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# Bonds and guarantees: Key considerations in the current economic environment

A presentation by:  
Claire King, Fenwick Elliott  
Mathias Cheung, Atkin Chambers  
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# Introduction

- **The basics:**
  - On demand bonds
  - Guarantees
  - ABI Bonds
- **Setting up properly:**
  - Essentials to focus on in the current environment
- **Protecting your position when things go downhill**
- **Summary**



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# The basics



# What is an On Demand Bond?

- Terminology is confusing:
  - “*Demand*” Guarantees (but not guarantees at all)
  - Performance Guarantees
  - Performance Bonds
  - Standby Letters of Credit
- Look at the content NOT the label attached
- Bank makes immediate payment upon presentation of a compliant demand
- “... *an irrevocable undertaking to pay a specified sum to the beneficiary in the event of a breach of contract, rather than a promise to see to it that the contract will be performed...*” [The Law of Guarantees]
- No enquiry into rights and obligations of contractor and employer
- More likely to be issued by a bank, insurer or financial institution
- Only defence is fraud

# Different Types of On Demand Bonds

## Tender Bonds

- Aim: Give assurance that the contractor is serious about a bid
- Some jurisdictions used widely / compulsory
- Typically allow a call if:
  - Contractor withdraws tender without Employer's consent
  - Contractor awarded tender but doesn't enter contract
  - Contractor doesn't provide performance bond

## Advanced Payment Bonds

- Employer can call back money paid for plant / equipment in advance due to high cost or criticality
- Protects employer from funds being diverted

## Retention Bonds

- Given in lieu of retention
- Reduced at PC and released at end of DLP

## Performance Bonds

- Required to cover a percentage of contract price
- Generally constant percentage until practical completion
- Likely to expire completely at the end of the Defects Liability Period

## Offsite Material Bonds

- Protection for the Employer where materials not on site but paid for
- Also provides protection against insolvency

# On Demand Bonds: grounds for stopping a call?

Under English law only two ways to potentially stop a call:

1. The fraud exception
2. Obtaining an injunction under the main construction contract



# The Fraud Exception (1)

## ***Edward Owen Engineering v Barclays Bank International*** [1978] 1 QB 155

*“So long as the Libyan customers make an honest demand, the banks are bound to pay; and the banks will rarely, if ever, be in a position to know whether the demand is honest or not. At any rate they will not be able to prove it to be dishonest, so they will have to pay. All this leads to the conclusion that the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with the question whether the supplier has performed his contracted obligation or not; nor with the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. **The only exception is when there is a clear fraud of which the bank has notice.**” [Emphasis added]*



# The Fraud Exception (2)

- “....it is nothing to the point that at the time of trial the beneficiary knows, and the bank knows, that the documents presented under the letter of credit were not truthful in a material respect. **It is the time of presentation that is critical.**” – **Group Josi Re Co SA v Walbrook Insurance CO Ltd** [1996] 1 Lloyds Rep 345
- Heavy burden on bank seeking to resist payment OR party seeking to restrain the bank
- How can you prove a bank knows of a fraud?



# Restraining the Beneficiary from making a call

- **Permasteelisa Japan v Bouyguesstroi and Bank Intesa SpA [2007] EWHC 3508:** must “*positively establish*” that demand would not comply with contractual mechanism. Seriously arguable not enough. Injunction refused
- **Simon Carves v Ensus: [2011] EWHC 657:** “*strong case*” for injunction was sufficient. “*There is no legal authority which permits the beneficiary to make a call on the bond when it is expressly disentitled to do so*”.
- **Doosan Babcock v Comercializadora de Equipos y Materiales Mabe Limitada [2013] EWHC 3201:** “*realistic prospect*” of showing the employer had wrongfully failed to issue a Taking Over Certificate in breach of contract and demand would allow employer to benefit from its own wrong
- **MW High Tech v Biffa Waste Services Ltd [2015] EWHC 949:** dispute about whether there had been a default under the contract so as to allow a demand under performance bond to be made. No injunction granted following *Permasteelisa*
- “*..it seems unlikely that the ground for interference would be extended by an English Court any further than, at the very most, a clear case of total failure of consideration, illegality or **failure to comply with a condition precedent**. Any wider exception would be too likely subvert the value of the performance bond as a commercial instrument, to find favour with the court.*” [The Law of Guarantees]

