KEY POINTS

- A recent Court of Appeal judgment holds that "principal debtor" and "primary obligor" language clearly point to an obligation of indemnity rather than guarantee.
- The judgment confirms that the courts will give priority to parties' freedom of contract in defining their relationship.
- Protections attaching to guarantees therefore do not apply.

Feature

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Equity set alongside freedom of contract: *Deutsche Bank Unitech*, round two

In this article, the authors consider whether LIBOR manipulation engages the "unusual features" principle, such that any unusual feature of the contract between creditor and debtor can discharge the guarantor from liability (provided the contract with the guarantor is characterised as a guarantee and not as an indemnity).

A tension has for some time been evident between, on the one hand, the imposition of particular legal and equitable duties on parties to certain types of contract or in certain situations, and, on the other hand, the autonomy or freedom of commercial parties to agree to circumscribe the same. In the wider sphere of financial litigation, this tension has played out in a long running debate arising from the contractual estoppel line of cases – see *Lowe v Lombank* [1960] 1 WLR 196; *Peekay Intermark Ltd v Australia & New Zealand Banking Group Ltd* [2006] 2 Lloyd's Rep 511; *Springwell Navigation Corp v JP Morgan Chase Bank* [2010] EWCA Civ 1221, [2010] 2 CLC 705; and *Prime Sight Ltd v Lavarello* [2013] UKPC 22, [2014] AC 436. For the present (fraud excepted), the party autonomy wing might be said to be in ascendancy. However, the last chapter in that debate has quite clearly not been written.

This might also be seen as background context for a similar debate evident in the Court of Appeal's recent decision in *Deutsche Bank AG v Unitech Global Ltd* [2016] EWCA Civ 119 (3 March 2016). The issues in *Deutsche Bank* arose in the sphere of banking surety law and a similar debate: namely whether equitable principles trumped the freedom of parties to express their relationship in particular terms and so the operation of equitable principles or the consequences of breach. The Court of Appeal's approach shows that freedom of contract still holds the advantage. There is a lot at stake in this argument particularly in the terms of the future role of English law in the sphere of financial litigation. Equally there is a great deal to be said in favour of solutions underscoring the primacy of freedom of contract in financial transactions. The case was heard by Longmore and Christopher Clarke LJJ and Sales J, with Longmore LJ delivering the single judgment of the court.

In *China and South Sea Bank Ltd v Tan* [1990] 1 AC 536 at 544, Lord Templeman expressed the maxim: "equity intervenes to protect a surety". In that case, however, equity provided no assistance to the guarantor's complaint that a creditor had failed to have regard to its interests when exercising a power of sale over mortgaged securities. As Lord Templeman made clear, a creditor/mortgagee can make up its own mind and consider its own interests when determining if and when to sell mortgaged securities. The guarantor in that case was not able to seek the discharge of the guarantee simply by reason of the grant of time by the creditor to the debtor (under well-established rules of equity) because the guarantee provided expressly that the grant of further time by the creditor to the debtor would not result in the discharge of the guarantee – the agreed terms meant that the parties wished to exclude the equitable rule in question.

The debate was similar in *Deutsche Bank*. The Court of Appeal (albeit in the context of an application for permission to amend) declined to intervene in principle to allow for protection (ie release) of an obligor in equity where the underlying credit facility – which was the subject of a guarantee and indemnity by the parent company of the principal debtor – contained interest provisions that had been impacted by LIBOR manipulation. Once more, however, the express wording of the guarantee and indemnity proved fatal to the assertion of protection on the part of the parent company obligor against the creditor bank.

THE ISSUES IN *DEUTSCHE BANK*

The underlying complaint in the *Deutsche Bank* actions will be familiar from the ongoing LIBOR litigation. It relates to a facility agreement under which US$150m was advanced, and to a US$11m interest rate swap, where the interest rates under both the loan and the swap were tied to LIBOR. Here, as in most LIBOR cases, the borrower (Unitech Global) under contracts with a rate-submitting bank (Deutsche Bank) complains that the bank's manipulation of LIBOR has some consequence for the credit facility agreement. Deutsche Bank's manipulation of LIBOR is a matter of public record, as it has accepted it in regulatory decisions in the UK and the US.

A previous Court of Appeal hearing ([2013] EWCA Civ 1372) allowed Unitech Global to proceed with an allegation that it had been induced to enter the agreements by implied representations from the bank to the effect that LIBOR was genuine. Unitech Global further claims that the manipulation of LIBOR breached implied terms to the same effect.

