Chapter 1

“Guarantees” and “Guarantees” (& Standbys): Independence & Sanity
I. Introductory Note

From the time that special letters of credit payable to a named beneficiary became popular in North Atlantic trade in the post Napoleonic era, there have been records of so-called “clean” letters of credit. The earliest available LC treatises dating to the beginning of the 20th century contain references to such letters of credit. In some respects, such credits were precursors to standby letters of credit. Such undertakings appear, however, in reported cases that antedate these texts. In Pillans v. Van Mierop, 3 BURR. 1035 (1764) [England], Lord Mansfield addressed issues arising from a promise to accept a draft drawn on the banking house issuing the promise. One of the defenses was that the promise to accept was not connected with an underlying trade transaction for goods but with an extension of credit, making it a clean credit (although the phrase was not used). While they were sometimes used as simplified commercial letters of credit in which payment was sought against a demand representing the tender of goods or services, there is also some evidence to think that they were also used in a more expansive manner.

After World War II, market pressures to use this reliable device increased. It began to be used in situations that were either unrelated to a sales transaction or as a claim made in the event of non-payment for a sales transaction that had been billed directly to the buyer.

As these undertakings became more common, the name “standby” gained currency, connoting an undertaking that would be available (i.e. would “standby”) in the event of non-payment. The enactment by US States of UCC Article 5 (from 1953-1963), which had the effect of de-mystifying letters of credit for lawyers, opened up endless possibilities for the use of standbys in the United States. So great was this growth that bank regulators, responding to concerns about the failure of a bank in part due to imprudent standby issuance, required that standbys be included in calculating lending limits. By the 1990s, continuing concern had led to the imposition of capital requirements with a higher ratio for standbys than for commercial letters of credit. This process also lead bank regulators to issue guidelines regarding the issuance of standbys that were gradually extended to all types of letters of credit. See OCC Interpretative Rulings, 12 CFR Section 7.1016, reprinted at LC Rules & Laws: Critical Texts (6th ed., IIBLP 2014) p.315.

Despite a period of slower growth in standbys caused by the capital adequacy requirements, the amounts outstanding by US banks in standbys now exceeds commercial LC outstandings by a ratio of at least 5:1 and is increasing annually while the figures for commercial letters of credit reveal a significant decline.

From a legal perspective, the most important point to note about standby letters of credit is that they do not differ in any respect from commercial letters of credit. This reality is reflected in the absence of any differentiation in Revised UCC Article 5. Although the UN LC Convention encompasses standby letters of credit and independent guarantees, it can be made applicable to commercial letters of credit as provided in Article 1(2). The exclusion of commercial letters of credit was a political concession to concerns by the ICC.

Indeed, in many cases it is difficult to determine whether an undertaking is a standby or a commercial letter of credit since the undertakings are titled with various names such as “letter of credit” or no name at all. The use of commercial standbys backing payment for sales of goods and direct pay standbys in which there is no default, add to the difficulty of distinguishing standbys and commercial letters of credit.
While standbys were growing in the US, a similar product came into use in Europe. This product arose from similar market concerns for more dependable money-like promises but started at a different point. English bankers took a product other than the letter of credit, the accessory or suretyship guarantee, and attempted to make it independent instead of dependent by drafting changes. The suretyship origin of independent guarantees can be seen today in the forms still in use in many banks which contain recitals related to the underlying transaction that belong in a guarantee. This product is known as a demand guarantee, an independent guarantee, a bank guarantee, or first demand guarantee. Where it is truly independent, it is identical to the standby at the abstract level of law. Unlike a standby, however, the question of its independence is a real one; a question that never seriously arose for standbys, which all analogized to letters of credit. In many jurisdictions, however, the courts have to consider the nature of the undertaking, which involves not only examination of the name used, but its operative provisions.

With the increased use of standbys, it became apparent that rules designed for commercial letters of credit were not satisfactory to address problems that arose and were too imprecise to give desired certainty of result. As a result, the Institute of International Banking Law & Practice, in cooperation with the UN Commission on International Trade Law and the ICC, drafted the International Standby Practices or ISP98 which provide rules of practice for standby letters of credit and are being increasingly used for independent guarantees. See LC Rules and Laws: Critical Texts, (6th ed., IIBLP 2014) at p.29 (Institute of International Banking Law & Practice 2004). Although the ICC has issued separate rules for independent guarantees, the Uniform Rules for Demand Guarantees, or URDG458, they are rarely used. To remedy this situation, URDG 758 was drafted in 2009. It was based in part on UCP600, ISP98, and URDG 458 (1992). While it addresses some of the deficiencies of URDG 458, its use has been uneven across regions of the world.

**Rules and Laws**

ISP98, Rule 1.01 (Scope and Application).
ISP98, Rule 1.06 (Nature of Standbys).
ISP98, Rule 1.07 (Independence of the Issuer-Beneficiary Relationship).
URDG 758, Article 1(a) (Application of URDG).
URDG 758, Article 2 (Definitions), ¶ 18 (Guarantee), ¶ 13 (Demand guarantee or guarantee).
URDG 758, Article 5 (Independence of Guarantee and Counter-Guarantee).
URDG 458, Article 2.
UN LC Convention, Article 1 (1) (Scope of application).
UN LC Convention, Article 2 (1) (Undertaking).
Rev. UCC Article 5, Section 5-102 (10) & Comment 6.
Rev. UCC Article 5, Section 5-103 (a) & Comments 1 & 2.
II. Text


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**J.P. Doumak, Inc. v. Westgate Financial Corp.**

Guaranty Document

WESTGATE FINANCIAL CORP.  

84 WASHINGTON STREET  

HOBOKEN, NEW JERSEY 07030

TELEPHONE: (201) 222-3200  
FAX NO. (201) 222-3975  

www.westgatefinancial.com

Date: June 22, 2000  
Guaranty No. JM#2 (Revised)  
Amount: $24,510.00

J.P. Doumak, Inc.  

561 7th Avenue, 13th Floor  

New York, New York, 10018

Gentlemen:

We are advised that our client, John Michael's Inc., has purchased from J.P. Doumak, Inc. under Purchase Order # 542582 dated May 3, 2000 the following merchandise:

Quantity:  
Price: SEE ATTACHED COPY OF  
Description: Purchase Order

Latest shipping date acceptable: June 30, 2000.  
Partial shipments: [ ] are permitted [X] are not permitted.


Special Instructions: Copies of invoice and bill of lading, landed duty paid, consigned to John Michaels, Inc. c/o P.L.P. Cutting, 318 West 39th Street, 6th Floor, New York, New York shall be sent to Westgate Financial Corp., within four (4) days after shipment via overnight carrier. Copies of the packing list and bill of lading shall be faxed to Westgate Financial Corp. at (201) 222-3975 on the day after shipment.

Inspection and approval of goods by Boyd International Consultants, or its designated agent, as evidenced by its Certificate of Inspection that the goods conform to the contractual specifications and approved sample.

Our liability under this guaranty is limited to $24,510.00 and expires on August 21, 2000 unless written demand upon us for payment under this guaranty is made prior to August 21, 2000.

(Continued)
Westgate Financial Corp. will make payment to you for any invoices under this guaranty by our check payable to your order.

This guaranty is delivered with the understanding that we have the right, at any time, to have delivery of the merchandise to which the above order pertains, made directly to us or any other party at our order. This Payment Guaranty supercedes and replaces the Payment Guaranty dated June 9, 2000, which by your acceptance of the Payment Guaranty is rendered null and void.

Payment: We hereby guaranty payment of invoices covering the aforesaid merchandise once delivered; providing all of the terms and conditions hereof and of the above-mentioned purchase order are strictly complied with, each of them being of the essence; the merchandise and documents are properly labeled; J.P. Doumak, Inc., has complied with all applicable rules, regulations, and statutes; and duplicate invoices including our guaranty number (original invoices to be sent to our client) are presented to our office, 84 Washington Street, Hoboken, NJ 07030, upon shipment of merchandise.

Very truly yours,

WESTGATE FINANCIAL CORP.

BY: __[signature]________________
Bruce Cohen, President


“(1) If the [principal], unless relieved from the performance by any clause of the contract or by statute or by the decision of a tribunal of competence jurisdiction, shall in any respect fail to perform under the contractor commit any breach of his obligation thereunder, then the guarantor shall pay to the principal up to a total aggregate sum not exceeding the amount of TWO MILLION ONE HUNDRED TWENTY TWO THOUSAND SIX HUNDRED FORTY SEVEN AND SEN EIGHTY SEVEN ONLY (RM2,122,647-87) on the principal’s demand notwithstanding any contestation of protest by the contractor or by the guarantor or by any other third party, provided always that the total of all partial demands so made shall not exceed the aggregate sum of TWO MILLION ONE HUNDRED TWENTY TWO THOUSAND SIX HUNDRED FORTY SEVEN AND EIGHTY SEVEN ONLY (RM2,122,647-87) and the guarantor’s liability to pay the principal as aforesaid shall correspondingly be reduced proportionate to any partial demand having been made as aforesaid.”
Text of Undertaking from Marubeni Hong Kong and South China Ltd v. Government of Mongolia [2005] EWCA Civ 295 [England].

“To: MARUBENI HONG KONG LTD

In consideration of you entering into the Deferred Payment Sales Contract No 258500 (hereinafter called the “Agreement”) with Buyan Holding Company Ltd, a corporation duly organized and existing under the laws of Mongolia, with its principal office at I-4000-68-4 Ulaanbaatar, Mongolia (hereinafter called the “Buyer”) for sales and purchase of a textile plant the contract price of which is United States Dollars Eighteen Million Eight Hundred Eleven Thousand Six Hundred Seventy (USD18,811,670), the undersigned Ministry of Finance of Mongolia unconditionally pledges to pay to you upon your simple demand all amounts payable under the Agreement if not paid when the same becomes due (whether at stated maturity, by acceleration or otherwise) and further pledges the full and timely performance and observance by the Buyer of all the terms and conditions of the Agreement. Further Ministry of Finance undertakes to hold indemnify and hold you harmless from and against any cost and damage which may be incurred by or asserted against you in connection with any obligations of the Buyer to pay any amount under the Agreement when the same becomes due and payable (whether at stated maturity, by acceleration or otherwise) or to perform or observe any term or condition of the Agreement or in connection with any invalidity or unenforceability of or impossibility of performance of any such obligations of the Buyer.

This covenant shall come to force from the date of implementation of this agreement and remain in full force and effect until all amounts due to you by the Buyer under the Agreement have been paid in full and all the terms and conditions of the Agreement have been fully performed and observed by the Buyer.

The Ministry of Finance hereby waives any right to require you to proceed against the Buyer or against any security received from the Buyer or any third party or to pursue any other remedy available to you. The letter also provided that all disputes related to this pledge shall correlate in accordance with the jurisdiction courts of England. It is common ground that the proper law of the contract constituted by the MMOF letter is English law.


“We the undersigned, American International Insurance Company of Puerto Rico, hereby establish in the name and for the account of C.M. Constructora, S.A., an irrevocable and unconditional guarantee in the amount of FIVE MILLION SIX HUNDRED NINETY-SIX THOUSAND THREE HUNDRED TWENTY-TWO and 42/100 United States dollars (US$ 5,696,322.42), as a guarantee for the completion by the contractor of its obligations to Construtora Andrade Gutierrez S.A.(which shall hereinafter be called the “Owner of the Works”) pursuant to the stipulations of the contract dated May 6, 1996.”

Under the terms of the letter of credit, the only conditions for payment are: (1) that CAG provide AIICO with “written notification ... prior to the expiration date” of May 6, 1999, and (2) that such written notification “contain the amount to be paid” and “state that the contractor [C&M] had not performed its contractual obligations.”
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‘[Grupo Urvasco] irrevocably and unconditionally: (a) guarantees to the Losan Entities [that is Carey] punctual and complete performance by the Obligors [that is Grupo Hotelero Urvasco] of the Guaranteed Obligations; (b) [this has to do with the lease of the property] (c) undertakes with the Losan Entities to be responsible as primary obligor for any failure by an Obligor to perform, discharge or fulfil for whatever reason any of the Guaranteed Obligations when due and promptly on demand by any Losan Entity: (i) fully, punctually and specifically perform or procure to be performed the relevant Guaranteed Obligations as if it were itself a direct and primary obligor to the Losan Entities in respect of such Guaranteed Obligations and be liable as if the Transaction Documents had been entered into directly between the Guarantor and the Losan Entities; (ii) pay the amount of any Guaranteed Obligation which has not been paid by the relevant Obligor and without any deduction or withholding; and (d) undertakes with the Losan Entities to indemnify any of them immediately on demand against any cost, loss or liability suffered and expenses incurred by any Losan Entity: (i) in consequence of an Obligor’s failure to perform any of its obligations under the Transactions Documents; (ii) if any obligation guaranteed by the Guarantor is or becomes unenforceable, invalid or illegal. The amount of the cost, loss or liability shall be equal to the amount which that Losan Entity would otherwise have been entitled to recover under the Transaction Documents.

Excerpt of Undertaking from ILG Capital LLC v. Van Der Merwe, [2008] EWCA Civ 542 [England].

The guarantee begins by describing itself as “THIS GUARANTEE” and Mrs Van Der Merwe is described as “the Guarantor”. Recital (A) records the grant of the facility to HPIE (described as “the Borrower”) of US$23,000,000. Recital (B) says that it was a condition precedent to the grant of the facility that the “Guarantor enters into this Guarantee of the obligations of the Borrower to the Lender under the [Loan] Agreement”. Recital (C) says that the guarantee is an “all monies” guarantee.

7. The document contains a single definition in clause 1.2. The defined term is “Guaranteed Monies” and the definition is:

“(i) all moneys and liabilities (whether actual or contingent) which are now or may at any time hereafter be due, owing, payable, or expressed to be due, owing or payable, to the Lender from or by the Borrower (ii) all interest. . . costs, commissions, fees and other charges and expenses which the Lender may charge against the Borrower; and (iii) all legal and other costs, charges and expenses which the Lender may incur in enforcing or obtaining, or attempting to enforce or obtain, payment of any such moneys. . .”

