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Things to check when dusting off that Guarantee

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It is perhaps an inevitable result of the current global pandemic that employers, main contractors and subcontractors alike will be dusting down the guarantees they have been given, or provided to others, in respect of their ongoing projects. For those who have been given them they need to establish what security those guarantees actually provide and, perhaps as importantly, how quickly they will pay out. For those who have provided such guarantees, they may want to know in what circumstances a demand for payment can be made from them (or their bondsmen) and for how long they may be able to delay payment.

In this Insight, we look at some of the key questions to ask when dusting off such guarantees (by which we mean true guarantees, i.e. not on-demand bonds or securities). In looking at these issues we also review some of the most recent case law concerning guarantees and how the issues raised need to be taken into account when assessing your risks, whether as the beneficiary or guarantor.

Before that, however, we first set out the basic characteristics of guarantees (as opposed to on-demand securities) that need to be borne in mind when reviewing them.

Basic Characteristics

What is a guarantee and how does it differ fron an on-demand bond?

The terminology surrounding performance securities is frequently both confused and confusing. However, a pure guarantee (i.e. not an "on-demand" form of security) can be defined as follows:

> *"A contract of guarantee, in the true sense, is a contract whereby the surety (the guarantor) promises the creditor to be responsible for the due performance by the principal of his existing or future obligations to the creditor if the principal fails to perform them or any of them."*[1]

Liability under a guarantee to make a payment will therefore only arise if there is a liability under the main or underlying contract and the principal. In other words, it is a contingent or secondary liability.[2] This is important as it may have real implications for when payment under a guarantee has to be made. Liability must be established and ascertained under the underlying contract, in accordance with its terms, first.

In contrast, a pure "*on-demand*" security is not contingent on a liability being established under the underlying contract. An on-demand bond (commonly referred to as performance bonds, unconditional guarantees, performance guarantees and demand guarantees) is an unconditional undertaking to pay a specified amount to a named beneficiary, usually on demand, and sometimes on the presentation of certain specified documents.[3]

Bonds differ from guarantees because the issuing bank has a primary and independent obligation to pay upon the satisfaction of the conditions for payment specified on the face of the bond.[4] The principle that bonds are independent from their underlying transactions is commonly referred to as the "*autonomy principle*". In *The Bhoja Trader* Donaldson LJ outlined the commercial justification for the autonomy principle:

> *"Thrombosis will occur if, unless fraud is involved, the Courts intervene and thereby disturb the mercantile practice of treating rights thereunder as being the equivalent of cash in hand."*[5]

In contrast, a guarantor's liability is secondary to that of the principal. It therefore remains contingent rather than actual unless and until the principal defaults. Moreover, the guarantor's liability is the same as the principal's liability to the creditor and it also has the same defences available to it. This is not the case for bonds because of their independence from the underlying contract.

When assessing whether you have a guarantee or an on-demand security in front of you it is important to review how the document is intended to work as a whole with the key characteristics of guarantees vs on-demand securities firmly in mind.

Requirement for guarantees to be in writing and signed

A guarantee is also a contract and as such must satisfy the basic requirements for a valid contract, namely offer, acceptance, intention to create legal relations and consideration.

However, for very sound historical reasons section 4 of the Statute of Frauds 1677 also provides that a guarantee must be in writing AND signed by the guarantor or someone with his authority. If these requirements are not adhered to then the document will not be enforced.

It should be noted that an email exchange (where an email sign-off is applied to that chain) may, depending on the circumstances, form a guarantee.[6] In the current COVID-19 lockdown environment this is something to be aware of when exchanging emails in relation to guarantees in case one is created by default.

The rule in Holme v Brunskill[7]

The rule laid down by the Court of Appeal in the nineteenth century was that a subsequent alteration to the debtor's obligations agreed to by the creditor would not bind the guarantor without their previous consent unless it was either wholly trivial or insubstantial.[8] In the context of a construction contract this could spell disaster for the beneficiary of the guarantee (i.e. the employer) as a variation to the underlying works could invalidate the guarantee.