# What is a guarantee?

- ***Vossloh AG v Alpha Trains (UK) Ltd*** [2010] EWHC 2443:

*“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.”*

- Guarantees are secondary obligations
- Creditor must be a party
- Liability is the same as for the underlying contract
- Liability (and the amount of the liability) needs to be established and ascertained before payment is made
- Clause confirming that an amendment to the underlying contract will not relieve the Guarantor of their liability
- S4 of the Statute of Frauds Act 1677: in writing and signed

# The “Hybrid” (!) : what is a **Conditional Bond**?

- Some bonds are in fact a hybrid between bonds and guarantees, in that they are conditional and require of some proof of some primary default under the underlying building contract.
- A typical example in the UK is the ABI Model Form bond, standard clause 1 of which provides that:

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

- Be careful not to mistake a conditional bond such as an ABI bond for an unconditional on-demand bond!



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# Setting up properly



- Cost of securities increasing
- Added to the contract price?
- Alternatives?

## News

# Henry collapse drops bomb in bonding market

Aaron Morby

4 months ago

Share   

The collapse of Henry Construction has triggered a serious bonding crunch for contractors.

# What is it?



INCORPORATION OF  
URDG



INCORPORATION OF A  
CONCLUSIVE  
EVIDENCE CLAUSE



GUARANTOR NOT A  
FINANCIAL  
INSTITUTION



WORDING  
SUGGESTING BANK'S  
LIABILITY NOT  
SECONDARY



NO EXCLUSION OF  
GUARANTOR'S  
EQUITABLE  
DEFENCES



PARTIES IN  
DIFFERENT  
JURISDICTIONS

# Safeguards for On Demand Bonds?

- Consider if additional documents need to be presented with any demand?
- Who is required to sign the demand?
- Can have hybrid forms
- URDG 758:
  - Set of contractual rules published by the ICC
  - Rules include safeguards
  - Art.15(a):
    - Demand is supported by a statement by the beneficiary indicating in what respect the applicant is in breach of its obligations under the underlying relationship
    - Statement may be in the demand itself, or in a separate signed document accompanying or identifying the demand

# Who is the security from?

- **Bondsman:**
  - Check their financial strength
  - Don't accept security without doing your due diligence
  - Applies to contingent as well as on demand securities
- **Parent company guarantee:**
  - Do they have any assets?
  - What jurisdiction are they located in?
    - How easy is it to trace assets?
    - How easy is it to transfer assets out of that jurisdiction?
    - How easy is it to enforce judgments in that jurisdiction?





# Bonds / Guarantees vs. Underlying Contracts: **Avoid Inconsistencies**

- **Beware!** Inconsistencies between the terms of a bond or guarantee and the terms of an underlying contract often give rise to disputes and complicate a call on the bond. Common drafting errors / oversights include:
  - Inconsistent terms regarding the expiry / termination / discharge of the bond
  - Inconsistent terms regarding the requirements / conditions for calling on the bond
- See e.g. ***Simon Carves Ltd v Ensus UK Ltd*** [2011] EWHC 657 (TCC):
  - The bond provided for a longstop expiry date of 31 August 2020
  - The underlying ICE Contract provided that the bond shall be “null and void” and shall be returned upon Acceptance Certificate
  - Akenhead J held at [37] that upon issuance of the Acceptance Certificate in February 2020, the bond must be treated as null and void (i.e. the underlying ICE Contract terms prevailed)



