



Welcome to the June edition of *Insight*, Fenwick Elliott's newsletter which provides practical information on topical issues affecting the building, engineering and energy sectors.

This issue considers bonds and guarantees and three recent decisions in this area that warrant an update

Insight

The latest on bonds and guarantees

We last looked at bonds and guarantees in the 20th issue of *Insight* in February 2013 (http://www.fenwickelliott.com/files/insight_issue_20.pdf)

But three recent decisions in this area, *Liberty Mercian Ltd v (1) Cuddy Civil Engineering Ltd (2) Cuddy Demolition and Dismantling Ltd EWHC 411 (TCC)*, *Wuhan Gouyu Logistics Group C Ltd and another v Emporiki Bank of Greece SA [2013] EWCA Civ 1679* and *Doosan Babcock Ltd v Comercializadora de Equipos y Materiales Mabe Limitada [2013] EWHC 3010 (TCC)*, [2013] EWHC 3201 (TCC) warrant an update.

The first case, *Cuddy*, examines what happens in practice when a contractor fails to provide the bonds and warranties required of it by the contract. The second, *Wuhan*, considers the approach of the Court of Appeal to a bank which attempted to circumvent its obligation to make payment once the bond had been called. The third case, *Doosan*, provides a possible exception to the general rule that on-demand bonds are payable on demand (save for a clear case of fraud by the beneficiary), provided that there is strong evidence that the terms of the underlying contract clearly and expressly prevent the beneficiary from making a call.

Each decision and its practical implications are considered in detail.

Cuddy (TCC, 3 September 2013)

The facts

In October 2009, Liberty Mercian Limited ("Liberty") invited the Cuddy Group ("Cuddy") to tender for works relating to the construction of a new supermarket in Cardigan. The works were to be carried out under an amended NEC3 form, the terms of which required a parent company guarantee, performance bond and subcontractor warranties to be provided in favour of Liberty and also the contract administrator, Waterman Transport & Development Limited.

Following correspondence between Cuddy and two of its subsidiaries, Cuddy Civil Engineering Limited ("CCEL") and Cuddy Demolition and Dismantling Limited ("CDDL"), the works commenced towards the end of 2010. Liberty requested that CCEL provide the warranties on 6 June 2011 and the performance bond on 29 November 2011 but CCEL provided neither.

It was not clear whether a contract had been formed between Liberty and CCEL or Liberty and CDDL, and a dispute subsequently arose in relation to whether a valid contract had been formed, and if so, between whom.

Liberty issued a termination notice on 7 January 2012, and later, legal proceedings against Cuddy, CCEL and CDDL.

The issue the court had to decide was

(i) if a contract had been formed with CCEL, whether CCEL was obliged to procure the parent company guarantee, performance bond and warranties from its subcontractor, Quantum Limited ("Quantum") and (ii) whether specific performance should be ordered in relation to their provision.

CCEL sought to argue that (i) specific performance was inappropriate and that damages were an adequate remedy as the bond provided for a liquidated sum that was easy to express in terms of damages (ii) it had a £2m breach of contract claim against Liberty and (iii) it was not practically possible for it to procure a performance bond as CCEL's usual bond markets were unwilling to issue a performance bond for a contract that had been terminated.

As regards the warranties, CCEL maintained that (i) it was impossible for it to obtain warranties from its subcontractor Quantum as Quantum was in administration and the administrator refused to provide a warranty and (ii) specific performance was not appropriate in circumstances where the contract had been terminated as it would be difficult to fix a date for the expiry of the bond.

The decision

The court held on the facts that a contract did exist between Liberty and CCEL and CCEL's obligation to provide the bonds and warranties survived the termination of that contract. Because CCEL had no parent company however, judgment was reserved as to whether an order for specific performance would be appropriate in relation to CCEL's failure to provide the warranties and a parent company guarantee.