In cases like *Deutsche Bank*, the manipulation may also trigger a number of equitable principles intended to protect the guarantor (in this case Unitech Limited, the parent company of Unitech Global, the debtor) by discharging it from liability. As noted in the introduction, however, these principles are dependent not only on the wording of the contract between the bank and Unitech Limited but also on its characterisation as guarantee or as indemnity.

The Court of Appeal had to decide whether to allow an amendment which (among other things) sought to add a defence

that the guarantee was discharged by such principles. The key issues before the Court of Appeal in this regard were:

- whether the LIBOR manipulation was an "unusual feature" which could, if proven, cause the contract between the bank and Unitech Limited to be discharged under principles of equity; and
- whether that principle in fact applied to the clause in question.

It is worth noting that the discharge defence was no doubt advanced at least partly because Unitech Global wished to avoid repaying the bank the US$120m in restitution it will owe if it succeeds on its rescission defence (see the judgment at [52–55]).

DOES LIBOR MANIPULATION ENGAGE THE "UNUSUAL FEATURES" PRINCIPLE?

The "unusual features" doctrine is a classic instance of the courts' piecemeal development of the protection of guarantors through principles of equity. The principle was considered by the Court of Appeal in *North Shore Ventures Ltd v Anstead Holdings Inc* [2012] Ch 31. Giving the judgment of the Court in *North Shore*, Sir Andrew Morritt C cited the following passage from Lord Nicholls's speech in *Royal Bank of Scotland plc v Etridge (No 2)* [2002] 2 AC 773:

> 'It is a well-established principle that, stated shortly, a creditor is obliged to disclose to a guarantor any unusual feature of the contract between the creditor and the debtor which makes it materially different in a potentially disadvantageous respect from what the guarantor might naturally expect. The precise ambit of this disclosure obligation remains unclear.'

The principle, on its face, therefore applies to unusual features "of the contract". The question in *Deutsche Bank* was whether the doctrine extended beyond the contractual terms, to the "contractual relationship". Ultimately, the Court of Appeal, for reasons set out below, did not decide the issue. But it is ripe for consideration.

Some support for a wider interpretation (beyond the terms of the contract) comes from *North Shore*, where the court held (at [14]) that the principle of disclosure was that:

- the creditor is obliged to disclose to the surety any contract or other dealing between creditor and debtor so as to change the position of the debtor from what the surety might naturally expect; but
- the creditor is not obliged to disclose to the surety other matters relating to the debtor which might be material for the surety to know.

Accordingly, *North Shore* itself would appear to extend the principle to the terms of the contract or "other dealings" which changed the position of the debtor from what the surety might naturally expect, but not to "other matters" even if they might be material. The rationale for the *North Shore* principle, although not expressed as such in the decision, appears to be akin to the rationale for the equitable principle in *Holme v Brunskill* (1878) 3 QBD 495 (by which a guarantor is discharged from liability by a material binding variation to the underlying contract): that equity prevents two parties to a triangular relationship altering their arrangements behind the back of the third.

As Longmore LJ said in *Deutsche Bank* at [19], this ambit is 'perhaps not entirely clear from the authorities'. That said, on the authority of *North Shore* and *Deutsche Bank* it now appears likely in any future case that protection will be afforded both to contractual arrangements between debtor and creditor and to other dealings. The unresolved issue is the scope of the "other dealings" that might qualify, particularly where "other matters" are expressly outwith the doctrine. On the facts of *North Shore*, the circumstances of a criminal investigation into the debtor were (perhaps unsurprisingly) characterised as "other matters" and not contracts or dealings. This characterisation is entirely understandable in that it concerned matters which did not relate to anything that passed between the creditor and debtor.

The issue of LIBOR manipulation by the bank is more difficult. Longmore LJ considered it arguable that 'manipulation by the Bank of a rate by reference to which interest was calculated would be a most unusual feature'. This appears to reflect a degree of flexibility in the *North Shore* principle which has yet to be worked out fully in the cases.

The guarantor may have the benefit of other, well-established defences, such as that a creditor cannot plead his own fraud in making a claim against the surety. It is an open question, in light of the tentative comments of the Court of Appeal, whether the *North Shore* principle will provide a broader basis for extending the rationale of those defences in LIBOR cases such as *Deutsche Bank*.

COULD THE PRINCIPLE APPLY TO THE OBLIGATION IN QUESTION ANYWAY?

In fact, the Court of Appeal in *Deutsche Bank* did not need to determine the scope of the principle on the facts of the case. This is because of the well-trodden further issue before it, namely whether the facility wording in question constituted a guarantee or an indemnity. Where the obligation is properly described as a "true indemnity" (described as such at [18]), on the current state of the law equity will not step in.

