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Welcome to the September 2015 edition of *Insight*, Fenwick Elliott's newsletter which provides practical information on topical issues affecting the building, engineering and energy sectors.

This issue considers the current approach of the courts to the issues raised in two important judgements this year relating to bonds and guarantees, as well as outlining the practice points arising from these cases.

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Bonds and guarantees: back to basics?

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The law on bonds and guarantees has moved in an interesting direction since we last looked at the topic in June 2014 in our 36th issue of *Insight*, and two judgments in particular are worthy of mention. This 51st issue of *Insight* considers the current approach of the courts to the issues raised in each case as well as the practice points arising.

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The law on bonds and guarantees has moved in an interesting direction since we last looked at the topic in June 2014 in our 36th issue of *Insight*,[2] and two judgments in particular are worthy of mention: *MW High Tech Projects UK Ltd v Biffa Waste Services Ltd* on the restraint of calling on-demand bonds (which suggests a move away from the wide scope for restraining such calls that has recently been favoured by the courts), and *Caterpillar Motoren GmbH & Co. KG v Mutual Benefits Assurance Company* which was concerned with the all too familiar on-demand bond versus payment guarantee debate.

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MW High Tech Projects UK Ltd v Biffa Waste Services Ltd [2015] EWHC 949 (TCC)

The facts

MW High Tech Projects UK Ltd ("MW") was appointed by Biffa Waste Services Ltd ("Biffa") to design, construct, install, commission and test a waste to energy plant under an EPC contract ("the Contract"), the terms of which obliged MW to procure a retention bond.

It was a condition precedent to making a call on the retention bond that Biffa should first call on the Parent Company Guarantee ("PCG") that had been provided by MW's parent company. If the bondsman did not accept each and every aspect of the call in writing within ten days, then the condition precedent would be treated as being discharged and Biffa would be entitled to make a call on the bond.

The contract was subsequently terminated and Biffa made a call on the PCG for the costs of completing the works and liquidated damages. MW's parent company declined to make payment under the PCG on the grounds that the contractual basis relied upon by Biffa for calling on the PCG was not *"valid"* and did not constitute a call under the contract, which in turn meant that Biffa had not satisfied the condition precedent in the contract for making a call on the retention bond.

Biffa ignored MW's protests, and, around a year later, Biffa wrote to the bondsman demanding payment of the maximum sum available under the retention bond in the absence of any acceptance of the demand by MW's parent company. MW rejected the call and issued an urgent ex parte application seeking to restrain Biffa from calling the bond on the basis that the first call on the PCG lacked an adequate contractual basis, and in order for the condition precedent to be satisfied, the demand under the PCG was required to be *"valid"*. An interim injunction was granted in the terms sought by MW and the matter was held over to a full hearing at which Biffa was present.

The decision

At the full hearing, Mr Justice Stuart–Smith reviewed the relevant case law and emphasised the general principle that the courts will not, as a general rule, interfere with the process through which bonds are called and paid save in exceptional circumstances following the decision of the Court of Appeal in *Wuhan Gouyu Logistics Group C Ltd and another v Emporiki Bank of Greece*

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SA [2013] EWCA Civ 1679. In *Wuhan*,[3] the Court of Appeal held that in the case of on-demand bonds, the obligation to make payment crystallises immediately upon the on-demand bond being presented to the payer, and the payer can only resist payment of a conforming bond if there is a clear case of fraud on the part of the beneficiary. This finding was made despite the fact that by the time the matter had reached the Court of Appeal, it had been established in separate final and binding arbitral proceedings that the call was not contractually justifiable.

Mr Justice Stuart-Smith also referred to *Sirius International Insurance Co. v FAI General Insurance Ltd* [2003] EWCA (CIV) 470 which confirmed that a beneficiary to a bond will not be restrained from making a call on it purely because there is a dispute as to whether the underlying contract has been broken.

With the above authority in mind, Mr Justice Stuart-Smith refused to engage in the dispute between the parties in relation to the validity of the claim under the PCG in the underlying contract because, on the facts, (i) MW did not allege there was any, or any obvious, fraud known to the bank/bondsman, and (ii) the terms of the underlying contract did not preclude the beneficiary from making a call.

In relation to the second point, Mr Justice Stuart-Smith noted that the test is a strict one: the beneficiary's right to call on the bond must clearly be precluded by either the express or implied terms of the contract, and that a call will only be restrained if it is positively established that the beneficiary is not entitled to make a call on the bond; it is not sufficient for there to be a seriously arguable case that the beneficiary was not entitled to draw down under the underlying contract.

