



**Bonds and guarantees**

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# **Bonds and Guarantees**

## **Introduction**

Bonds and guarantees are often only treated as an afterthought when it comes to risk analysis and negotiation of construction projects. Where used, they tend to be viewed very much as “ancillary” documents to the main construction contract. However this does not do justice to the significant role that these instruments may in fact play if something goes wrong with a project.

The current inclement economic climate has led to an increase in the failure rate of construction projects and insolvency of parties to construction projects. In turn bonds and guarantees are coming under greater scrutiny as employers and contractors alike become ever more anxious about their exposure to risk. There has been a marked increase in the number of cases in which we have seen employers call, or threaten to call, performance bonds in recent times.

As a result, it is essential that parties to construction contracts are familiar with the characteristics of bonds and guarantees, the differences between them and considering where it may be appropriate to use, or resist the use, of each.

## **Fundamental features of bonds and guarantees**

Although in practice the words “bond” and “guarantee” are often used interchangeably, under English law they have particular meanings.

### **What is a bond?**

A bond is usually contained in a document given by a third party in support of the obligations of another party, containing a promise to pay money immediately or on a future date. It thereby provides an assurance to the beneficiary that the contracting party will perform its obligations, and security if it does not.

Performance bonds are most likely to be called in the event of a contractor going insolvent or (less frequently) in the event of a dispute between the employer and the contractor. The obligation to pay money is commonly capped at 10% of the contract sum until completion of the works and then at 5% until the rectification of defects notified in the warranty period is complete. These sums and periods are, however, a matter of negotiation.

### **Who issues bonds?**

Bonds are normally issued by banks, insurance companies or specialist surety companies. Collectively these are known as bondsmen.

Bondsmen will invariably seek a counter-indemnity from the party requesting the bond (i.e. the contractor). In the case of a bank bond, this would normally be secured against the contractor's

overdraft facility.

### Conditional bonds

Conditional bonds are sometimes referred to as “default” or “proven default” bonds and are predicated on a breach of the underlying contract by the contractor. They are conditional in the sense that there has to be sufficient proof by the employer of the default of the contractor and of damage having been suffered by the employer before the bondsman is obliged to make any payment under the bond. Usually, the bond will be structured such that the bondsman will only be obliged to make payment where there has been a default under the contract and the claim is either agreed (between contractor and employer) or the employer proves its claim in formal dispute resolution proceedings. Bonds can also be made conditional on an adjudicator’s decision or on an expert’s determination. If the decision or determination is not final and binding on the parties, the bond will need to include a mechanism to account for any overpayment or underpayment once the dispute has been finally resolved.

For the beneficiary of a conditional bond it is important that the bond must be drafted so that the beneficiary is able to call on the bond in the event of the contractor’s insolvency. The case of *Perar BV v General Surety and Guarantee Company Limited* (1994) CILL 935 CA illustrates the problem. The court in the *Perar* case held that the automatic determination of the employment of the contractor upon its insolvency did not constitute default for the purposes of the bond. From the employer’s perspective this took away the most common reason for having a bond in the first place, namely the protection it offered in the event that the contractor went insolvent. The case went on to say that a default would only arise if the contractor, following its insolvency, failed to discharge its obligations and pay the employer direct loss and/or damage caused by the determination – most obviously the employer’s loss will be the costs of completing the works assuming the insolvent contractor cannot do so. As this would only be ascertained much later on there is a danger that the bond may have expired by that date.

The *Perar* case was not surprising in the sense that under English law it has for some time been established that insolvency is not *per se* a breach of contract. It confirmed that that principle is just as applicable to bonds as it is to other contracts.

As a result, it is therefore absolutely imperative that beneficiaries of bonds include wording clarifying that the insolvency of the contractor and/or the automatic determination of the employment of the contractor for insolvency constitutes an event of default for the purposes of calling the bond.

### Key drafting points

The following points should be borne in mind when negotiating and entering into conditional bonds:

- (i) Conditional bonds have been held to be guarantees and as such the law of guarantees will apply to them. Accordingly, unless express protective wording is incorporated, any alteration of the underlying contract could potentially release the bondsman.

- (ii) The bond should make it clear whether multiple calls can be made up to the cap.
- (iii) Employers will want the widest possible definition of insolvency to be inserted into the underlying construction contract and into the bond.
- (iv) The bond should have a definite expiry date. The bond should also provide that the beneficiary can claim under the bond in respect of any claims which have been notified to the bondsman on or before the expiry date but which have not been determined by the expiry date.

### On-demand bonds

On-demand bonds are commonly used in international project finance. They are usually given by banks rather than insurance companies.

The fundamental difference between an on-demand bond and a conditional bond is that an on-demand bond is expressed such that a particular sum of money will be paid by the bank "on demand", without further conditions.

Subject to what is said below the approach English law takes to on-demand bonds is that they have the effect that their wording suggests. Most importantly, therefore, English law will not look to impose conditions on the beneficiary which the bond itself does not impose.