8. Clause 2 contains the main payment obligation and reads:

“In consideration of the Lender agreeing to enter into the Agreement, the Guarantor as principal obligor and not merely as surety unconditionally and irrevocably:

2.1 guarantees to the Lender the due and punctual payment of the Guaranteed Moneys and agrees that, if at any time or from time to time any of the Guaranteed Moneys are not paid in full on their due date. . . it will immediately upon demand unconditionally pay to the Lender the Guaranteed Moneys which have not been so paid

2.2 As an original and independent obligation under this Deed, the Guarantor shall

2.2.1 indemnify the Lender and keep the Lender indemnified against any loss. . . incurred by the Lender as a result of a failure by the Borrower to make due and punctual payment of any of the Guaranteed Monies. . .” (Continued)
9. Clause 3 is headed “Preservation of Guarantee” and provides:

“3.1 The Lender shall be at liberty without thereby affecting its rights hereunder at any time at its absolute discretion and with or without the consent or knowledge of or notice to the Guarantor:

3.1.1 to give time to any Obligor for the payment of all or any sums due or payable under the Agreement or any other Finance Document;

3.1.2 to neglect or forbear to enforce payment of all or any sums due or payable under the Agreement or any other Finance Document and (without prejudice to the foregoing) to grant any indulgence or forbearance to and fail to assert or pursue or delay in asserting or pursuing any right or remedy against any Obligor thereunder;

3.1.3 to accept, vary, exchange, renew, abstain from perfecting, or release any other security now held or to be held by it for or on account of the Financial Indebtedness;

3.1.4 to amend, add to or vary the terms of the Finance Documents;

3.1.5 to compound with, accept compositions from and make any other arrangements with any other Obligor.

3.2 This Guarantee and the rights of the Lender hereunder shall not be affected by:

3.2.1 the appointment of a receiver, trustee or similar officer of any other Obligor, its undertaking or all or any of its or his asset.

3.2.2 Any alteration of the status of any other Obligor or any defective or irregular exercise of the powers of the Borrower to raise finance

3.2.3 The insolvency, bankruptcy, death, incapacity, winding up, liquidation or dissolution of any other Obligor;

3.2.3 Any failure by the Lender to take any other security for all or any part of the indebtedness agreed to be taken by the Lender pursuant to the Finance Documents or any total or partial invalidity, voidability or unenforceability of any such security;

3.2.4 The doing by the Lender of anything referred to in clause 3.1 above; or

3.2.5 Any other act or circumstance which (apart from this provision) would or might constitute a legal or equitable defence for or discharge of a surety or guarantor, and this Guarantee may be called and/or enforced without steps or proceedings first being taken against any other Obligor.”

10. Clause 4.2 provided that:

“A certificate in writing signed by a duly authorised officer or officers of the Lender stating the amount at any particular time due and payable by the Guarantor under this Guarantee shall, save for manifest error, be conclusive and binding on the Guarantor for the purposes hereof.”

11. Clause 5 said that the guarantee was “a continuing guarantee” and would remain in force until all sums “due from the Borrower under the Finance Documents have been paid in full”. Clause 7.3 prevented the Guarantor from asserting any set-off against the Borrower. Finally, clause 14 said that the guarantee was to be governed by English law.
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TTI Team Telecom International Ltd v. Hutchison 3G UK Ltd
[2003] All ER (D) 83 (Apr) (Q.B. 2003) [England]

Judge Thornton QC

1. Background to the Dispute

1. This claim seeks to restrain a threatened call on a bond which was provided by the bank of the claimant, a specialist supplier of software. The Bond was ancillary to the provision of software services to, and under an Agreement with, the defendant, a provider of services to mobile telephone users.

2. The background to the dispute is the development in the United Kingdom of Third Generation or 3G mobile telephone licenses and services. The defendant, Hutchison 3G UK Limited (“H3G”), is a wholly owned subsidiary of Hutchison 3G UK Holdings Limited, the majority of whose shares are owned by Hutchison Whampoa Limited which is registered in Hong Kong and whose other shares are owned by NTT DoCoMo registered in Japan and KPN Mobile registered in the Netherlands. ...

3. TTI Team Telecom International Ltd (“TTI”), a company registered in Israel and which has been in business since 1992, specialises in the provision of such services and, in particular, markets a system with the appropriate name of Manager of Managers which is minimalised to MOM. This is a customised software system which provides management functions that have been developed by TTI and which comprises a suite of management features such as inventory, fault, performance, configuration and service management.

4. The parties entered into an Agreement which came into effect on 14 February 2002, the “Effective Date”, and a contract price, the “Total Price”, of £13,485,610. The price was payable against the achievement of defined milestones, being the staged delivery and the successful acceptance testing of a defined part of the overall functionality to be provided by the MOM. A first or Advance Payment of £1,059,305 had to be paid by H3G on the Effective Date before TTI had performed any services or delivered any of the software. The next five Milestones provided for the five stages of delivery of the MOM split into Functionality 1-5. ...

5. The Agreement also provided that TTI should procure a bond, described in the Agreement as ‘an advance payment bond’, in the form appended to the contract in respect of the Advance Payment. A bond in similar but not identical terms guaranteeing payment to H3G by TTI for the same sum as the Advance Payment, £1,059,305, was subsequently procured from Bank Leumi Le Israel with the same date, 14 February 2002, as the Effective Date. The current dispute arises because H3G gave notice of its intention to draw down the total amount guaranteed by the Bond on 12 November 2002 in circumstances in which TTI disputes H3G’s entitlement to do so. Thus, as TTI believed, H3G was threatening a breach of its obligations relating to that Bond contained in its Agreement with TTI. TTI seeks an interim injunction to prevent that draw down and consequent perceived breach of the Agreement from occurring.

...
with and by the dates specified in the Programme Schedule which was contained in Appendix B.

16. The Total Price was £13,485,610 which was made up of items defined in clause 15. These consisted of a variety of product, library, miscellaneous and support services items. Within this overall Total Price, spread in an undefined way through these items and their constituent parts, was an amount of £900,000 for the required Hewlett-Packard Open View Licences. The Total Price was to be paid in the instalment payments that were linked to the Milestones. There was no defined or obvious linkage between the priced items in clause 15 and the amount of each lump sum stage payment provided for each Milestone in Appendix B. In other words, the Agreement did not identify the relationship, if any, between the make up of the priced items listed in clause 15 and that of the lump sum Milestone Payment Amounts.

17. H3G was to pay the Total Price by making the lump sum Milestone Payments on the relevant Milestone Date or on such later date as that Functionality Set was Accepted. The Agreement provided that any liquidated damages payable for delayed Acceptance under clause 13 could be deducted from a Milestone Payment. The Agreement also provided for the payment of General Damages for additional costs incurred as a result of a Conditional Acceptance and any resulting delay in Acceptance of the relevant Milestone, for the provision of general warranties by TTI linked to a Limits of Liability provision limiting TTI’s liability for loss and damage arising out of the Agreement to a sum equal to the Total Price and for an accounting exercise to be carried out following a termination of the Agreement by H3G to determine what final sum should be paid by TTI to H3G or vice versa taking into account the additional cost to H3G of completing the Agreement and the value of any elements of the MOM supplied and retained by or paid for by H3G.

18. The Agreement made no express provision for the repayment of the Advance Payment or any part of it. This notable omission occurred despite the fact that, for much of the period during which functionality was being prepared, delivered, installed and tested TTI would have received a total sum in excess of the value of the work provided. This situation would have arisen because the Advance Payment was so large and because the Total Price was being paid in a small number of relatively large payments that would not be directly linked to the value of the work that had been performed immediately prior to payment. This omission gave rise to a submission by TTI that no part of the sum paid as an Advance Payment was recoverable by or accountable to H3G even if H3G terminated the Agreement and even if that termination left TTI in credit when all payments including the Advance Payment it had received were set against both its overall entitlement to payment and its liability in to pay damages. In consequence, H3G submitted, the Agreement did not allow H3G to exercise or claim under the Bond following its termination of the Agreement since the Agreement only allowed the Bond to be exercised in relation to, and the Bond only guaranteed, TTI’s obligation to repay the Advance Payment but, on analysis, TTI had no such obligation.

20. The parties agreed that there was no material difference between the wording of the draft bond appended to the Agreement and that of the Bond provided by the Bank to H3G. The Bond was in these terms:

“Our Guarantee No: ...
Valid until 15 February 2003

In consideration of the Purchase Order Contract dated 30 January 2002 which incorporated the terms of the Agreement dated 30 January 2002 (“the Agreement”) entered into between ... TTI ("Supplier") and H3G ... ("Buyer") ... for the supply of a Manager of Managers ("the System") and in further consideration of the Agreement stipulating that TTI shall give Buyer a Performance Bond under the fulfilment of the Supplier’s obligations under the Agreement.

Now we the undersigned, Bank Leumi Le Israel B.M.... hereby issue this irrevocable undertaking ...("Performance Bond") to guarantee such payment to Buyer by Supplier up to the amount set forth below, in the measure and to the extent that Supplier should fail to carry out its material obligations under the Agreement, during the period starting after receipt of the down payment of £1,059,305 as per the Supplier’s written advice to us and ending no later than 15 February 2003 (and that date may be extended in the manner stated below) ... provided however that the total responsibility under this performance bond is limited to the sum of £1,059,305 ... subject to the reduction clause stated below:

The Performance Bond will be automatically reduced by the value shown on any reduction certificate(s) received by the Bank, which has been issued and signed by Buyer and Supplier.

The Performance Bond will be automatically extended for one year if the Bank shall receive, prior to the expiry date, a written notice from Buyer stating that an automatic extension of the Performance Bond is required under clause 5 (sic) of the Agreement, however not beyond 15 February 2005.

Claims against the Bank on account of this present Performance Bond shall be made on presentation of the following:
A. Buyer’s certificate stating (I) that the Supplier is in breach of its obligations under the Agreement (II) the respect(s) in which the Supplier is in breach, and (III) the amount claimed represents the extent of the Supplier’s liability to repay the said Advance Payment.

B. A copy of the Buyer’s written notice to Supplier of its intention to draw down the present Performance Bond, such notice to be dated at least 5 days prior to the attempted draw down for a sum up to the amount defined above.

This Performance Bond is issued subject to the International Standby Practice I.C.C. Publication 590 (‘ISP98’) and any matter not addressed by ISP98 shall be governed by and construed in accordance with English Law and the parties submit to the exclusive jurisdiction of the Courts of England.

This Performance Bond is personal to the Buyer and is not transferable or assignable."

22. On 12 November 2002, with little or no warning, H3G served two notices on TTI. The first terminated the Agreement and the second gave notice of H3G’s intention to draw down the total amount guaranteed by the Advance Payment Bond.

5. The Law

5.1. Introduction

29. Although this case is concerned with a contract describing itself as a performance bond, the principles governing the court’s supervisory jurisdiction in relation to a beneficiary’s threatened call are not limited to bonds. This bond is subject to ISP98 which governs International Standby Practices which are stated in Rule 1 to include documentary standby letters of credit. Such documents include performance, financial and direct pay standby letters of credit and any similar undertaking which is independent, irrevocable and documentary in nature. Thus many other performance, bank and retention bonds and guarantees are subject to the same considerations.

30. All these cases are concerned with situations where an issuer, whether bank, financial institution or other independent party, agrees irrevocably to make a payment to a beneficiary against the presentation of documents without any consideration of the underlying transaction or the validity of the grounds for, or the merits of, that payment to the beneficiary. The issuer has a sole overriding obligation before making payment which is to ensure that the documents that are presented conform strictly and in all respects with the requirements for presented documents that govern the documentary credit in question. These credits are used to finance, secure or assist an underlying commercial transaction whether of sale, services or the provision of work and materials and to give comfort to one party to that transaction that the other party will honour or discharge a payment obligation to which that underlying transaction subjects it to.

31. This faith in and reliance upon the integrity of standby payments is vital for international and, indeed much national, commercial activity. It is for this reason that English courts have developed a clear non interventionalist approach when an issuer making payment to a beneficiary is asked to desist by a third party, usually the other party to the underlying transaction who will also be the customer of the issuer and who will have to reimburse the issuer when the issuer claims reimbursement for its payment under the documentary demand. Only if the issuer is about to make payment to the beneficiary in circumstances where fraud, dishonesty or bad faith in relation to the demand is shown to exist or where the original issue of the documentary credit was procured by fraud or, possibly, where the underlying transaction was itself procured by fraud will a court intervene to restrain payment by the issuer to a beneficiary. This approach conforms to the principles governing documents to which ISP98 applies since Rule 1.05 provides that it is only defences raised by an issuer to a payment demand that are based on fraud, abuse or similar matters that are to be left to the applicable law.

32. However, the third party potentially interested in the payment, who is both a party to the underlying transaction and who procured the credit and stands to lose out if the standby credit is called upon and paid out by the issuer, will always have a vital concern if the issuer is about to make a payment in circumstances where the beneficiary has no ground to make a documentary demand or is doing so in contravention of its agreement with the third party contained in the underlying transaction.

33. Notwithstanding the third party’s concern to prevent a wrongful payment by the issuer to the beneficiary, the English courts are reluctant to intervene on its behalf, albeit that the good standing of the issuer will not usually be affected since any intervention would stop a demand before it is made. The current approach of English courts to third party applications to restrain calls by beneficiaries on issuers under documentary credits was clearly and authoritatively stated by Morison J in Cargill International SA and another v Bangladesh Sugar and Food Industries Corp [1996] 4 All ER 563. This summary of the applicable approach was approved by the Court of Appeal in approving his decision (see [1998] 2 All ER 406). The judge stated:

“I start with the commercial purpose of a performance bond. There is a wealth of authority concerned with the question whether and in what circumstances an interlocutory
The court will not grant an injunction in either case unless there has been a lack of good faith. The justification for this lies in the commercial purpose of the bond. Such a bond is, effectively, as valuable as a promissory note and is intended to effect the ‘tempo’ of parties’ obligations, in the sense that when an allegation of breach of contract is made (in good faith), the beneficiary can call the bond and receive its value pending resolution of the contractual disputes. He does not have to await the final determination of his rights before he receives some moneys. On an application for an injunction, it is, therefore, not pertinent that the beneficiary may be wrong to have called the bond because, after a trial or arbitration, the breach of contract may not be established; otherwise the court would be frustrating the commercial purpose of the bond. The concept that money must be paid without question, and the rights and wrongs argued about later, is a familiar one in international trade, and substantial building contracts. A performance bond may assume the characteristics of a guarantee, especially, if not exclusively, in building contracts, where the beneficiary must show, as a prerequisite for calling on the bond, that by reason of the contractor’s non-performance he has sustained damage (see Trafalgar House Construction (Regions) Ltd v General Surety and Guarantee Co Ltd [1995] 3 All ER 737, [1996] AC 199).

However, it seems to me implicit in the nature of a bond, and in the approach of the court to injunction applications, that, in the absence of some clear words to a different effect, when the bond is called, there will, at some stage in the future, be an ‘accounting’ between the parties in the sense that their rights and obligations will be finally determined at some future date... As far as I am aware, and no case was cited to me to suggest otherwise, the performance bond is not intended to supplant the right to sue for damages. Indeed such a contention would conflict with what I believe to be the commercial purpose of these instruments...

