Fenwick Elliott
The construction & energy law specialists
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Welcome to the February edition of ***Insight***, Fenwick Elliott's newsletter which provides practical information on topical issues affecting the building, engineering and energy sectors.

The purpose of this twentieth issue of *Insight* is to provide (i) an update on recent developments of the law relating to bonds and (ii) practical tips on how to negotiate bonds and guarantees in light of those developments.

Insight

Bonds and guarantees update:

Distinguishing a bond from a guarantee and bondsman's obligations

In our sixth issue of *Insight*, we reported on the first instance decision in *Hackney Empire Ltd v Aviva Insurance UK Ltd*[1] which considered the issue of whether conduct in agreeing payments outside of the building contract was prejudicial to the bondsman such that the bondsman was discharged from liability. That case has now been considered by the Court of Appeal.

Meanwhile, the question as to whether a security document is an on-demand bond or a guarantee continues to occupy the courts. The Court of Appeal has emphasised the need for a consistent approach by the courts. The court also noted that ultimately, the banks are concerned with the wording of the security document not about (i) the relationship between the supplier and customer, (ii) whether the supplier has performed his contractual obligations or (iii) whether the supplier is in fault unless there is clear evidence of both fraud and the bank's knowledge of that fraud. The Court of Appeal has therefore provided useful guidance on how to differentiate between on-demand bonds and guarantees.

A reminder of the key legal principles

Primary and secondary obligations

Bonds and guarantees are basically forms of informal security that support a contractual obligation (usually in the form of a separate security document) and are based on either primary or secondary obligations.

Bonds based on primary obligations are where the bondsman promises to pay a certain amount on receipt of a written demand immediately (absent very limited challenges such as fraud, or the bond having expired) without reference to the liability of the contractor or any other condition. There is no need to involve the original contracting party, which simplifies matters significantly if insolvency proceedings are in prospect or on foot.

Primary obligation bonds are variously referred to as single bonds, simple bonds, on-demand bonds, demand guarantees and documentary demand bonds and are common in international projects but are not seen as often in the UK market save for advance payment and retention bonds.

Bonds based on secondary obligations usually take the form of a guarantee and are referred to as conditional bonds, surety bonds and default bonds, and the bondsman's liability is dependant on there being a breach by the contractor of the underlying construction contract. They are much more commonly seen in the UK construction market because they are economic and they are usually readily available from most contractors.

(It's not) all in the name

Do not be fooled into thinking that the answer lies in the name however. Careful, or careless, drafting sometimes means that bonds fall somewhere between an on-demand bond and a conditional bond (or guarantee), and the name of the bond will not necessarily be determinative of its type.

To complicate matters further, the construction industry usually uses the term "performance bond" for a secondary obligation or conditional bond, whereas bankers' understanding of the term "performance bond" is that of an on-demand bond.

It is the wording of the bond or guarantee itself that is instructive. In the case of on-demand bonds, for example, if the effect of the wording of the on-demand bond is for payment to be made without any preconditions, then that document should be described as an on-demand bond. For guarantees, the wording should reflect the fact that payment is secondary to a breach of contract and loss as a result of that breach.

(Not so new) guidance for distinguishing on-demand bonds from guarantees

In the recent Court of Appeal decision in *Wuhan Guoyu Logistics Group Co Limited & Others v Emporiki Bank of Greece SA*,[2] the Court of Appeal provided important guidance on how to distinguish an on-demand bond from a guarantee.

The first instance Commercial Court had decided that the answer lay in the security instrument's name. It was described as a "Payment Guarantee" and the court held therefore that it must be a guarantee as opposed to an on-demand bond. As a result, the bank's liability to pay was a secondary obligation which would only arise on a breach of the underlying contract.

Both the first instance Commercial Court and the Court of Appeal considered the usual factors that might identify the Payment Guarantee as either an on-demand bond or a traditional guarantee. The Court of Appeal emphasised there were many pointers in different directions which did not make the decision an easy one but it came down in favour of the guidance given in the 11th edition of *Paget's Law of Banking* (which is supported by judicial authority).