The effect of giving an on-demand bond has therefore been construed by the English courts as being equivalent to a letter of credit (*Edward Owen Engineering v Barclays Bank International Limited* [1978] 1 All E.R. 976).

The courts will not, in the absence of fraud, grant injunctive relief to prevent an on-demand bond being called.

An on-demand bond puts the bondsman under a primary obligation and as such is independent of the underlying contract. In the *Edward Owen* case Lord Denning stated that "... [T]he bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions".

Although a bondsman is *prima facie* obliged to pay out on any demand under an on-demand bond, the contractor could seek to obtain injunctive relief from the courts against payment being made on the following grounds:

- (i) where the bond is not truly unconditional, on its proper construction. Simply calling a bond an "on-demand" bond will not be decisive, and the actual terms of the bond will need to be considered carefully. In *Trafalgar House Construction (Regions) Limited v General Surety and Guarantee Company Limited* [1995] 3 All ER, the deed was described as a bond but was held to be a guarantee;

- (ii) where the written demand required by the terms of the bond is deficient. Even if a successful challenge is made on these grounds, it is likely to only be a delaying tactic until a proper demand is made; and
- (iii) fraud. A contractor may successfully obtain relief if there is fraud on the part of the beneficiary. In the context of a performance bond, fraud has been defined as the beneficiary making a claim for payment to which the beneficiary knew it was not entitled. However, where such an injunction is sought against a bank, restraining the bank from making payment under the bond, the burden of proof is high. The facts must be such that the only realistic inference to draw from the evidence is one of fraud, which must be clear, both as to the fact of fraud and as to the bank's knowledge.

Where an employer makes a call under an on-demand performance bond and it is subsequently found that its demand exceeded the amount to which it was entitled, it is generally accepted (unless it is expressly stated to the contrary) that the employer is obliged to account for the excess.

### **The different types of bonds**

#### **Performance bonds**

Performance bonds are designed to ensure that the contractor delivers goods or performs services in accordance with the terms of the contract. If the contractor fails to perform the contract, it is likely that the employer will suffer a loss, usually because of delay or because the buyer is obliged to pay a higher price to acquire the goods or services elsewhere.

The bondsman thus undertakes to pay to the employer a sum of money if the contractor fails to perform the contract. The bondsman does not undertake to deliver the goods or perform the services itself. The counter-indemnity from the contractor in favour of the bondsman, and the contractor's own primary obligation, are designed to ensure that the contractor does his utmost to perform the contract.

#### **Advance payment bonds**

Advance payment bonds manage the risk of the contractor's failure to earn the whole of any advance payment from the employer by failing to provide goods and services to an equivalent value. The failure may result from the contractor's insolvency, fraud or default through using the advance payment for another purpose.

Such bonds usually contain a reduction clause, whereby the amount of the bond reduces in accordance with monthly certificates until the certified value of work done exceeds the advance payment.

#### **Retention bonds**

Retention bonds cover the risk of the contractor's failure to perform the contract. Retention monies

are normally viewed as a security for the cost of rectifying defective works. Early release of retention monies (the attraction to the contractor being to obtain early release of retentions to help cashflow), can be secured by a bond providing the employer with added security from the bondsman in the event of the contractor's default in carrying out defective works.

#### Off-site materials bond

Off-site material bonds cover an employer against the risk of paying the contractor for materials being manufactured off-site. If the contractor or sub-contractor becomes insolvent, the employer can claim on the bond for the amount of the goods it has paid for in the event that the goods it has paid for are not delivered to site.

#### Bid bonds

Bid bonds are used to compensate an employer if a contract has to be re-awarded because a prospective contractor refuses to enter into the contract after his tender is accepted. Because the form of contract is likely to be unclear or at least not to have been entered into at that stage, a conditional bond is unlikely to be appropriate.

#### Adjudication bonds

Adjudication bonds are conditional bonds which require the bondsman to pay out on an adjudicator's decision. These are now the norm in UK PFI/PPP projects. As adjudication is now becoming more and more common internationally, it may well be that adjudication bonds will become more common for those outside of the UK in due course.

However, the outcome of an adjudication may only be an interim position. Unless the contract provides that the adjudicator's decision is final and binding, it may be varied by subsequent arbitration or litigation. An adjudication bond is unlikely to be appropriate in these circumstances. Such a bond would need to cover a mechanism for balancing payments when the dispute is finally determined, which could make it a complex document.

In *A Straume (UK) Ltd v Bradlor Developments Ltd* [2000] BCC 333, it was held that under the English insolvency law, the employer would need the leave of the court to commence/continue with adjudication where the contractor was in administration.

### **Guarantees**

#### What is a guarantee?

A guarantee is given by a third party (a guarantor) to provide an undertaking to a beneficiary that the guarantor will answer for the debt or default of a third person (the principal debtor). The principal debtor remains primarily responsible for payment or performance of the relevant obligation. Guarantees are often provided by parent companies where a party is contracting with a subsidiary

without substance.

Guarantees can be either performance guarantees or financial guarantees. Under a performance guarantee, the guarantor will fulfil all of the obligations of the contractor under the construction contract. Under a financial guarantee, the guarantor will compensate the beneficiary for the loss it suffers as a result of the principal debtor's default.

