

Bonds, Advanced Payments & Guarantees

Cambridge Summer School

7 September 2017

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Introduction

- Definitions and terminology;
- On-demand bonds:
 - What are they?
 - Challenging a call on an on-demand bond.
- Guarantees:
 - What are they?;
 - Statue of Frauds;
 - Variations & the rule in *Holme v Brunskill* [1877] 3 QBD 495.
- How to tell the difference between an on-demand bond and a guarantee: *Wuhan* [2012] EWCA Civ 1629. *National Infrastructure Development Co Ltd v BNP Paribas* [2016] EWHC 2508 (Comm) *Banco Santander SA* [2017] EWCA Civ 27;
- Advanced payment and security;
- Getting your money back after a call.

Terminology and Basic Definitions

Warning!

- Tendency for terminology to be mixed up:
 - “Performance guarantee”;
 - “Performance bond”;
 - “On demand bond”;
 - “Conditional bonds”;
 - “Unconditional Guarantees”;
 - “Demand guarantees”.
- Key: Terms of the document will need to be examined to determine the true nature of the document.



Construction Contracts: Common forms of Bonds

- Common forms of bonds in construction contracts:
 - Bid (or tender) bonds;
 - Advance Payments bonds;
 - Retention bonds;
 - Performance bonds;
 - Off-site materials bond.

Terminology and Basic Definitions

- Don't rely on the title of a document.
- Analyse its contents.
- Instruments often unclear as to whether they are:
 - Unconditional/on demand: Bondsman (or bank) pays without proof of contractor's default;
 - Growing use internationally since 1970. Previously rare in UK. Can be hybrids (e.g. certificate of breach);
 - Conditional/guarantee: must establish contractor's liability (but can sue Bondsman at same time or alone) and Guarantor better protected from having to pay out;
 - Long standing use. Often complex wording/old-fashioned.

Definitions: On Demand Bonds

“an undertaking issued by the guaranteeing bank on the request of his client to pay a certain amount (or an amount that can be ascertained) to another person (the beneficiary) without restriction or condition, unless the letter of guarantee is conditional, if [the bank] is requested to do so within the period specified in the letter of guarantee. The letter of guarantee shall state the reason for which it is issued.”

Article 414 of the UAE Federal Commercial Law No. 18/1993

The Commercial Code

Definitions: On Demand Bonds

*“1. The bank **unconditionally undertakes** and covenants to pay on demand any sum or sums which may from time to time be **demanded in writing** by the owner up to a maximum aggregate sum of ONE MILLION FIVE HUNDRED THOUSAND DOLLARS (\$1,500,000.00) to be held by the owner.”*

Wood Hall Ltd v Pipeline Authority [1979] HCA 21 (Australia)

Issuing bank has an **independent** and **primary obligation** to pay upon the satisfaction of the **conditions for payment** specified on the face of the bond

Edward Owen Engineering Ltd v Barclays Bank International

[1978] 1 ALL ER 976 [CA]

Definitions: Guarantees



- *“A guarantee is an accessory contract by which the promisor undertakes to be answerable to the promisee for the debt, default or miscarriage of another person, whose primary liability to the promisee must exist or be contemplated.”*
[*Mercers v New Hampshire*]
- Secondary Obligation:
 - Contingent rather than actual unless or until the principal defaults;
 - Guarantor’s liability = principal’s liability to the creditor;
 - Same defences available.
- Strict rules apply which **MUST** be complied with.

Guarantees – key checklist

- In writing and signed (Section 4, Statutes of Frauds 1677)
- Secondary liability – ancillary to the primary contract;
- Creditor must be a party;
- Consideration must be present;
- Right of subrogation – implied by Section 5 of the Mercantile Law Amendment Act 1856;
- Implied Indemnity;
- Variations discharge surety;
- Parole evidence rule – oral evidence is not admissible;

Grounds for Preventing a Call

- **Fraud:**

“conduct involving dishonest intent, or recklessness as to the truth of a statement” (Derry v Peek [1889] 14 App Cas 337 [HL]).

- **On notice:**

- Bank must be aware of it at the time of the call.

- Also comply with **criteria for an injunction** to be granted:

- Serious issue to be tried;
- Damages NOT an adequate remedy;
- Less harm to grant an injunction than to preserve the status quo;

American Cyanamid v Ethicon [1975] 1 ALL ER 504 [HL].

Weakening of the Autonomy Principle?

- Australian, Singaporean and Malaysian case law
 - Doctrine of unconscionability
- BUT until recently English Courts reluctant to weaken the Autonomy Principle – i.e. the bond stands alone.
- Two recent cases appeared to signal a change:
 - *Simon Carves v Ensus UK* [2011] EWHC 657 (TCC);
 - *Doosan Babcock v Comercializadora de Equipos y Materiales Mabe* [2013] EWHC 3010 (TCC).

