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Briefing note

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On-demand Bonds: Is the lifeblood of international commerce still flowing freely?

On-demand bonds (and letters of credit) have habitually been recognised by the judiciary as the lifeblood of international commerce. On limited/non-recourse financed projects, where lenders closely analyse contractor recourse and seek to reduce construction risk, they offer important performance security and credit enhancement.

This briefing comments on a recent trend of judicial interference in the liquidity and prompt enforceability of on-demand bonds by increasing the scope for calls to be challenged, in the face of many decades of precedent to the contrary. It also provides a refresher on the rationale for the ongoing popularity of these instruments and other potential threats to bringing successful claims under on-demand bonds.

Why have an on-demand bond?

In order to understand the recent cases on on-demand bonds, it is important to place them in context and understand why they are so regularly utilised.

On-demand -vs- conditional

On-demand bonds have been the usual form of security taken for contractor performance of EPC and turnkey construction contracts on limited/non-recourse financed projects (aka "project finance") and not only where there is an international component. The intention is that these instruments do not require any proof of liability, causation or amount of loss in order for the beneficiary to issue a demand and receive payment from the issuer, although there may be basic documentary conditions as to the form of demand that may need to be satisfied. On-demand bonds are usually issued by banks who would not typically wish to become involved in investigating or assessing the merits of demands or disputes. It is, however, well established that where such instruments act as security for performance of a contract, a beneficiary will be subject to a duty to

Key issues

- Project finance banks often insist on on-demand performance bonding
- On-demand bonds are also often used to replace retention or secure advance payments
- There appears to be an increasing scope for bond calls to be rejected or even injuncted
- The terms of the underlying contract are often consulted alongside the bond terms in analysing bond calls and are therefore as important in analysing injunction risk
- Is English law on course to become out of step with the international precedent it helped formulate?

account for any amounts "wrongfully" called or "over-called" (in other words, amounts for which the contractor would not have been liable pursuant to the relevant contract).

On-demand bonds are commonly contrasted with conditional guarantees, issued by surety companies. These are true guarantees and their surety issuers will typically require proof of default and liability (legal causation of loss as well as ascertainment of the quantum of loss suffered by the beneficiary) before meeting a claim under the bond. Although conditional guarantees offer some credit enhancement to developers and funders, in some jurisdictions they suffer from the reputation of sureties seeking to delay or contest calls.

Regrettably, where these instruments are used as performance security, both types (on-demand and conditional) are often labelled as the "performance bond" or "performance guarantee" with predictable confusion resulting.

What type of bond to expect

As mentioned above, in project finance transactions, where there is a requirement for prompt accessibility to funds, conditional performance bonds have not usually been regarded as appropriate. The special purpose vehicles used on such projects are usually relatively lightly (and/or tightly) capitalised and project financiers are keen to ensure that in the event of contractor default there is access to liquid security in order to rescue projects or simply meet liabilities arising at the relevant point in time. As a result, contractors are usually required to procure an on-demand bond or letter of credit.

In contrast, in a standard development (i.e. where there is no project financing) conditional guarantees are by far the most common form of performance security instrument, due in part to the ability of lenders to have security over the property/development asset, but also due to:

- historical concerns about the potential for abusive/wrongful calls on on-demand bonds (albeit, in the UK at least, without substantive empirical evidence for such concern)
- the 1994 Latham Report, which brought sweeping reform to the UK construction industry, concluding that "*bonds should not be on-demand and unconditional, but should have clearly defined circumstances for them being called*"
- the difficulty for many contractors in arranging bonding with banks and the relative high cost of on-demand bonding (including, in addition to the direct premium cost, the associated accounting treatment and collateral requirements).

Aside from performance security, on-demand bonds are used regularly in all sectors of the construction industry to replace cash security that would otherwise have been required (e.g. for securing advance payments or to replace retention).