#### Formalities

Guarantees must be in writing and signed by the guarantor. Unless executed as a deed, there must be consideration. The guarantor must have the necessary capacity to give the guarantee, otherwise the guarantee will be void.

#### Duration of the guarantee

The guarantee backs up contractual duties and, as such, the employer will push for it to last as long as the liabilities of the actual contracting parties under the contract. This will include the limitation period within which to bring claims for poor performance of the underlying contract. Under English law, the majority of construction contracts are entered into by way of a deed. Unless the contract provides otherwise, this will mean that the applicable limitation period is twelve years from the date of breach. However, it is common for this period to be limited by agreement, particularly in relation to defective works. Often, however, a distinction is drawn between patent and latent defects.

However, parent companies should attempt to limit their liability and push for guarantees that expire upon the certification of making good defects or upon notice of practical completion.

#### Discharge of guarantee

A guarantor's obligations are the same as the contractor's obligations under the underlying contract. As a result, the guarantor will be released automatically if there is a material variation or alteration in the terms of the underlying contract without the guarantor's consent (*Holme v Brunskill* [1878] 3 QBD 495).

Consequently, an employer will attempt to ensure that the guarantee includes wording to the effect that the guarantee is *not* discharged or released by any alteration to the nature or extent of the works, any allowance for time, forbearance, indulgence or other concession granted to the contractor under the guaranteed building contract.

These clauses are known as protective or saving clauses, and it is usual for them to be included in guarantees.

#### Enforceability

An employer will want the guarantee to state that its right to claim under the guarantee is not subject

to an obligation first to seek recourse against the contractor before being able to pursue a remedy under the guarantee. In other words, the employer will want to be able to bring a claim against the guarantor instead of, or alongside, bringing a claim against the contractor itself.

Parent companies will often not want to be dragged into any dispute and so will want to resist this.

### Set off

Employers will request that the guarantee states that the guarantor will not compete against it to recover sums from the contractor, and waives any rights for set off or counter claim the guarantor may have against the contractor in connection with the guarantee.

Without such a clause the benefit of the guarantee would be undermined where the contractor owes sums both to the employer and the guarantor.

### **Are guarantees more attractive than bonds?**

An on-demand bond will often be the employer's preference when considering which security to take out, given the ease of calling on a primary obligation compared with calling on a secondary obligation. Effectively, a sum of money will be set aside when an on demand bond is in place. The disadvantage for beneficiaries of secondary obligations is that the claim still has to be substantiated against the guarantor and, in practice, a claim against the guarantor is resisted just as strongly as any claim against the original party to the contract.

However, the employer's decision will depend on other factors such as cost, time and commercial bargaining strength. The benefit of guarantees is that often they are given free of charge and, as such, are not an expense which will be added to a contract sum. On-demand bonds can be expensive, and assuming that contractors are willing to meet this cost, they should build this expense into their price.

Contractors should bear in mind the bargaining strength that an on-demand bond will give employers. An employer with an on-demand bond can use the threat of calling in the security at any point (whether it is right or wrong) against the contractor, who will usually have a parallel obligation to the bondsman under his indemnity, if the bond is called. Although such threats have been rare in the past and in the good times, we have seen employers demonstrate far less resistance to calling (or threatening to call) bonds in recent times.

### **Recent case law**

#### On demand bonds: the fraud exception

*Enka Insaat Ve Sanayi A.S v Banca Popolare Dell'Alto Adige SPA* [2009] EWHC 2410 (Comm)

The grounds on which a claim on an on-demand bond may be resisted are extremely limited. Save in



the case of fraud on the part of the party claiming or a failure to comply with the procedural requirements of the bond, the courts have been reluctant to interfere with the irrevocable obligations assumed by bondmen. In the *Enka* case, the court considered the fraud exception in the context of an application for summary judgment pursuant to Part 24 the English Civil Procedure Rules (**CPR**).

The contractor entered into a contract with the owner to design and construct a multi-functional retail and office building in Moscow. The contractor entered into a subcontract with the sub-contractor for the design and installation of the external facade of the building.

The subcontract required the sub-contractor to procure “guarantees” by an international first class bank in the form appended to the subcontract. The sub-contractor procured an advance payment guarantee from Banca Popolare Dell’Alto Adige SPA (**BP**) and a performance guarantee from Cassa Di Risparmio Di Bolzano SPA (**CRB**) to secure performance by the sub-contractor of its obligations under the subcontract. The “guarantees” procured by the sub-contractor were actually on-demand bonds and not contracts of guarantee.

The owner gave notice terminating the main contract and made demands on the guarantees put in place by the contractor under the main contract. The contractor subsequently issued demands on the performance guarantee and the advance payment guarantee and gave notice to the sub-contractor terminating the subcontract. BP and CRB failed to satisfy the demands made on the guarantees by the contractor. The contractor subsequently made the application for summary judgment to secure payment by the bondsmen. The bondsmen sought to resist the summary judgment application on the grounds that the demands under the guarantees were made fraudulently because the contractor did not have an honest belief that the sub-contractor was at the time liable to the contractor for the sums claimed.