Therefore, the question arises as to why, if the beneficiary can sue to recover what he has actually lost, the seller (in this case) [ie the party in the analogous situation to TTI] should not be able to recover any overpayment. It would seem in principle, correct that if a performance bond does not exhaust one party’s rights, it should not exhaust the rights of the other party.” (page 568 - 569).

5.2 Lack of Good Faith

34. A lack of good faith has for a long time provided a basis to restrain a beneficiary from calling a bond or guarantee. In the Elian and Rabbath v Matsas [1966] 2 L 495, the Court of Appeal intervened on the application of the Court of Appeal intervention. In Elian and Rabbath v Matsas, the Court of Appeal intervened on the application.
Chapter 1 — “Guarantees” and “Guarantees” (& Standbys): Independence & Sanity

37. The decision in this case largely accords with the decision in the Elian and Rabbath case and the dicta of Morison J in the Cargill International case since the main contractor in this case was, as described by the Judge-Advocate, “utterly lacking in bona fides”. If a similarly clearcut case came before an English court, it would, in the light of these cases, grant restraining relief. However, the bad faith needed to find a restraining application must be both significant and clearly established.

5.2. Exceptions to the General Principle

5.2.1. Introduction

5.2.2. No consideration or performance provided in underlying contract

5.2.3. “See to it” or Precondition of Loss

38. TTI suggested that this approach to third party applications against beneficiaries to prevent calls on bonds adumbrated in the Cargill International case was not a general statement of the applicable principles governing English courts that I should follow even though it had received the approval of the Court of Appeal in that very case. However, a consideration of cases decided both before and since Morison J’s decision and its confirmation on appeal that were cited in argument and have been decided in England, Australia, Singapore and Malaysia shows that there are three limited exceptions to this general non-interventionist approach.


40. The starting point in England is Eveleigh LJ’s judgment in the Potton Homes case in 1984. His judgment was obiter, extempore, given in an interlocutory appeal and as part of a two-judge Court of Appeal. He stated, at page 29:

“For a large construction project the employer may agree to provide finance (perhaps by way of advance payments) to enable the contractor to undertake the works. The contractor will almost certainly be asked to provide a performance bond. If the contractor was unable to perform because the employer failed to provide the finance, it would seem wrong to me if the court was not entitled to have regard to the terms of the underlying contract and could be prevented from considering the question whether or not to restrain the employer from the mere assertion that a performance bond is like a letter of credit.”

41. This dicta has been followed in the High Court of Singapore in Kvaerner Singapore Pte Ltd v UDL Shipbuilding (Singapore) Pte Ltd, (1993) 3 SLR 350, GP Selvan JC, where the buyers had failed to open a letter of credit as required by the underlying contract of sale and were restrained from demanding payment under a performance guarantee. This case was also decided on the basis of the bad faith of the buyers in failing to open the letter of credit yet attempting to call the related performance guarantee.

42. The next potential exception first arose in the decision of the High Court of Australia in the Wood Hall Ltd case in 1979. This was a case where a contractor provided two guarantees, one a performance guarantee and the second a bank guarantee in lieu of the employer retaining 10% retention. The contractor sought to prevent the employer calling these guarantees on the grounds that there had been no want of due and faithful performance of the work. The High Court held in favour of the employer. The guarantees, in their true construction, were demand guarantees. They were unqualified in their language. Had the guarantees been qualified and “see to it” in form, relief by way of declaration would have been granted to the contractor to obviate a call on demand without proof of entitlement by the employer.

43. This case has led to a line of authority in both the Federal and state courts in Australia where bonds and guarantees provided by contractors in support of retention or advance payments have been construed with the aim of distinguishing those that are performance guarantees from those which are dependent on, or have as a precondition, the need by the caller to establish loss or an entitlement under the underlying contract to recovery or damages. These cases include Pearson Bridge (NSW) PTY Ltd v The State Rail Authority of New South Wales (1982) 1 A.C.L.R. 81, Supreme Court of New South Wales, Yeldham J, where the judge construed a bond to be arguably subject to a precondition of proof of an entitlement to exercise the underlying contractual remedy. He therefore granted an interim injunction restraining the employer from calling the bond pending the trial of the question of whether the employer had been entitled to determine the contract.

44. In England, there has built up a similar line of authority where the courts have had to distinguish performance or on demand bonds or guarantees which may be called without proof of loss from “see to it guarantees”
which require such proof as a precondition of call. These authorities include the Trafalgar House case (a “see to it” bond) and the Gold Coast case (a performance bond). Had it been in issue in the Trafalgar House case, there seems little doubt that the court would have restrained the employer from calling the bond since there had been no prior proof of loss. The case in fact concerned a claim against the bondsman who, in the light of the ultimate decision of the House of Lords, successfully defended a call made by on the bond on the grounds that the demand was subject to prior proof of loss.

... 6.3. Performance or “See To It” Bond

6.3.1. Introduction

62. TTI contended that since a call can only be made if the Agreement was terminated lawfully, no call can be made unless and until the parties have agreed or a court has determined that the Agreement was lawfully terminated under clause 34. In other words, the Bond is not a performance bond or a demand bond, despite it calling itself a performance bond. Instead, the guarantee that is provided for by the Bond may, on strict analysis, only be called where H3G's loss has first been established. Such a bond is usually called a “see to it” bond.

6.3.2. The Law

63. The distinction between a demand and a “see to it” obligation is that the former, unlike the latter, is one which must be honoured in accordance with its terms following a demand which is, on its face, regular and in conformity with the terms of the instrument. In such circumstances, unlike the latter type of obligation, the bank or other guarantor, is not concerned with relations between the supplier and the beneficiary or customer (ie those between TTI and H3G) nor with the question whether the supplier has performed his contractual obligations or not nor with the question of whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, without proof of conditions. The only exception is where there is a clear fraud of which the bank has notice (see Edward Owen Ltd v Barclays Bank [1978] 1QB 159, CA at page 171, per Lord Denning MR).

64. The nature of the guarantee must be determined from the words of the Bond in its factual and contractual context having regard to its commercial purpose. The recent Gold Coast case provides guidance as to how to interpret a bond for this purpose. Tuckey LJ stated at pages 620 - 621:

“16. In Paget's Law of Banking (11th edition) under the heading "Contract of suretyship v demand guarantee" the authors say:

‘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.’...

17. There is a further feature which favours the buyer [contending for an on demand instrument] and that is that payment is to be made against a certificate. In I.E. Contractors Ltd v Lloyds Bank Plc [1990] 2 Lloyd's Rep 496 at p. 500 Lord Justice Stauton observed:

‘There is a bias or presumption in favour of the construction which holds a performance bond to be conditional upon documents rather than facts. But I would not hold the presumption to be irrebuttable, if the meaning is plain.’

18. In Paget there is a further passage under the same heading to which I have referred which says:

‘...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.'

There is a passage to similar effect in Documentary Credits by Jack, Malek and Quest [2001] where the authors say at par. 12(57):

‘In particular ... a (demand) guarantee will not be construed only as payable only if a particular event has occurred simply because the guarantee sets out, without more, the event or events following the happening of which it is intended a demand may be made.’

What is said in these passages is illustrated by Esal (Commodities) Ltd v Oriental Credit Ltd [1985] 2 Lloyd's Rep 546 where the words of the instrument were:

‘We undertake to pay the said amount on your written demand in the event that the supplier fails to execute the contract in perfect performance.’

The Court held that the bond was payable on demand despite the fact that it referred to the suppliers failure to perform the underlying contract about which there was a dispute. At p.549 Lord Justice Ackner (with whom the other members of the Court agreed) observed:
‘... If the performance bond was so conditional, then unless there was clear evidence that the seller admitted that he was in breach of the contract of sale, payment could never safely be made by the bank except on a judgment of a court of competent jurisdiction and this result would be wholly inconsistent with the entire object of the transaction, namely to enable the beneficiary to obtain prompt and certain payment.’

6.3.3. Decision

65. Particular regard must be had to the fact that the Bond was issued subject to ISP98. This document seeks to codify International Standby Practices and is applicable to standby instruments such as this Bond. These instruments are subject to certain General Principles of which the most significant are:

“1.06 Nature of standbys

a. A standby is an irrevocable, independent, documentary and binding undertaking when issued and need not so state.”

...  

c. Because a standby is independent, the enforceability of an issuer’s obligations under a standby does not depend on:

i the issuer’s right or ability to obtain reimbursement from the applicant;

ii the beneficiary’s right to obtain payment from the applicant;

iii a reference in the standby to any reimbursement agreement or underlying transaction.”

“1.08 Limits to responsibilities

An issuer is not responsible for:

a. performance or breach of any underlying transaction;

b. accuracy, genuineness, or effect of any document presented under the standby; ...

66. These considerations suggest that the Bond is a demand or performance instrument. This conclusion is reinforced by the following further considerations:

1. The language of the Bond suggests that it is a demand bond. Thus, it states that claims should be made upon presentation of the defined buyer’s certificate and a buyer’s written notice to the supplier of its intention to draw down the bond without any additional qualification that the supplier should be, or be shown to be, in default or has been held liable to pay loss or damages.

2. The four criteria of a demand bond identified by Paget (see paragraph 63 above) are all present in this case. Thus, the Bond: (i) relates to an underlying transaction between parties in different jurisdictions viz a buyer incorporated in England but whose shareholders are based in Hong Kong, Japan and the Netherlands and a seller incorporated in Israel; (ii) was issued by a bank; (iii) contained an undertaking which was the equivalent of an undertaking to pay, on demand; (iv) contained no clauses excluding or limiting the defences available to the guarantor bank. This is in contradistinction to the guarantee in the Gold Coast case which, although ultimately held to be an on demand guarantee, stated that “any variation, amendment to or waiver given in respect of the [underlying agreements] will not limit, reduce or exonerate [the bank’s] liability under this Guarantee ...”.

3. The sum guaranteed is made payable against documents and not against facts. The obligation being guaranteed, being the carrying out of material obligations under the Agreement, was set out to identify the happening on which it was intended that the demand could be made.

67. On analysis, the only real basis that underlay TTI’s contention that the Bond was a “see to it” bond was this argument:

1. The Agreement continued in force unless “terminated earlier in accordance with the provisions of the Agreement” (clause 3.2).

2. The Agreement could only be terminated earlier than the contracted for date by H3G if it used clause 35. That clause specified a number of events that justified an early termination by H3G, one of which was the presentation of a winding up petition against TTI. Clearly there had actually to be in existence a winding up petition before that ground for termination existed. Thus, a termination would not be lawful unless a winding up petition had actually been served on TTI.

3. If an actual winding up petition had to precede a clause 35 termination, it ought to follow that, in relation to the other grounds for termination set out in clause 35, an actual termination, rather than a purported or potentially invalid termination based only on the say-so of H3G, had to precede a clause 35 termination. Thus, the grounds relied on had to be admitted by TTI or found to exist by a court or arbitrator before a valid termination on such grounds could proceed.

4. It followed that the words in clause 3.2 of the Agreement: “termination in accordance with” meant: “terminated following admission or proof or the establishment by judgment or award of the underlying facts on which that termination is based”. 
5. The words: “terminated in accordance with clause 35” in clause 4.2 must mean the same as the words: “terminated ... in accordance with the provisions of this Agreement” in clause 3.2.

6. Thus, proof, admission or judgment in relation to the underlying default had to precede a termination since a valid termination depended on H3G having first established the default. It followed that no call could be made on the Bond without there first having been a valid termination, namely an admission or finding of default by TTI.

68. This somewhat tortuous reasoning is unsustainable. Firstly, any use by H3G of clause 35 must inevitably precede a finding of default by a court or arbitrator. The clause requires H3G to have an honest belief that the grounds for activating the termination provisions are present. Of course, following a termination which is valid on its face, a court might hold that the grounds relied on did not in fact exist. That would, subsequently, turn a valid termination into an invalid termination but, pending such a finding, the parties and third parties are entitled to proceed on the basis that the termination was lawful. Secondly, the suggested construction of the word “termination” so as to embrace, as a necessary precondition of that termination, a finding by a court that TTI was in default, flies in the face of the language and underlying commercial purpose of the Bond. Lord Justice Ackner’s words in the Essal (Commodities) Ltd case (see paragraph 63 above) are wholly apposite here to defeat such a construction.

6.3.4. Conclusion

69. The Bond is a demand or performance bond, a draw down from which is wholly dependent on the presentation of valid documentation by H3G. The Bond is not a “see to it” bond and no proof by H3G of the underlying facts or that the underlying termination was valid is required.

7. Overall Conclusion

97. TTI has put forward six bases for challenging and seeking to preclude H3G’s threatened call on the Bond. One, (ground 6) was based on H3G’s lack of faith and has no factual basis. Two, (grounds 1 and 2) were based on assertions that a precondition to call had not been met and that the Bond was a “see to it” bond which were incorrect given the terms of the Agreement. Two, (grounds 4 and 5) were based on alleged failures to terminate the agreement correctly on procedural grounds which failed since the suggested grounds of non-conformity with the contractual procedure for termination were not made out. Moreover, these grounds of challenge are, on analysis, not open to TTI since they are neither allegations of want of good faith nor allegations of want of a jurisdictional basis to call the Bond. The final basis of challenge (ground 3) was a factual merits-based ground not open to TTI. This ground alleged that the Milestone Dates set out in the Agreement had been varied. Moreover, it, too, had not been made out.

98. It follows that TTI’s application for an interim injunction has failed and must be dismissed. I will hear the parties as to whether any declarations should be made to reflect the decisions of law contained in this judgment and as to whether the action should be dismissed or be the subject of a trial of any dispute as to the validity of the termination or as to H3G’s entitlement to call the Bond and, if so, what directions for trial should be givenback.

**CONSTRUCTORA ADRADE GUTIERREZ, S.A. v. AMERICAN INTERNATIONAL INSURANCE COMPANY OF P.R.**

247 F. Supp. 2d 83 (D.P.R. 2003)

The instrument at issue here, which was originally executed and printed in Spanish, contains as part of its title1 the wording “performance bond.” Nevertheless, the wording of the agreement as exemplified by the first paragraph is akin to that of an independent letter of credit rather than that of a guaranty, a surety or a performance bond dependent upon the original agreement2. See, e.g., International Paper Co. v. April Agro Industries, 747 F. Supp. 111, 114-117 (D.P.R. 1990) (discussing guaranties and sureties under Puerto Rico law).

