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Bank and parent company guarantees in international arbitration

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RESUMO: Garantias bancárias ou da companhia controladora são características comuns de contratos internacionais, especialmente em importantes projetos de construção. Podem ser usados para garantir uma variedade de coisas, tais como o pagamento pelo empregador, a entrega do projeto, o desempenho do contrato ou que a parte mantenha uma oferta aberta durante um determinado período. Tipicamente, os beneficiários de tais garantias correm para chamá-las no caso de uma disputa, enquanto a parte emitente tentará parar tal chamado. Arbitragens ou litígios *multi-forum* frequentemente surgem. Em 2008, a Corte Suprema Suíça proferiu três julgamentos tratando de tais situações.

PALAVRAS-CHAVE: Garantias bancárias – Garantias da companhia controladora – Contratos internacionais – Arbitragem.

ABSTRACT: Bank or parent company guarantees are common features of international contracts, particularly in major construction projects. They can be used to guarantee a variety of things, such as payment by the employer, delivery of the project, performance of the contract or that a party keep a tender offer open during a certain period. Typically, the beneficiaries of such guarantees scramble to call them in the event of a dispute, while the party in whose favour it has been issued will attempt to stop such a call. Multi-forum litigation or arbitration often results. In 2008 the Swiss Supreme Court rendered three judgments dealing with such situations.

KEYWORDS: Bank guarantees – Parent company guarantees – International contracts – Arbitration.

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1. CASE ONE: NO EXTENSION OF THE ARBITRATION TO NON-SIGNATORY PARENT COMPANY

In this matter the Swiss Federal Supreme Court dealt with a guarantee issued by a parent company, an Italian corporation, in favor of its affiliate in Qatar within the framework of the construction of an industrial complex in Qatar. (Swiss Federal Supreme Court, decision of August 19, 2008, 4A-128/2008, Swiss Arbitration Association (ASA) Bulletin 4/2008, p. 777 *et seq.*) The Qatari contractor and a Cypriot subcontractor entered into a subcontract whereby the Cypriot party undertook to perform dredging works. The contract was subject to Swiss substantive law and contained an ICC arbitration clause which provided for Geneva to be the place of arbitration. The Italian parent company of the contractor acted as guarantor. It issued a document captioned “Parent Company Guarantee Letter”, which contained, amongst others, the following terms:

“Re Ras Laffan Common Cooling Water System Project Subcontract for Dredging/Stockpiling Works.

With reference to the above contract, we, Z_____ Spa (hereinafter referred to as the ‘guarantor’) (...), as ultimate parent company of Y_____ (hereinafter referred to as the ‘contractor’) do hereby enter into the following undertaking with M/s X_____ (hereinafter referred to as ‘X_____’) stating that:

1. The contractor has been awarded the subcontract for the marine portion of the works for the project in subject by the main contractor (...).

6. The contractor will perform all of its obligations contained in the subcontract agreement.

7. In consideration of the above, the guarantor (...) undertakes to reimburse the sum of expired invoices as indicated in Item 5 thereof if the contractor fails in any respect to perform the said financial obligations in above mentioned subcontract agreement or commits any breach thereof. The guarantor will on simple demand from X_____ take whatever measures may be necessary to secure the payment of obligations of the contractor under the subcontract agreement, and will indemnify and keep indemnified X_____ as if the guarantor was the original obligor.”

A dispute arose regarding unforeseen subsoil conditions. The Cypriot subcontractor subsequently initiated arbitration against the Qatari contractor and its Italian parent. It claimed some \$20 million for additional costs due to the subsoil conditions, acceleration of the works and the second Gulf war. The subcontractor also requested an order extending the deadline for completion of the works. The parent company argued that it was not bound by the arbitration agreement in the subcontract. On January 2008 the arbitral tribunal issued a preliminary award denying its jurisdiction *ratione personae* (personal jurisdiction) regarding the parent company. The subcontractor applied to the Swiss Federal Supreme Court to have the award set aside.

The Supreme Court confirmed the award. According to the privity of contract rule, an arbitration clause in a contract binds only the contracting parties. Exceptions to this principle do, however, exist: the assignment of a right, the assumption of a debt either in lieu of the original debtor or jointly and severally, and the transfer of a contract.