CPR Part 24 provides that a court may give summary judgment against a defendant if the defendant has “*no real prospect of successfully defending the claim ... and there is no other compelling reason why the case ... should be disposed of at a trial*”. The court found that the manner in which that test should be applied where summary judgment was sought against a bank under a letter of credit or performance guarantee was not entirely clear.

In *Safa Limited v Banque Du Caire* [2000] 2 Lloyd’s Rep 600, the court had held that the test to be applied was whether the bank could establish with a real prospect of success that the demand was fraudulent. However, in *Solo Industries UK Limited v Canara Bank* [2001] 1 WLR 1800, Mance LJ had considered that a “*real prospect of success*” was a low test to satisfy. The court in that case held that such a low test was inappropriate for use between a bank and the beneficiary of a letter of credit or performance guarantee. The court in the *Solo* case provided for a higher test - short of “*established fraud*” a bondsman would not normally be allowed to raise any defence.

After considering the relevant case law, the court in the *Enka* case decided that the test to be applied was the “*real prospect of success*” test, as this was the test set out in CPR Part 24. The court felt that

the facts of the case could be distinguished from those in the *Solo* line of cases, though it must be said that the court's reasoning for this is not entirely clear.

The court accepted that as the demands made on BP and CRB were in the form required by the terms of the guarantees, the banks could only resist those demands if they were made fraudulently. The test applied by the court was whether there was a real prospect that the banks would establish at trial that the only realistic inference was that the demands made by the contractor were fraudulent. The court recognised that the burden of proof was high and it would have been necessary for the banks to establish that the contractor knew that it had no right to make a demand on the guarantees in the sum claimed.

The advance payment guarantee provided:

*"We, ... hereby unconditionally and irrevocably guarantee to pay without delay to [the contractor] within 5 business days upon presentation by [the contractor] to us of the first and any subsequent written demands duly signed by [the contractor's] authorized signatory..."*

*The Demand shall state that:*

- 1. [The sub-contractor] has failed to fulfil its obligations to the Contractor under the Subcontract;*
- 2. accordingly, [the Contractor] is entitled to receive payment of the Advance Payment ..."*

The performance guarantee contained similar provisions. Both the performance guarantee and the advance payment guarantee were governed by English law.

The banks' contention was that the function of the performance and advance payment guarantees was to guarantee the liability of the sub-contractor to the contractor and therefore there must be a causal connection between the alleged breach by the sub-contractor and the amount claimed by the contractor. The banks claimed that in making the demand under the guarantees, the contractor did not honestly believe that the sub-contractor was then liable in the sum claimed. The demand was therefore fraudulent. In particular, the banks argued that:

- (i) The demands were made as a precipitate reaction to the termination of the main contract with no thought as to whether the contractor was entitled to the sums claimed.
- (ii) The contractor had not attempted to assess whether any, and if so how much, damage had been caused by the sub-contractor's alleged breaches of the subcontract but had simply asserted that *"the sub-contractor had failed to fulfil its obligations under the subcontract and that accordingly [the contractor] was entitled to receive payment."*
- (iii) The word *"accordingly"* implied a requirement that there should be a causal connection between the alleged breach and the amount claimed.

- (iv) The contractor did not believe that it had to demonstrate that the alleged breaches had caused any particular loss before demands could be made.
- (v) The contractor's belief that the guarantees did not require the contractor to assert that the alleged breaches of the sub-contractor had caused a particular loss was "*astounding*" and so "*uncommercial*" that there was sufficient evidence that the alleged belief was not one which the contractor honestly held.

The contractor contended that the word "accordingly" simply required the contractor to state that it was entitled to receive payment from the banks because the sub-contractor had breached its obligations. There was no requirement that the contractor had to state that the sub-contractor was liable to repay the advance payments or that the breaches of contract by the sub-contractor had caused any measurable loss to the contractor. The contractor simply believed that the sub-contractor had failed to fulfil its obligations under the subcontract and accordingly believed that it was entitled to receive payment under the guarantees.

In construing the guarantees the court took into account the nature of the guarantees, which as noted above, were drafted as on-demand bonds. On-demand bonds of this type are not contracts of guarantee and are instead independent obligations to make payment on demand. In the context of the guarantees procured by the sub-contractor, the court held that the contractor's right to payment was *not* dependent on the establishment of loss. It was *solely* dependent on the making of a demand which specified that the sub-contractor had failed to fulfil its obligations. The meaning of the word "accordingly" in the guarantees required the contractor to state that it was entitled to receive payment from the banks because the sub-contractor had breached its obligations. There was no express requirement in either guarantee that the contractor was required to state that the breaches caused a loss. If it had been intended that when claiming under the guarantees the contractor could only demand such a sum as was estimated to represent the loss and damage caused by the sub-contractor's breaches of contract, the guarantees could easily have said so in clear terms.