The first paragraph of the instrument issued by AIICO states: “We the undersigned, American International Insurance Company of Puerto Rico, hereby establish in the name and for the account of C.M. Constructora, S.A., an irrevocable and unconditional guarantee in the amount of FIVE MILLION SIX HUNDRED NINETY-SIX THOUSAND THREE HUNDRED TWENTY-TWO and 42/100 United States dollars (US$ 5,696,322.42), as a guarantee for the completion and unconditional payment of the sum of LION SIX HUNDRED NINETY-SIX THOUSAND UNITED STATES DOLLARS (US$ 696,322.42) to C.M. Constructora, S.A., in the event of its default in the performance of its obligations hereunder.”

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1. The way an instrument is labeled and/or entitled does not give an instrument its legal effect. See e.g., *Egyptian American Bank v. United States*, 13 C.Ct. 337, 341-344 (1987), aff’d, 861 F.2d 728 (Fed. Cir. 1989).
2. The Court includes the terms guaranty, surety and performance bond given that in some of the case law the terms are referred to interchangeably.
3. It should be noted that the Puerto Rico law pertaining to “letters of credit” was recently repealed. The law in effect when the instrument at issue was executed (in May 1996) was the same discussed in the Revlon case cited above, *7 L.P.R.A. § 1601 et seq.* (1983). This section was repealed on September 19, 1996, and the new law came into effect 120 days thereafter. The current law dealing with “letters of credit” is codified at *19 L.P.R.A. § 1221 et seq.*
Chapter 1 — “Guarantees” and “Guarantees” (& Standbys): Independence & Sanity

of the Works”) pursuant to the stipulations of the contract dated May 6, 1996.” The words “irrevocable and unconditional” clearly conform with the typical language of a letter of credit designed to serve as a guarantee to the beneficiary against harm caused by a contractual default, and completely independent of any other contractual obligation. See *Ground Air Transfer, Inc. v. Westates Airlines, Inc.*, 899 F.2d 1269, 1272 (1st Cir. 1990)(discussing the ordinary principles of letters of credit under the UCC). “Letters of Credit” are recognized under Puerto Rico law, which is somewhat analogous to the UCC. See, e.g., *Revlon Realistic, Inc. v. Las Americas Trust Co.*, 135 D.P.R. 363, 1994 Juris P.R. 27, 1994 Juris P.R. No. 27 (1994) (letters of credit connect the issuer and the beneficiary with total independence from the underlying contract between the customer and the beneficiary.) The plain language of the document (Docket No. 39, Exhibit 2A) leads the Court to conclude that the instrument issued by AIICO in favor of CAG was an unconditional letter of credit. The Court need not consider the extrinsic evidence submitted by the parties given that the language of the instrument is clear and unambiguous.

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**Vossloh Aktiengesellschaft v. Alpha Trains (UK) Ltd**

[2010] EWHC (Ch) 2443, All E.R. 86 [England]

**Sir William Blackburne:**

**Introduction**

1. These proceedings are concerned with the true construction of an agreement in writing executed as a deed and dated 15 September 2009. It is between the claimant, Vossloh Aktiengesellschaft (“VAG”), and Angel Trains International Limited. The latter has since undergone a change of name to Alpha Trains (UK) Limited (“Alpha”). The agreement describes itself as a “Guarantee.” I shall refer to it as the “2009 Guarantee.” VAG is described in it as the “Guarantor,” and Alpha and its affiliates are collectively referred to as the “Angel Trains Group.” Members from time to time of that group “and their respective agents, assigns, directors, employees, officers, secondees and servants” are each described as a “Beneficiary” with “Beneficiaries” construed accordingly.

2. The issue which I am asked to decide is the basis on which, under the 2009 Guarantee, VAG can be required to make payment to a Beneficiary.

3. It is the contention of VAG, which has appeared by Geraldine Andrews QC and James Willan, that its liability under the 2009 Guarantee is triggered upon proof (whether by admission or by decision of a competent court of law) of a breach of contract by any one or more of those entities referred to in it as the “Guaranteed Party”. That expression is defined as meaning two named companies in the Vossloh Group “and each other member from time to time” of that group.

4. It is the contention of Alpha, which is sued in its own right and as representative defendant on behalf of all the Beneficiaries under the 2009 Guarantee and has appeared by Stephanie Barwise QC and Jennifer Jones, that VAG’s liability under it is triggered by a demand alone. By that is meant (as counsel described it in their skeleton argument) that the obligation undertaken by VAG is in the nature of an “on demand performance guarantee” in that it constitutes an unconditional independent promise to pay on demand all amounts demanded.

5. VAG was prompted to bring these proceedings with a view to determining the basis of its liability under the 2009 Guarantee following the receipt by it of a letter of demand to VAG claiming in excess of €17 million. That letter was replaced by a revised demand dated 22 February 2010 in the sum of €17,267,354. VAG contends that none, or at the most only a small part, of that sum is payable under 2009 Guarantee.

**Background**

6. VAG is the parent company of the Vossloh Group of companies which are leaders in the rail infrastructure and technology market. One of its subsidiaries is Vossloh Locomotives GmbH (“VL”) which manufactures and supplies locomotives. It previously had another name.

7. Alpha, under its former name Angel Trains International Ltd, was a member of the Angel Trains Group which was formerly owned by the Royal Bank of Scotland Group plc (“RBS”). On completion of the sale of the Angel Trains Group by RBS in August 2008, its UK and international operations were separated and now function under separate ownership and separate management. From December 2009 the international businesses began using the Alpha Trains name.

8. The commercial dealings between the Alpha Group (as it is now called) and the Vossloh Group relevant to these proceedings date back to 2000. On 13 September 2000 a company in the (then) Angel Trains Group entered into a co-operation agreement with VAG to facilitate a mechanism for the sale of locomotives by Vossloh Group companies to Angel Trains Group companies and to create an operations
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and maintenance services facility for the locomotives. This led to the establishment that same year of two companies owned, albeit in unequal shares, by the two Groups. One of those two companies was called Locomotive Capital Ltd ("LCL"), 10% of whose shares were held by the VAG Group and the remaining 90% by the Angel Trains Group. LCL in its turn had three wholly-owned subsidiaries. One of them, referred to for short as LCUKL, was the purchasing party under a Master Purchase Agreement (the "MPA") (also known as the "German MPA") dated 23 April 2001 and made with VL. Another of the subsidiaries was the purchasing party under other purchase agreements including, in particular, two agreements referred to in evidence as the "German Agreements" and another which was referred to as the "2001 Agreement".

9. The MPA acted as a framework agreement pursuant to which LCUKL could purchase locomotives from VL from time to time by issuing "Call Off Notices" ("CONs"). The German Agreements and the 2001 Agreement operated in a similar manner.

10. The other jointly owned company was set up to provide the maintenance and services operation. This company was owned 10% by the Angel Trains Group and the remaining 90% by the Vossloh Group. A representative of the minority shareholder was appointed to the board of each of the two jointly owned companies.

11. From at least 2002 onwards, locomotives were purchased from VL by various members of the Angel Trains Group, issuing CONs under the MPA. The purchasers included group affiliates in Belgium, Germany, Switzerland and Luxembourg. The same happened under the German Agreements and the 2001 Agreement.

12. Prior to the sale of the Angel Trains Group in the summer of 2008, RBS, the ultimate parent of the Group, used its own money to finance the purchase of locomotives pursuant to the MPA. The Group purchased locomotives on a speculative basis before any third party customers had committed to acquiring them. Payment was in stages prior to the delivery of the locomotives and before therefore any income could be generated from them. By the end of 2002, the Group was committed to the spending of €95 million on purchasing locomotives from VL.

13. In around late 2002, RBS, in the light of the level of its financial outlay and exposure, made it a condition of the grant of its approval to any further locomotive purchases from VL that VAG should provide a parent company guarantee of VL's obligations under the MPA. The first such guarantee was entered into on 5 March 2003. It was given in favour of LCUKL alone. This guarantee was replaced by a guarantee dated 15 September 2006 which extended the guarantee to the obligations of a VL affiliate in respect of an order for the purchase of locomotives in Spain. The 2006 guarantee also enabled other companies within the Angel Trains Group to benefit from the guarantee and to make claims under it.

14. In consequence of the sale and restructuring of the Alpha/Angel Trains Group in the summer of 2008, the 2006 guarantee was replaced on 15 September 2009 by the further guarantee, namely the 2009 Guarantee which is the subject of these proceedings.

15. Alpha has complained that sixty-three G1206 cargo locomotives supplied to them by VL suffer from various defects in their engines and gearboxes. Fifty-two of the locomotives were supplied under CONs issued pursuant to the MPA. The remaining eleven were supplied under the German Agreements and the 2001 Agreement.

16. A formal notice of dispute under clause 21 of the MPA was given by Alpha on 12 September 2008. This was followed by a pre-action protocol letter of claim dated 29 January 2010, which also related solely to the locomotives supplied pursuant to the MPA. It claimed losses in excess of €14 million. On the same date, Alpha sent a letter of demand to VAG under the 2009 Guarantee claiming losses in excess of €17 million in respect of all sixty-three locomotives. This, as I have mentioned, was replaced by a revised demand dated 22 February 2010 in the sum of €17,267,354, which again related to all sixty-three locomotives. The bulk of that sum is made up of what Alpha estimates to be costs of repair.

17. Alpha accepts that it has not yet expended any money on repair, or incurred a liability to pay anything approaching the amount demanded. It also admits that if it is paid the €17 million and expends it, it cannot afford to pay the money back to VAG. Alpha says that it has purchased six new engines for its fleet at a cost of €1.8 million because the bulk of the fleet is undergoing maintenance or repair, and that it has compensated customers in the total sum of €687,554 for poor performance of the locomotives or for their withdrawal from service for longer than anticipated. Those two figures total €2,487,544.

18. VAG does not accept that Alpha would be successful in recovering either of these heads of damage from VL or VAG even if it were to succeed in proving liability. Proceedings in respect of the fifty-two locomotives supplied pursuant to the MPA have been issued against VL by LCUKL and other members of the Alpha Group in the Technology and Construction Court. Both liability and quantum are in dispute. There will be detailed technical issues (involving expert evidence) on both sides. There has been an order for service of the particulars of claim in those proceedings by 6 August 2010.
The Law

19. Before coming to the 2009 Guarantee I set out my understanding of the relevant law, starting with some general observations. In the summary that follows I have drawn from the section headed “In general” in chapter 44 (on suretyship) in volume 2 of Chitty on Contracts, 30th edition, and from chapter 1 of Andrews and Millett on the Law of Guarantees, 5th edition. The propositions which I set out accord with my experience of the law in this area and, in any event, are extensively supported by authority in the footnotes to both books. I am mindful of the fact that Ms Andrews is the co-author of the second of those textbooks.

20. Contracts of suretyship, of which the 2009 Guarantee is an example, are an area of law bedevilled by imprecise terminology and where therefore it is important not to confuse the label given by the parties to the surety’s obligation (although the label may be indicative of what the parties intend) with the substance of that obligation. Because the parties are free to make any agreement they like, each case must depend upon the true construction of the actual words in which the surety’s obligation is expressed. This involves “construing the instrument in its factual and contractual context having regard to its commercial purpose”, a task which the court approaches “by looking at it as a whole without any preconception as to what it is.” See Tuckey LJ in Gold Coast Ltd v Caja de Ahorros Del Mediterraneo [2002] EWCA Civ 1806, [2002] 1 Lloyd’s Rep 231 at [10] and [15]. Further, as Ms Andrews observed, the court must endeavour to avoid a construction which renders a clause otiose or duplicative.

21. A contract of suretyship is in essence a contract by which one person, the surety, agrees to answer for some existing or future liability of another, the principal (or principal debtor), to a third party, the creditor, and by which the surety’s liability is in addition to, and not in substitution for, the liability of the principal. Even the use of the expressions “creditor” and “debtor” (as in “principal debtor”) can be misleading: the liability which is “guaranteed” may consist of the performance of some obligation other than the payment of a debt, and it does not have to be a contractual liability.

22. Contracts of suretyship fall into two main categories: contracts of guarantee and contracts of indemnity. Because they have many similar characteristics, and similar rights and duties arise between the parties, it is not unusual to find the term “guarantee” used loosely to describe what is in reality an indemnity.

23. A contract of guarantee, in the true sense, is a contract whereby the surety (the guarantor) promises the creditor to be responsible for the due performance by the principal of his existing or future obligations to the creditor if the principal fails to perform them or any of them. Depending on its true construction, the obligation undertaken by the surety may be no more than to discharge a liability, for example a particular debt, if the principal does not discharge it so that if for any reason the principal ceases to be liable to pay that debt (it may have been discharged and replaced by some other debt or liability) the surety will not come under any liability to the creditor. The surety’s liability in such a case is conditional upon the principal’s failure to pay the particular debt so that if the condition is fulfilled the surety’s liability will sound in debt. In contrast to that is the more usual case (sometimes referred to as a “see to it” guarantee) where, on the true construction of the contract, the surety undertakes that the principal will carry out his contract and will answer for his default. In such a case, if for any reason the principal fails to act as required by his contract he not only breaks his own contract, but he also puts the surety in breach of his contract with the creditor, thereby entitling the creditor to sue the surety, not for the unpaid debt, but for damages. The damages are for the loss suffered by the creditor due to the principal having failed to do what the surety undertook that he would do. See Moschi v Lep Air Services Ltd. [1973] AC 331 at 344 to 345 (Lord Reid).

24. An essential distinguishing feature of a true contract of guarantee – but not its only one – is that the liability of the surety (i.e. the guarantor) is always ancillary, or secondary, to that of the principal, who remains primarily liable to the creditor. There is no liability on the guarantor unless and until the principal has failed to perform his obligation. The guarantor is generally only liable to the same extent that the principal is liable to the creditor. This has the consequence that there is usually no liability on the part of the guarantor if the underlying obligation is void or unenforceable, or if the obligation ceases to exist (to which principle – the so-called principle of co-extensiveness - there are, however, a number of exceptions). It will depend upon the terms of the contract of suretyship whether a demand must be made on the principal or on the guarantor (or on both) in order to trigger the guarantor’s obligation to pay. Many modern guarantees expressly negative the need for the creditor to make a demand on the principal or on the guarantor or to take any other given step before enforcing the guarantee.

25. In contrast to the contract of guarantee is the contract of indemnity. In one sense all contracts of guarantee (strictly so called) are contracts of indemnity (as indeed are many contracts of insurance) since, in its widest sense, an indemnity is an obligation imposed by operation of law or by agreement of the parties. In the narrower sense in which, in the current context, the expression occurs, a contract of indemnity denotes a contract where the person who gives the indemnity undertakes his indemnity obligation by way of security for the performance of an obligation by another. Its essential distinguishing feature is that, unlike a contract of guarantee (strictly so called), a primary liability falls upon the giver of the indemnity. 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.