The court did not consider damages would be an appropriate remedy for CCEL's failure to provide a performance bond and warranties as CCEL did not have assets and it was questionable whether any judgment against it would be able to be satisfied.

Further, the fact that Liberty was in breach of contract was irrelevant to CCEL's obligation to provide the performance bond.



Insight

All things considered, the court did not consider CCEL's arguments that it could procure the bonds and warranties to be satisfactory. An order was therefore made that CCEL was to use its best endeavours to procure the warranties and performance bond and the matter was listed for a further hearing so that CCEL could return to court and demonstrate the efforts it had made.

Practice points – for contractors

- You should use your best endeavours to procure performance bonds and warranties. The court did not give any specific guidance in *Cuddy* as to what best endeavours might mean¹, but it is likely that your efforts would have to be wide ranging and convincing. If your best endeavours prove to be fruitless, and there is no evidence to the contrary, then the court would be unlikely to require you to provide the impossible.
- Do not try and argue that it would be impossible for you to provide a performance bond on the basis that your financial position will not permit you to fund one unless you have provided full disclosure of your financial position. As a general rule, those who plead poverty must give full disclosure of their financial position in order to establish their lack of means beyond all doubt. If, for example, you fund the defence of litigation, it will be very difficult for you to simultaneously maintain a lack of means.
- If you have access to funds from a third party on either a commercial or non-commercial basis, and there is an arrangement or agreement by conduct whereby that third party is to perform your contractual obligations, then the court may expect the third party to provide a

performance bond on your behalf. Equally, if any such agreement or arrangement also includes an obligation to enforce the terms of any subcontract, then the third party might also be required to enforce the terms of the subcontract and procure any warranties on your behalf.

Practice points – for employers

- If you are an employer and there is no expiry date in the draft form of bond, you should focus on obtaining evidence confirming it is possible for the contractor to procure a performance bond. Everything will depend on what the market is prepared to offer, and it would therefore be worthwhile approaching the market to find out (i) which banks or insurers are prepared to provide a bond and (ii) what date they will accept for the expiry of the bond.
- If you can identify a bank or insurer that will provide an acceptable bond and expiry date, then the court may require the contractor to procure the bond you have identified.

Doosan (TCC, 11 & 24 October 2013)

The facts

Doosan Babcock Limited ("Doosan") contracted to supply two boilers to Comercializadora de Equipos y Materiales Mabe Limitada ("Mabe") and procured performance guarantees in accordance with the contract. The guarantees were payable on demand and were due to expire upon the earlier of the issue of Take-Over Certificates ("TOCs") by Mabe, or 31 December 2013.

The provider of the guarantee undertook to make payment to Mabe:

"on receipt of your first demand in writing stating that [the Claimant] has not performed its obligations in conformity with the terms of the Contract."

In July 2013, Doosan asked Mabe to issue the TOCs on the basis that the boilers had been taken into use but Mabe refused, arguing the boilers were only being used temporarily. Mabe subsequently notified a claim for delayed supply and defects in the boilers and Doosan sought confirmation from Mabe that it would provide 7 days advance notice of any call on the performance guarantees. Mabe refused and so Doosan applied for an interim injunction restraining a call on the basis that Mabe was (i) in breach of contract in refusing to issue the TOCs and (ii) was relying upon its own breach of contract to enable payment under the guarantees. The court granted the relief Mabe sought and listed the matter for a further hearing, asking the parties to prepare further evidence on whether the boilers were just being used on a temporary basis.

The decision

At the restored hearing, the judge found that the boilers were in commercial use and that the temporary use of the boilers was not in accordance with the terms of the parties' contract. The judge referred to the principles in the *American Cyanamid case* and *Simon Carves v Ensus UK²*, where Mr Justice Akenhead said that a beneficiary could be restrained from making a call on the bond if the claimant has a strong case that the terms of the underlying contract clearly and expressly prevent the beneficiary from making a call. Mr Justice Akenhead also made an alternative finding that interim relief could be granted on the basis that Mabe should not be permitted to benefit from its own wrong, applying the principle set out by the House of Lords in *Alghussein Establishment v Eton College*.