- Doosan supplied two boilers to MABE for a power plant in Brazil.
- Performance Guarantees which expired on the issue of Take Over Certificates (“**TOCs**”) were issue.
- Wide wording:

“on receipt of your first demand on us in writing stating that [the Claimant] has not performed its obligations in conformity with the terms of the Contract”
- Boilers taken into use on November 2012 and May 2013.
- MABE refused to issue TOCs as a “*temporary measure*”.

- August 2013: MABE lodged claim for US\$57 million for delayed supply and defects in the boilers;
- Doosan requested 7 days notification if call was made on the bond:
 - MABE refused;
 - Doosan applied for an interim injunction AGAINST MABE.
- Judge found boilers were in commercial use:
 - Exported 7500 hours of electricity since installation;
 - Failure to make performance tests:
 - LADs NOT non-issue of TOCs.
- Test in American Cyanamid Satisfied:
 - Right to make a call qualified by the underlying contract.

BUT *MW High Tech Projects UK Ltd v Biffa Waste Services Ltd*

- Mr Justice Stuart-Smith noted:

“It seems to me, both on the principle and authority that the only established acceptance to the rule that the court will not intervene should be where there is a seriously arguable case of fraud, or it has been clearly established that the beneficiary is precluded from making a call by the terms of the contract.”

- It is not sufficient that:

“There is a seriously arguable case that the beneficiary was not entitled to draw down. It must be positively established that he was not entitled to draw down under the underlying contract”.

A Similar Approach in the UAE

“The bank shall not be entitled to refuse payment to the beneficiary for reasons relating to the bank’s relation with the client or the client’s relation with the beneficiary.”

Article 417 (1) of the Commercial Code

“In exceptional circumstances, the court may on application of the client place an attachment on the amount of the guarantee with the bank provided that the client has serious and certain reasons for its request.”

Article 417(2) of the Commercial Code

- Sub-clause 4.2 provides that the employer shall not make a call on the Performance Security except in the circumstances listed out at items (a)–(d).
 - Failure by the contractor to extend the Performance Security beyond the expiry date if the Works are not complete at that date.
 - Failure by the contractor to pay an amount to the employer under sub-cl.2.5 or cl.20.
 - Failure by the contractor to remedy a default within 42 days of being notified of the defect.
 - When an employer can terminate the contract under sub-clause 15.2.

- Essential characteristics:
 - The Surety undertakes to be responsible, in addition to the Principal, for the due performance by the Principal of his obligations to the Creditor / Beneficiary if there is a failure of performance by the Principal;
 - The liability of the Surety is ALWAYS secondary to that of the Principal who remains liable under the Principal Contract to the Creditor / Beneficiary.

- Principle of co-extensiveness:
 - Surety's liability is to the same extent as the liability of the Principal to the Creditor under the Principal Contract;
 - Defences available to the Principal are available to the Surety.
- Example:
 - Parent Company Guarantee;
 - employer can turn to the contractor's parent company if the contractor doesn't perform or goes bust.
- Right of indemnification from primary debtor.

Guarantees: Must be in Writing

- Section 4, Statute of Frauds 1677

*“No action should be brought whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriage of another person... Unless the agreement upon which such action shall be brought... shall be **in writing** and **signed by the party to be charged** therewith...”*



Guarantees: Must be in Writing

- *Action Strength Ltd v International Glass Engineering* [2003] 2 All ER (Comm) 331.
 - SC seeking direct payment from employer after contractor insolvency could not establish a direct guarantee because the oral agreement was unenforceable b/c Statute of Frauds.
- BUT BE CAREFUL.
- *Golden Ocean Group v Salgaocar Mining* [2012] EWCA Civ 265.
 - Exchange of emails was enough as the electronic emails constituted in writing AND email signature constituted a signature.

Guarantees: Variations to Underlying Contract

- Any amendments to the underlying contract, after giving the guarantee, will discharge the guarantor's liability UNLESS:
 - Guarantor gives his consent (e.g. in an indulgence clause);
 - Variation is patently insubstantial or incapable of adversely affecting the guarantor.
- Known as the rule in *Holme v Brunskill* from the case of the same name (1878) 3 QBD 495.

How to tell the difference between an on-demand bond and a guarantee

“Where an instrument (i) relates to an underlying transaction between the parties in different jurisdictions, (ii) is issued by a bank, (iii) contains an undertaking to pay “on demand” (with or without the words “first” and/or “written”) and (iv) does not contain clauses excluding or limiting the defences available to a guarantor, it will almost always be construed as a demand guarantee”.

