Is your guarantee a guarantee? Note to shipowners

The law of guarantees is not always obvious or easy to understand without proper guidance. This article clarifies the difference between a guarantee and an indemnity, why it matters, and what steps can be taken to protect the shipowner's position.

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Ships are typically shipowners' largest assets and they are often considered a security for any claims that the charterers may have against the owners. However, in some instances, the charterers may insist on additional security by way of a guarantee, especially where the shipowner is a special purpose vehicle with no other known assets. A common scenario is where the charterers ask the parent company of a shipowning company to guarantee the due performance of its subsidiary's obligations under a charterparty.

A guarantor who is the *de facto* owner and provides a guarantee covering only the scope of the shipowners' obligations under the charterparty may not be exposing themselves to any additional risks. However, the law of guarantees is not always obvious or easy to understand. For example, an agreement that is referred to as a "guarantee" may in fact be a contract of indemnity with more onerous obligations for the guarantor. This article considers the difference, why it matters, and what steps can be taken to protect the guarantor's position.

Some terminology

- **A guarantee**: a contract where the "guarantor" makes a promise to the "beneficiary" about the due performance by the "principal" of his existing or future obligations under the underlying contract
- **A guarantor:** the party giving the guarantee
- **A beneficiary:** the party receiving the guarantee – in other words, the party that might make a claim against the guarantor if the principal does not perform
- **The principal:** the party who the beneficiary originally contracts with, and who the guarantor is guaranteeing
- **An indemnity**: a contractual promise to make a beneficiary whole if a prescribed event occurs. Importantly, the beneficiary does not need to prove that there has been any breach of contract – they only need to prove loss, which the indemnifying party must then pay (this is why shipowners request LOIs in return for agreeing to undertake certain acts).

Guarantee or Indemnity?

Under English law, there are some crucial differences between a contract of guarantee and a contract of indemnity.

A contract of **guarantee** is defined as a contract where the guarantor promises the beneficiary to be responsible for the due performance by the principal of his existing or future obligations under the underlying contract if the principal fails to perform any of them. In a shipping context, this means that the guarantor is promising the charterers to be responsible for the due performance by the shipowners of their obligations to the charterers under the charterparty.

A guarantee is based upon the existence of a valid obligation owed by the principal to the beneficiary and the guarantor assumes a secondary liability to answer for the principal who remains primarily liable. In view of this, pursuant to a true guarantee, the guarantor (i) will not be liable under the guarantee unless the principal is liable to the beneficiary, (ii) will be discharged of his obligations if the obligation of the principal is unenforceable, discharged or materially varied without the guarantor's consent and (iii) will be entitled rely on all the defences which are available to the principal (e.g. the defences they have under the charterparty).

Under a contract of **indemnity**, the indemnifying party (often referred to as the "guarantor" nevertheless) assumes a primary obligation that is independent of any liability which the principal (shipowner) may owe to the beneficiary (charterers).

Accordingly, (i) the beneficiary may make a demand under a contract of indemnity without having to establish a breach of the underlying contract, (ii) the guarantor will be obliged to pay out if the indemnity is triggered even if there is no dispute under the underlying contract, and (iii) the guarantor will not necessarily have the benefit of all the defences/limitations that are available to the principal.

Because of these significant differences between the two classes of contracts, it is important to understand whether an agreement is one for a guarantee or an indemnity.

Avoid agreeing to an indemnity if possible

A contract of indemnity imposes more onerous obligations upon the guarantor (who is in fact an indemnifying party rather than a true guarantor) than a true contract of guarantee as it is not necessary for the charterers to prove a breach under the charterparty; all that needs to be shown is that the requisite conditions set out in the guarantee document have been met.

Further, and potentially of greater significance, is that under an indemnity, the "guarantor" may not benefit from any defences or limitations available to the shipowners such as the ICA or the Hague-Visby Rules. We have seen a "guarantee" being requested that contains an indemnity for any losses that the charterers may suffer as a result of the owners' acts. This means the guarantor's scope of liability could be significantly wider/unlimited even when the shipowners' liabilities are limited. This has obvious implications for insurance coverage because, for example, if the guarantor is waiving rights of limitation, or Hague-Visby defences, the additional amounts that they must pay could fall outside of P&I cover.

In view of this, when asked to give a guarantee, care should be taken to ensure that the guarantor is fully aware of the nature of the guarantee they are giving (i.e. whether it is a true guarantee or in fact an indemnity), and if possible, try and avoid agreeing to an indemnity if possible.

Here are some example wordings that may suggest the document is an indemnity rather than a guarantee:

"*The Guarantor hereby unconditionally and irrevocably guarantees as primary obligor and not by way of secondary liability only…*"

"The Guarantor hereby agrees to indemnify and hold harmless the Charterers in full against any and all losses, claims damages, liabilities…"

"*The Guarantor agrees to pay for any and all costs and expenses incurred by the charterers in* enforcing any of their rights under the charterparty…"

Limit the scope of any guarantee/indemnity

Sometimes the guarantor may have no choice but to agree to an indemnity for various commercial reasons. In such situations, the guarantor should ensure they fully understand the scope of the indemnity, i.e. in what circumstances the guarantor will be required to indemnify the charterers, and try and narrow down the scope of the indemnity as far as possible. Indeed, this is something that should be considered carefully whether the guarantor is entering into a true guarantee or an indemnity.

Here are some points to consider when considering the scope of a guarantee or an indemnity:

- **Time** – How long should it be open for? Is it indefinite, or does it end on re-delivery of the CP, or after?

- **Which beneficiaries/liabilities?** – Who can claim under the guarantee and for what losses? Is it the named charterer only, or if other companies in their group have claims against the owners, will the guarantee cover those too?

- **Amount** – Is there a financial limit? This could be fixed in terms of the principal's liability, USD, or the guarantor's insurance limits? Is the guarantor responsible for the principal amounts only, or also interest and costs? If the guarantor must pay the beneficiary's legal costs, is that limited to the cost that the principal is order to pay, or any costs that the beneficiary incurs (even if unreasonably done)?

- **Defences/limits** – Must the guarantor pay even if the principal has defences to the beneficiary's claim? For example, if the if the charterer incurs a cargo claim of USD100,000 that would be apportioned 50/50 with owners under the charterparty's ICA clause, can the charterer claim only 50% of that claim from the guarantor, or the full amount?

- **When must payment be made**

  ? – Can the beneficiary claim directly under the guarantee, or do they have to first claim under the charterparty, and then claim the award under the guarantee if the principal cannot pay? What steps must the beneficiary take to attempt recovery from the principal? Can the guarantor defend the claim (eg. If they think the principal did not do a good job of defending it) or must they pay without further enquiry?

- **Counter-guarantee** – If a charterer requests the parent company of a ship-owner to guarantee the owner's performance, would it be reasonable for the parent company of the charterer to give a guarantee in the same terms? (if a charter is for a long period the financial status of a charterer can change significantly over time).

Seek legal advice

Whether an agreement is a guarantee or an indemnity is a matter of construction and the presence or absence of the word "guarantee" in the document is not conclusive. Accordingly, when Members are asked to give a "guarantee" for a related company, we strongly advise that legal advice is sought from your usual Defence lawyer. We would always be happy to review draft guarantees for our Members to ensure that their position is adequately protected.