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Demand guarantees: the consideration dilemma

__Jonathan Clark__, __Alex Shattock__ and __Sayra Tekin__ consider the problem of consideration for demand guarantees and how courts may decide the issue.

A curious problem has emerged in the context of demand guarantees (sometimes called "performance bonds" or "independent guarantees"). Consideration, a necessary component of a valid contract under English law, is frequently absent or difficult to discern for such agreements. This oddity has been commonly explained away by drawing analogy between demand guarantees and letters of credit. An examination, however, of the elements required for both valid letters of credit and demand guarantees highlights the dangers of this assumption.

Courts have not yet addressed the issue because banks have been careful not to risk their reputations by reneging upon a demand guarantee for a technical lack of consideration from the beneficiary of the demand guarantee. For counterparties to banks that have gone into liquidation since the financial crisis, it is questionable whether this rationale continues to offer the same comfort.

DEMAND GUARANTEES AND LETTERS OF CREDIT

Letters of credit are a well-established aspect of international commerce. It is frequently assumed that letters of credit and demand guarantees are the same, or substantially the same. There is good reason for this as they have similar characteristics.

They are both instruments that have been used to provide certainty of performance. They are often used in international transactions to ensure that payment will be received where the buyer and seller may not know each other and are likely to operate in different countries.

A demand guarantee is: (i) an irrevocable undertaking; (ii) issued (usually) by a bank; (iii) on the instructions of the applicant (who is obligor in the underlying contract); (iv) to pay the beneficiary; (v) upon demand in the form specified in the demand guarantee; (vi) an amount up to the maximum specified in the demand guarantee. A demand guarantee is distinct from a pure guarantee. It provides a primary obligation to perform. It is also independent from the applicant's liability under the underlying contract and payment will be required pursuant to the demand guarantee on an assertion of default. This is sometimes referred to as the autonomy principle.

A letter of credit is likewise irrevocable in nature. It also constitutes a primary obligation that is triggered upon presentation of certain documents stipulated in the letter of credit.

There are, nevertheless, important differences. The main difference is that they perform different functions. Letters of credit were created as a method to facilitate a transaction. They provide a mechanism for payment. Demand guarantees, on the other hand, come into effect when a transaction falls through. They provide financial security should default occur. Unlike a letter of credit, it is not intended to be the primary form of payment and, if things go well, should not be called upon at all. As we explain below, these differences in function inform the role of consideration in forming a valid agreement.

ROLE OF CONSIDERATION

The autonomy principle creates a unique problem in the context of demand guarantees and letters of credit. The applicant enters into a letter of credit or demand guarantee with the issuing bank supported by consideration. The benefit of this contract, however, is for the beneficiary who is only party to a separate agreement with the applicant. In the ordinary course, the beneficiary provides no consideration to the issuing bank. A conceptual question, therefore, arises as to whether there is an enforceable contract between the beneficiary and the issuing bank.

Traditional contract law theory would suggest not. English contract law is based upon the principle of reciprocity. Chitty on Contracts explains that "a promise is not, as a general rule, binding as a contract unless it is either made in a deed or supported by some 'consideration'" (Chitty on Contracts (31st Ed, 2012) at 3-001). The rationale is to provide discernable limits to the enforceability of agreements.

This has led to attempts to rationalise the autonomy principle within the traditional confines of English contract law. One theory seeks to reconcile this anomaly by characterising the applicant, who has supplied consideration to the issuing bank, as agent for the beneficiary (Ellinger and Neo, The Law and Practice of Documentary Letters of Credit, p 110). However, this interpretation seldom reflects the intention of the parties at the point of contracting.

Neither does the Contract (Rights of Third Parties) Act 1999 adequately explain the rights of the beneficiary under a letter of credit or a demand guarantee. In many cases it is expressly excluded under the terms of the demand guarantee and there is little incentive for the applicant or the issuing bank to agree otherwise.

Letters of credit

Letters of credit rarely require consideration to give rise to a binding obligation. Attempts have been made to explain this anomaly by framing the letter of credit itself as an unilateral offer by the issuer that is accepted when the beneficiary presents documents to the issuer. The mere presentation of documents has been said to be good consideration (Raiffeisen Zentralbank Osterreich AG v China Marine Bunker (Petrochina) Co Ltd [2006] EWHC 212 (Comm)).

If this analysis is accepted, however, the issuing bank may revoke the letter of credit before the offer is accepted. It is not possible to reconcile this explanation with the irrevocable nature of most letters of credit. This explanation ignores the irrevocable nature of the obligation even before presentation of the documents. The question arises as to why, if this was the basis of the consideration, a bank could not simply renege on a letter of credit prior to the presentation of the documents.

