Fenwick Elliott
The construction & energy law specialists

Issue 6 December 2011

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

In this issue find out what you need to know about negotiating a bond or guarantee

Insight

Negotiating a bond or guarantee

This month in our sister newsletter *Dispatch*, we reported on the case of *Kookmin Bank v Rainy Sky SA & Others*[1] where the Supreme Court preferred the Buyers' construction of a bond because it was consistent with the commercial purpose of the instrument. In the course of his judgment, Lord Clarke noted that the language used by the parties will often have more than one potential meaning. If there are two possible constructions, then the Court is entitled to prefer the construction which is the more consistent with business common sense and to reject the other. In the *Kookmin* case, the common sense view was that the bond covered the obligation to refund the full amount of all advance payments made in the event of the Builder's insolvency.

Albeit a victory for common sense, one of the more telling points of that case, was that it ended up in the Supreme Court. This illustrates the need to take particular care when negotiating bonds to ensure that the commercial requirements of the parties are clear and well documented so as to minimise the risk of subsequent disputes. We thought it might be sensible to end the year with some practical tips and advice for negotiating bonds and guarantees.

Bond or guarantee?

One cause of misunderstanding is the wide variety of names which are applied to bonds and guarantees in the construction industry. These include: on-demand bonds, simple bonds, performance bonds, conditional-demand bonds, bank guarantees, demand guarantees, default bonds, performance bonds, surety bonds, surety guarantees and parent company guarantees. It is important to look beyond the names applied to these documents. The label attached to a document is not conclusive as to the legal principles upon which it is based.

Basic legal principles

Essentially the document should be based on one of two fundamentally different legal principles.

(i) Primary obligation. This is simply an undertaking from the bondsman to pay a sum of money to the client without reference to the liability of the contractor. It is this principle which underlies a true "on-demand" bond. These bonds are common on international projects but less so in the UK domestic market (except in the case of advance payment and retention bonds).

(ii) Secondary obligation (usually in the form of a guarantee). This is where the bondsman's liability to pay the client is contingent upon a breach by the contractor of the underlying construction contract. So if the client cannot establish a breach by the contractor then the bondsman has no liability to pay. It is this principle that underlies the default bond, which is the more common form of guarantee used in UK projects.

It is not always easy to distinguish whether a bond is truly on-demand or whether it is conditional upon breach of the construction contract. Clever (or not so clever) drafting also sometimes means that bonds fall somewhere in between.

Typical wording

In a true "on-demand" bond you would usually expect to find wording along the following lines:

"I promise to pay you £X on receipt of your written request without proof or conditions".

The key criteria is that payment is to be made without condition, and note that if this is the effect of the wording, it is not necessary that the instrument includes the words "on demand".

In contrast, a guarantee should reflect the secondary nature of the obligation i.e. that payment will only be made if there is a breach or default and loss sustained under the construction contract. Here the following typical wording should appear:

"The Guarantor guarantees to the client that in the event of a breach of the Contract by the contractor the Guarantor shall discharge the damages sustained by the client as established and ascertained pursuant to and in accordance with the Building Contract"

Impact of the law of guarantee

The principal requirement of bonds and guarantees is that they be clearly written but guarantees are subject to the specific principles of the law of guarantee.

A guarantee is similar to a simple contract in that all the requirements for a contract must be present, such as an intention to create legal relations, consideration, etc. In addition to this, a guarantee must be in writing and signed to be enforceable. In the *"Action Strength"*[2] case a subcontractor sought payment directly from the client where the main contractor had become insolvent. The subcontractor's claim was on the basis that the client had said that the subcontractor should carry on working and that the client would ensure that he got paid.

The sub contractor's claim failed on the basis that the apparent "guarantee" by the client in respect of the main contractor's payment obligations had not been recorded in writing and so could not constitute a guarantee. This case is obviously a warning to contractors and subcontractors who proceed on the strength of a verbal

1 [2011] UKSC 50
2 [2009] UKHL 17

Insight

assurance from a third party that they will be paid. The effect of the verbal assurance was probably intended to act as a guarantee but failed to satisfy the requirements of a guarantee.