Wuhan Guoyu Logistics v Emporiki Bank of Greece [2012] EWCA Civ 1929

Commercial Court – Guarantee/Court of Appeal – On-demand bond

How to tell the difference between an on-demand bond and a guarantee

- Longmore LJ in the *Wuhan* case noted the following points in favour of a conclusion that the document was a traditional guarantee:
 - The document was called a “*payment guarantee*” not an “on-demand bond”;
 - Clause 1 said that the Bank guaranteed “*the due and punctual payment by the Buyer of the 2nd instalment*”;
 - Clause 2 described the second instalment as being payable (in terms different from the Building Contract) 5 days after completion of the cutting of the first 300 metric tons of steel of which written notice was to be given with a certificate countersigned by the Buyer;

[cont.]

How to tell the difference between an on-demand bond and a guarantee

- Longmore LJ in the *Wuhan* case noted the following points in favour of a conclusion that the document was a traditional guarantee:
 - Clause 3 guaranteed the due and punctual payment of interest;
 - Clause 4 imposed an obligation on the Bank to pay “*in the event that the Buyer fails punctually to pay the second instalment*”;
 - Clause 7 said that the guarantor’s obligation was not to be affected or prejudiced by any variations or extensions of the terms of the shipbuilding contract or by the grant of any time or indulgence.

How to tell the difference between an on-demand bond and a guarantee

But in the *Wuhan* case, what mattered were the actual words used in the body of the instrument:

*“(i) Clause 4, the clause which required payment by the Bank, provided that payment was to be made: (a) on the **Seller’s first written demand** saying that the Buyer has been in default of the payment obligation for 20 days; and (b) **“immediately”** without any request being made to the Seller to take any action against the Buyer;*

[cont.]

How to tell the difference between an on-demand bond and a guarantee

*(ii) Clause 7 provided that the Bank's obligations were **not to be affected or prejudiced by any dispute between the Seller and the Buyer** under the shipbuilding contract or by any delay by the Seller in the construction or delivery of the vessel;*

*(iii) Clause 10 provided a limit to the guarantee of US\$10.3 million representing the principal of the second instalment plus interest for a period of 60 days. This meant that it was **not envisaged that there would be any great delay in payment after default** as there would be if there was a dispute about whether the second instalment ever became due.”*

J Murphy & Sons Limited v Beckton Energy Limited [2016] EWHC 607 (TCC)

- Power Plant in Beckton, using amended FIDIC Yellow Book.
- Murphy provided an on demand bond.
- The project was delayed and Beckton notified Murphy it would call on the bond.
- Murphy considered that Beckton needed to obtain an engineer's decision first. They sought a declaration and an injunction.
- Liquidated damages under sub-clause 8.7 would normally be subject to sub-clause 2.5 [Employer's Claims] or 3.5 [Engineer's Determinations]. However, the "*subject to sub-clause 2.5*" had been deleted. Clause 8.7 was therefore a self contained regime triggering payment of delay damages.
- Carr J held that the trigger for the bond was belief on the part of the demanding party in its entitlement, not for that entitlement to have been subject to a final determination.

NIDCO v BNP; Paribas and Santander

- National Infrastructure Development Co engaged Construtora (a Brazilian Contractor) under the FIDIC Yellow Book with amendments to construct a highway in Trinidad and Tobago.
- Stand by letters of credit (a form of letter of credit) were issued as guarantees of “*payment of last resort*”.
- The project was terminated and Construtora entered into administration. An LCIA arbitration was also commenced.
- The Brazilian courts issued an injunction to stop the Brazilian subsidiaries of the European Banks from paying.
- The Brazilian courts extended that injunction to cover the European Banks.
- The Banks therefore refused to pay noting that they could be fined if they ignored the court injunction.

National Infrastructure Development Co Ltd v BNP Paribas
[2016] EWHC 2508 (Comm) and
National Infrastructure Development Company Ltd v Banco
Santander SA [2017] EWCA Civ 27

- NIDCO applied for summary judgment of US\$58 million against BNP Paribas and US\$38 million against Santander.
- Mr David Foxtton QC emphasised that the LOC's were equivalent to cash and should be paid. He also refused a permission to stay enforcement.
- The Court of Appeal sighted Carr J with approval in *Murphy v Beckton* and confirmed that payment should be made.
- Santander argued that the fraud exception applied as the amounts were subject to final determination.
- Further that the English court should extend this concept to include the doctrine of "unconscionability".
- The Court of Appeal rejected both arguments.

Petrosaudi Oil Services (Venezuela) Ltd v Novo Banco S.A & Ors [2017] EWCA Civ 9

- The general counsel signed demands under various letters of credit stating that Petrosaudi was obliged to pay under the drilling contract.
- He was considered to be fraudulent because he considered monies to be due when the underline liability arising from the invoices could not at that stage be enforced.
- The Court of Appeal considered money should be paid out.
- They also considered that the general counsel simply had a different view as to whether certain invoices were payable, and that this was not fraudulent.

