BCLP. Client Intelligent

Insights

CONSTRUING A PARENT COMPANY GUARANTEE: PRIMARY OR SECONDARY OBLIGATION… OR BOTH?

Feb 03, 2022

The issue of whether a *parent company guarantee* (PCG) creates a secondary liability (as opposed to a primary obligation) has been taxing the courts again.

Reminder: a true "guarantee" is only ever a secondary obligation, governed by the legal doctrine of surety. It is very different from a primary obligation that arises where an indemnity is provided by one party to hold another party harmless in respect of a loss it might suffer as a consequence of a particular event. Whether a *primary and/or secondary obligation arises* is always a question of drafting and fact. Many employers require a primary obligation as well as a secondary guarantee (for reasons set out below) and it is here that disputes often arise.

A notoriously tricky area of law, described by *Hudson* as "bedevilled by terminology", Mrs Justice Jefford's clear and well reasoned judgment in *Black & Veatch Corporation v Kazstroyservice Global BV* provides not only a welcome reminder of how the court determines whether liability is primary or secondary but also illustrates how archaic guarantee language can lead to misunderstandings between the parties as to how the guarantee will operate in the event of subsidiary default.

This blog takes a look at what happened and considers the practical takeaways.

Facts

Black & Veatch and Petron entered into an agreement to form a consortium to undertake an *EPC contract* where together they would act as "contractor" (broadly one party designing, the other constructing). As part of these arrangements, Global, Petron's parent, provided Black & Veatch with a PCG in respect of Petron's obligations under both the "consortium agreement" and the EPC Contract.

Work started in 2015 but the project quickly ran into delay and disputes arose about who was at fault. During 2017, Petron went into liquidation and at the end of that year, Black & Veatch made a demand under the guarantee (which Global refused to pay).

Then, in 2019, under the consortium agreement, Petron commenced arbitration proceedings against Black & Veatch. This was followed by Black & Veatch issuing proceedings against Global at the start of 2020 alleging, among other issues, that Global had failed to:

- Ensure performance by Petron and so had assumed "full responsibility" for the performance of Petron's obligations; and
- "Complete work" in breach of its obligations under the EPC contract.

In other words, Black & Veatch did not expect Global merely to pay damages because of Petron's default but rather carry out the works itself.

In response, Global sought to rely on Petron's claims against Black & Veatch in the arbitration as a defence of equitable set-off under the PCG. The crux of its defence was that the PCG was a classic "see to it" guarantee creating a secondary obligation, which by its very nature meant that Global was entitled to rely on any defences to the claims for breach of the underlying contract that Petron would be able to rely on, in accordance with the principle of co-extensiveness.

Issues

The court was asked to decide various issues but the one this blog will focus on is: what type of obligation did paragraph 2 of the guarantee place on Global?

> *"**[First sentence][part 1]** In consideration of the Beneficiary entering into the Consortium Agreement with the Subsidiary, the Guarantor irrevocably and unconditionally guarantees to the Beneficiary the due, full and punctual performance and discharge by the Subsidiary of all its obligations under or arising from the Consortium Agreement and **[part 2]** undertakes with the Beneficiary that, whenever the Subsidiary fails to perform or discharge any such obligations when due, the Guarantor shall, on demand by the Beneficiary, perform or discharge or cause the Subsidiary to perform or discharge the obligation in respect of which such failure has occurred. **[Second sentence]** The Guarantor shall be entitled in or against any demand, action or proceedings by the Beneficiary to raise any equivalent rights in defense of liability as the Subsidiary would have against the Beneficiary under the Consortium Agreement. [Emphasis added]*

The options were:

Primary (as Black & Veatch argued). Did it create an independent obligation between Global and Black & Veatch whereby Global would carry out the works if Petron was in default? Such an obligation would be independent of the underlying contract which was the subject of the guarantee. This would mean that unless the guarantee expressly provided otherwise, Global would not be entitled to rely on Petron's claims in defence of liability; or

Secondary (as Global argued). Global argued that the guarantee was a "see to it" guarantee. This meant that under the guarantee, Global's obligation as guarantor was to "see to it" that its subsidiary (Petron) performed its obligations under the underlying contract. If Petron failed to do this, Global, as guarantor, would be in breach of that undertaking and the beneficiary's (Black & Veatch's) remedy would be damages for breach of the guarantee.

