Notes From The Field
An English Law Perspective On The Oil & Gas Market

Codifying Independent Parent Company Guarantee Practice: Food for Thought
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The increased volume of cases brought before the English courts in recent years on the topic of guarantees has highlighted the fundamental need for guarantors and beneficiaries to clearly understand the principles and nature of the law governing this complex area of collateral support.

Guarantees come in a variety of guises and there is often a great deal of misunderstanding surrounding the legal principles underlying them. This is not helped by two relatively common phenomena: the draftsperson's lack of precision in their work and an arbitral or judicial body's ability to blur the lines between classic guarantees and demand guarantees (otherwise known as performance bonds or default bonds). Labelling a contract as a 'guaranty' does not automatically make it a guarantee in the pure, legal sense. Instead, a guarantee's existence is determined by the nature of the obligation and the relationship created, and not by the prose used to describe it.

In an industry where the commercial exposure to financial risk is high, the nature of, and ability to enforce, collateral support takes increasing prominence. Demand guarantees and parent company guarantees ("PCGs") are popular forms of security provided in upstream oil and gas transactions. Much work has been undertaken to regulate the international practice of demand guarantees, but in stark contrast, a similar attempt to distil and standardise the make-up of PCGs has not been pursued. Whilst the drive behind the codification of demand guarantees has stemmed from the inadequacies highlighted by the construction and banking sectors, the issues surrounding PCGs have largely been ignored.

Building on the approach taken by the International Chamber of Commerce ("ICC") Uniform Rules for Demand Guarantees ("URDG"), and given the widespread use of PCGs in connection with upstream petroleum contracts, this article briefly sets out the main differences between demand guarantees and PCGs, then examines the latest version of the URDG (the "URDG 758") and finally considers whether it is time for the wheels to be set in motion to homogenise PCG terms, with a particular focus on the oil and gas industry.

**Demand Guarantees v PCGs**

Demand guarantees originated in the construction industry over forty years ago. In its traditional form, a demand guarantee is a direct undertaking by the guarantor which imposes a primary obligation on it to pay a specified amount to the beneficiary on its first demand for payment in situations where the principal fails to perform the underlying contract. The presentation of specified documents triggers payment from the guarantor to the beneficiary, even if defences are available to the principal against the beneficiary. The construction of the demand guarantee means that it will be strictly interpreted in accordance with its provisions and will not be coloured by the underlying guaranteed obligation.

PCGs, on the other hand, are very different beasts, primarily because they are largely influenced by the underlying guaranteed obligation. In its purest sense, a PCG is a conditional promise by a parent company to answer to a third party for the debt or default of its subsidiary; it is a secondary obligation which is contingent on the subsidiary's primary obligation under the underlying agreement, co-extensive with the liability of its subsidiary, and fixed only by the subsidiary's failure to satisfy its side of the bargain with the beneficiary. If the subsidiary has defences to liability, then those defences are equally available to the principal against the beneficiary. The construction of the demand guarantee means that it will be strictly interpreted in accordance with its provisions and will not be coloured by the underlying guaranteed obligation.

Guarantors have traditionally been the darlings of the courts, and where there has been a dispute over contractual interpretation, the guarantee has been interpreted in their favour. Largely as a result of this, the classic nature of English law guarantees has been eroded over the last decade or so and modern PCGs now often extend to cover the primary obligation (by virtue of including an indemnity to cover when the beneficiary has experienced loss under the underlying contract) and state that they are payable on demand. If only a classic form of guarantee existed, the guarantor would be exonerated from its obligations in cases where the guarantor's secondary obligation, or the primary obligation of its subsidiary, was found to
be invalid. In order to ensure that the PCG survives in such circumstances, beneficiaries have sought to protect their interests by including indemnity formulations in their PCGs as well.

**Uniform Rules for Demand Guarantees**

Demand guarantees are more complex in nature than PCGs given that banks are involved in the demand guarantee arrangement, in addition to the guarantor and the beneficiary (who are the only two parties to a PCG). Over the years, complaints from disgruntled contractors over the treatment of demand guarantees led the ICC to step in to regulate this form of collateral support by publishing a series of contractual rules. The URDG 458 was the ICC’s first attempt to codify demand guarantees and was used in practice for eighteen years, being succeeded only in 2010 by the URDG 758.

The objective of the URDG 758 was ambitious but simple: to become the international standard practice for demand guarantees. In doing so, the URDG 758 sought to bring precision, clarity and comprehension into the 21st century world of demand guarantees in order to create a platform on which a successful demand guarantee practice could be built.

The URDG 758 applies to any demand guarantee or counter-guarantee in which it is incorporated by reference. In 35 articles, the URDG 758 covers everything from the requirements for a demand, to the extent of the guarantor’s liability under the demand guarantee and the treatment of force majeure events covering documentary instruments. A skeleton form of demand guarantee is appended to the uniform rules, and optional clauses are also provided, which afford flexibility to the parties when entering into their contract.

However, the URDG 758 is diluted by the fact that it is only voluntary in nature and relies on the draftsperson to incorporate its set of rules. That said, even if demand guarantees are issued without incorporating the URDG 758, over time the URDG 758 could be used to plug the gap or influence the implementation of national laws even if it is not expressly recognised in the demand guarantee itself.

The URDG 758 is also potentially undermined by the fact that the provisions of the national law governing the demand guarantee are expressed to prevail over the URDG. The URDG 758 provides, unless otherwise agreed, that the guarantor’s law and jurisdiction applies to the guarantee so, to the extent of any conflict between the domestic law of the guarantor and the rules of the URDG 758, the domestic law will apply. However, given the extensive research that the ICC conducted in monitoring international demand guarantee practice in preparation for compiling the URDG 758, the scope for conflict should be fairly limited.