Practice point

If (i) the right to make a call under an on-demand bond is qualified by the terms of the underlying contract and (ii) you can advance strong evidence that the terms of the underlying contract clearly and expressly prevent the beneficiary from making a call, then it would be worthwhile you seeking an interim injunction restraining a call.



Insight

Wuhan (Court of Appeal, 20 November 2013)

The facts

Arbitration proceedings were on foot between the buyer and seller in relation to the underlying ship building contract which was secured by a so-called 'payment guarantee'. The seller claimed that the second instalment under the contract was due to be paid and subsequently submitted a demand to the bank for payment under the terms of the payment guarantee.

The bank declined to make payment on the basis there was no final and binding arbitration award in relation to the second instalment and instead placed the amount due in escrow. When the Award was finalised, and there was confirmation that the second instalment was not in fact due, the bank issued an application for a declaration that a trust was created when the amount due was released from escrow on the basis that the sellers knew they were not entitled to the money that had been paid over.

The issue then was whether the bank was liable to make payment. Because of the unusual nature of the case, the matter was leapfrogged straight to the Court of Appeal.

The decision

The Court of Appeal held that in the case of on-demand bonds, the general principle is that the obligation to make payment crystallises immediately upon the on-demand bond being presented to the payer. The payer can only resist payment of a conforming bond if there is a clear case of fraud by the beneficiary.

The Court of Appeal went on to say that money paid out under an on-demand bond could never be subject to a trust

in the manner argued for by the bank. The implication of a constructive trust whereby the bank sought to impose a fetter upon the seller's right to dispose of the moneys paid out under the payment guarantee would be completely contrary to the general principle that on-demand bonds are payable on demand (save for fraud).

The bank was accordingly ordered to release the money to the seller notwithstanding that it was common ground that no payment was due in relation to the Award.

Their Lordships emphasised that the payment guarantee was a completely separate contract to the underlying contract between the buyer and seller that contained entirely separate obligations that were entirely independent of the underlying contract. The liability to make payment crystallised on presentation of the payment guarantee and this was the case regardless of whether the person calling the bond was entitled to the money claimed or not.

Practice point

On-demand bonds are payable on demand, and unless there is a clear case of fraud by the beneficiary, payment must be made immediately a bond has been called.

Conclusion

The *Wuhan* and *Cuddy* decisions serve to reinforce the seriousness with which the courts treat the security that is afforded by bonds, guarantees and warranties which are all designed to protect against default or non-performance.

In *Wuhan*, the Court of Appeal emphasised that conforming on-demand bonds do what they say on the tin: (except in the case of fraud) they are payable on demand without reference to the underlying contract or any liability arising under that contract. There is, however, one possible exception. If there is strong evidence that the terms of the

underlying contract clearly and expressly prevent the beneficiary from making a call, then the court may be prepared to follow *Doosan* and restrain a call.

In *Cuddy*, the High Court expected the contractor to use its best endeavours to procure the security required by the contract but the court stopped short of saying it would order the contractor to procure the impossible.

Footnotes

¹ As a general rule, best endeavours clauses impose an obligation to do what can reasonably be done in the circumstances, and the commercial context and intentions of the parties will also be important. Bar some qualifications, no stone should be left unturned in an attempt to comply (see *Sheffield District Railway Co v Great Central Railway Co* [1911] 27 TLR 451).

² In the *Simon Carves* case, the parties had agreed expressly that the beneficiary's right to make a demand on the guarantee was either qualified or would be extinguished if certain events occurred.

Should you wish to receive further information in relation to this briefing note or the source material referred to, then please contact Lisa Kingston. lkingston@fenwickelliott.com. Tel +44 (0) 207 421 1986

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