This is known as a "secondary" obligation because Global's obligation to pay Black & Veatch damages would only arise if Petron defaulted on its primary obligation to Black & Veatch to carry out the works under the underlying contract.

If the obligation was secondary, the principle of co-extensiveness would apply. This would mean that Global could rely on any defence to the claims for breach of contract that Petron could rely on. In other words, it could rely on Petron's claims in the arbitration as a defence and set-off any such amounts awarded against the damages that Black & Veatch claimed were due from Global.

Judgment

The court agreed with Global that the PCG was a "see to it" guarantee and therefore a secondary obligation which meant that the principle of co-extensiveness applied.

Key points from the judgment included:

- A 'reminder' that the paragraph 2 wording is a device to make a guarantor liable for breaches of the underlying contract but NOT to carry out works:

"…the purpose of the guarantee is to guarantee Petron's performance and not to impose an obligation on Global itself to perform. What the words are, therefore, doing is creating a breach by Global, as guarantor, when Petron's obligations are not performed. It is, as submitted, a device to place Global in breach when Petron does not perform. It is unrealistic to read the guarantee as providing two distinct and significantly different obligations in the two elements of part 2 of the second sentence and I do not accept ….that the guarantee contemplates that Global might literally perform such obligations as Petron had failed to perform…"

- Confirmation of the long line of authority that just because a guarantee is called a guarantee does not mean that the court will automatically pronounce it so (and conversely, just because a document calls the guarantor a "primary obligor" does not mean that primary liability is automatically created):

"There is no doubt that that case [Moschi v Lep Air Services Ltd. [1973] AC 331] is authority for the proposition that any document described as a guarantee is to be construed on its own words. The mere fact that it is called a guarantee does not bring with it all the legal consequences of a guarantee and the nature of the obligation may not attract those accoutrements…"

The court also considered the factual background and concluded that:

"It is improbable that commercial parties would enter into an agreement – particularly one designated as a guarantee – with such complex and convoluted consequences and I find it impossible to conclude that this is what they intended to achieve by the inclusion of the words 'perform or discharge'."

Thoughts

The court's conclusion that this guarantee was a classic "see to it" guarantee and therefore a secondary obligation does seem to be the correct decision on the facts.

No "primary obligor" language was included in the guarantee and there was no clear, separate and independent obligation on the parent to indemnify or hold harmless the beneficiary in the event of breach of the original contracts. In addition, Black & Veatch's argument that Global had agreed to physically complete the works itself seemed improbable on the facts. Certainly, in practice it is rare to see a parent agreeing to this obligation.

What the judgment does illustrate is the care parties need to take when entering into a guarantee. Parties should consider in advance what should happen on default and ensure that necessary provision is made in the guarantee.

Parents as a rule tend not to like giving a PCG primarily because it sits on their balance sheet for the duration of the underlying contract (normally 12 years post *practical completion*). If a parent does provide a PCG, it often resists including a primary obligation (indemnity).

Conversely, beneficiaries often ask for an indemnity in addition to the secondary obligation. Why? In a nutshell, because *indemnities*:

- Provide better protection should the subsidiary default.
- Are harder to displace than guarantees because unlike guarantees, they survive termination and/or material variation of the underlying contract.
- May provide wider recompense than damages.
- Are not (necessarily) subject to the principle of co-extensiveness.

Guarantees containing both secondary and primary obligations are common in the market although this is largely dependent on the bargaining position of the parties.

If the parties agree to include an indemnity then, as can be seen from this case and the long line of case law that precedes it, great care needs to be taken with the drafting. Key tips include:

- Use clear words. There is no need to include the words "primary obligor" but you do need to be very clear that *it is an indemnity*.

- Ideally, try and keep the indemnity separate from the guarantee so as to distinguish between the two obligations.

This article first appeared on the Practical Law Construction blog dated 2 February 2022.

RELATED CAPABILITIES

- Construction Disputes
- Commercial Construction & Engineering

MEET THE TEAM

Katharine Tulloch

London

katharine.tulloch@bclplaw.com
+44 (0) 20 3400 3056

Natalie Wardle

Paris

natalie.wardle@bclplaw.com
+44 (0) 20 3400 4623