It is interesting to note that Mr Justice Stuart-Smith made specific reference to more recent authority on on-demand bonds which tended to suggest that there was a further exception which widened the strict test above; namely, that a call could be restrained where there was a strong case that the beneficiary was in breach of the underlying contract. In *Simon Carves v Ensus* [2013] EWHC 3210 (TCC), the contract provided that the bond was to become null and void upon the issue of an Acceptance Certificate, save in respect of pending or previous claims. An Acceptance Certificate had been issued, but a dispute arose as to whether any claims were pending or had been previously notified by the time of its issue. The court found that the party seeking the injunction had a strong case that the call was not permitted under the terms of the contract. Further, in *Doosan Babcock v Mabe* [2011] EWHC 657 (TCC), an injunction was granted because the court found that the contractor had a strong case that the employer was in breach of the underlying contract: the employer had refused to issue taking over certificates for various units and it was only as a result of that breach that the employer was in a position to make a call on the on-demand bond in question.

Mr Justice Stuart-Smith emphasised that under the preferred, strict approach, it was not necessary for the beneficiary to show that the reasons for making the call were *"valid"* having regard to the underlying contract. If a clear contractual preclusion could not be demonstrated, the court would not intervene purely because the alleged breach relied on by the beneficiary was unfounded, as this would deprive an on-demand bond of its commercial benefit; nor did business efficacy justify implying a term into the underlying contract requiring any call to be *"valid"*. All that was necessary was for the beneficiary to make a demand in the form required by the bond. In the current case, there was an added condition precedent in that the beneficiary first had to make a call under the PCG, but again, there was no requirement for the call under the PCG to be a *"valid"* one, nor was it necessary for such a term to be implied into the underlying contract. Mr Justice Stuart-Smith emphasised that to find otherwise would encourage protracted satellite litigation at short notice to try and establish whether or not calls on security documents were misconceived, which would subvert the normal approach of on-demand bonds.

Accordingly, the Judge found that there were no grounds upon which the call on the bond could be restrained.

Practice points

- The courts will only interfere with irrevocable obligations such as bonds in exceptional cases, and as a general rule, a beneficiary will not be restrained from calling on a bond simply because there is a dispute as to whether the underlying contract has been breached.

There are two established exceptions to this general rule: first, there is obvious fraud known to the bank; and secondly, it must be positively established that the beneficiary's right to drawdown is clearly precluded

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by the express or implied terms of the underlying contract.

- A call on an on-demand bond will only succeed if there are sufficient grounds, for example, that drawdown was not permitted without the consent of the other parties, or there was obvious fraud that was known to the bank. Documentary evidence in support of the grounds is also required.

Caterpillar Motoren GmbH & Co. KG v Mutual Benefits Assurance Company [2015] EWHC 2304 (Comm)

The facts

Caterpillar Motoren GmbH & Co. KG ("Caterpillar") entered into two subcontracts with International Construction and Engineering Inc. ("ICE") for the provision of construction services in relation to two power plants in Liberia. Each subcontract (which was in materially identical terms) required ICE to procure an advance payment bond ("APB") and a performance bond ("PB") in favour of Caterpillar, which ICE did. The APBs were described as instruments that guaranteed the due performance by ICE for an advance payment made by Caterpillar to ICE for sundry activities and/or tasks, and the PBs were described as instruments that guaranteed the due performance of all work by ICE.

Disputes subsequently arose between Caterpillar and ICE, and Caterpillar purported to terminate the subcontracts and demanded the return of advance payments and also a sum in respect of liquidated damages. ICE disputed Caterpillar's claims and called on the APBs and PBs.

As regards the APBs, Caterpillar argued that ICE had failed to execute the tasks for which an advance payment had been made. As regards the PBs, Caterpillar asserted that ICE had not complied with its obligations under the subcontracts, and that, in any event, the damages for breach by ICE exceeded the sums claimed. The bondsman, Mutual Benefits Assurance Company ("MBAC"), said that the APBs and PBs were not on-demand bonds but payment guarantees. It had not been established that ICE was liable to Caterpillar, and MBAC argued that the payment guarantees were not therefore due.

The issue before the court was whether the APBs and PBs were on-demand bonds (which were payable on demand) or payment guarantees (in which case Caterpillar would have to prove a liability). Following the decision in *Wuhan*,[4] whilst everything ultimately turns on the wording of the instrument in question, there will be a presumption that a bond is an on-demand bond where it (i) relates to an underlying transaction between parties in different jurisdictions; (ii) is issued by a bank; (iii) contains an undertaking to pay "on demand"; and (iv) does not contain clauses excluding or limiting the defences that are available to a guarantor.