It is well recognised that modern facility agreements are usually drafted on standard forms of wording with the objective of protecting banks. They are intended as a riposte to the principle that "equity intervenes to protect a surety", the means deployed being the drafting of contractual terms which modify or exclude equitable principles that might otherwise act to the detriment of the lender.

In *Deutsche Bank* there were effectively two arguments raised by the bank which were raised in answer to the *North Shore* argument. The first was that the facility contained indemnity obligations. The second was that the rule was ousted in any event. The Court of Appeal construed the facility obligation as constituting a primary indemnity (at [19–21]) and so held that the *North Shore* argument had no application. It is therefore worth considering the facility wording which resulted in this successful outcome for the bank. The facility agreement in question provided as follows:

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'15.1 Guarantee and indemnity

The Guarantor irrevocably and unconditionally:

(a) guarantees to each Finance Party punctual performance by the Company of all its obligations under the Finance Documents;
(b) undertakes with each Finance Party that, whenever the Company does not pay any amount when due under or in connection with any Finance Document, the Guarantor must immediately on demand by the Facility Agent (acting on the instructions of the Majority Lenders) pay that amount as if it were the principal obligor in respect of that amount; and
(c) agrees with each Finance Party that if, for any reason, any amount claimed by a Finance Party under this Clause is not recoverable from the Guarantor on the basis of a guarantee, then the Guarantor will be liable as a principal debtor and primary obligor to indemnify that Finance Party in respect of any loss it incurs as a result of the Company failing to pay any amount expressed to be payable by it under a Finance Document on the date when it ought to have been paid. The amount payable by the Guarantor under this indemnity will not exceed the amount it would have had to pay under this Clause had the amount claimed been recoverable on the basis of a guarantee.'

The bank relied upon sub-cl (c) as containing an indemnity "to which the legal rules about guarantees did not apply". The Court of Appeal agreed at [20] that the sub-clause had the effect of constituting an indemnity if any amount was not recoverable on the basis of a guarantee "for any reason". Those words, the Court of Appeal held, would encompass irrecoverability by reason of non-disclosure of features which ought to have been disclosed. The wording was effective therefore to render reliance on *North Shore* irrelevant.

DISCHARGE BY BREACH

A further feature of the Court of Appeal's conclusion that sub-cl 15(c) was an indemnity is that a (further) equitable rule, again applicable only to guarantees, was not available to the debtor. There is no doubt that under ordinary contractual principles a repudiatory breach of a guarantee agreement must be accepted for the guarantee to be discharged. If it is not accepted, or the contract is affirmed, the guarantor remains liable. In *Deutsche Bank* there was never any such acceptance of any repudiatory breach regarding LIBOR. However, it was argued that a non-repudiatory breach of the underlying contract with the principal would nevertheless discharge the guarantee, whether or not accepted.

There is some support for this equitable principle on the current authorities (see eg *National Westminster Bank Plc v Riley* [1986] BCLC 268 and *The Wardens and Commonality of the Mystery of Mercers of the City of London v New Hampshire Insurance Co* [1992] 2 Lloyd's Reports 365). However, the breach in question must be "not insubstantial"). The Court of Appeal in *Deutsche Bank* considered this principle to be an "interesting question" ([25]) but, ultimately, one that did not require an answer as it was a rule applicable only to guarantees and not to primary obligations of indemnity. Accordingly, in respect of this aspect of the equitable principles in play, absent further development, the safest course for lenders is to include primary contractual language of indemnity.

CONCLUSION

The incremental approach of equitable rules has historically focussed upon the position of secondary guarantee liability and not primary indemnity obligations. The modern trend is to give primacy to the parties' freedom to restrict or disapply those rules. The Court of Appeal's judgment in *Deutsche Bank* provides robust protection to the primacy of the parties' bargain, as expressed in the financial documents which they execute. Nevertheless, it is clearly in lenders' interests to ensure that they enter contracts in terms similar to those in *Deutsche Bank*, making it clear that the liability of the "guarantor" is primary as well as secondary. Correspondingly, if a "guarantor" wants to be sure of receiving any of the protections traditionally attaching to contracts of guarantee, then it should expressly provide for them in the mechanisms of the contract in terms which operate independently of its overall characterisation. ■

Further Reading:

- Guarantees: What needs to be disclosed? [2010] 9 JIBFL 534.
- Satisfaction guaranteed? [2014] 5 JIBFL 293.
- LexisPSL: Practice note: Guarantees – varying the underlying transaction.