As such, the demands made by the contractor were not fraudulent. The court held that the banks had not demonstrated a real prospect that they would be able to establish at trial that the demands made by the contractor under the guarantees were fraudulent. Summary judgment was therefore awarded in favour of the contractor.

#### *Comment*

This case demonstrates the limited grounds on which payment under an on-demand bond may be restrained.

It also demonstrates that there is a high burden of proof required to establish fraud in these circumstances. Arguments proffered by the banks in this case demonstrate how parties can often be confused as to the function of performance security. Whilst on-demand bonds and guarantees are very different in nature, it is not uncommon in the construction industry for terms such as "performance

bond" and "performance guarantee" to be applied to both. The courts will, however, look closely at the language used to determine the intentions of the parties. Here, the documents were held to be on-demand bonds even though the obligation on the sub-contractor was to provide "guarantees".

*HLC Engenharia v ABN Amro* [2005] EWHC 2074 (QB)

The applicant contractor applied for an interim injunction restraining the first respondent bondsman from making any payment under an on-demand performance bond and restraining the second respondent bank and third respondent employer from receiving payment under the bond.

The bond guaranteed the contractor's performance of a contract to design and build a waste recovery centre. The bond provided that if the contractor was in default, the bondsman was required to satisfy any demand for payment by the employer specifying the nature of the fault. The project ran into difficulties, and the employer went into administration. The second bank asked the employer to make a demand under the bond, but the employer refused to do so, on the basis that it did not regard the contractor as being in default. The second bank purported to make a demand under the bond, alleging several breaches of contract.

The contractor contended that (1) there were serious issues to be tried on three matters, namely that the bond contained a condition precedent requiring the demand to be made by the employer, that the second bank's demand was fraudulent and that it would be inequitable to require the bondsman to pay out on demand in circumstances where the parties to the relevant contract agreed that the terms of the performance bond had not been triggered; (2) the balance of convenience favoured the injunction. As regards (2), when considering whether to grant an injunction, the English courts must balance two competing factors – this is the "balance of convenience". One is the harm which might be suffered by the applicant for an injunction if it is not granted and the applicant then ultimately succeeds in its claim. The other is the harm that might be caused to the party the subject of the injunction if the applicant is not in the end entitled to its underlying claim.

The court granted the application and so prevented any sums being paid pending the full trial of the matter. The court held that:

- (i) The contractor had demonstrated a serious issue to be tried as to the validity of the demand. The evidence showed that the second bank was concerned that a direct demand might be invalid, and more importantly, it appeared that the employer could never legitimately make a demand. The employer had also established that the only realistic inference to be drawn from the facts was that the demand was fraudulent and that the second bank was aware of the fraud, entitling the bondsman to avoid payment on the bond. The second bank knew or ought to have known that there could be no basis on which the employer or anyone else could allege culpable delay or faults in design or workmanship on the contractor's part.
- (ii) The balance of convenience overwhelmingly favoured granting the injunction. Even if there

was greater doubt as to the existence of two serious issues, the balance of convenience would still favour granting the injunction because of the potentially irredeemable injustice that would be caused if it was refused.

#### Injunctions restraining employers from making calls on 'on demand' bonds

*Permasteelisa Japan KK v Bouyguesstroi and another* [2007] EWHC 3508 (TCC)

The sub-contractor was engaged to supply and install curtain walling for an office development in Russia. The sub-contractor was required, under the sub-contract, to procure an on-demand performance bond in favour of the contractor (which it did).

The sub-contract provided:

*"In case the subcontractor fails to comply with one of its contractual duties and/or obligations and if such default exceeds a period of ten (10) days after the contractor gives the subcontractor formal written notice of remedying such a default ... the [contractor] shall be entitled to the following measures ... call all or part of bank guarantees."*

The sub-contract contained an arbitration clause which provided for arbitration in London under the UNCITRAL Rules, to be administered by the LCIA. The contractor made a call upon the bond.

The sub-contractor responded by (1) seeking (amongst other things) an injunction against the contractor restraining it from making any further call under the bond; (2) obliging it to pay any sums received under the bond into a bank account in London; and (3) giving notice of arbitration to the contractor, seeking various remedies, including an interim measures award under UNCITRAL Rules restraining the contractor from making any further call under the bond, and obliging it to pay any sums received into a bank account in London.

The court granted an interim injunction against the contractor, pending a full hearing to determine whether to continue the injunction. At the time of the full hearing, the arbitral tribunal had not yet been fully appointed.

The sub-contractor at the full hearing claimed (amongst other things) that:

- (i) Under the sub-contract, the contractor was only entitled to make a call under the bond if (1) the sub-contractor had failed to comply with one of its contractual duties; (2) formal notice of such failure had been given; and (3) the sub-contractor remained in default for a period of at least 10 days after such formal notice.
- (ii) The sub-contractor had not failed to comply with its contractual duties.
- (iii) Even if the sub-contractor had failed to comply with its contractual duties, the contractor had issued a demand under the bond before the expiry of the required ten day period, so had

failed to comply with the contractual requirements entitling the contractor to make a call under the bond.