A third way

An exception to the usual requirement in project finance transactions for on-demand security emerged during the heyday of UK PPP social accommodation projects. Many of the leading contractors could not obtain or afford to obtain bonding for all of the large projects they were undertaking and as a result a compromise was reached in the development of so-called adjudication bonds – effectively fast-track conditional instruments. Increasing costs and the complexity of such instruments saw both PPP contractors and funders return to on-demand bonding, although adjudication bonds are still sometimes seen in a simplified format for smaller-scale PPP and other types of projects.

Grounds for injuncting demands/payments under an on-demand bond[1]

Historically, the courts maintained a very high burden for any claimant seeking an injunction in relation to an on-demand bond or letter of credit in strong contrast to the usual tests that are applied to injunction hearings[2]. Firstly, they restricted

[1] The English courts are broadly happy that the same rules govern the assessment of injunction applications, be they against a bank in order to prevent a pay-out, or against a beneficiary in order to prevent the demand in the first place. In this briefing, we will for brevity refer to injunctions of bond demands/calls, but note that the same principles are likely to apply to injunctions of bond payment as well.

[2] See, e.g., the *American Cyanamid* tests: (1) Is there a serious question to be tried? (2) Would damages be an adequate remedy in the absence of an interim injunction? (3) What is the balance of convenience? (4) Are there any relevant special factors?

injunctive challenges to cases of fraud[3] in recognition of these instruments' vital role in international trade and the need for liquidity. Secondly, and in consequence of that restriction, the courts refused to look at underlying questions of contractual liability when considering injunctive applications. A series of cases in recent years has, however, seen potential further grounds for injunction/resistance accepted by the courts.

The Fraud Exception

Whilst identified as the clear example of where courts will restrain bond demands, establishing fraud in connection with an bond call is difficult - an incorrect demand made, however wrongly or negligently, will not be deemed to be fraudulent if it was made with the honest belief that it was a valid demand. A court will not impute fraud even where there has been no prior allegation of performance failure or default – there has to be evidence of the fraudulent intent.

The *Sirius* exception

The *Sirius* case[4] confirmed that, in addition to the fraud exception, a demand can be injuncted or resisted where it can be "*positively established*" that the beneficiary is expressly not entitled to bring it according to the terms of the underlying contract. *Sirius* was interesting for a number of reasons, not least of which is that, in making their demand, the beneficiaries effectively expressly admitted that they were not entitled to do so - it was not decided whether, without that admission, the bank could have been prevented from paying given the terms of the letter of credit contained the standard language preventing the bank from conducting any further investigation as to the circumstances giving rise to the claim. The exception produced by the *Sirius* decision remains very limited in practice.

That position (i.e. the need to have positively established the claimant's lack of entitlement) was endorsed in the *Permasteelisa*[5] case (again dealing with letters of credit), where the court confirmed that "*the same will not apply where there is only a serious arguable case […] otherwise the commercial effectiveness of letters of credit would be eroded*".

The *Simon Carves* exception and *Doosan*

In the *Simon Carves* case[6], the court appears to have moved away from the "*positively established*" standard set down in *Sirius* and *Permasteelisa* and adopted standards/tests that are more familiar to other interim injunction applications - notably, that the party seeking the injunction must merely satisfy the court that it has a "*strong case*" that the call is not permitted. Although the court acknowledged the various precedents as to the status of on-demand bonds, it did not feel restrained from making an assessment on underlying merits[7]. The court also suggested that the reputational damage that would have been suffered by the contractor in the event the bond call were not to have been injuncted would and could not ultimately have been adequately compensated by damages at final decision stage.