Note that with modern forms of communication the requirement for a signature may be satisfied without the guarantor having actually put pen to paper[3]

One of the basic rules of a guarantee is that any variation in the construction contract can discharge the bondsman from liability. It is for this reason that the following wording often referred to as an "Indulgence Clause" will usually be present in any default bond:

"The Guarantor shall not be discharged or released by any alteration of any of the terms, conditions and provisions of the Contract or in the extent or nature of the Works and no allowance of time by the client under or in respect of the Contract or the Works shall in any way release, reduce or affect the liability of the Guarantor under this Guarantee Bond"

There is no need for such wording in on-demand bonds because they are a primary obligation operating independently of the underlying construction contract. A word of warning about relying on such wording: if the amendment to the construction contract is significant then it is still advisable to get the consent of the bondsman. *Hackney Empire Ltd v Aviva Insurance UK Ltd*[4] supports the principle that a performance bond including an indulgence clause protects clients where contractual variations are made without consent, but not without qualification.

Practical advice

To conclude, we thought it might be sensible to set out some tips when you are asked to negotiate a bond or guarantee.

1 Ideally, when proposing a bond or guarantee you should have a draft "model" form of wording available for consideration. Where a model form is being used, parties should still approach so called "tried and tested" precedents with caution. Precedents are only tried and tested to the extent that they have not been analysed by a Court and found to be wanting. It is entirely possible that a precedent form may have been used previously without those signing it have ever fully understood its effects.

2 The following general points ought to be considered on first review of a draft form of wording for a bond or guarantee:

2.1 Does the text include phrases like "on-demand", "without proof or condition" and "primary obligor"? (These will obviously point to an intention to impose a primary obligation).

2.2 Is it intended that the guarantee or bond is to be issued by a bank (or by a specific bank) or by a parent company?

2.3 Does the wording mention a fixed or maximum value of the security required?

2.4 Is there apparent evidence of amendment of a standard form?

3 The priority when being presented with a draft document should be to establish whether or not the client is looking for security in the form of a primary or secondary obligation. Any request for an "on-demand" bond in a domestic context should be firmly resisted by contractors, and clients should expect to have to fully justify why they feel the need to have such a potentially drastic security option. In most circumstances the negotiated position will be the offer of a conditional bond as a reasonable alternative by the contractor or dependant on the strength of a clients' negotiating position, a negotiated maximum "on-demand" sum.

4 Turning to the small print, as with any other contract the general question to think about when considering the detailed terms and conditions is something like: "Does the wording clearly describe the obligations of the parties and prescribe the outcomes for all of the relevant eventualities?" If the client wants a primary obligation and the contractor is willing to concede this then it is in the interests of both parties to make sure this is clearly expressed so that future disputes may be avoided.

5 It is important that the small print is consistently clear (ambiguity leads to arguments) as to the following issues:

5.1 The nature of the obligation imposed.

5.2 The period over which the obligation is to be maintained and/or the expiry date.

5.3 The maximum or aggregate maximum sum payable.

5.4 The mechanism by which notice of demand is be provided.

5.5 What amounts to a default?

5.6 If it is necessary for a loss to be "sustained" and how that sustained loss is to be proved.

5.7 Those events that will discharge the guarantor's obligations.

5.8 How disputes are to be resolved and pursuant to what law (just in case).

If you would like to know more, please go to the Research & Insight section of our new website - http://www.fenwickelliott.co.uk/research-insight where you can find an article by Julie Stagg entitled "Payment, security and challenging times".

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 *Golden Ocean Group Ltd v Salgaocar Mining Industries Pvt Ltd* [2011] EWHC 56 and *WS Tankship II BV v Kwangju Bank Ltd* (25 November 2011)
4 [2011] EWHC 2378