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CORRECT USE OF A FIRST DEMAND BANK GUARANTEE WITH REGARDS TO A COMMERCIAL/OFFICE LEASE AGREEMENT

First demand bank guarantees are nowadays a common medium used to secure payments in commercial and other lease agreements.

This newsletter summarizes the key aspects of their benefits.

1. What is a first demand bank guarantee?

A first demand bank guarantee is characterized by a personal payment commitment made by the guarantor directly to the beneficiary¹.

This commitment is of an abstract and independent nature with respect to the relations existing between the parties to the lease agreement.

As a result, it follows that the bank cannot register any exceptions arising from either the contractual relations between it and the tenant or the contractual relations between the landlord and the tenant against the landlord.

This mechanism enables the landlord to ask the bank to pay him directly any amount due by the tenant pursuant to the lease agreement.

2. What are the main differences between a first demand bank guarantee and a security (*cautionnement*)?

Both a security and a first demand bank guarantee are personal sureties, which offer a second solvent debtor to the creditor if the main debtor defaults.

The main difference between the two sureties arises from the ancillary or independent nature of the guarantor's commitment: the security-guarantor's commitment

is ancillary while the first demand bank-guarantee-guarantor's commitment is independent.

Where the security is concerned, the guarantor is required to pay the debtor's debt, while the guarantor bound by a first demand bank guarantee is required to execute a personal obligation.

This distinction means that a security-guarantor can register all exceptions arising from the lease contract against the landlord while a first demand bank guarantee-guarantor cannot. The first demand bank guarantee is therefore more creditor-friendly.

This independent or ancillary nature results from the parties' wording of the surety, which is therefore a crucial point of the agreement.

3. How does a first demand bank guarantee work regarding a commercial/office lease agreement?

There is no legal obligation for the tenant to provide a bank guarantee to the landlord. As a result, if the landlord wishes to receive such guarantee, a specific provision should be included in the lease agreement.

In practice, issuing a first demand bank guarantee could be considered as a condition precedent to the contract, or the lease agreement could state that the guarantee must be issued within X days after the signature by the parties of the contract otherwise the landlord has the right to terminate the contract with immediate effect due to a breach of its contractual obligations by the tenant.

If the landlord wants to call in the guarantee, the process is very easy. He neither has to inform the tenant beforehand nor provide the bank with any receipt or settlement (unless the guarantee expressly includes such requirement for documentation).

Furthermore, as previously explained under point 2., in the case of non/late payment, the tenant has no right to

¹ See Article 2011, 5° of the Civil Code

oppose the calling in of the guarantee. For its part, the bank must pay and cannot raise any exception in relation to the validity, the existence and/or the execution of the lease agreement nor to the termination of the tenant's obligations.

If there is a specific provision in the lease agreement, the tenant can be obliged to reinstate the first demand bank guarantee to its full amount after each payment made by the bank.

4. What is the maximum amount covered by a first demand bank guarantee in relation to a commercial or an office lease agreement?

A first demand bank guarantee is usually issued to secure all contractual obligations of a tenant arising from a commercial or office lease agreement. This should not be confused with the maximum amount covered by the guarantee, which is the limit the bank would pay if the landlord calls in the guarantee.

Luxembourg law does not state a maximum amount so the parties can freely fix the limit in the lease agreement.

According to common practice regarding commercial and office lease agreements, the tenant is requested to provide the landlord with a first bank demand guarantee of an amount equal to 6 months rent and common charges (+ VAT if applicable). With regards to the wording, it's strongly advisable to specify that the guarantee should be issued for an amount of (x) euros, equal to (x) month(s) of rent and common charges (+ VAT if applicable).

If the lease agreement includes an indexation of the rent, the maximum amount of the first demand bank guarantee can be indexed as well but only if there is a specific provision in the contract.

5. What is the duration of a first demand bank guarantee in relation to a commercial or an office lease agreement?

There is no legal duration of a first demand bank guarantee and thus the parties can freely fix it in the lease agreement.

If the duration of the guarantee is not expressly mentioned in the contract, the guarantee remains in force until the termination date of the lease agreement, legal or contractual extension included.

In practice, it is strongly advisable to include a provision in the contract stating that the first demand bank guarantee stays valid until the tenant has fully carried out his contractual obligations. The landlord will check the position of the tenant by way of a final statement on the payment of the rent, the common charges and, if applicable, the costs of refurbishment of the leased premises.

6. What happens to the first demand bank guarantee if the leased premises are sold?

A first demand guarantee is a personal and independent commitment of the bank that has issued it. The guarantee is also not automatically transferred to the new owner of the leased premises by virtue of their sale.

In practice, the new owner of the leased premises should ask the tenant to provide him with a new first demand bank guarantee. The tenant could refuse if the bank does not cancel the initial guarantee he gave to the former owner of the leased premises.

The seller and the buyer of the leased premises could also contractually agree on the transfer of the guarantee.

7. What happens to the first demand bank guarantee if the tenant remains in the leased premises after the termination date of the contract?

When the tenant remains in the leased premises after the termination date of the contract, the first demand bank guarantee no longer applies.

This is so even if the tenant remains in the leased premises without the agreement of the landlord (*occupant with neither right nor title*) (see Art. 1740 of the Luxembourg Civil Code).

8. What happens to the first demand bank guarantee if the tenant goes bankrupt?

Following French jurisprudence, the bankruptcy of a tenant does not affect the validity of the first demand bank guarantee. Because of its independent nature, the first demand bank guarantee is not extinguished in the event that the debtor is put into receivership or compulsory liquidation, even if the creditor does not file a claim with the receiver or liquidator.

Although we have found no literature or jurisprudence publicly available in Luxembourg on this matter, there is no reason why this solution should not apply in Luxembourg given the similarities between the two legal systems.

The landlord could then act directly against the bank for the payment of his claim.

For more information on the above, please contact:

Stéphanie JUAN

Partner, Real Estate, Zoning & Environment
Avocat at the Luxembourg Bar, PhD in Public Law
stephanie.juan@molitorlegal.lu

Martina HUPPERTZ

Partner, Banking and Finance
Admitted to the Luxembourg Bar, list IV
Rechtsanwältin (Bar of the District of the Higher Regional Court Koblenz)
martina.huppertz@molitorlegal.lu