As such, standard wording is now added to guarantees essentially permitting such changes in advance. For example, the standard wording in the ABI Model Form of Guarantee is as follows:

> *"The Guarantor shall not be discharged or released by any alteration of any of the terms conditions and provisions of the Contract or in the extent or nature of the Works and no allowance of time by the Employer under or in respect of the Contract or the Works shall in any release reduce or affect the liability of the Guarantor under this Guarantee Bond."*[9]

The inclusion of such wording is also a clue (although not decisive) that you are looking at a guarantee rather than an on-demand security.

So what should I check for?

There are a number of key things to check when dusting off the guarantee that has been sitting quietly in a document cupboard for a number of years. These include:

1. When does the guarantee expire?
2. How much does the guarantee cover?
3. Has the guarantor got any assets?
4. How do I notify a claim or, alternatively, have I been properly notified?
5. When will I get paid or, if you are seeking to postpone paying out, how long can I defer payment for?

These are addressed in turn below.

When does my guarantee expire?

The most urgent thing to check when dusting off a guarantee is when it expires. In the UK market guarantees typically expire either on Practical Completion (which is the preferred choice for Contractors) or at the end of the Defects Liability Period (which an Employer will push for where possible). You will need to check this and then work out if the requisite certificates[10] have been issued for either of them as required by the underlying construction contract. Some guarantees may last for longer in which case you will need to check when the limitation period under the construction contract expires but this is unusual.

If the guarantee has already expired then for the guarantor they can obviously breathe a sigh of relief. However, if the expiration date or stage is close then you will need to ensure you are in a position to notify your claim under the guarantee, in accordance with its terms, as soon as practicable. This may require action under the underlying contract to "*crystallise*" the debt and as such an action plan may be needed to make sure this can be done in time depending on the terms of the guarantee. Likewise, if you are the guarantor you may need to diarise the expiration date and keep quiet (if that is an option).

The recent case of *Yuanda v Multiplex*[11] illustrates the importance of expiry dates and understanding what has to be done before them. In that case it was held that there had to be an adjudication on the dispute between the parties under the Subcontract to "*establish and ascertain*" the Liquidated Damages claimed against Yuanda *before* the expiry of the guarantee in question (which was

based upon the ABI Model Form but with bespoke amendments).

How much does the guarantee cover?

The next obvious thing to check is how much the guarantee is for. Is it likely to cover the majority of the claims being brought under the underlying contract? It is also worth checking if the amount reduces at some stage (perhaps on Practical Completion), in which case you may also need to ensure a claim is notified sooner rather than later.

Has the guarantor got any assets?

This one seems basic but one obvious thing to check is that the guarantor is worth something. If a parent company guarantee has been provided by a company in a remote offshore jurisdiction and has miraculously undergone a corporate restructuring and been emptied of all its assets, it is not going to be worth much! A guarantee is only as good as the financial strength of the guarantor. Likewise, enforcing a guarantee against an offshore entity may be more difficult than against an entity incorporated within the United Kingdom.

In contrast, if the guarantee has been provided by a well-known bondsman or bank and is not going to go under then the guarantee's value will be "*as shown on the tin*".

Notification

The next point to check is notification. What are the requirements? Where, for example, does the notice need to be sent, by what mode and what does it need to say? This needs to be carefully checked, particularly if the expiry of the guarantee is edging closer and email service is not allowed.

In the current COVID-19 pandemic you may also want to leave more time for service (if it has to be in hard copy) if there is a hard deadline to hit or, alternatively, seek permission to serve in another form (i.e. electronically) well in advance.

If you are in receipt of a notice then again you should also check it has been served properly, particularly if the expiry date is very close.

When will payment be made? How long can I defer payment for?

As outlined above, the key feature of a guarantee as opposed to an on-demand security is that liability can be no greater than pursuant to the underlying construction contract. What that liability is must also be clear.

The wording used in the ABI Model Form of Guarantee Bond, which will be key to determining when the monies can be claimed and then paid, is as follows:

> *"The Guarantor guarantees to the Employer that in the event of a breach of the Contract by the Contractor the Guarantor shall subject to the provisions of this Guarantee Bond satisfy and discharge the damages sustained by the Employer* **as established and ascertained pursuant to and in accordance with the provisions of or by reference to the Contract** *and taking into account all sums due or to become due to the Contractor."* **[Emphasis added]**

In the recent case of *Yuanda v Multiplex* it was held that for a party simply to certify that monies were due to it was not sufficient. As Mr Justice Fraser stated:

> *"… a mere statement or assertion by Multiplex to Yuanda that a sum is due to Multiplex by way of LADs cannot be, without more, treated as though it were a certificate, nor can it be equated to the establishment and ascertainment of damages due to Multiplex pursuant to and in accordance with the terms of the sub-contract."*[12]

In that case adjudication was sufficient to establish and ascertain the damages sustained and therefore the damages that could be claimed under the guarantee.