This first instance decision caused some alarm as it appeared to be a significant and unexpected step-down from the high threshold previously required before a bond call could be injuncted. The policy ground for such a change was not immediately obvious and some commentators sought to constrain it within a *Sirius*-style exemption for cases where it is established that the bond has been called when the underlying contract says there should be no bond at all. Others theorised as to whether the *Simon Carves* decision may have been affected by it involving a domestic project (a bioethanol plant in Teesside) and would not be followed in a case where a bond was being used as "*the lifeblood of international*

[3] By way of example, Lord Denning in *Edward Owen Ltd -v- Barclays Bank* [1978] 1 QB 159, stated that an on-demand bond (a "performance guarantee" in that case) "*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 […] The only exception is when there is a clear fraud of which the bank has notice*".
[4] *Sirius International Insurance Co v FAI General Insurance Limited* [2003] 1 WLR 2214
[5] *Permasteelisa Japan KK -v- Bouyguesstroi and Banca Intesa Spa* [2007] EWHC 3508 (TCC)
[6] *Simon Carves Ltd -v- Ensus UK Ltd* [2011] BLR 340
[7] In the *Simon Carves* case, a bond had been extended by agreement, but without prejudice to an argument that a completion stage had been attained, which would have meant the bond had expired.

commerce". This viewpoint, however, was threatened when *Simon Carves* was followed by the *Doosan* decision[8] (which involved a power plant in Brazil).

The court in *Doosan* suggested that, even if it had been wrong to follow *Simon Carves*, it would have reached broadly the same decision by way of application of the rule in *Alghussein*[9] that "*no man can take advantage of his own wrong*" (which in *Doosan* was the non-issuance of a completion certificate by the employer simply as a means of triggering a liquidated damages liability under the contract and therefore a potential bond claim).

Other grounds for resisting a call on an on-demand bond

In addition to the exceptions mentioned above, there are other pitfalls which are commonly encountered which might interfere in the swift enforcement of a bonding instrument.

Bond is Conditional not On-Demand

There is a wealth of case law on the risks associated with failing to draft an on-demand bond cleanly, in particular in relation to the inclusion of language more consistent with the nature of a conditional guarantee. These decisions proceed on a case-by-case basis interpreting the instruments against the background matrix of both the bond itself and the underlying contract to which it relates and, if this is still unclear, customary market practice. We do not comment in detail on this case-law in this briefing but instead have set out in the box on the right various circumstances which have the potential, alone or in combination, to cause a bond to be found to be a conditional guarantee rather than on-demand. Of course, if a bond, on its true construction, is found to be conditional, rather than on-demand, a beneficiary may ultimately still be able to make a successful call on the bond, albeit subject to the additional proof requirements of such documents.

Not on-demand?

- Surety/related company issuer rather than bank
- Bond includes more than merely procedural requirements for bringing a claim (e.g. a requirement to show loss and causation)
- Bond contains traditional English law 'guarantee' language and boilerplate protections against guarantee discharge
- Bond allows the bondsman to make independent enquiries into the underlying events

Uniform Rules for Demand Guarantees[10]

It is not uncommon for on-demand bonds to incorporate by reference the ICC's Uniform Rules for Demand Guarantees (URDG) 758. Beneficiaries of bonds which incorporate the URDG should be aware of the procedural rules to which they must adhere if a bond call is to succeed. These include a requirement for any call to be accompanied by a statement setting out the nature of the breach which has led to the call being made. In addition to the procedural requirement, beneficiaries should be aware that contractor insolvency – a primary reason for insisting on a bond in the first place – may not constitute a 'breach' or 'default' for the purposes of the underlying contract and thus access to funds under the bond may be delayed until a contractual breach has actually occurred, for example a failure by an insolvent contractor to pay termination compensation (provided this liability crystallises before the bond is due to expire[11]). The URDG additionally oblige a bank to provide such notice, perhaps thereby increasing the likelihood of an attempt (by either the bank or, more likely, the contractor) to injunct the beneficiary from bringing a claim.

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[8] *Doosan Babcock Limited -v- Commercializadora de Equipos y Materiales Mabe Limitada [2013] EWC 3010 (TCC)* and shortly again in a follow-up hearing *[2013] EWHC 3201 (TCC)*

[9] *Alghussein Establishment -v- Eton College* [1991] 1 All ER 267

[10] Note that we refer here only to the URDG 758 rules. Other, similar, rules exist (e.g. the UCP 600 and ISP 98, which are, in our opinion, more appropriate for banking and finance documents) in respect of which similar considerations arise.