The leading case on assignment is the *Peugeot case*, involving a dispute between the French car manufacturer and a Serbian automotive company. The Supreme Court admitted that where a contractual right is assigned, the arbitration clause also passes to the assignee, provided that the assignment is valid –which, in *Peugeot*, was not the case. The award was set aside since the arbitral tribunal had overlooked a non-assignment clause in the contract. (Swiss Federal Supreme Court, decision of October 16, 2001, Swiss Arbitration Association (ASA) Bulletin 1/2002, p. 97 *et seq.*; Matthias Scherer, “Three Recent Decisions of the Swiss Federal Tribunal Regarding Assignments and Transfer of Arbitration Agreements”, Swiss Arbitration Association (ASA) Bulletin 1/2002, p. 109 *et seq.*).

The leading case on assumption of debts is *Lukoil v MIR*, which involved a dispute between a Russian company and a Turkish contractor over the construction of a holiday resort. The arbitral tribunal found that Lukoil had paid invoices for the Russian owner which had employed the Turkish contractor. Hence, it had assumed the obligations of the owner under the construction contract, including the obligation to arbitrate disputes. (Swiss Federal Supreme Court, decision of December 18, 2001, 4P 126/2001, Swiss Arbitration Association (ASA) Bulletin 2002, p. 482 *et seq.*).

With the exception of the specific case of assumption of debts, an arbitration clause in a main contract is not applicable to the undertakings of a third party to guarantee the performance of a party to the main contract. In order for an arbitral tribunal constituted pursuant to the main contract to have jurisdiction over the guarantor, the guarantee agreement must contain a specific arbitration clause to that effect or a clause referring to the arbitration clause in the main contract. Failing such language, the guarantor must have expressed, explicitly or by its conduct, the intention to be bound by the arbitration clause in the main contract.

However, none of these prerequisites was met in the case at hand. The conduct of the parent company could not reasonably have been construed as interference in the performance of the contract which might justify an extension of the application of the arbitration clause. The Supreme Court clearly distinguished the present case from its leading precedent on extension of arbitration agreements to non-signatories. In that case, which involved a construction project in Lebanon, an individual had continually interfered in the performance of the contract signed by a company he controlled. The ICC arbitral tribunal found that by his conduct, the individual had consented to be bound by the arbitration agreement contained in the contract entered into by his company, a finding which was upheld by the Supreme Court. (Swiss Federal Supreme Court, decision of October 16 2003, 129 III 727, Swiss Arbitration Association (ASA) Bulletin 2/2004, p. 364 *et seq.*).

In the case at hand the Supreme Court ruled that mere affiliation to the same group of companies is insufficient to justify the extension of an arbitration clause. Therefore, the arbitration clause in the main contract did not bind the non-signatory parent company, even if it had issued a parent guarantee.

The court also ruled that the guarantee agreement itself could not be construed as incorporating the arbitration clause in the main contract. This could be the case only if the guarantee qualified as the assumption of a debt under Swiss law or as the equivalent of such an assumption under the law applicable to it (the Supreme Court found that since the guarantee agreement did not contain a choice of law clause, it was governed by Italian law, as this was the law with the closest connection).

The reference in the parent guarantee to the subsidiary company's obligation under the subcontract could not be construed (or in good

faith have been understood by the subcontractor) as incorporating, by reference, the subcontract's arbitration clause. The purpose of the reference was merely to identify the obligations which the parent company undertook to guarantee.

2. CASE TWO: GUARANTOR HAVING SIGNED THE CONTRACT CONTAINING THE ARBITRATION CLAUSE IS BOUND BY IT

In 1986 a party from Yugoslavia and two Italian parties, Y Srl and Z SpA, entered into a cooperation agreement for the construction of an industrial plant in Bosnia, subject to Swiss law and incorporating an ICC arbitration clause. Z SpA signed the agreement as a guarantor. In 1991 the Yugoslavian party initiated arbitration, asserting non-performance of the contract by the Italian parties. Y Srl raised a counterclaim. Z SpA stated that it was not bound by the arbitration agreement and did not participate in the arbitration. After a long suspension due to the political situation in Bosnia, the tribunal rendered a preliminary award admitting its jurisdiction over the claim raised against Z SpA. In the subsequent final award it found that Z SpA was in fact a partner, enjoying all rights and bearing all obligations under the contract. Even if Z SpA were only a guarantor, its liability would have been triggered since Y Srl had not performed the contract and would be unable to do so due to its insolvency. However, ultimately, the tribunal dismissed the Yugoslav party's claims, finding that it had previously waived such claims.