So has the objective of the URDG 758 been successfully realised? According to some, the URDG 758 is criticised as having introduced some new ambiguities into the world of demand guarantees and so is thought to remain a work in progress. According to others, the use and uptake of the URDG 758 at a satisfactory rate is seen as a testament to its success. The jury is still out.

**Uniform Rules for PCGs**

Unlike demand guarantees, there are no equivalent internationally recognised rules for PCGs. Although many of the model form oil and gas industry contracts, such as Oil & Gas UK’s decommissioning security agreement, the Association of International Petroleum Negotiators (“AIPN”) joint operating agreement (“JOA”) and the AIPN LNG Master MSA, include a placeholder for a PCG, no form is provided or guidance given as to its substance and there has been little appetite so far to do so.

The question of who is best placed to initiate and conduct an assessment of the PCG market is open to debate. With the wealth of experience that the ICC has accumulated in producing the standard text for demand guarantees, on an international platform the ICC is the most obvious choice of candidate. At a domestic level, Oil & Gas UK could be a contender. In August 2007, the Oil & Gas UK Standard Contracts Committee published a model form of PCG and a short paper setting out some general principles for use. Although Oil & Gas UK’s model form of PCG and general principles could be used as an industry starting point, it would be beneficial for the industry to re-visit these precedents; seven years have
passed since the preparation of these materials and there has been a significant amount of case law during this time on the subject of guarantees.

Given the vast deployment of PCGs in the oil and gas industry, that the underlying documents to which they relate vary greatly in content and that there are usually a multitude of sins for which PCGs are provided to cover, perhaps standardising an industry set of rules for PCGs may prove difficult in practice.

The JOA is a good example of an underlying upstream petroleum contract, the obligations of a party under which are frequently guaranteed. Typically, under the terms of the JOA, upon any proposed transfer by a co-venturer of part or all of its participating interest, the remaining co-venturers’ prior written consent will be required. Depending on the financial capacity of the proposed transferee, the remaining co-venturers may seek a PCG from the transferee’s parent in consideration for consenting to the proposed transfer. The terms of a PCG in this example are likely to be broad in nature but it is also important for the guarantor to consider whether the PCG should be limited in any way. For instance, to the extent that any amounts have been paid in full by the guarantor under the PCG and the beneficiary receives any proceeds of sale of petroleum under the JOA relating to the same obligations, the PCG should provide that the beneficiary should pay the proceeds of sale to the guarantor in order to ensure that the beneficiary does not benefit from double recovery in relation to the same default. Any codification of PCGs in the oil and gas industry will therefore need to be sensitive to the fact that this form of collateral support is often bespoke to the underlying contract, and so any standard form PCG that is developed by the industry will require a variety of optional clauses which the parties can choose to insert in order to mirror the flexibility granted by the form of demand guarantee under the URDG 758.

Consultation with governments in the codifying of international PCG practice in the oil and gas sector may prove to be a stumbling block. For instance, the British government, through the Department of Energy and Climate Change (“DECC”), requires that licensees and proposed licensees demonstrate sufficient financial capacity to meet their share of the proposed work programme and their existing licence commitments. PCGs from oil and gas companies may be requested by DECC in order to secure a licence award, an assignment, well consents for exploration and appraisal wells, a field development and decommissioning liabilities, as they evidence the availability of cash resources the licensee has access to in order to pay its share of costs. DECC has two prescribed forms of PCG that it is prepared to accept (the multi-licence PCG and the licence-specific PCG) and does not entertain any substantial deviation in form or substance from these standard forms. Educating governments and practitioners will therefore be vital to the success and implementation of an independent PCG practice in the oil and gas industry, and it will be important to involve these bodies in any PCG codification process.

Conclusion

Although it is likely that any push to regulate PCGs in the international oil and gas industry will be resisted by those companies who already have approved forms of precedent guarantees in place, in order to level the playing field among PCG issuers, and on the premise that uniform rules equal increased certainty and predictability for both guarantors and beneficiaries alike, there may be merit in codifying PCG practice and creating a standard form of PCG. The industry will need to buy into the argument that the advantages that a codified system has to offer outweigh the disadvantages of employing a more rigid arrangement.

The establishment by the ICC of the URDG was no mean feat and involved extensive monitoring of international demand guarantee practice, the product of which took around two-and-a-half years to perfect. Any regulation in the international practice of PCGs should build on the legacy of the URDG 758 and borrow from its wealth of experience; it would be a mistake for any PCG task force to ignore its struggles and shortcomings. Any group tasked with such codification should not enter into such an assignment half-heartedly, as the process is likely to require persistent commitment and dedication in order to produce a workable standard protocol, which balances the power between the guarantor and the beneficiary and which can be successfully used across the industry.
In the words of Arnold Bennett, “Any change, even a change for the better, is always accompanied by drawbacks and discomforts.” Bearing this in mind, in the short term, the success of any future PCG codification will depend on the ability of the draftsperson to recognise the clarifications, drafting amendments and expansion of scope requirements necessary to enhance any adopted standard. In the long term, it will be marked by the endorsement and acceptance by the oil and gas industry; the percentage of guarantees which adopt the uniform rules on PCGs compared to those that are not; and the way in which the uniform rules are applied.

Given the attention that the English courts have paid to the law of guarantees in recent years, the impetus exists for uniform rules on PCGs to be codified, but the concept at present lacks momentum. Perhaps now, on the eve of the fourth anniversary of the URDG 758, the oil and gas industry should embrace this new challenge and engage in setting the wheels in motion to give this proposal teeth and clear direction.