- (iv) In the light of the above, the sub-contractor had a seriously arguable case that the contractor was not entitled to call the bond on the principles in *American Cyanamid v Ethicon* [1975] AC 395; and the balance of convenience was in favour of continuing the injunction.
- (v) The sub-contractor was entitled to an injunction under section 44(3) of the Arbitration Act 1996 (the Arbitration Act) on the grounds that it sought to preserve assets until an arbitral tribunal had been appointed under the sub-contract and was able to hear an application for an interim measures award under the UNCITRAL Rules.

The contractor argued:

- (i) The court should not grant an injunction against the contractor restraining it from calling upon an on-demand performance bond unless a seriously arguable case of fraud had been established (which was not the case here).
- (ii) The court should not grant an injunction affecting the proceeds of the bond unless there was a good arguable case that there was a risk of dissipation by the contractor.
- (iii) The contractor was entitled to call on the bond and any argument as to the underlying merits should be resolved by arbitration.
- (iv) The court should not grant an injunction where the dispute (under the building contract), was to be determined by arbitration.

The court reasoned as follows:

Under section 44 of the Arbitration Act, the court had the same power to grant interim injunctions for the purpose of and in relation to arbitral proceedings as it had for the purpose of and in relation to legal proceedings. However, this power was limited to cases of “urgency” where the order was necessary for the purpose of preserving evidence or assets. In addition, the court would only act if or to the extent that any arbitral tribunal had no power or was unable to act effectively. The court was entitled to issue an injunction in this case because the arbitral tribunal had not yet been fully appointed (so it had no power or was unable to act effectively); an application for an injunction in relation to a call on a bond was one of “urgency”; and the injunction sought related to the preservation of assets.

Where section 44 of the Arbitration Act applied, the court would generally apply the same principles when determining whether to continue the injunction as it would if the same dispute were before it in court.

The court would grant an injunction in the following circumstances:

- (i) where it was seriously arguable that the beneficiary could not honestly have believed in the validity of the call on the bond. Applying this principle, the court would not grant an injunction because no case of fraud had been made out; and
- (ii) where there was an express contractual term in the underlying contract which restricted the circumstances in which the beneficiary could call on the bond and it was established that the beneficiary was not entitled to make a call on the bond.

Applying this principle, the court would *not* grant an injunction because it had *not* been positively established that the contractor was not entitled to call upon the bond. The sub-contractor had established that there was a seriously arguable case that the contractor was not entitled to call upon the bond - but that was not sufficient.

If (contrary to the above) the court should take a less rigorous test, applying a test of the balance of convenience, the court would still not grant an injunction because the effectiveness of performance bonds should take priority. If a call on the bond was delayed, the bond might well expire before the arbitral tribunal was effective. The court would not grant a freezing injunction affecting the funds because the sub-contractor had not established that there was a serious risk of dissipation of the proceeds of the call, and, in addition, the court was unlikely to make such an order where (as here) the assets were overseas.

#### *Comment*

From an employer's perspective, the construction contract should not purport to restrict the circumstances in which an employer is entitled to make a call on an on-demand bond (e.g. by stating that the bond can be called only upon the contractor's breach of contract). If the construction contract does restrict the circumstances in which an employer is entitled to make a call on an on-demand bond, there is a risk that the contractor could obtain an injunction restraining the employer from making any demand on the bond on the basis that the contractor is not in breach of contract and, by making a call on the bond, the employer is in breach of the express terms of the construction contract.

Instead, the construction contract should simply provide that if the employer makes a call under the bond and it is subsequently agreed or determined that the amount called by the employer exceeds its entitlement, the employer is required to account to the contractor for the excess.

#### On demand bonds: accounting for the excess

*Spiersbridge Property Developments Limited v Muir Construction Limited* [2008] CSOH 44 Outer House, Court of Session

Where an employer has made a demand under a performance bond for more than it was entitled to receive, the employer will need to account for this excess. The question arose in this case as to whether the employer was required to account to the contractor (under the building contract) or the

bank (under the performance bond), where neither the construction contract nor the performance bond addressed the issue.

The court implied a term into the construction contract that an employer who had made a call upon an on-demand performance bond was required to account to the contractor for the proceeds, retaining only the amount equivalent to the loss suffered by the employer as a result of any breach of contract by the contractor. The court rejected the argument that any term should be implied into the performance bond requiring the employer to account for any excess to the bank. The court noted (amongst other things) the legal and practical difficulties that would arise if a bank became involved in a dispute about the merits of the case.

#### Guarantees: construction of the contract

*ILG Capital Llc v Van Der Mewe and another* [2008] All ER (D) 297

The guarantors (husband and wife) were the directors of a company which entered into a loan agreement (governed by New York law) as borrower with a lender. The guarantors each entered into identical guarantees (the guarantee) in favour of the lender (governed by English law). The company failed to pay amounts (approximately US\$30 million) due to the lender under the loan agreement and the lender sought payment under the guarantee. The guarantors sought to rely on expert evidence of New York law to the effect that there was an implied covenant of good faith and fair dealing which required the lender to give the company reasonable notice of its demand and that since the lender had not given such notice, the company had a complete answer to the claim.