Paget's guidance states:

> *"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.*
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> …
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> *In construing guarantees it must be remembered that a demand guarantee can hardly avoid making reference to the obligation for whose performance the guarantee is security. A bare promise to pay on demand without any reference to the principal's obligation would leave the principal even more exposed in the event of a fraudulent demand because there would be room for argument as to which obligations were being secured."*

1. [2011] EWHC 2378
2. [2012] EWCA Civ 1716

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The Court of Appeal confirmed that Paget's guidance should apply as a strong presumption where the obligation to pay is expressed to be "on demand", and added that it should even apply in circumstances where the fourth criterion is not satisfied (namely, where the security document does not contain clauses excluding or limiting the defences available to a guarantor). It did not matter at all that the security document was, on its face, a "Payment Guarantee".

Had the first instance Commercial Court decision been permitted to stand, the Court of Appeal expressed concern that security documents of the sort encountered in this case would be almost worthless because they would allow the bank to resist payment on the basis that a foreign buyer is disputing whether a payment is due and refusing to sign the certification of approval required by the underlying contract, as was the case here.

An important point to note about guarantees

Any material variation in the construction contract can discharge the bondsman from liability in circumstances where the parties to the contract guaranteed have varied the terms of the contract without the bondsman's consent.[3]

In the recent decision of *Aviva Insurance UK Limited v Hackney Empire Limited*[4], the Court of Appeal held that the bondsman can also be discharged if advance payments of the contract price are made by the employer to a contractor unless they are expressed to be extra-contractual payments or a loan, neither of which has any connection to the original contract.

On the facts of *Aviva Insurance UK Limited v Hackney Empire Limited*, on-account payments were not an alteration of the original contract and had not been certified as due by the architect or otherwise falling due under the original contract sum, but were made for reasons that were entirely unconnected to the building contract with a view to easing the contractor's cash flow problems and enabling it to complete the works. There was a side agreement that did not in any way reduce the contractor's obligations or the employer's entitlement, and there was therefore no variation to the underlying contract that might have prejudiced the bondsman. The bondsman's obligation was what he signed up for.

Variations to the original contract and additional payments (particularly in the current economic climate to improve cash flow and the likelihood of the works being completed) are common in construction contracts. A bondsman will not be released from any liability by reason of contractual variations or advance payments if (i) the bondsman has specifically consented to the variation or advance payment, or (ii) there is an "indulgence clause" which recognises that the underlying contract may be varied and confirms that the bondsman will still meet a call on the bond upon any variation.

On-demand bonds do not generally require indulgence clauses because they operate independently of the underlying construction contract.

Some practical tips

Distinguishing on-demand bonds from guarantees

1 Don't be too concerned with the title of the document. Titles can be deceptive.

2 Do think about the content. Is the obligation to pay expressed to be "on demand"? Does the security document contain clauses excluding or limiting the defences available to a guarantor? If so, there is a strong presumption in the international market that the document will be an on-demand bond.

3 The document is more likely to be a guarantee if you are operating in the UK market since guarantees are a standard form of security in the UK construction industry.

4 If you suspect that the bond might be an on-demand bond and you are operating in the UK market, see if you can resist it. It is not always necessary to have such a form of security in the domestic market. Instead, try and negotiate a conditional bond or limit the sum which is to be payable "on demand".

In relation to the bondsman's obligations

Advanced payments should be the exception rather than the rule as, despite best intentions that an advance payment might improve the prospects of completion, they might on facts be found to be prejudicial which might absolve the bondsman from liability.

If you must make advanced payments:

- consider using a side agreement in relation to any "payments on account" pending full substantiation of any claim. If you do so, the court may be more inclined to find this type of arrangement to be outside of the terms of the underlying contract, in which case the bondsman's liability will be unaffected.

Alternatively (and ideally, as a belt and braces measure):

- be sure to obtain the express consent of the bondsman to any advance payment whatsoever and document the arrangement to avoid any doubt that the payment is made outside the underlying contract, and

- draft an indulgence clause to protect your right to make variations to the underlying contract.

Conclusion

The Court of Appeal has now provided further useful guidance to assist in distinguishing between on-demand bonds and guarantees. As with the drafting of any document, the need for clarity is paramount.

Remember it is the content of the document, not its title which is of paramount importance. Remember too, if a primary liability (or on-demand bond) is required, the four presumptions set out by Paget. Only three of the four presumptions are present in the *Wuhan* case. That was enough for the Court of Appeal to decide that the heading on the face of the security was not conclusive.

Should you wish to receive further information in relation to this briefing note or the source material referred to, then please contact Lisa Kingston.
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3. See *Holme v Brunskill* [1877] 3 QBD 494
4. [2012] EWCA Civ 1716