26. The fact that the obligation to indemnify is primary and independent has the effect that the principle of co-extensiveness does not apply to a contract of indemnity. The indemnity not only shifts the burden of the principal’s insolvency onto the indemnifier but it also safeguards the creditor against the possibility that his underlying transaction with the principal is void or unenforceable. It also prevents the discharge of the principal or any variation or compromise of the creditor’s claims against the principal from necessarily affecting the liability of the indemnifier under his contract with the creditor. Otherwise, the rights and duties of the parties to a contract of indemnity are generally the same as those of the parties to a contract of guarantee.

27. So much for some of the essential differences. Whether a particular contract of suretyship is of the one kind or the other or, indeed, a combination of the two turns on its true construction. A contract which contains a provision preserving liability in circumstances where a guarantor would otherwise be discharged (for example, the granting of time by the creditor to the principal or a material variation of the underlying contract between the principal and the creditor, without (in either case) the guarantor’s consent) will usually indicate that the contract is one of guarantee because such a provision would be unnecessary if the contract were one of indemnity. On the other hand, a provision stating that the surety is to be liable in circumstances where the principal has ceased to be liable (for example, on the principal’s release by the creditor) may be indicative either of a guarantee (because the provision would be unnecessary in the case of a contract of indemnity) or of an indemnity (because it makes clear that the liability of the surety was intended to continue regardless of the liability of the principal). See, for example, Clement v Clement, (unreported, Court of Appeal, 20 October 1995). Context is important in deciding what the nature is of the obligation under consideration as even minor variations in language, plus a different context, can produce different results. See IIG Capital LLC v Van Der Merwe [2008] EWCA Civ 542, [2008] 2 Lloyd’s Rep 187 (“IIG”) at [20] (Waller LJ). But if, in a contract of guarantee (strictly so called), the parties are minded to exclude any one or more of the normal incidents of suretyship “clear and unambiguous language must be used to displace the normal legal consequence of the contract...” See IIG at [19] (Waller LJ).

28. This brings me to the so-called “performance bond”, sometimes known as a “performance guarantee”, often as a “demand bond” or “demand guarantee” or even as a “first demand guarantee”. In the context of the present dispute I prefer the expression “demand bond”. In essence it is a particularly stringent contract of indemnity. It is a contractual undertaking by a person, usually a bank, to pay a specified amount of money to a third party on the occurrence of a stated event, usually the non-fulfilment of a contractual obligation by the principal to that third party. Sometimes the wording of the contract has the result that the liability of the person who has given the bond arises on mere demand by the creditor, notwithstanding that it may be evident that the principal is not in any way in default or even that the creditor himself is in default under his contract with the principal. It all depends on the wording of the instrument. It is often a difficult question to determine whether, on its true construction, a particular contract which provides for payment on demand is a performance or demand bond (where the obligation to pay is triggered by a demand alone or by a demand accompanied by the provision of specified documents) or whether it is a guarantee (strictly so called) where the obligation to pay is of the “see to it” kind, i.e. conditional on proof by the creditor of default by the principal.

29. The result of the foregoing brief survey is that, with the parties free to agree whatever terms they choose, 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. Where on the spectrum a particular case falls may call for a nice judgment on the part of the court faced with the task of construing the instrument in question. The instant case calls for just such a judgment.
The 2009 Guarantee

30. The following are the material terms of the 2009 Guarantee:

1.1 Definitions

In this Guarantee (including the recitals), except where the context otherwise requires:

Angel Trains Group means Angel Trains and its Affiliates.

Beneficiary means each member of the Angel Trains Group from time to time and their respective agents, assigns, directors, employees, officers, secondees and servants. Beneficiaries shall be construed accordingly.

Call-Off Notice means together each German Call-Off Notice and Spanish Call-Off Notice and includes a reference to any of them.

German Call-Off Notice means each contract for the sale and purchase of, as applicable, locomotives and other items as contemplated by the German MPA ...

Guaranteed Party means [VL], Vossloh Espana S.A.U. and each other member from time to time of the Guarantor Group.

Guarantor Group means the Guarantor and its Affiliates.

Parties means the parties to this Guarantee.

Relevant Document means each of

(a) the German MPA;
(b) each German Call-Off Notice;
(c) the Spanish MPA;
(d) each Spanish Call-Off Notice; and
any other agreement for the sale and purchase of locomotives and/or related items entered into between any member of the Angel Trains Group and any member of the Guarantor Group, from time to time.

and all notices, consents, certificates and other documents from time to time issued pursuant to or in connection with any of the above and all other agreements, letters and documents designated as such by the Parties and Relevant Documents shall be construed accordingly.

Secured Obligations means any and all present and future monies, liabilities and obligations (whether for the payment of money or otherwise and whether actual or contingent and whether owed jointly or severally or in any other capacity whatsoever) owed by any member of the Guarantor Group to a Beneficiary under or in connection with any Relevant Document. References to Secured Obligations shall include references to any part thereof.

Spanish Call-Off Notice means each contract for the sale and purchase of, as applicable, locomotives and other items as contemplated by the Spanish MPA ...

1.2 Interpretation

Except where the context otherwise requires, in this Guarantee:

(j) references to the obligations guaranteed under this Guarantee shall include a reference to indemnified obligations.

2. GUARANTEE AND INDEMNITY

2.1 In consideration of the Angel Trains Group placing orders under any Call-Off Notice the Guarantor hereby unconditionally and irrevocably as a continuing obligation and as principal debtor and not merely as surety, as a separate, continuing and primary obligation:

(a) guarantees to each Beneficiary the due and punctual observance and performance by each Guaranteed Party of each obligation owed by such Guaranteed Party to that Beneficiary contained in the Relevant Documents to which that Guaranteed Party is a party;
(b) guarantees to each Beneficiary the due and punctual payment by each Guaranteed Party of all of its Secured Obligations;
(c) undertakes with each Beneficiary that whenever a Guaranteed Party does not pay any of the Secured Obligations as and when the same shall be expressed to be due, the Guarantor shall forthwith on demand pay such Secured Obligations which have not been paid at the time such demand is made,
(d) as a separate and independent stipulation, agrees that if any purported obligation or liability of the Guaranteed Party which would have been the subject of this Guarantee had it been valid and enforceable is not or ceases to be valid or enforceable against a Guaranteed Party on any ground whatsoever whether or not known to any Beneficiary, the Guarantor shall nevertheless be liable to the relevant Beneficiary in respect of that purported obligation or liability as if the same were fully valid and enforceable and the Guarantor was the principal debtor in respect thereof and shall be paid or caused to be paid by the Guarantor under this Guarantee upon demand; and
(e) as principal obligor and as a separate and independent obligation and liability, indemnifies each Beneficiary against any losses suffered by it from time to time in connection with or as a direct or indirect result of the failure of a Guaranteed Party to duly and punctually perform its terms, representations and warranties, conditions, covenants and obligations contained in the Relevant Documents to which it is a
party or failure to duly and punctually pay the Secured Obligations or as a result of the whole or any part of the Relevant Documents being or becoming void, voidable, unenforceable or ineffective as against that Beneficiary for any reason whatsoever, irrespective of whether such reason or any related fact or circumstance was known or ought to have been known to that Beneficiary.

3. PAYMENTS
3.1 All sums payable hereunder shall be paid on demand to such bank account as may be specified in any demand made by a Beneficiary hereunder, in immediately available funds, free of any restriction or condition and free and clear of and without any deduction or withholding, whether for or on account of tax, by way of set-off or otherwise, except to the extent required by law.

4. CONTINUING GUARANTEE
This Guarantee shall be effective from the date hereof. The guarantee constituted by this Guarantee shall be continuing and shall extend to the ultimate balance of the Secured Obligations and to the performance in full of all obligations guaranteed hereunder, regardless of any intermediate payment or discharge in whole or in part or performance in part.

5. DISCHARGE AND RELEASE
5.1 The Guarantor may not terminate this Guarantee by notice to any Beneficiary or otherwise.

6. WAIVER OF DEFENCES
6.1 The liabilities and obligations of the Guarantor under this Guarantee shall remain in force notwithstanding any act, omission, neglect, event or matter whatsoever whether or not known to the Guarantor, any Guaranteed Party or any Beneficiary (other than the irrevocable payment of the Secured Obligations to a Beneficiary and the full performance of all obligations guaranteed hereunder) and the foregoing shall apply, without limitation, in relation to:
(a) anything which would have discharged the Guarantor (wholly or in part) whether as surety, co-obligor or otherwise or which would have afforded the Guarantor any legal or equitable defence;
(b) any winding up, dissolution, reconstruction or reorganisation, legal limitation, disability, incapacity or lack of corporate power or authority or other circumstances of, or any change in the constitution or corporate identity or loss of corporate identity by, the Guaranteed Party or any other person connected with Guaranteed Party or the Guarantor; and
(c) anything which renders the Guaranteed Party’s obligations void, invalid or unenforceable under the Relevant Documents and any defence or counterclaim which the Guaranteed Party may be able to assert against a Beneficiary or affects a Beneficiaries ability to recover amounts from the Guaranteed Party.
6.2 Without limiting Clause 6.1, none of the liabilities or obligations of the Guarantor under this Guarantee shall be impaired by any Beneficiary:
(a) agreeing with a Guaranteed Party any amendment, variation, assignment, novation or departure (however substantial or material) of, to or from a Relevant Document so that any such amendment, variation, assignment, novation or departure (including any which may have been made before the signing of this Guarantee) shall, whatever its nature, be binding upon the Guarantor in all circumstances, notwithstanding that it may increase or otherwise affect the liability of the Guarantor;
(b) releasing or granting any indulgence of any kind to the Guaranteed Party or any third party (including, without limitation, the waiver of any preconditions for drawing under, or of any breach of, any Relevant Document, or entering into any transaction or arrangements whatsoever with or in relation to a Guaranteed Party and/or any third party;
(c) taking, accepting, varying, dealing with, enforcing, abstaining from enforcing, surrendering or releasing any security, right of recourse, set off or combination or other right or interest held by a Beneficiary for the Secured Obligations and the other obligations guaranteed hereunder or in relation to any Relevant Document in such manner as it or they think fit;
(d) claiming, proving for, accepting or transferring any payment in respect of the Secured Obligations and the other obligations guaranteed hereunder in any composition by, or winding up of, a Guaranteed Party and/or any third party or abstaining from so claiming, proving for, accepting or transferring;
(e) any termination of a Relevant Document;
(f) any act or omission of a Guaranteed Party pursuant to any agreement with the Guarantor or otherwise;
(g) any other circumstance, matter or thing which (in the absence of this provision) would or might have that effect, except a discharge or amendment of this Guarantee expressly made or agreed to by Angel Trains in writing.
6.3 The Guarantor hereby waives any right it may have of first requiring a Beneficiary to proceed against or enforce any other rights or security or claim payment from any person (including each Guaranteed Party) before claiming from the Guarantor under this Guarantee.
6.4 Subject to the terms of this Guarantee, and in particular this Clause 6, the Guarantor shall be entitled to raise such defences which are available to the Guaranteed Party under the Relevant Document only after the Guarantor has complied with Clause 2.1 of this Guarantee. However the Guarantor is not entitled to refuse payment or performance based on this right to reclaim.
7. **DEMANDS**

Demands under this Guarantee may be made from time to time, and the liabilities and obligations of the Guarantor under this Guarantee may be enforced, irrespective of

(a) whether any demands, steps or proceedings are being or have been made or taken against the Guaranteed Party and/or any third party; or

(b) whether or in what order any security to which a Beneficiary may be entitled in respect of the Secured Obligations and the other obligations guaranteed hereunder is enforced.

...

11. **MISCELLANEOUS PROVISIONS**

11.1 This Guarantee is not personal to Angel Trains and may be assigned by Angel Trains to any person, firm or company, provided that Angel Trains shall notify the Guarantor in writing of such assignment, whereupon the Guarantor shall be obliged to make any payment demanded under this Guarantee to the person, firm or company specified in such notice and such payment shall constitute a full and valid discharge of the Guarantor in relation to that payment. The Guarantor is not entitled to transfer, novate or assign any of its obligations under this Guarantee.

11.2 A certificate of a Beneficiary setting forth the amount of any Secured Obligations not then paid by a Guaranteed Party shall be conclusive evidence of such amount against the Guarantor in the absence of any manifest error.

11.3 No failure or delay by a Beneficiary in exercising any right or remedy provided by law under or pursuant to this Guarantee shall impair that right or remedy or operate or be construed as a waiver or variation of it or preclude its exercise at any subsequent time and no single or partial exercise of that right or remedy shall preclude any other or further exercise of it or the exercise of any other right or remedy.

...

12. **GOVERNING LAW AND JURISDICTION**

12.1 This Guarantee is governed by and shall be construed in accordance with, English law...”

The arguments

31. As VAG is not a bank or in any way equivalent to a bank and the 2009 Guarantee was not given in a banking or like context, the jurisprudence discussed above raises a strong presumption that the payment obligations undertaken by VAG do not constitute a demand bond. What grounds then are there in the context and wording of the document for rebutting that presumption?

32. Dealing first with context, Ms Barwise pointed to the following factors: (1) express requirements in a memorandum of understanding entered into between VAG, LCUKL and Angel Train Contracts Ltd on 11 February 2000 and also in a co-operation agreement between Angel Trains Ltd (formerly Angel Train Contracts Ltd) and VAG on 13 September 2000 to act in good faith towards each other in the furtherance of their mutual business interests, (2) the fact that the two groups jointly owned LCL which in turn owned LCUKL and LCD (the locomotive purchasers under the MPA and the other agreements – see paragraph 8 above), thereby demonstrating the extent to which the groups were bound up in each other’s activities and shared a community of interest, (3) the nature of the MPA as a framework agreement with no limit either on the number of locomotives to be purchased under it or on its duration, a circumstance matched in the 2009 Guarantee which states (by clause 4) that it is to “extend to the ultimate balance of the Secured Obligations” and (by clause 5.1) that VAG may not terminate it in any way, and (4) Alpha’s requirement which it says it communicated to VAG (although VAG disputes this) for a form of security which could be realised promptly to protect it from exposure arising from non-delivery of or defective locomotives. Ms Barwise did not suggest that these factors in themselves showed an intention that the 2009 Guarantee should operate as a performance bond but submitted that they made it more likely that, if the wording of the 2009 Guarantee justified such a construction, I should be the more willing to conclude that that is indeed what it is.