The question therefore was whether the guarantors assumed under the guarantee (1) a secondary obligation, which was dependent upon the primary obligation of the company (so that if the obligations under the loan agreement fell away or were unenforceable, the guarantor's liability would also fall away); or (2) a primary obligation which was independent of the liability of the company (so that the guarantors were under an unconditional obligation to pay amounts demanded by the lender).

Under the guarantee the guarantors guaranteed "*as principal obligor and not merely as surety unconditionally and irrevocably*" the punctual payment by the company and agreed that if the company did not do so the guarantors would "*immediately upon demand unconditionally*" pay the monies which had not been so paid. Clause 3 set out a long list of matters which would not discharge the guarantors' obligations under the guarantee, including "*any other act or circumstance which (apart from this provision) would or might constitute a legal or equitable defence for or discharge of a surety or guarantor*". There was a "conclusive evidence" clause, stating that a certificate in writing signed by a duly authorised officer of the lender stating the amount payable by the guarantors was, save for manifest error, binding on the guarantors. The guarantors were prevented from asserting any set-off against the company.

The Court of Appeal noted the following principles from the decided cases:



- (i) A security instrument had to be looked at as a whole, without preconceptions as to what it was.
- (ii) The context in which the security instrument came into being was important. Thus, performance bonds given by banks were almost invariably construed as imposing a liability on the bank to pay, regardless of any disputes in relation to liability under the underlying contract.
- (iii) It could not be assumed that cases relating to banking instruments provided any useful guide when construing guarantees given outside the banking context.
- (iv) Even minor variations in language plus a different context could produce different results.
- (v) The absence of language appropriate to a demand bond outside the banking context gave rise to a "strong presumption against" interpreting an instrument as a demand bond.
- (vi) It could be argued, in a banking context, that a "conclusive evidence" clause converted a secondary security instrument (which contained no language typically found in a demand bond) into a demand bond. However, in a non-banking context, a "conclusive evidence" clause had to be scrutinised to ascertain whether the guarantee was primary or secondary.
- (vii) Since personal liability was at stake, the Court of Appeal agreed that it was relevant to consider what protections there would be (if the guarantee was on-demand) for the guarantors in the event that the guarantors were forced to pay the demand as certified but it later transpired that the company did not owe the sum.

The Court of Appeal concluded where a loan agreement required the giving of guarantees (whether on-demand or secondary liability guarantees), a call and payment of what was found to be due from the guarantors would "almost certainly" lead to a right of indemnity from the company if the guarantee had to be paid. If the guarantors paid out under the guarantee and it was subsequently determined that they had overpaid, then, if the company refused to seek return of any overpayment, the guarantors would have a right of subrogation by which they could force the lender to pay back sums found to have been overpaid. However, the Court of Appeal noted that the precise mechanism for repayment was not the most relevant question to consider when construing the guarantee. If the guarantee by its clear language required payment, then it was for the guarantors to protect themselves against that eventuality.

There was a presumption against the guarantee being construed as an on-demand obligation which would only be rebutted if clear language was used. Clause 3 (the clause which set out a long list of matters which would not discharge the guarantors' obligations under the guarantee) pointed in favour of that presumption (since such a clause was only necessary if the guarantors undertook a secondary liability). The language used in the guarantee: "as principal guarantor", "not merely as surety", and "immediately upon demand unconditionally" indicated that the guarantors were taking on something

more than a secondary obligation. The matter was put beyond doubt by the "conclusive evidence" clause.

#### *Comment*

It is interesting to note that clause 3 (which was presumably included in the guarantee as a "belt and braces" provision) was relied upon by the guarantors (rather than the lender) on the basis that it was inconsistent with an on-demand guarantee. Parties should be aware of this when considering whether to include such a provision in a guarantee which is clearly intended to be an on-demand guarantee.

#### On-demand advance payment guarantees

*Uzinterimpex JSC v Standard Bank plc* [2008] EWCA 819

The Court of Appeal considered whether, under an advance payment guarantee, there were circumstances in which a party could recover the amount of the excess from the bank. An English company (the **purchaser**) entered into a contract for the purchase of cotton from a company in Uzbekistan (the **seller**). The contract required the purchaser to pay for 90% of the cotton in advance and to pay for the remainder by a letter of credit.

The purchaser obtained a loan from a syndicate of banks to fund the 90% advance payment. The syndicate included the defendant English bank (**E Bank**). E Bank required security for this advance so, as part of the deal, the National Bank of Uzbekistan (**U Bank**) provided an on-demand guarantee to E Bank for the amount of the advance payment. Furthermore, under the facility agreement, the purchaser was required to pay all proceeds it received from the sale of the cotton into a designated account with E Bank (the **Transaction Account**).

The guarantee was subject to English law. The guarantee provided:

*"U Bank would pay on receipt by U Bank of a demand from E Bank stating that the seller had failed to fulfil its contractual delivery obligations; and*

*the amount of the guarantee would automatically reduce by 90 per cent of the value of each consignment delivered upon presentation of (amongst other things), shipping documents and commercial invoices which conformed to the requirements of the letter of credit."*

Both sides experienced difficulties in complying with the contract. The purchaser failed to give instructions for the shipping of the cotton in the amounts and at the times required and the seller failed to make prompt presentation of the requisite shipping documents.