[11] *Perar BV -v- General Surety & Guarantee Co Ltd* (1994) CA 66BLR77

Although the URDG can create pitfalls, they can also assist in confirming on-demand, rather than conditional, bond status. In *Meritz Fire*[12], the Court of Appeal confirmed that the bondsman was obliged to pay out once a compliant demand had been submitted under a bond which was subject to the URDG, regardless of the underlying circumstances which had seen the main contract transferred to a new contractor after the original contractor was dissolved.

Procedural requirements

Failure to follow a pre-agreed procedure for making bond claims will also lead to a risk of injunction/resistance. In *Franz Maas*[13], a bond call needed to specify that the [contractor] had "*failed to pay… under [its] contractual obligations*". The actual demand submitted referred only to a failure "*to meet contractual obligations*" and therefore the call was successfully resisted (albeit in circumstances such as these the resistance is usually only temporary until a compliant demand is submitted).

Pre-existing foreign judgments

A pre-existing foreign judgment may prevent practical enforcement of a English-law bond claim by the English courts. In *Maritza*[14], the court sent down a judgment in favour of the claimant but stayed enforcement until a pre-existing order (equivalent to an injunction) of the French court, preventing the bank from paying out under a bond, was lifted. This was on the basis that the place of performance (i.e. payment) was held to be France, and the English court would not enforce judgment which required the performance of an act which would be illegal in the country of performance[15]. Had the place of performance been London (notwithstanding international parties and the pre-existence of the French law injunction), it is unlikely that the same position would have been reached[16].

Finally, it is possible that the principles of "international comity" could also ultimately prevent/dissuade an English court from allowing a bond claim to be enforced. This has yet to be fully tested in the courts, although in *Power Kurber International*[17], a pre-existing Kuwaiti law prohibition on payment under a letter of credit was felt to be so "out of step" with the principles of English law and international commerce that the principle of international comity could not be applied.

A clot on the landscape?

The narrow view of *Simon Carves* is that it is restricted to issues of bond existence and expiry, rather than an assessment of any underlying merits, but *Doosan* does appear to have taken this further. Although both are first instance decisions, we do now seem to be a long way from fraud if a bond call can be injuncted in circumstances where there are arguments over whether or not a trigger/release event has occurred and irrespective of the merits of the arguments on either side.

The immediate result of the uncertainty raised by these decisions has been an increase in the temperature of debates around the extent of provisions in contracts which regulate the nature of on-demand bonds (e.g. clause 4.2 of FIDIC). Additionally, lawyers in some civil law jurisdictions are starting to use these decisions (and the qualifications they have engendered in legal opinions) to question the efficacy of using English law to govern these standard banking documents.

No one suggests that the beneficiary of bonds should be entitled to call bonds and letters of credit in circumstances where they do not believe they should be entitled to the proceeds. However, it is equally essential that where a bank has agreed to make payment "on-demand", the courts support the enforcement of that obligation. If on-demand bonds are to remain the

[12] *Meritz Fire and Marine Insurance Co Ltd -v- (1) Jan de Nul NV and (2) Codralux SA* [2010] EWHC 3362 (Comm)
[13] *Franz Maas (UK) Limited -v- Habib Bank AG Zurich* [2001] Lloyd's Rep 14
[14] *AES-3C Maritza East 1 Eood v Crédit Agricole Corporate and Investment Bank & Anor [2011] EWHC 123 (TCC)*
[15] Following the principle in *Ralli Brothers -v- Compania Naviera Sota y Aznar* [1920] 2 KB 287
[16] Contrast with, e.g., *Kleinwort -v- Ungarische Baumwolle Industrie AG* [1939] 2 KB 678
[17] *Power Kurber International -v- National Bank of Kuwait* [1981] 1 WLR 1233

"*lifeblood of international commerce*"[18], then the trend of allowing interim injunction applications which stand or fall based on an assessment of the underlying circumstances must be a threat to circulation. Treatment is recommended.

[18] *Harbottle v National Westminster Bank [1978] QB 146*

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