33. Coming next to the wording of the 2009 Guarantee Ms Barwise submitted that, properly understood, clauses 2.1, 3.1, 6.3, 6.4, 7 and 11.2 show that the document constitutes a demand bond. The opening words of clause 2.1 stating that VAG’s contractual promises were entered into “as a principal debtor and not merely as a surety, as a separate, continuing and primary obligation...” show that all that follows in that clause are primary and not secondary obligations. Clause 3.1 states in terms that all that is payable under the instrument is to be “paid on demand”. Clause 6.3, whereby VAG waives any right to require a Beneficiary to proceed against any other person before claiming against VAG, emphasises the immediacy and primacy of VAG’s obligations. Likewise clause 6.4, stating in effect “pay now, argue later”. This would be unnecessary in a true guarantee since, under a guarantee, the guarantor is always entitled to raise defences available to the principal. Clause 7, when read with clause 6.4, shows that the Beneficiary is entitled to payment by VAG irrespective of whether it has made a demand or proceeded against a third party. This is reinforced by clause 11.2 stating that the Beneficiary’s certificate of the amount due is to be “conclusive evidence of such amount” save for manifest error.

34. Taking these indications in the wording with the contractual context, the 2009 Guarantee, she submitted, is correctly to be interpreted as a demand bond.
35. Ms Andrews submitted that the key clause defining VAG’s obligations is clause 2.1. Subparagraphs (a) and (b) of that clause are secondary obligations (and are expressed in the classic language of a guarantee); subparagraph (c) is probably also secondary in nature; subparagraphs (d) (almost certainly) and (e) (certainly) are primary obligations. But, whether or not the obligations are primary or secondary in nature, the clause assumes that there has been default by the principal (i.e. VL) in performing the underlying MPA or in making a payment that is contractually due under it. Clause 2 cannot therefore be construed as giving rise to any liability to pay against a mere assertion of breach or a failure to pay money.

36. Ms Andrews submitted that Ms Barwise could derive no assistance from the other clauses on which she relied. Clause 3.1 is no more than a standard form demand clause found in guarantees. It does not define the circumstances in which VAG’s liability arises. Instead, its reference to “all sums payable hereunder” points to the liability which arises, if at all, under clause 2.1. In a performance or demand bond, by contrast, the demand is critical because it is that which triggers liability. Clause 3 does not seek to do this. Clause 6 contains provisions typically found in guarantees. The express reference in clause 6.4 to the Guarantor having first to comply with clause 2.1 begs the question of what that compliance entails. So far from precluding VAG from raising any defence available to the Guaranteed Party, it merely defers the right to raise the defence until after compliance with clause 2; in so doing it preserves the co-extensiveness of VAG’s liability with that of the principal. That is the antithesis of a performance or demand bond. Clause 11.2 is a standard form “conclusive evidence” clause which entitles the Beneficiary referred to in the 2009 Guarantee to certify the amount of any Secured Obligation which has not been discharged by the Guaranteed Party. The certificate goes to quantum not to liability.

Discussion

37. The first point to note is that under the 2009 Guarantee the liability of the “Guarantor” (as VAG is described) extends to what are termed “Secured Obligations”. As appears from the definition of that expression set out above these are not confined to monetary obligations but include “all present and future monies, liabilities and obligations (whether for payment of money or otherwise…)”. They may be owed by “any member of the Guarantor Group to a Beneficiary”. “Beneficiary” is defined as “each member of the Angel Trains Group from time to time and their respective agents, assigns, directors, employees, officers, secondees and servants”. The obligations must arise “under or in connection with any Relevant Document”. “Relevant Document” is defined to mean each of (1) the MPA (2) each so-called “German Call-Off Notice” (i.e. each contract for the acquisition of a locomotive or other item as contemplated by the MPA) (3) the “Spanish MPA” (i.e. a master purchase agreement dated 11 September 2006 for the acquisition of locomotives) (4) each so-called “Spanish Call-Off Notice” (i.e. each contract for the acquisition of a locomotive or other item as contemplated by the Spanish MPA) and (5) “any other agreement for the sale and purchase of locomotives and/or related items entered into between any member of the Angel Trains Group and any member of the Guarantor Group, from time to time”. The reach therefore of VAG’s obligations under the 2009 Guarantee is exceedingly extensive both in terms of those entitled to its benefit and the scope of the obligations caught by it.

38. The next point to note is that by clause 1.2 (j) references to obligations “guaranteed” under the 2009 Guarantee are to “include a reference to indemnified obligations”. The contrast is between obligations that are “guaranteed” by the instrument and those that are “indemnified” by it and suggests therefore that “guaranteed” as used in the instrument includes secondary liability so that it would be wrong to construe the 2009 Guarantee as confined to indemnified obligations.

39. Clause 2 which sets out VAG’s obligations (it is headed “Guarantee and Indemnity” and is plainly intended to state what those obligations are) is of critical importance. Sub-clauses (a) and (b) of Clause 2.1 are, as Ms Andrews submitted, framed in the classic language of guarantee (i.e. of a secondary obligation triggered upon proof of a breach of obligation by the principal). Sub-clauses (d) and (e) are worded as primary obligations. Sub-clause (c), although not prefaced by the expression “guarantee” (as sub-clauses (a) and (b) are) has the appearance of a secondary obligation: it is premised upon a default in payment by “a Guaranteed Party”. The obligation is to make good on demand any “Secured Obligations which have not been paid at the time such demand [i.e. demand of VAG] is made”.

40. I do not consider that the opening words of clause 2 are effective to convert into purely primary obligations obligations which are otherwise secondary in nature. The words used are certainly capable of having that purpose and effect. But, if that had been their purpose, it is difficult to see why the clause then goes to the trouble of setting out sub-clauses which, as worded, have the appearance of secondary obligations. The opening words are more consistent with an intention to set out in what follows a mixture of primary and secondary obligations. This is achieved, as a matter of interpretation, by reading the opening words as if a comma appears after the words “as a continuing obligation”. The sub-clauses that follow show all the signs of an intention to subject VAG to an obligation to answer for every kind of default that could arise under or in connection with what is referred to in the definition of Secured Obligations as “a Relevant Document”. The possibility of overlap and duplication does not matter provided that all possibilities are covered.
41. But, as Ms Andrews observed, the critical question is whether, even if all that follows is by way of primary obligation, the liability thereby assumed by VAG is triggered merely by demand (or, as she put it, by assertion) on the part of someone who qualifies as a Beneficiary or whether in addition it is necessary to demonstrate the existence of a breach or failure of obligation under or in respect of a Relevant Document. The wording of sub-clauses (a) and (b) are difficult to read except as obligations premised upon a failure of observance or performance of an underlying obligation (in the case of sub-clause (a)) or of punctual payment under an underlying obligation (in the case of sub-clause (b)) by a Guaranteed Party under a Relevant Document. It is not realistically possible, in my view, to read sub-clause (c) except as conditional on a failure of payment of an underlying debt by a Guaranteed Party and as intended therefore to subject VAG to an obligation in debt to make good that failure. Likewise sub-clause (e). It assumes that the Beneficiary has suffered loss “in connection with or as a direct or indirect result of the failure of a Guaranteed Party to duly and punctually perform...” a term etc contained in a Relevant Document “...or a failure “to duly and punctually pay the Secured Obligations...” VAG’s liability is premised upon a failure of performance of some underlying obligation. The intention is to make good the loss thereby suffered. It is premised upon the establishment of that loss by the Beneficiary.

42. Clause 3.1 does not define the circumstances in which VAG’s liability arises. Instead it assumes that there is a liability “thereunder” (i.e. under the 2009 Guarantee) to make a payment. The liability, if it exists, must arise from some other term of the instrument. I agree therefore with Ms Andrews that this clause does not lend support to the case that Ms Barwise seeks to make. But then neither does it detract from it.

43. That brings me to clause 6. Headed “Waiver of Defences” sub-clauses 6.1 to 6.3 contain provisions I would expect to find in a guarantee strictly so called. In any event, Ms Barwise did not suggest that they give support to the existence of a performance bond. To my mind, the “pay now, argue later” terms of sub-clause 6.4 point to the existence of a secondary rather than to a primary liability. The sub-clause assumes that VAG may raise defences which the Guaranteed Party could have raised if the demand had been addressed to it. Its purpose is simply to postpone the exercise of that right by VAG until after the demand has been fully met. If VAG’s liability were primary, let alone one triggered by a demand alone, the fact that the Guaranteed Party has or may have a defence to the demand would be quite immaterial. I do not therefore consider that Ms Barwise can find support in this clause for the case that she advances. Nor do I accept her submission that its presence throws light on a proper understanding of the other clauses on which she relies.

44. The same is true of clause 7 which is headed “Demands”. It does no more than state that more than one demand may be made and that VAG’s liability may be enforced whether or not the Beneficiary has pursued to any extent its rights against the Guaranteed Party or in respect of any security it holds. In particular, I do not accept Ms Barwise’s submission that, when taken with clause 6.4, clause 7 shows that, in order to establish liability in VAG, it is unnecessary for the Beneficiary to establish any underlying liability in the Guaranteed Party.

45. Clause 11.2 is a conclusive evidence provision of a kind commonly seen in guarantees. As worded it is well capable of extending to the damages payable for breach of a Secured Obligation and is not confined merely to liquidated sums. It also assumes that there is a breach of the Obligation. The question is whether its reference to the certificate constituting “conclusive evidence... against the Guarantor in the absence of any manifest error” goes to the existence of the breach (i.e. liability) and not just to its monetary consequences (i.e. quantum). Ms Barwise did not suggest that on its own the clause would have the effect of converting the document into a demand bond but submitted that, when taken with clauses 2.1, 3, 6.3, 6.4 and 7, it should be taken as having that result and, in effect, as extending to liability as well as to quantum. In my view it is confined to the latter. Its reference is to a certificate “setting forth the amount ” of the Secured Obligation in question. I agree with Ms Andrews that it does not have the effect (whether taken on its own or in combination with the other clauses to which Ms Barwise referred) of transforming this contract into a demand bond.

46. In Bache & Co (London) Ltd v Banque Vernes et Commerciale de Paris [1973] 2 Lloyd’s Rep 437 (mentioned in Van Der Merwe) the conclusive evidence clause provided that the notice of default should be “as between [the claimants and the defendants] conclusive evidence that [the defendants’] liability hereunder has accrued in respect of the amount claimed.” The Court of Appeal in that case held that the clause was valid. In Van Der Merwe it was pointed out, in reference to a passage in The Modern Contract of Guarantee English Edition (2003) by O’Donovan and Phillips, that “The extraordinary effect of this type of clause, and the more usual conclusive evidence clause, in the context of a guarantee, however, is that a guarantee which is not phrased in terms of a performance bond payable simply on demand without proof of default becomes analogous to such a guarantee as a result of the inclusion of this clause.” The same textbook also refers (in earlier passages) to such clauses being strictly construed and to any ambiguity being resolved in favour of the guarantor.

47. Adopting that strict approach it seems reasonably clear that clause 11.2 is not to be construed as having the
effect for which Ms Barwise contended. I do not need to rely on any ambiguity in its expression to reach this conclusion.

Conclusion

48. Viewing the instrument as a whole I do not consider that the presumption against construing it as a demand bond has been rebutted. Clause 2, which sets out what the obligations are which VAG has undertaken, is premised upon the establishment of a failure of performance (including a failure of payment) under a Relevant Document. None of the other provisions, viewing them individually or in combination, alter that conclusion.

49. That brings me back to context. I am not persuaded that any of the points urged by Ms Barwise (and summarised at paragraph 37 above) should lead to a different conclusion. Turning in particular to the second of Ms Barwise’s points, an acceptance that, at any rate until late 2004 (which is long prior to the 2009 Guarantee), there was a measure of community of interest does not make it more likely that VAG should be willing in 2009 to enter into a demand bond than if the two groups had at all times been wholly at arm’s length in their dealings. In any event, as Ms Andrews pointed out, there are several factors which point against VAG’s obligations under the 2009 Guarantee being in the nature of a demand bond. They include the fact that they are unlimited in amount and duration and can be the subject of multiple demands (VAG’s only escape from liability being to bring about a termination of the underlying purchase agreements), the fact that there is no express right of recourse (which might have been expected if this were indeed a demand bond) to enable VAG, having satisfied a demand, to effect any recovery from the person primarily liable, the fact that, as the very extensive definition of “Beneficiary” shows, a demand can come from such a wide range of persons and the fact that the benefit of the instrument is expressed (by clause 11.1) to be assignable to any person.

50. For completeness I should mention two further points made by Ms Barwise. The first, drawing on the width of definition of “Beneficiary” and the fact that the underlying purchase agreements (the so-called Relevant Documents) involve overseas entities, is that the instrument was intended, as she put it, “to be used internationally by Beneficiaries who might not understand the subtleties of English law in relation to guarantees/indemnities” and that those underlying purchase agreements might well be subject to civil law jurisdictions and thus to good faith obligations, with references to “demand” and the like being read literally. I am unable to give any weight to this argument. The instrument is expressed by clause 12.1 to be governed by and construed in accordance with English law. (So also, as it happens, is the MPA which is the principal underlying purchase agreement). The parties must therefore take English law as they find it. It cannot be right to give the instrument a meaning different from what English law fairly requires merely because one of the parties affected by it has been accustomed to a different system of law where the approach to contractual interpretation may be different.

51. The other point raised by Ms Barwise concerned the fact that the instrument was preceded by two earlier instruments, namely the guarantee dated 15 September 2006, which itself superseded the earlier guarantee dated 5 March 2003 (see paragraph 13 above). Drawing on the evidence before the court that there was no substantial renegotiation of terms after the first of the guarantees was executed, she addressed submissions on the nature and effect of that guarantee, pointing out that, by clause 2.1(b), VAG undertook to make payment to LCUKL “upon first written demand by Locomotion Capital [i.e. LCUKL] without further proof or condition” and that by clause 13 it was agreed that “A certificate of Locomotion Capital setting forth the amount of any Guaranteed Amounts not then paid by the Contractor shall be conclusive evidence of such amount against the Guarantor in the absence of any manifest error.” Accepting that those words do not appear in that precise form in the 2009 Guarantee but pointing out that clause 2.1 of that instrument contains provisions similar to what were clauses 2.1 and 3.1 of the 2003 guarantee she submitted that the 2003 guarantee gave rise to a demand bond and that, as there had been no renegotiation of its terms before execution of the later instruments, the 2003 guarantee shows what the parties were intending to achieve by the 2009 Guarantee. As I understood it this was with a view to approaching the 2009 Guarantee with a greater willingness to construe it as a demand bond.

52. But, as Ms Andrews submitted in reply, there were changes in wording in the later instruments, not least in the scope between the 2003 guarantee and the later instruments. The plain fact is, she said, that they are not the same.

53. In my judgment, it is not a permissible approach to the construction of an agreement to draw comfort from, let alone be guided by, an earlier and different agreement which the later agreement has replaced, any more than it is permissible to do so by reference to earlier drafts of the later agreement. The terms of the earlier instrument might be material to rectification of the later instrument, but I am not having to deal with any such question.