The Yugoslav claimant sought in vain to set the award aside based on Art. 190 of the Private International Law Act. The Federal Supreme Court confirmed the award on 21 August 2008. (Swiss Federal Supreme Court, Decision of 21 August 2008, 4A-194/2008, Swiss Arbitration Association (ASA) Bulletin 4/2008, p. 793 *et seq.*).

3. CASE THREE: NO JURISDICTION OF ARBITRAL TRIBUNAL APPOINTED UNDER THE MAIN CONTRACT TO DEAL WITH DISPUTES ARISING UNDER A SEPARATE GUARANTEE AGREEMENT

At the heart of this case, which involved an application to set aside a partial award in International Chamber of Commerce (ICC) Arbitration 14.441/JHN, was a turnkey contract for the rehabilitation of a fertilizer plant in Turkey. Y GmbH undertook to modernize and increase the capacity of the plant of X AS, a Turkish company, for a price of € 22.95 million. The contract was governed by Swiss substantive law.

According to the contract, the employer had to pay upfront 15 per cent of the contract price in the form of a bank guarantee issued by a bank in favor of the contractor. The guarantee was to last either until the end of the warranty period or the end of a 30-month period from the date on which the contract came into force, whichever period was shorter. The plant was operational in September 2004. A dispute then arose about the result of the taking-over tests, the plant's performance and its level of sulphur emissions. The contractor was of the view that the tests had been successful and that the handover could be deemed to have taken place. (For a precedent where an arbitral tribunal sitting in Switzerland admitted that in spite of the employer's refusal to issue a take over certificate, the plant was deemed to have been delivered, see Swiss Arbitration Association (ASA) Bulletin 2006, p. 729). The employer, on the other hand, considered that the plant had suffered various downtimes due to repair works required to remedy defects attributable to the contractor. On 4 August, 2005, the employer sought to call the bank guarantee in the full amount of € 3,442,500 at the seat of the issuing bank in Finland. The employer also obtained the attachment of assets equivalent to the guarantee amount from the Finnish bank's Turkish affiliate. The contractor applied successfully for an interim injunction from a Finnish court enjoining the employer from calling the guarantee. However, the Finnish proceedings were suspended after the contractor initiated arbitration proceedings – an ICC arbitration with seat in Switzerland – against the employer on the merits. In Turkey, the contractor appealed the attachment order. The Turkish proceedings continued in parallel to the arbitration. In the arbitration, the contractor sought the following, among other forms of relief:

- an order barring the employer from calling the guarantee;
- the return of the original of the guarantee;
- the withdrawal of the employer's actions in Turkey; and
- an order for the employer to cover all costs relating to the abusive call on the guarantee.

The employer objected that the claims were groundless and that in any event the arbitral tribunal lacked jurisdiction regarding disputes over the guarantee.

In an interim award of 9 April, 2008, the arbitral tribunal rejected the jurisdictional objection and ordered the employer to refrain from calling the guarantee in an amount exceeding € 1 million. The tribunal

found that up to the amount of € 1 million, the call was not incompatible with the purpose of the guarantee, which included enabling the employer to receive payment without being obliged to demonstrate a contractual violation on the part of the contractor. It also dismissed the claim for a withdrawal of the employer's action in Turkey and for the original of the guarantee to be returned. The arbitral tribunal observed in passing that it would have been conceivable for the contractor to exchange the guarantee against a guarantee in the lower amount of € 1 million, but that the contractor had not made such an offer in the proceedings.

The employer filed a request with the Swiss Federal Supreme Court to have the interim award set aside. According to Art. 190 of the Private International Law Act, the court has exclusive jurisdiction to deal with all challenges to international arbitral awards. Applications to set aside must be filed within 30 days of notification of the award.