# Bonds / Guarantees vs. Underlying Contracts: **Dispute Resolution Procedures**

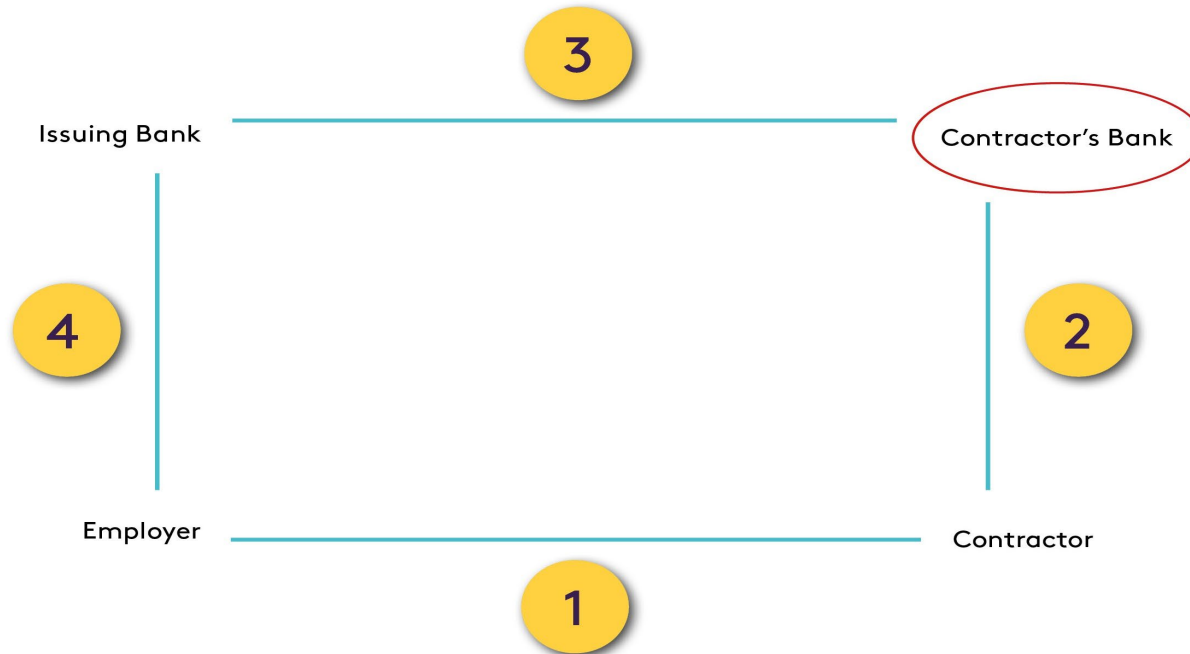
- Another common complication arises from inconsistent dispute resolution provisions between a bond / guarantee and an underlying building contract
- Especially problematic if underlying contract provides for adjudication or arbitration, but the bond / guarantee is silent:
  - Likely to result in jurisdictional challenge if a party seeks to refer dispute about bond / guarantee to an arbitration together with a dispute under the underlying building contract for convenience
  - Can an arbitration clause capturing “any dispute or difference **arising out of or in connection with the Contract**” come to the rescue?
- All this can be avoided if proper thought is given to the dispute resolution provisions of both the underlying contract and the bond / guarantee during pre-contractual negotiations

# Bonds / Guarantees vs. Underlying Contracts:

## Governing Law / Jurisdiction Clauses

- Governing law / forum can make a material difference to availability of injunctive relief and grounds for resisting bond call. Taking latter as an example:
  - **English and Hong Kong Law** – only if demand is fraudulent or precluded by the terms of underlying contract: see *MW High Tech Projects UK Ltd v Biffa Waste Services Ltd* [2015] EWHC 949 (TCC) at [33]-[36]
  - **Australian Law** – may grant injunction to enforce a promise not to call on bond: see *Reed Construction Services Pty Ltd v Kheng Seng (Australia) Pty Ltd* (1999) 15 BCL 158 at 164
  - **Singapore Law** – “unconscionability” is a further established ground for restraining a bond call: see *JBE Properties Pte Ltd v Gammon Pte Ltd* [2011] 2 SLR 47 at [10]
  - **UAE Law** – **Art. 417(2) of UAE Federal Commercial Law No. 18/1993** allows the court to place an attachment order on the drawdown sum “*in exceptional circumstances*” if there are “*serious and certain reasons for the request*” (e.g. if there is evidence that the sums claimed are not due and/or significant payments to the contractor are outstanding)
- For illustration of why governing law is important, see *Shanghai Electric Group Co Ltd v PT Merak Energi Indonesia* [2010] 2 SLR 329, where Singapore Court applied English law grounds only because bond was expressly governed by English law

