to-it guarantee or a demand guarantee (in its entirety or at least in part). There have been instances of a demand guarantee being issued when the issuer's subjective intention was to issue a see-to-it guarantee instead.

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