Annex A – Parent Company Guarantee:

- *“If the Contractor fails to so perform his obligations and liabilities and comply with the Contract, we will indemnify the Employer against and from all damages, losses and expenses (including legal fees and expenses) which arise from any such failure for which the Contractor is liable to the Employer under the Contract.”*
- *“We hereby authorise them to agree any such amendment or variation, the due performance of which and compliance with which by the Contractor are likewise guaranteed hereunder. Our obligations and liabilities under this guarantee shall not be discharged by any allowance of time or other indulgence whatsoever by the Employer to the Contractor, or by any variation or suspension of the works to be executed under the Contract, or by any amendments to the Contract or to the constitution of the Contractor or the Employer, or by any other matters, whether with or without our knowledge or consent.”*

- Annex C – Performance Security – Demand Guarantee:
- *“As the request of the Principal, we (name of bank) hereby irrevocably undertake to pay you, the Beneficiary/Employer, any sum or sums not exceeding in total the amount of xxxxxxxxxx (the “guaranteed amount”) upon receipt by us of your demand in writing and your written statement stating:*
 - a) that the Principal is in breach of the obligation(s) under the Contract, and*
 - b) The respect in which the Principal is in breach.*
- *Any demand for payment must contain your [minister’s/directors’] signature(s) which must be authenticated by your bankers or by a notary public. The authenticated demand and statement must be received by us at this office on or before (the date 70 days after the expected expiry of the Defects Notification Period for the Works)...(the “expiry date”), when this guarantee shall expire and shall be returned to us.”*

Sub-clause 4.2 provides that:

“The Employer shall indemnify and hold the Contractor harmless against and from all damages, losses and expenses (including legal fees and expenses) resulting from a claim under the Performance Security to the extent to which the Employer was not entitled to make the claim.

The Employer shall return the Performance Security to the Contractor within 21 days after receiving a copy of the Performance Certificate.”

Uniform Rules for Demand Guarantees (URDG 758)

- Safeguards against unfair calling – Article 22:
- Key features:
 - Issuer of the bond must without delay transmit a copy of the demand and documents to the contractor.
- Requirements for demand – Article 15:
 - Simple written demand in agreed form; or
 - Certificate, judgment or award from third party.
- Fraud:
 - Rules of National Law will apply.

Advanced Payment and Security

- Advanced Payments are reasonably common in large international projects. They are basically interest free loans that provide the contractor with cash to commence the work, begin procurement and order long leading items.
- Clearly it is commercially sensible to ensure that any cash advance given to a contractor has the security of a Bond or a Guarantee.
- The Advanced Payment, the amount of the Bond and future payments to the contractor therefore need to be carefully balanced to ensure that the contractor's cashflow is maintained whilst the employer is not over exposed.
- The value of the Advanced Payment, Bond or Guarantee therefore needs to reduce as the work progresses taking into account the amount of the advanced payment.

Advanced Payment – FIDIC Yellow Book

Clause 14.2 [Advanced Payment] provides:

- The Advanced Payment is an interest free loan for “mobilisation and design”;
- The amount and the timing of instalments, together with currencies and proportions should be set out in the Appendix to Tender;
- The Employer is not obliged to make any payment until a Guarantee has been provided by the contractor.
- The Guarantee must be valid and in enforcement until the Advanced Payment has been repaid.
- The amount of the Advanced Payment is progressively reduced by the amount repaid by the contractor in the Payment Certificates.

Advanced Payment – FIDIC Yellow Book

- The Certificates are certified by the Engineer.
- Advanced Payments are repaid by way of percentage deductions in payment certificates;
 - Deductions commence when value exceeds 10% of the Accepted Contract Amount less Provisional Sums; and
 - *“Deductions shall be made at the amortisation rate of one quarter (25%) of the amount of each Payment Certificate (excluding the Advance Payment and deductions and repayments of retention) in the currencies and proportions of the Advanced Payment, until such time as the Advanced Payment has been repaid”.*
- If the Advanced Payment has not been repaid before the issue of the TOC then the balance becomes immediately due and payable.

Getting your money back after a call

- What happens to the money if there is an excessive or unfair call on an on-demand bond?
- Likely to be a duty to account implied at common law (see *Cargill International SA v Bangladesh Sugar & Food Corp* [1997] EWCA Civ 2757, bond money paid under a bond was to be repaid if no loss had been suffered).

BUT

- Entire agreement clause may be problematic;
- Implied term will not deal with damage caused to commercial reputation which can be significant;
- Provide expressly for that and also for accounting;
- Timing, need to establish right via dispute resolution provisions in main contract;
- No enhanced protection for those monies if entity that called the bond going insolvent;
- Check main contract refers to the bond;
- State clearly when a bond can and cannot be called.

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Questions

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