The purchaser accepted documents which the seller presented which conformed to the requirements of the letter of credit and (for those consignments) the guarantee duly reduced in amount. However, in numerous instances the seller failed to submit shipping documents which complied with the requirements of the letter of credit. In many of these cases, the purchaser rejected the documents (as

non-compliant) but still took delivery of the goods, re-sold them and remitted the proceeds of the sub-sale to the Transaction Account. As a result of the purchaser's rejection of the documents, E Bank did not operate the machinery under the guarantee to reduce the amount guaranteed.

E Bank made a call under the guarantee for the whole amount outstanding at that time on the basis that the seller was in breach of its delivery obligations under the contract. The seller felt strongly that it was wrong of E Bank to make a call under the guarantee for various reasons, including the fact that E Bank had effectively made a double recovery, to the extent that the amount it demanded under the guarantee included the price of consignments of cotton which the purchaser had already taken into possession and delivered to third parties (and remitted the funds from the sub-sale to the Transaction Account). The seller was unable to seek recovery of this excess from the purchaser since it was now insolvent. The seller obtained an assignment from U Bank of any rights of action U Bank had against E Bank and sought recourse against E Bank.

The seller initially argued that there should be an implied term in the guarantee that if any demand under the guarantee was ultimately found to have been excessive, E Bank should repay to U Bank the amount of the excess. By the end of the trial, the seller had re-formulated its argument: it now alleged an implied term that E Bank would account to U Bank (or the seller as its assignee) in circumstances in which E Bank had received both the proceeds of the guarantee and the proceeds of the cotton to which it related. The seller argued that such a term was implied by law or was necessary to give business efficacy to the contract or to reflect the obvious intention of the parties. If it were not implied (the seller argued) E Bank would receive a windfall.

The court roundly rejected the notion of any implied term in the guarantee for numerous reasons, including the following:

- (i) Unless clearly stated otherwise in the underlying contract, the accounting would usually be between the parties to reflect their rights and liabilities under the underlying contract. This provided the answer to the 'windfall' argument;
- (ii) It was essential to the operation of international commerce that undertakings of this kind given by banks should operate in accordance with the terms which appeared on their face. The implied term for which the seller contended would have the potential effect of imposing on E Bank a liability which could not be identified from the face of the document and which would be very uncertain in its effect;
- (iii) U Bank was concerned only with the presentation of a valid demand under the guarantee. If such a demand was made it became liable to pay in accordance with the guarantee. It was not concerned with matters such as whether E Bank had (or had not) received any funds from the purchaser from any other source (such as the Transaction Account).

*Comment*

It is clear that any accounting is to occur between the parties to the underlying transaction and not (in the absence of fraud) by the bank under the guarantee. The underlying contract should therefore always set out an accounting mechanism for the repayment of any excess, and employers need to take particular care in the drafting of the accounting mechanism.

### **Conclusions from the case law**

A contractor should be wary of on-demand bonds and the scope for their misuse. Once an on-demand bond has been issued, there is nothing, in the absence of the issuer's knowledge of fraud, to prevent the bond being called. This could have disastrous consequences for the contractor. The contractor should look out for phrases such as "on [first written] demand" or "on demand without proof or conditions", which will mean that the document is truly an on-demand bond. Once it is, English law will give effect to it as written.

The contractor should also consider the cost of an on-demand bond or guarantee. It is likely to be more expensive to provide an on-demand bond or guarantee.

The contractor should consider taking out unfair calling insurance to guard against the risk of an unwarranted demand, although this may be difficult to obtain.

An on-demand bond has obvious advantages for the employer. It is therefore not surprising that employers will frequently require an on-demand bond. The contractor's ability to resist such a request depends on his negotiating strength, but the following points may assist the contractor:

- The employer's main concern is often the insolvency of the contractor.
- An on-demand bond is purely a financial instrument where the issuer's prime consideration is the financial strength of the contractor. A surety or insurance company will carry out an underwriting exercise and will carry out an assessment not only of the contractor's financial position, but also the contractor's ability to perform its contractual obligations. If the employer is concerned not only as to the contractor's financial status but also as to the contractor's ability to perform, then the issuer may take more comfort from the issue of a guarantee. However, caution should be exercised because the surety's willingness to provide a bond may result from the nature and extent of the security held by the surety over the principal's assets, rather than solely the ability of the principal to perform.

Claims relating to non-performance should be justified. Any rights which the contractor has, such as outstanding payments, should be taken into account.

An on-demand bond does not necessarily avoid litigation. If the employer suffers damage in excess of the value of the bond he will have to pursue the claim for the excess under the contract. If the contractor disputes the claim he (or his insurers) may pursue the employer (but usually not the bondsman) to recover any excess payment.

An on-demand bond may place additional costs and risks on the contractor which he is obliged to reflect in his pricing.