Result

54. I shall make the declaration sought.
Alpha’s alternative case

55. Alpha contended that, if I should reach the conclusion that I have concerning the nature of the 2009 Guarantee, there was evidence that VL was in breach of its obligations under the MPA in that, as Mr Althen, the legal director of Alpha Trains (UK) Limited, put it in paragraph 39 of his first witness statement, “the beneficiaries to the 2009 Guarantee have to date incurred the sum of €2,487,544 (broken down as follows: €1.8 million for the purchase of new engines and €687,554 arising from losses incurred by locomotive operators) which is recoverable under clause 6.1 of the MPA…” with the consequence that VAG is obliged to indemnify the beneficiaries in that amount under clause 2.1(c) of the 2009 Guarantee in any event. (See paragraph 17 above.) Judgment in that sum was sought or, at the least, a declaration that VAG is liable under the 2009 Guarantee to pay that sum. I understood from this that the Beneficiaries (as they are described in the 2009 Guarantee) had incurred those amounts as a result of defects in the locomotives supplied under the MPA, in part by replacing defective locomotives and in part as a consequence of the defects in those locomotives.

56. I feel a difficulty about acceding to this alternative claim. As mentioned at paragraph 18 above LCUKL and other members of the Alpha Trains Group have issued proceedings against VL (and possibly others – I am unaware of the precise details) in the Technology and Construction Court for relief, including damages, under the MPA. The proceedings arise out of the same matters that form the basis of the alternative claim before me. Liability and quantum are in dispute in those proceedings. Subject to any further argument that counsel may wish to address on the point (the matter was only lightly touched on in argument before me) the better course would be to see what happens in those proceedings. If liability in VL (or in some other member of the Guarantor Group as defined by the 2009 Guarantee) is established (whether by decision of the court or otherwise) then, as it seems to me, VAG’s liability under the 2009 Guarantee to effect an indemnity against that liability will arise (subject only to demand). As I understand matters, however, that point has not yet been reached.

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**Marubeni Hong Kong and South China Ltd v. Government of Mongolia**


Before Lord Justice Waller, Lord Justice Carnwath and Sir Martin Nourse

This was an appeal against the decision of Cresswell J [2004] 2 Lloyd’s Rep 198.

Mark Howard QC and David Garland, instructed by Ashursts, for the claimant; Antony White QC, instructed by Richards Butler, for the defendant. The further facts are stated in the judgment of Carnwath LJ. Wednesday, 13 April 2005

**JUDGMENT**

Lord Justice CARNWATH:

**Background**

1. On 29 March 1996, the claimant (“MHK”) entered into a Deferred Payment Sales Contract (the “DPS 1 Contract”) with Buyan Holding Company Limited (“Buyan”), a Mongolian company. The contract was for the purchase by Buyan of machinery, equipment and materials for a cashmere processing plant. The purchase price was US$18,811,670. The first instalment of the price was to be paid within 60 days of the signature of the contract, and the remaining amount was to be paid in 12 equal semi-annual instalments. The first of these was due on 19 October 1998.

2. The defendant is the Government of Mongolia. Its involvement arises in this way. The contract provided for a document described as a “guarantee” to be issued by the Mongolian central bank on behalf of the Mongolian Government (“the Government”), in the form set out in a Schedule to the contract. In the event, a letter in somewhat modified form was issued by the Minister of Finance, dated 11 May 1996 (“the MMOF Letter”). On the same date, the Deputy Minister of Justice of Mongolia signed a document addressed to MHK, entitled “Legal Opinion of the Minister of Justice of the Government of Mongolia”, referring to the “guarantee given by the Ministry of Finance, acting for and on behalf of the Government of Mongolia”, and stating his opinion that the “guarantor” had “full power and authority” to enter into the guarantee.

3. The appeal concerns the effect of that letter as between MHK and the Government, in the dispute which has since arisen as to performance of the contract. For the background to the dispute it is sufficient to quote the judgment:

...  

11. Between October 1996 and May 1997 the claimant supplied machinery, equipment and materials to Buyan under the DPS 1 Contract. A dispute arose as to the quality and fitness for purpose of Mitsuboshi machines supplied by MHK to Buyan.
12. In 1998 there was a Rescheduling contained in six agreements dated 4 February 1998 between MHK and/or Marubeni and Buyan and in 1999 there was a further Rescheduling contained in five agreements of about April 1999 between MHK and/or Marubeni and Buyan. The defendant says that these refinancing packages involved a material variation of the transaction to which the guarantee related, such as to result in the discharge of the defendant’s obligations under the MMOF Letter. The claimant says that there was no such material variation and the obligations were not discharged.

13. It is MHK’s case that Buyan repeatedly failed to pay instalments due under the DPS 1 Contract and has made no payments at all after 19 April 2000. MHK gave formal notice to the defendant on 5 November 2001, requiring repayment of the sum of US$13,796,556 together with accrued interest by 12 November 2001. No payment was made.

14. These proceedings were issued in August 2001.

The MMOF letter

4. The material parts of the letter are in the following terms:

To: MARUBENI HONG KONG LTD

In consideration of you entering into the Deferred Payment Sales Contract No 258500 (hereinafter called the “agreement”) with Buyan Holding Company Ltd, a corporation duly organized and existing under the laws of Mongolia, with its principal office at I-4000-68-4 Ulaanbaatar, Mongolia (hereinafter called the “Buyer”) for sales and purchase of a textile plant the contact (sic) price of which is United States Dollars Eighteen Million Eight Hundred Eleven Thousand Six Hundred Seventy (USD18,811,670), the undersigned Ministry of Finance of Mongolia unconditionally pledges to pay to you upon your simple demand all amounts payable under the Agreement if not paid when the same becomes due (whether at stated maturity, by acceleration or otherwise) and further pledges the full and timely performance and observance by the Buyer of all the terms and conditions of the Agreement. Further Ministry of Finance undertakes to hold indemnify and hold you harmless from and against any cost and damage which may be incurred by or asserted against you in connection with any obligations of the Buyer to pay any amount under the Agreement when the same becomes due and payable (whether at stated maturity, by acceleration or otherwise) or to perform or observe any term or condition of the Agreement or in connection with any invalidity or unenforceability of or impossibility of performance of any such obligations of the Buyer.

This covenant shall come to force from the date of implementation of this agreement and remain in full force and effect until all amounts due to you by the Buyer under the Agreement have been paid in full and all the terms and conditions of the Agreement have been fully performed and observed by the Buyer.

The Ministry of Finance hereby waives any right to require you to proceed against the Buyer or against any security received from the Buyer or any third party or to pursue any other remedy available to you . . .

The letter also provided that

. . . all disputes related to this pledge shall correlate in accordance with the jurisdiction courts of England.

It is common ground that the proper law of the contract constituted by the MMOF letter is English law. (By contrast, disputes under the DPS 1 contract itself were to be decided by Japanese arbitration under Japanese law.)

The hearing before Cresswell J

5. The judge was presented with an agreed list of five issues, the hearing of which took 10 days, including expert evidence on both sides on Mongolian law. Group A (Issues 1 to 4) was concerned with whether the Government was bound by the letter. The judge decided this question in favour of MHK. He held, in summary, that the guarantee was issued with express actual authority of the Government; that the authorisation was valid as a matter of Mongolian law; that, if it was not actually authorised, the Minister of Finance had apparent authority to enter into the guarantee on behalf of the Government; and that the Deputy Minister of Justice had actual or apparent authority to issue an opinion letter in relation to such a transaction.

6. This part of the judgment is not directly subject to appeal. However, some of the discussion is relevant to the issues which are raised by the appeal. In particular, the judge made clear that his findings as to both actual and apparent authority depended on the letter being correctly characterised as a “guarantee”, that is as imposing a secondary rather than a primary liability. The significance of this distinction lies at the heart of the appeal.

7. Group B (Issues 5(1) and (2)) was concerned with whether the letter had been subsequently discharged. The agreed issues were:

5. If the defendant is bound by the issue of the MMOF Letter, whether it was discharged as the result of refinancing agreements between the claimant and Buyan in February 1998 and April 1999; in particular:

(1) Whether, on a true construction of the MMOF Letter, the defendant has undertaken a primary liability (joint and/or several) to the claimant so that the rule in Holme v Brunskill (1878) 3 QBD 495 has no application.
(2) If the answer to 5(1) is no, whether the refinancing packages of February 1998 and April 1999 involved any material variation in the transaction to which the guarantee related such as to result in the discharge of the entirety of the defendant's obligations under the MMOF Letter.

8. The judge decided both issues against MHK, with the result that MHK's claim failed. His final comment was:

This conclusion should not come as a surprise to any person experienced in the law and practice of domestic or international finance. A standard form bank guarantee will typically contain a number of provisions designed in an attempt to avoid the application of the rule in Holme v Brunskill. . . . Reschedulings would almost inevitably lead to the discharge of a surety from liability, unless the surety consented to the same. MHK recognised this but chose not to consult the defendant . . .

The appeal

9. For MHK, Mr Howard helpfully summarised the central issue in the appeal. It turns on the correct characterisation of the MMOF Letter: was it an unconditional independent promise by the Mongolian Government to pay on demand all amounts payable under the sales contract (that is a demand bond), or was it a secondary or conditional promise to act as a surety? In the former case, the obligation to pay arises upon a simple demand or demand supported by a specified document. In the latter case, not only must the claimant prove the actual indebtedness of the debtor, but the guarantor has all the defences available to the debtor, and is discharged automatically (under the rule in Holme v Brunskill) if there is any variation of the arrangements with the principal debtor without his consent which might prejudice his interests.

10. Procedurally, MHK applied to the Court of Appeal for permission to appeal, initially only on the ground that the MMOF Letter was, on its true construction, "a demand guarantee or demand bond" creating primary obligations. (For simplicity, I shall use the single term "demand bond".) Jacob LJ adjourned the application for further written submissions, noting that the judge had found that there was no actual or apparent authority for the Minister of Finance to undertake a primary liability. MHK then applied to amend its grounds of appeal to challenge that finding. Waller LJ granted MHK permission to amend the grounds of appeal, and to appeal on the grounds as so amended.

11. By a respondent's notice, the Government asks for the appeal to be dismissed on the ground that MHK should not have been permitted to advance the case that the instrument was a demand bond, having expressly disclaimed it in opening. It submits, further, that, even if the MMOF Letter did create primary obligations, the result under the rule in Holme v Brunskill should be the same.

12. It is unfortunate that the clarity of the issues, so carefully agreed by the parties, became obscured by uncertainty as to the precise nature of MHK's case at different stages. However, it will be convenient to consider first the case as now put, before considering, if it becomes necessary to do so, whether it is a case which it should be permitted to advance.

Submissions

13. Mr Howard says that the wording of the letter is to be interpreted against the background of previous authorities which have treated similar wording as giving rise to an independent obligation. They are Esal Commodities v Oriental Credit CA [1985] 2 Lloyd's Rep 546; Siporex Trade SA v Banque Indosuez [1986] 2 Lloyd's Rep 146; and IE Contractors v Lloyds Bank plc [1990] 2 Lloyd's Rep 496. The same approach has been confirmed more recently by this court in Gold Coast Ltd v Caja de Ahorros del Mediterraneo [2001] EWCA Civ 1806. Those authorities show, it is said, that:

. . .where in international transactions a bond or guarantee is expressed to be payable upon demand, in the absence of clear words indicating that liability under it is conditional upon the existence of liability or the part of the account party in connection with the underlying transaction, the guarantee is intended and should be construed as an independent guarantee entitling the beneficiary to payment simply against an appropriately worded demand accompanied by such other documents (if any) as the guarantee may require.

14. In relation to the MMOF Letter he relies in particular on the wording of the first promise, under which the obligation of the Mongolian Government is expressed to be "unconditional", and the trigger is a "simple demand". Further, the express waiver of any right to require MHK to proceed against the buyer or against any security is inconsistent with the idea that the Government should be able to avail itself of defences available to the buyer. Further, it is unlikely that the parties intended the rights under a letter governed by English law to be dependent on the resolution of issues, which under the main contract were to be determined by Japanese arbitration.

15. He criticises the judgment for disregarding these authorities, and for giving too much weight to the description of the MMOF Letter as a "guarantee" in the Legal Opinion letter. Such a description was not regarded as conclusive in the Gold Coast case (see paras 18 and 21). Further, the judge failed to recognise that the commercial purpose of the MMOF Letter was to provide security which was readily and easily realisable, on a failure by Buyan to meet its payment obligations. This purpose would be frustrated by a construction requiring MHK to prove default before making demand under the MMOF Letter.
16. He also relies on the terms of the DPS I contract, referred to in the terms of the MMOF Letter, which required (by article 7.1) the procurement of a letter of guarantee, the stated purpose being “in order to secure the due and punctual payment” by Buyan of the contract sums. In the context of international trade, security provided by a government, whose credit standing is likely to be superior, should not be treated in English law as less extensive than that provided by a bank.

17. Mr White, for the Government, says that reliance on Esal, and the cases following it, is misconceived. They all relate to irrevocable instruments issued by banks. The Government is not a bank, and is not in the business of providing irrevocable financial instruments in return for a fee or commission. Outside the field of first demand instruments or performance bonds issued by banks, the courts have not been willing, in the absence of clear words, to interpret documents in which a party undertakes obligations in relation to an agreement between two other parties as imposing unconditional primary liability. The mere fact that the obligation of the guarantor is expressed to be to pay “on demand”, and without conditions, is insufficient to create primary liability.

18. In support of this submission, he refers to three cases relating to very different contexts, one to hire purchase, and the others to building contracts. The first, also relied on by the judge, was Stadium Finance Ltd v Helm (1965) 109 SJ 471 (CA transcript 25/5/65). The document in question was described as an “indemnity form”, signed by the mother of an infant purchaser under a hire purchase agreement, which contained the following:

I will upon demand pay to you such sum or sums of money as may at any time or from time to time have become payable by the customer but be unpaid by him.

The Court of Appeal held that this obligation created secondary rather than primary liability. Lord Denning MR said (transcript pages 3-4):

In every case we come back to the test. Was one of these two persons primarily liable and the other only secondarily liable? If so, it is a guarantee by the one who is only secondarily liable...you cannot judge the difference simply by reference to the literal construction of the document...you have to look at the substance of the matter...Taking this indemnity form, Clause 1 was clearly a guarantee. It is an agreement to pay on demand any sum which the guarantor ought to have paid and has not ...

19. Similarly, in the building context, in General Surety and Guarantee Co v Frances Parker Ltd (1977) 6 BLR 16, Donaldson J declined to read the words “will forthwith pay on demand”; in a counter-guarantee provided by the parent of a building contractor, as creating a primary liability.