The decision

Mr Justice Teare considered the terms of each bond and noted that in the case of the APBs, MBAC *"guarantees and undertakes to pay" "forthwith on demand"* and *"without reference to"* the contractor. The word *"guarantees"* could be suggested to mean that the parties intended that MBAC would only pay where ICE had failed to perform its obligations, whereas the words *"forthwith on demand"* and *"without reference to"* the contractor strongly suggested MBAC's liability was to pay the sum which was demanded by Caterpillar.

Mr Justice Teare also noted that the APBs met the *Wuhan* requirements for an on-demand bond in that they: (i) related to an underlying transaction between parties in different jurisdictions; (ii) contained an undertaking to pay on demand; and (iii) although MBAC was not a bank, it was a financial or insurance institution that was engaged in the business of providing bonds to its customers. Further, the APBs also contained clauses which excluded or limited the defences that were available to a guarantor, but this was of little consequence since it was otherwise clear that the APBs were on-demand bonds, and there was nothing in the background or language of the instruments that suggested they were intended to be payment guarantees.

As for the PBs, they provided a liability to pay *"lawful"* claims which tended to suggest a payment guarantee over an on-demand bond. There was also an obligation upon MBAC to pay Caterpillar once Caterpillar had declared that ICE was in default, but MBAC was to pay *"unconditionally" "the amount of damages claimed by"* Caterpillar, which was inconsistent with the concept of lawful claims and payment guarantees. The deciding factor, however, was that any demand was expressed as being *"conclusive"* as regards the amount that was due from MBAC, which left Mr Justice Teare in no doubt whatsoever that the PBs were on-demand bonds as opposed to payment guarantees.

Practice points

In addition to the test in *Wuhan* mentioned above, it is important to look beyond the name that is applied to a security instrument in order to

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ascertain whether it is an on-demand bond or a payment guarantee.

- An on-demand bond is in very simple terms a primary obligation that takes the form of an undertaking from the bondsman to pay a sum of money to the employer without reference to the liability of the contractor. As such, it tends to include phrases such as *"on-demand"*, payment *"without proof or conditions"*, and payment upon *"first written demand"*, all of which are indicative of on-demand bonds.

- Payment guarantees, on the other hand, are secondary obligations in which the bondsman's liability to pay the employer is contingent upon a breach by the contractor of the underlying construction contract. If the employer cannot establish a breach by the contractor then the bondsman has no liability to pay. Payment guarantees may mention the words *"guarantee"* and *"lawful claims"* or include other wording that is suggestive of a secondary obligation.

Conclusion

Caterpillar Motoren v MBAC provides yet a further example of a dispute as to whether a security instrument is an on-demand bond or guarantee. The difference between the two is critical to the beneficiary as an on-demand bond is payable immediately (so protecting cash flow) without any need to demonstrate breach and loss under the terms of the underlying contract. A payment guarantee, on the other hand, can only be called if breach of the underlying contract has been demonstrated and any loss crystallised (but not settled) by the contracting parties. This can be a time-consuming and occasionally impossible task if one or both of the contracting parties is insolvent, and on-demand bonds are therefore a preferable form of security to payment guarantees.

The decision in *MW v Biffa* confirms the traditional position that on-demand bonds are important commercial instruments that should, to all intents and purposes, be equivalent to cash, and should not be subject to a preliminary dispute as to whether the underlying demand is justifiable, which goes against the usual pay now, argue later ethos of on-demand bonds. The wider approach to calls on bonds that has been adopted by the courts in recent years, as demonstrated by the *Simon Carves v Ensus* and *Doosan Babcock v Mabe* decisions, has been replaced by a return to the traditional, more restrictive approach seen in *Wuhan* that requires any alleged restrictions on the right to call on-demand bonds to be positively established before any injunction will be granted restraining the call. The decisions in *Simon Carves v Ensus* and *Doosan Babcock v Mabe* do, however, provide scope for challenge and it is therefore hoped that the Court of Appeal will in time provide authoritative guidance in order to reconfirm the accepted approach once and for all.

Footnotes

1. This is particularly so in the international context where on-demand bonds are often the only effective form of security in the event of default.

2. See http://www.fenwickelliott.com/files/insight_issue_36.pdf.

3. Which was covered in detail in the 36th issue of *Insight*.

4. Supra.

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