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Securing company claims using directors' private assets: what kind of guarantee is used?

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Introduction

Loans granted to a company are almost systematically guaranteed. In Luxembourg, the most widely used guarantees have traditionally been:

- suretyships; and
- first demand guarantees.

These are regulated quite differently. The suretyship regime is detailed in articles 2011 *et seq* of the Civil Code. On the other hand, unlike countries such as France, Luxembourg has no legislation concerning first demand guarantees. However, abundant case law on the qualification differences between these two guarantees and a decision rendered by the Court of Appeal on 7 November 2019 (decision 113/19 – IX – CIV) has set out the distinctive criteria and particularities of first demand guarantees and suretyships.

The law of 10 July 2020 introduced professional payment guarantees (Memorial A 582, 2020), a new type of guarantee which transverses the traditional dichotomy between suretyships and first demand guarantees.

Facts

On 19 October 2007 bank D granted a loan of €14.4 million to company E to finance a yacht.

Several securities were granted to secure the loan's repayment. Guarantors A and C each signed a separate document entitled "Guarantee", guaranteeing payment of €14.4 million (the letters).

The letters, drafted in identical terms, stipulated that A and C irrevocably and unconditionally guaranteed, at the first request of bank D, a maximum amount of €14.4 million and that:

> *the guarantor accepts de facto all cash payments in execution of this independent and autonomous guarantee without protest, discussion or invocation of an exception relating inter alia to the underlying transaction.*

The bank terminated the loan agreement on 30 April 2009 as the borrower had failed to meet its repayment deadlines. Via a registered letter dated 29 May 2009, the bank's counsel asked guarantors A and C to pay the €14.4 million in accordance with each letter of guarantee. They did not comply. After the sale of the mortgaged yacht, a claim of €3,190,832.47 without interest remained to be paid to bank D.

First-instance court

At first instance, the judges qualified the letters as first demand guarantees. They considered that the guarantee was autonomous from the loan contract. The judges summoned guarantors A and C to pay the €3,190,832.47 in addition to interest for late payment and an indemnity for costs and expenses.

Court of Appeal

Guarantors A and C opined that they had entered into a suretyship and that they could therefore invoke the exceptions to the main loan contract. They considered that because the letter of guarantee referred to the loan agreement and the borrower's default, the letter of guarantee was not autonomous from the main contract.

The qualification of an autonomous guarantee on first demand presumes that:

- the will to undertake a first demand is expressed in the guarantee deed; and
- the guarantor has undertaken not to substitute itself for the principal debtor, but instead to provide the sum of money.

In the case of suretyship, the guarantor is substituted for the principal debtor and may invoke the exceptions to the principal obligation, to the exclusion of those which are personal to the principal debtor (article 2036 of the Civil Code).

The Court considered that it was clear from the wording of the letters that each guarantor had expressed its willingness to commit itself on first demand and release a specific sum of money, regardless of the amount debited by the principal debtor.

The Court also stated that the reference in the introduction to the letters which set out the context in which the undertakings were given did not affect the characterisation of the first demand guarantee.

Further, the fact that the bank had indicated in the registered letters of 29 May 2009 that it reserved the right to call on the guarantee in the event of the borrower's contractual default was also irrelevant.

The Court further emphasised that the letters expressly excluded the possibility of enforcing the loan contract's exceptions.

Therefore, the Court concluded that there was no evidence to suggest that the guarantee call was fraudulent or abusive.

In addition, the Court considered that guarantors A and C had separately undertaken to pay the entire maximum amount of €14.4 million. Consequently, each guarantor should have been ordered to pay the amount claimed by bank D.

Comment

In the case of an autonomous guarantee on first demand, the judge must order the guarantor to be condemned, except in the case of fraud or manifest abuse by the beneficiary. The beneficiary's lack of right must be obvious.

The amount of the guarantee call may not correspond to the exact amount of the principal debt. This is one of the consequences of the autonomous effect of the guarantee in relation to the principal contract. Moreover, the guarantor cannot invoke the exceptions to the principal contract – this is the main distinction from suretyships.

This is of fundamental importance currently, considering that, in view of the covid-19 pandemic, governments have granted special measures such as suspending the time limit for taking legal action (eg, the general measures for suspending time limits during a state of crisis as adopted by the Grand Ducal Regulation of 25 March 2020), suspending interest on arrears or postponing debt due dates. While the guarantor in a suretyship can take advantage of all of these exceptional measures, the guarantor in a first demand guarantee cannot. Thus, a lender (under the principal contract) could claim from the guarantor an amount equal to the principal debt, plus the accessories that have been suspended or cancelled by the governmental sanitary measures.

In light of the aforementioned case law, it is important that the letters of guarantee be properly drafted so that the guarantor and the guaranteed party are fully aware of the risks involved in the event of a guarantee call.

Professional payment guarantees, introduced by the law of 10 July 2020, are an interesting alternative to first demand guarantees and suretyships. The law that governs them provides the respective parties with a high level of flexibility when determining the conditions to implement this type of security. The parties will simply have to refer to this law in their written contract to set aside the law for the suretyship or a first demand guarantee. This new security is an instrument that enables the reconciliation of contractual freedom and legal certainty and can be adapted to the envisaged financial transactions. For instance, if expressly stipulated by the parties, the guarantor may raise the exceptions to the principal obligation. In the absence of such a stipulation in the professional payment guarantee contract, the guarantor cannot invoke the exceptions of the main contract. The freedom of contract given to the parties, within the framework of professional payment guarantees, also enables them to better tailor their respective obligations.

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