The employer complained that the arbitral tribunal had wrongly admitted its jurisdiction to decide on the contractor's claim for return of the guarantee. The tribunal had dismissed this claim. However, the employer considered that the dismissal was only provisional and that the tribunal had admitted in advance that it would have jurisdiction should the contractor amend its prayer for relief and offer a new guarantee at a reduced amount in exchange for the original of the € 3.4 million guarantee.

The Supreme Court found that, contrary to the employer's view, the request for delivery of the original had been disposed of in a final manner, since arbitral tribunals, like state courts, are bound by their interim awards (Decision 4A-224/2008 of October 10, 2008). As to the jurisdictional point, the court ruled that as long as a claim is not formally brought, it cannot be formally decided. If the contractor were to amend its claim by offering a lower guarantee in exchange for the original of the € 3.4 million guarantee, and the tribunal were to render an award granting the claim, the employer could challenge it. In conclusion, the court found that a prerequisite to any application to set aside an award was missing – a concrete interest on the part of the applicant to seek annulment.

The employer argued that the arbitral tribunal had no jurisdiction under Art. 190(2)(b) of the Private International Law Act to decide on the contractor's claims relating to the guarantee. That is, the tribunal has no jurisdiction to enjoin the employer from calling the guarantee and to

declare that the employer had to bear all costs in relation to the court proceedings in Finland and Turkey. The court distinguished:

- the contractual relationship between the contractor and the employer under the turnkey agreement, which contained an arbitration clause referring all disputes to arbitration;
- the relationship between the bank having issued the bank guarantee and its beneficiary, the employer; and
- the contract between the bank and the party having instructed the bank to issue the guarantee (i.e., the contractor).

The court found that the claims raised by the contractor were grounded exclusively on the turnkey agreement. The arbitral tribunal could determine, based on this agreement alone, whether the employer was entitled to call the guarantee pursuant to the agreement. Consequently, the arbitral tribunal's decision did not interfere with the other relationships. The issue as to whether the award interfered with the contractual rights of third parties (the bank) did not arise.

The main bone of contention among the parties was the purpose of the guarantee – that is, whether it was to guarantee full performance by the contractor or merely reimbursement of the first installment paid by the employer. The arbitral tribunal ruled that the contractor would have had to pay back the installment if the delivery of the plant were late or incomplete, which was not the case. On the other hand, the plant had not been handed over and the employer made a claim for defects in the performance of the contract. The arbitrators found that the guarantee secured both types of claim. However, the parties had contractually limited the damages payable to the employer to € 1 million. For damages exceeding this amount, the employer had to show, as a matter of Swiss law, serious negligence of the contractor (liability for serious negligence and intentional harm cannot be limited). The employer had not demonstrated the contractor's negligence. Therefore, it was entitled to call the guarantee only up to the amount of € 1 million.

4. COMMENTS

A number of lessons can be drawn from these three cases:

- A party that has agreed to limit the contractual liability of its counterpart to a certain amount is bound by the agreed threshold. Guarantees issued in favor of that party for a higher amount than the threshold may not be used to circumvent the latter.

- Limitations of liability, whether they limit the amount or the type of compensation (e.g., by excluding loss of profits) are not valid in the event of serious negligence or intentional conduct on the part of the beneficiary of the limitation.

- Guarantees are distinct from the underlying contract. In certain circumstances a party that has not signed the contract but has merely issued a guarantee in favor of a party to that contract may nevertheless be deemed to be bound by the contract's arbitration clause or other dispute resolution mechanism. However, the conditions for such an extension are restrictive. The Supreme Court has rejected the group of companies' doctrine and draws a clear distinction between guarantee undertakings that entail the transfer of the arbitration clause contained in the contract, the performance of which they guarantee, and those that do not.

- If a party that guarantees the performance of a party to a contract signs that contract, it may be deemed to be a party to the contract in its own right or be bound by the dispute resolution clause in the contract.

- However, the Supreme Court assesses each case on its own facts. The wording of the contract and, in particular, of the guarantees at hand will be decisive for any future ruling.