# Where is the counter security located?



## On-Demand Bond (International)

1. Construction contract
2. Counter-indemnity
3. Performance bond / counter-indemnity
4. Performance bond

# Location of the counter-security

- ***National Development Company Limited v Banco Santander S.A.*** [2017] EWCA Civ 217
  - Brazilian main contractor (in administration)
  - Standby Letters of Credit (value circa US\$100 million in total) subject to English Law and jurisdiction of English Courts
  - Counter indemnity issued by Brazilian banks to English banks
  - Injunction obtained in the Brazilian Courts against the Brazilian banks
  - Injunction later extended to cover the English banks as well
  - English banks concerned they wouldn't get paid out
  - Brazilian banks conscious they didn't have enough in the bank to get repaid
  - English Courts ordered payment (eventually)
- BUT:
  - Additional costs incurred in enforcement and delay
  - Luckily English courts have a robust approach to enforcing on demand securities

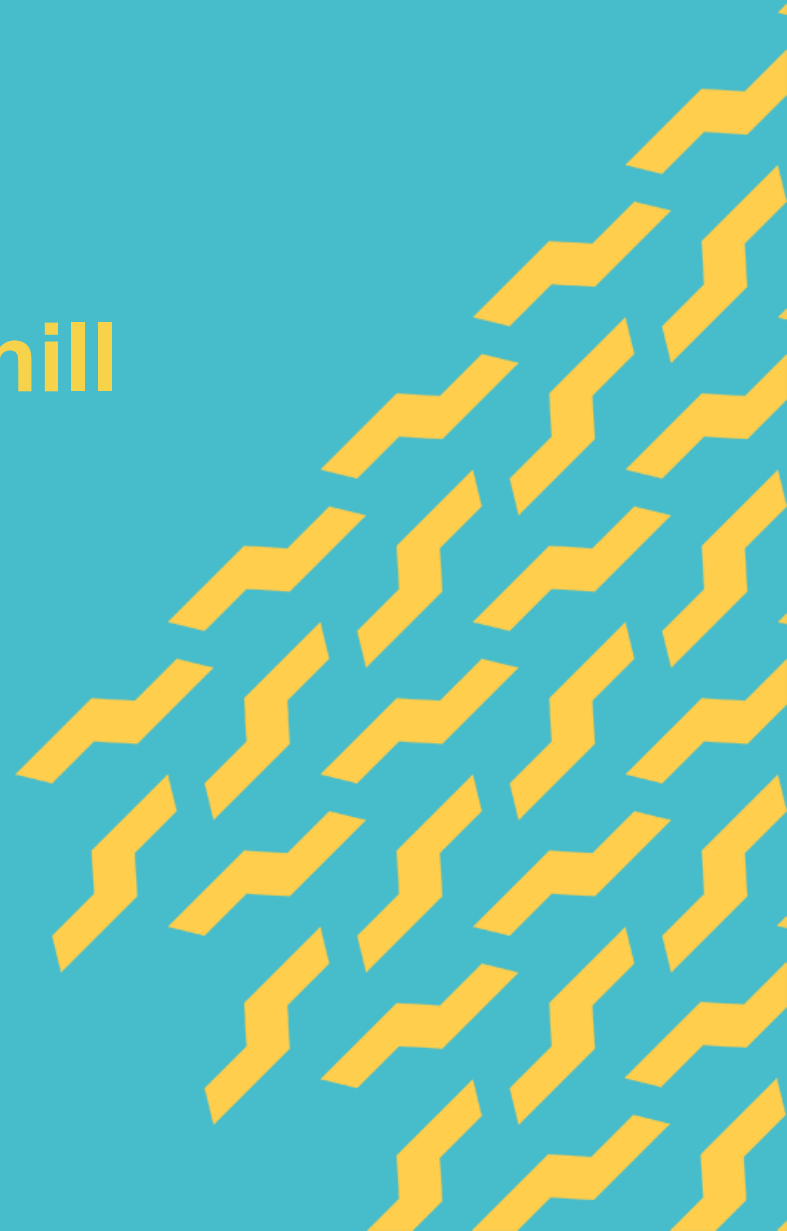


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# When things go downhill



# On Demand – Employer’s Perspective

- Check the expiry date on your On Demand Bond
- What grounds allow a call under the construction contract in question?
- Obey formalities to the letter
  - What wording is required in the demand?
  - **Sea Cargo Skips AS v State Bank of India** [2013] EWHC 177
    - Required a statement that delivery of a vessel had been delayed by more than 270 days according to Article IV(E) (the cancellation clause)
    - “slavishly follow the wording of the refund guarantee”
    - Failure to refer to Article IV(E) was fatal
    - *“the refund guarantee required, not a statement that there had been 270 days delay of any character which entitled the Buyer to cancel, but a statement that there had been 270 days delay of a particular character which entitled the Buyer to cancel, namely, that set out in article IV 1 (e).”*
  - Signatures?
  - Company seal?
- Location of institution you have to serve on
  - Consider using a process server