20. One of the problems in cases of this kind is terminology. In ordinary legal language, a “guarantee”, in contrast with an “indemnity” imposes a secondary liability:

The distinction between the two contracts is, in brief, that in a contract of guarantee the surety assumes a secondary liability to answer for the debtor who remains primary liable; whereas in a contract of indemnity the surety assumes a primary liability, either alone or jointly with the principal debtor. (Chitty on Contracts (29th edn) Vol 2, para 44.013) The obligation of the guarantor is not an obligation himself to pay a sum of money to the creditor, but an obligation to see to it that another person, the debtor, does something... (Moschiv v LEP Air Services [1973] AC 331, 347, per Lord Diplock)

21. The different usages are referred to by Andrews and Millett, Law of Guarantees (4th edn) page 14, in a section headed “Performance bonds”:

Bonds are simple covenants by one person to pay another, either conditionally or unconditionally. A performance bond, also commonly called a performance guarantee, or (confusingly) a demand guarantee, is a binding contractual undertaking given by a person, usually a bank, to pay a specified amount of money to a named beneficiary on the occurrence of a certain event, which is usually the non-fulfilment of a contractual obligation undertaken by the principal to the beneficiary.

As I understand it, the terms “demand bond”, as used in the grounds of appeal and “first demand bond” (as used by the judge - para 137) are intended in the same sense. The same authors refer to the difficulties experienced by the courts in determining whether a particular contract which provides for payment “on demand” is a performance bond, or...whether it is a guarantee in the true sense (sometimes referred to in this context as a “see to it” guarantee).

A similar contrast is drawn in Jack, Documentary Credits, 3rd edn, para 12.4:
Whatever the undertaking may be called, a distinction must be drawn between what is referred to in this chapter as an independent guarantee (encompassing demand guarantees, demand bonds etc) and a true contract of guarantee (or suretyship). Although the terminology unfortunately overlaps, the legal nature is very different . . .


A number of cases have involved discussion of the nature of performance guarantees’ which are, in essence, exceptionally stringent contracts of indemnity. They are contractual undertakings, normally granted by banks, to pay or repay, a specified sum in the event of any default in performance by the principal debtor of some other contract with a third party, the creditor. An unusual feature of several modern cases has been that the bank’s liability arises on mere demand by the creditor, notwithstanding that it may appear on the evidence that the principal debtor is not in any way in default, or even that the creditor is in default under the principal contract. Such guarantees are sometimes called first demand guarantees. It has been held that performance guarantees of this nature are analogous to a bank’s letter of credit . . .

23. Those passages provide the context for discussing the cases relied on by Mr Howard. They show that “demand bonds” (however described) are a specialised form of irrevocable instrument, developed by the banking world for its commercial customers. They have been accepted by the courts as the equivalent of irrevocable letters of credit. As such, they have been described as part of “the lifeblood of commerce”; and, in the words of Donaldson LJ:

Thrombosis will occur if, unless fraud is involved, the courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being the equivalent of cash in hand. (Intraco Ltd v Notis Shipping Corporation [1981] 2 Lloyd’s Rep 256, 257)

It cannot be assumed that cases relating to such banking instruments provide any useful guidance when construing guarantees given outside the banking context. The authorities relied on by Mr Howard must be seen in this light.

24. In Esal the instrument was issued by a bank; it was described on its face as a “performance bond”; and it was for a specified amount, being 10 per cent of the purchase price. The only difficulty arose from the wording:

We undertake to pay the said amount on your written demand in the event that the supplier fails to execute the contract in perfect performance . . .

The question was whether this had the effect that the performance bond was ineffective unless and until a breach of the underlying contract had been established. This reading was rejected as being inconsistent with the commercial purpose of a performance bond, that is, to enable the beneficiary to obtain prompt and certain payment, in a context in which the bank is “not concerned in the least” with the relations between the supplier and the customer (page 549, per Ackner LJ).

25. In Siporex Hirst J applied the same approach to the interpretation of an instrument issued by a bank pursuant to an obligation in an international trade agreement to provide a performance bond. The instrument was described in correspondence between the parties and with the bank as a performance bond. The judge commented:

There is in my judgment no real hardship on the bank in imposing this strict liability to pay. A performance bond is a commercial instrument. No bank is obliged to enter into it unless they wish to and no doubt when they do so, they properly exact commercial terms and protect themselves by suitable cross-indemnities, such as were entered into in the present case. (page 158)

26. In IE Contractors, the documents again were issued by a bank; were described as (or assumed to be) “performance bonds” (see issue (1) page 498); and were for damages up to specified amounts. The difficulty arose from the unusual form and language of the documents (see pages 501-502), and the wording of the operative clause:

We undertake to pay you, unconditionally, the said amount on demand, being your claim for damages brought about by the above-named principal.

It was held that this wording required the demand to contain some reference, express or implicit, to a claim for damages; but that this requirement was satisfied on the facts of the case (page 502).

27. The judgment of Staughton LJ contains some general discussion of the law relating to performance bonds. He discusses the possibility of different triggering events for payment under a performance bond: at one extreme, a simple demand “without requiring the presentation of any other document or the assertion of any fact”; and, at the other, a bond “conditioned upon the existence of facts rather than the production of a document asserting those facts” (page 499). He concludes, following Esal:
there is a bias or presumption in favour of the construction which holds a performance bond to be conditioned upon documents rather than facts. But I would not hold the presumption to be irrebuttable, if the meaning is plain. (page 500)

The latter observation was not necessary to the decision. There was no argument that the instrument in that case required more than the assertion of a claim to damages.

28. In all these cases the documents were issued by banks, and were described as, or assumed to be, performance bonds. Not surprisingly, the courts interpreted them against the background of the law relating to such instruments. They provide no useful analogy for interpreting a document which was not issued by a bank and which contains no overt indication of an intention to create a performance bond or anything analogous to it.

29. The most recent authority relied on by Mr Howard, decided since the date of the MMOF Letter, is the Gold Coast case. It concerned the interpretation of a refund guarantee issued by a bank pursuant to an obligation in a shipbuilding contract. Payment of specified amounts was to be made on "your first written demand", subject (under condition 1) to receipt of a certificate issued by Lloyds Bank that the refund had become due. The Court of Appeal held the instrument "had all the hallmarks of a first demand guarantee":

It describes itself as a guarantee, but this is simply a label; it does not use the language of guarantee. Rather, the obligation, which is expressed to be an irrevocable and unconditional undertaking, is that the banks will pay on a first written demand. The only express condition of payment is contained in condition 1. This requires a certificate but makes no reference to arbitration or underlying liability under the shipbuilding contract. The instrument contains its own dispute resolution provisions. (para 21)

Mr Howard relies on the court's disregard of the term "guarantee". However, the other features of the instrument were sufficient to displace the ordinary sense of that term. In particular, the provision for a bank certificate as a trigger for payment was a clear indication that the obligation to pay was independent of any need to establish default under the main contract.

30. Turning to the MMOF Letter, the starting-point in my view is that it is not a banking instrument, and it is not described, either on its face or in the supporting Legal Opinion letter, in terms appropriate to a demand bond or something having similar legal effect. The Legal Opinion describes it as a guarantee. The terminology is not of course conclusive. However, I agree with Cresswell J that, if MHK had wanted the additional security of a demand bond, one would have expected them to have insisted on appropriate language to describe it, in both the instrument itself, and in the Legal Opinion. The absence of such language, in a transaction outside the banking context, creates in my view a strong presumption against MHK's interpretation. (Since the letter did not follow the contractual form, I do not think that Mr Howard can find support in the words of article 7.1 of the DPS contract.)

31. The question then becomes whether there are sufficient indications in the wording of the instrument to displace that presumption. Mr Howard relies on the words "unconditionally pledges" and "simple demand". However, they are qualified by the following words, which indicate that the obligation only arises if "the amounts payable under the agreement (are) not paid when the same becomes due". As Cresswell J said, this wording appropriate to a secondary obligation, that is one conditional upon default by the buyer. It is true that in Esal similar wording was held insufficient to displace the ordinary effect of what was admittedly a performance bond. However, here the starting-point is different, and there is no reason for reading the words in other than their ordinary meaning.

32. That sense is reinforced by the following pledge of

. . . the full and timely performance and observance by the buyer of all the terms and conditions of the agreement.

It is not suggested, as I understand it, that this indicates anything other than a secondary obligation. It is true that the letter also contains a primary obligation, in the form of an indemnity against cost or damage resulting from the buyer's default. However, this does not assist MHK in this case, and there is no reason to treat this as qualifying the ordinary meaning of the earlier part of the letter.

33. Finally, Mr Howard relies on the clause under which the Government waives "any right" to require MHK to proceed against the buyer, or to pursue any other remedy. He suggests that this indicates the commercial purpose of the instrument, analogous to that of a performance bond, to provide security which is readily and easily realisable. If that was the intention, it seems to me a round-about way of indicating the purpose. In any event, it is at best a neutral indication. In a normal performance bond there would be no need for such a waiver, because there would be no question of the issuing party having any such right. Nor am I impressed by the fact that establishing a default under the main contract may require recourse to Japanese arbitration. Whatever the reasons which led the parties to the respective contracts to choose different systems of law, that by itself cannot in my view be a reason for altering the natural interpretation of the MMOF Letter.
34. I conclude, therefore, that the judge was correct to reject the submission that the MMOF Letter was to be treated as a demand bond or its equivalent.

35. This is sufficient to dispose of the single ground of appeal. I record that Mr Howard also hinted at an alternative submission that, even if not a demand bond, the instrument should be construed as creating some form of primary liability, sufficient to displace the rule in *Holme v Brunskill* (1878) 3 QBD 495. A variation of such an argument (based on *Hyundai v Pournaras* [1978] 2 Lloyd’s Rep 502) was rejected by the judge (paras 131-136), and was not expressly subject to appeal. Mr Howard did not himself rely on that case, and there was no application to amend the grounds of appeal to indicate any alternative interpretation.

36. The conclusion I have reached on the interpretation of the MMOF Letter makes it unnecessary to consider MHK’s appeal against the judge’s finding that the Minister of Finance had no authority, actual or apparent, to undertake a primary liability.

37. It also makes it unnecessary to consider Mr White’s submission that MHK should not have been permitted, in its closing argument, to advance the argument that this was a demand bond. However, it may be appropriate to make two comments:

(i) Mr White appears to have had legitimate cause for complaint at MHK’s apparent change of position on the demand bond issue. The authority of the Minister of Finance to issue the instrument on behalf of the Government was directly in issue. This depended on examination of conflicting expert evidence on Mongolian law and practice, including the interpretation of article 14(2) of the Mongolian Budget Law, under which the instrument was allegedly authorised.

(ii) On the other hand, I can understand why the judge did not make a specific ruling. The transcript does not suggest that Mr White articulated very clearly the nature of his objection, or the ruling (if any) he was asking the judge to make. Where a new point is sought to be raised in closing, the objection may take a number of forms, and the court’s response will differ accordingly. If the objection is that the new point is not covered by the pleadings, the court can insist on an application to amend, and rule accordingly. If the problem is that the witnesses have not had an opportunity to deal with the new point, it may be possible to recall them. It might have been open to Mr White to make a more fundamental objection: that a complex and expensive case had been conducted for 10 days by each party on a particular basis, and that it would be contrary to the overriding objectives of the CPR to allow a change. It is unnecessary for us to consider how, if such an objection had been made, the judge should have dealt with it.

**Conclusion**

38. For these reasons, I would dismiss the appeal, and confirm the judge’s order.

Sir MARTIN NOURSE:
39. I agree.

Lord Justice WALLER:
40. I also agree.

**IV. Alternative Text**

**Question 1-2.** What if the following text were used in the transaction in the case above?

[name and address of beneficiary] [date of issuance]

**Issuance.** At the request and for the account of [name and address of applicant] (“Applicant”), we [name and address of issuer at place of issuance] (“Issuer”) issue this irrevocable demand guarantee number [reference number] (“Guarantee”) in favour of [name and address of beneficiary] (“Beneficiary”) in the maximum aggregate amount of [currency/amount].

**Undertaking.** Issuer undertakes to Beneficiary to pay Beneficiary’s demand for payment in the currency and for an amount available under this Guarantee and in the form of the Annexed Payment Demand completed as indicated and presented to Issuer at the following place for presentation: [address of place for presentation], on or before the expiration date.

**Expiration.** The expiration date of this Guarantee is [date].
[Payment. Payment against a complying presentation shall be made within 3 business days after presentation at the place for presentation or by wire transfer to a duly requested account of Beneficiary. An advice of such payment shall be sent to Beneficiary’s above-stated address.]

[Drawing. Partial and multiple drawings are permitted.]

[Reduction. Any payment made under this Guarantee shall reduce the amount available under it.]

ISP98. This Guarantee is issued subject to the International Standby Practices 1998 (ISP98) (International Chamber of Commerce Publication No. 590).

[Communications. Communications other than demands may be made to Issuer by telephone, telefax, or SWIFT message, to the following: [numbers/addresses]. Beneficiary requests for amendment of this Guarantee, including amendment to reflect a change in Beneficiary’s address, should be made to Applicant, who may then request Issuer to issue the desired amendment.]

[Issuer’s name]

[signature]
Authorized Signature

Annexed Payment Demand

[INSERT DATE]

[name and address of Issuer or other addressee at place of presentation as stated in Guarantee]

Re: Demand Guarantee No. [reference number], dated [date], issued by [Issuer’s name] (“Guarantee”)

The undersigned Beneficiary demands payment of [INSERT CURRENCY/AMOUNT] under the Guarantee.

Beneficiary states that Applicant is obligated to pay to Beneficiary the amount demanded[, which amount is due and unpaid ] under[ or in connection with] the agreement between Beneficiary and Applicant titled [agreement title] and dated [date].

[Beneficiary further states that the proceeds from this demand will be used to satisfy the above-identified obligations and that Beneficiary will account to Applicant for any proceeds that are not so used.]

Beneficiary requests that payment be made by wire transfer to an account of Beneficiary as follows: [INSERT NAME, ADDRESS, AND ROUTING NUMBER OF BENEFICIARY’S BANK, AND NAME AND NUMBER OF BENEFICIARY’S ACCOUNT].
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[Beneficiary’s name and address]

By its authorized officer:

[INSERT ORIGINAL SIGNATURE]
[INSERT TYPED/PRINTED NAME AND TITLE]

[Before the Guarantee is issued, all text in [bold] should be completed, and optional text in [italics] should be included or deleted (or redrafted). Text in the annexed demand form preceded by “INSERT” (or other ALL CAPITALS guidance) and in [ALL CAPITALS UNDERLINED] is to be completed as indicated when the beneficiary prepares and presents a demand.]