A better explanation may be that letters of credit have simply arisen out of well-established mercantile practice and are recognised as an exception to the doctrine of consideration. Letters of credit are such a well-established form of trade financing that to challenge the beneficiary's right to enforce for lack of consideration could be quite destabilising. Jenkins LJ in Hamzeh Malas & Sons v British Imex Industries Ltd [1958] 2 QB 127, 129 observed:

> "*An elaborate commercial system has been built up on the footing that bankers' confirmed credits are of that character, and, in my judgment, it would be wrong for this court in the present case to interfere with that established practice.*"

Demand guarantees

The frequent conflation of demand guarantees and letters of credit has sometimes led to the assumption that demand guarantees are similarly exempt from the contractual requirement of consideration. However, it cannot be said that mercantile practice has developed to exempt consideration for demand guarantees as they are relatively recent in origin: Lord Denning MR described "a new business transaction called a 'performance guarantee'" in Edward Owen Engineering Ltd v Barclays Bank International Ltd [1978] QB 159, 164. Leading textbooks conflict on the issue and the matter has not been settled by the courts.

It is difficult to see what consideration the beneficiary of a demand guarantee could conceivably provide. Consideration must move from the beneficiary, it need not move to the issuing bank. The problem is that anything undertaken by the beneficiary under the underlying contract with the applicant is likely to precede the issue of the guarantee and thus constitute past consideration. Past consideration, as a general rule of English contract law, is not good consideration.

As demand guarantees are usually, like letters of credit, irrevocable, characterising the demand guarantee as an offer that is accepted upon presentation of certain documentation poses the same practical problems. If the demand guarantee was revocable, it has been suggested that presentation of documents procured from a third party may constitute sufficient consideration (see Malek, A QC and Quest, D, " Jack: Documentary Credits", (4th Ed, 2009) at 12.64). This explanation is, however, unsupported by precedent.

To date, the business community and commentators appear to have relied upon the fact that banks will not risk their reputation and renege upon such obligations having received, in all likelihood, a sizeable fee from the applicant. Nevertheless, at a time where bank and counterparty insolvency is a conceivable reality, this rationale may no longer hold.

As with letters of credit, courts will likely seek to give effect to the commercial purpose of the demand guarantee. However, it is difficult to extend the mercantile practice exception, applicable to letters of credit, to demand guarantees. Mercantile practice relating to letters of credit has been established over the course of almost 200 years whereas demand guarantees are relatively recent instruments.

COMMENTS

Courts go to great lengths to ensure that letters of credit are honoured. As such, challenges to those documents on the basis of a failure of consideration will be difficult. If questions of consideration do arise, courts may either try to find consideration from the circumstances or acknowledge the exception to consideration through mercantile practice.

Despite their similarity, the treatment of demand guarantees is less certain. It does not follow that they should be treated in the same way as letters of credit merely because they are similar in form. They are distinct instruments with a different emphasis in function and a different history. As such, the justification for seeing demand guarantees as an exception to the doctrine of consideration is difficult to maintain.

It may be that with recent bank insolvencies the problem of consideration for demand guarantees receives judicial attention. If it does, it seems there are three potential responses.

First, courts may decide that there is sufficient likeness to letters of credit to exempt demand guarantees from the rigours of consideration.

Secondly, courts may, as they have on occasion with letters of credit, go to great lengths to find fresh consideration passing from the beneficiary, particularly, as the applicant would, in all likelihood, have paid a sizeable fee to the issuer for the demand guarantee.

Finally, courts could potentially decide that demand guarantees fail to respect the doctrine of consideration under English contract law and are not, therefore, enforceable contracts. Should the courts reach this conclusion, it has been feared that this will disrupt, what has been described as, “the life blood of commerce” (per Lord Donaldson in The Bhoja Trader, [1981] 2 Lloyd’s Rep. 256 at 257).

WHAT TO CONSIDER WHEN DRAFTING

In theory, the solution to the issues raised in this article is a simple one. A demand guarantee, and indeed a letter of credit, duly executed as a deed will avoid the legal acrobatics required to find consideration in the relevant contractual context. This approach would offer certainty to contracting parties at a time when liquidators may be less concerned about an insolvent bank’s reputation than the management of a going concern would be and may, therefore, be willing to use arguments that beneficiaries have hitherto not had to face. In the end, whether this solution is adopted may come down to practicalities.

KEY POINTS

- Consideration is absent or difficult to discern for demand guarantees.
- Despite their similarities with letters of credit which are generally recognised as an exception to the doctrine of consideration, the assumption that demand guarantees are similarly exempt is untested in court.
- Executing a demand guarantee as a deed may be a solution.

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