In cases of insolvency by a contractor (or a subcontractor) where the ABI Model Form of Bond is used and the underlying form of Contract is the JCT Form, the problem may be that to establish and ascertain the damages arising as a result of that insolvency may take a while. For example, under the JCT Design and Build Contract 2016 there is an accounting provision provided for where a contractor is terminated for insolvency and another contractor has to complete the works. This does not, however, take place until *"following the completion of the Works and the making good of defects in them"*.[13] This may effectively mean that payment under a guarantee can be deferred for a while. That is likely to be the case unless suitable amendments are made to the guarantee and/or the underlying contract which make provision for an earlier pay out to be made if, for example, an Adjudication Decision is rendered.[14]

Conclusion

Guarantees are not an on-demand instrument, they are a secondary obligation. When and what is payable needs to be assessed by reference to the underlying contract. In practice that is often likely to mean that payment is not made pursuant to a guarantee for some time. When dusting off the guarantee you provided, or were provided with, in the current COVID-19 pandemic and assessing its strengths and weaknesses, that should be foremost in your mind. Only by asking the key questions outlined above and reviewing the underlying construction contract (or subcontract) properly will you be able to fully understand your position and ensure you plan accordingly.

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Footnotes

1. Vossloh AG v Alpha Trains (UK) Ltd [2010] EWHC 2443.
2. This is called the "principle of co-extensiveness". There are some limited exceptions to this rule where a guarantor may find himself liable notwithstanding the unenforceability of the underlying Contract but they are beyond the scope of this Article. For more information see Geraldine Andrews QC, Law of Guarantees, 7th edition, chapter 6.
3. Andrews, chapter 16-001.
4. Edward Owen Engineering Ltd v Barclays Bank International [1978] 1 All ER 976 (CA).
5. Intraco Ltd v Notis Shipping Corp, The Bhoja Trader [1981] 2 Lloyd's Rep 256 at 257.
6. Golden Ocean Group Ltd v (1) Salgaocar Mining Industries PVT Ltd (2) Mr Anil V. Salgaocar [2011] EWHC 56 (Comm), Mr Justice Christopher Clarke. For a note on this case see my article at: https://www.lexology.com/library/detail.aspx?g=ff33c1a8-4c80-4b03-b57f-9cd0dff87527.
7. (1877) 3 QBD 495.
8. See Hudson's Building and Engineering Contracts, 14th edition, chapter 10, p. 92.
9. See the recent case of Yuanda (UK) Company Limited v (1) Multiplex Construction Europe Limited; and (2) Australia and New Zealand Banking Group Limited [2020] EWHC 468 TCC as well as Ziggurat LLP v CC International Insurance Company plc [2017] EWHC 3286 (TCC) which both looked at modified forms of the ABI

   Model Form of Guarantee Bond and confirmed that this was an instrument of secondary liability, i.e. a Guarantee rather than an on-demand bond.
10. For example, the Notice of Completion of Making Good under the JCT form of Construction Contract.
11. Yuanda (UK) Company Limited v (1) Multiplex Construction Europe Limited; and (2) Australia and New Zealand Banking Group Limited [2020] EWHC 468 TCC.
12. See Yuanda (UK) Company Limited v (1) Multiplex Construction Europe Limited at paragraph 71.
13. See Clause 8.7.4 of the JCT Design and Build Contract 2016.
14. The parties also need to satisfy themselves that insolvency under the underlying Construction Contract constitutes a breach of contract. For discussion of this see Ziggurat LLP v CC International Insurance Company plc [2017] EWHC. In Perar v General Surety and Guarantee Co 1994 66 BLR 72 CA the Court of Appeal held that insolvency did not amount to a breach of contract although a failure to pay a sum due subsequently was a breach.