# On Demand – Contractor's Perspective

- Face reality: resisting a call on an On Demand Bond (under English law) is very difficult
- Consider if the call is a breach of the underlying contract?
- Deal with the underlying claim proactively if possible
- If the On Demand Bond is about to expire consider extending it
- Extend in good time:
  - Don't play "*who blinks first*"
  - Weigh up the costs of a call v paying up the cash
  - Damage on bonding capability if a call is made?



# Guarantees / Conditional Bonds : Employer's Considerations

- **Conditional bond** – unlike for on-demand bonds, more is required than just a simple demand: see e.g. recent case law on ABI bonds requiring ascertainment of loss:
  - ***Ziggurat (Claremont Place) LLP v HCC International Insurance Company Plc*** [2017] EWHC 3286 (TCC): Coulson J confirmed at [55] that, in the event of insolvency / termination, it suffices to operate the contractual procedure for calculating the post-termination account (e.g. clause 8.7 of JCT Contracts).
  - ***Yuanda (UK) Company Ltd v Multiplex Construction Europe Ltd & Another*** [2020] EWHC 468 (TCC): Fraser J held at [70]-[83] that an adjudication decision awarding LADs sufficed, but not a mere payment notice or demand demanding the payment of LADs.
- **Guarantee** – need to first establish breach of underlying primary obligations by adjudication, arbitration or litigation (as applicable).
- N.B. Calling on a conditional bond / guarantee may not be a quick fix – see e.g. ***Energy Works (Hull) Ltd v MW High Tech Projects UK Ltd & Others*** [2022] EWHC 3275 (TCC), which took 3.5 years from issuing claim (July 2019) to final judgment (December 2022) to unlock payment under a PCG.

# Guarantees / Conditional Bonds: Contractor's Considerations

## Generally...

- Consider the terms of any indemnity agreement with the bondsman / guarantor:
  - Do you have enough resources / cashflow to reimburse the bondsman / guarantor in respect of the drawn down sums?
  - When does the reimbursement have to be made? Does the indemnity require a payment into the bondsman / guarantor's account in advance?
- Consider whether there is any room for a commercial resolution to avert a demand on the bond / guarantee:
  - Extension of expiry date of bond / guarantee?
  - Payment into court, or if proceedings not yet commenced, on-account payment to Employer or into ring-fenced account?



# Remedies for Contractor if Bond Wrongfully Called

What are your entitlements under English law if an Employer wrongly calls on bond?

- Primary remedy – accounting between parties and repayment by Employer of wrongfully drawn down sums: see e.g. ***Cargill International SA v Bangladesh Sugar & Food Industries Corp*** [1998] 1 WLR 461 at 471 (Staughton LJ)
- Other remedies – damages (e.g. increased financing costs, loss of opportunities / revenue etc.) for breach of contract / bad faith? Likely to be difficult because:
  - No implied duty of good faith or duty otherwise not to call on bond unless there is actual default / loss: see e.g. ***Costain International Ltd. v Davy McKee (London) Ltd*** (CA, unreported, 26 November 1990)
  - No implied term requiring demand to have “contractual basis”, as a bond can be validly called despite genuine dispute over claims: see e.g. ***MW High Tech Projects UK Ltd v Biffa Waste Services Ltd*** [2015] EWHC 949 (TCC) at [36]
- **In any event, causation and quantum of financial losses arising from bond call probably difficult to evidence!**

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# ***QUESTIONS***

Thank you!



Claire King, Partner  
Fenwick Elliott LLP  
T: +44 0207 4211986  
E: [cking@fenwickelliott.com](mailto:cking@fenwickelliott.com)



Mathias Cheung  
Atkin Chambers  
T: +44 0207 404 0102  
E: [mcheung@atkinchambers.com](mailto:mcheung@atkinchambers.com)