

On-Demand Bonds, Injunctions and FIDIC Contracts

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Bonds and guarantees will usually be required in any major construction project and they are a requirement within FIDIC standard forms. An on-demand bond is a security that unconditionally requires a Bank or other surety to pay to the beneficiary a sum of money once a demand has been made and, on occasion, on the presentation of certain documents. This can be contrasted with a normal guarantee which will usually require the beneficiary to prove a liability against the obligor/debtor who has the benefit of the guarantee. These normal types of guarantees are commonly referred to as "see to it" guarantees.¹

Employers often ask whether they are entitled to make a call on an on-demand bond where a dispute exists, and contractors will want to know whether they are able to restrain the call on the bond. In this article we will look at several recent common law cases on this issue where the parties have used on-demand bonds drafted in terms similar to those found within the FIDIC forms of contract.

The Example Form of Performance Security – Demand Guarantee within the FIDIC Red Book 2017 at Annex C of the Guidance provides that a payment will be made of a sum not exceeding the Guaranteed Amount "upon receipt by us of your demand in writing and your written statement indicating in what respect the Applicant is in breach of its obligations under the Contract."²

An initial point to make is that the wording of the bond is fundamental to whether a call on a demand bond will be successful, as is the applicable law.³

There are three core principles applicable to on-demand bonds under English law:⁴



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- 1) on-demand bonds are regarded as the equivalent of cash and an injunction that prevents a bank from complying with its obligations under such an instrument is seen as interfering with that principle;
- 2) it is inherent in agreeing to provide an on-demand bond that the party providing that bond has agreed to payment being made notwithstanding the existence of a dispute as to the beneficiary's entitlement to payment; and
- 3) the bank or surety has made a promise in its capacity as a banker/surety and generally the court will not use its coercive powers to cause a bank or

¹ In *Moschi v Lep Air Services Ltd* [1973] AC 331, 348 Lord Diplock stated that the nature of the guarantor's obligation was "to see to it that the debtor performed its own obligation to the creditor".

² The Example Form of Performance Security -Demand Guarantee in the 1999 Red Book is worded slightly differently and the Employer must state that the Contractor is in breach and the respect in which the Contractor is in breach.

³ *Shanghai Shipyard Co. Ltd. V Reignwood International Investment (Group) Company Ltd* [2021] EWCA Civ 1147 (23 July 2021) [36] to [49]

⁴ *Shapoorji Palloni & Co Pty Ltd v Yumn Ltd and Standard Chartered Bank* [2021] EWHC 862 (Comm) at [18] and see also *Bol vanter Oil SA v Chase Manhattan Bank* [1984] 1 WLR 32, and *Tectronics International Ltd v HSBC Bank Plc* [2018] EWHC 201 at [23] to [28]



surety to dishonour its promise and thereby run the risk of damage to its reputation.

English courts will rarely injunct a call on an on-demand bond. There are two established exceptions: (a) where a condition precedent has not been complied with; and (b) where there is a strong case that there has been fraud. A third exception has on occasion been successfully argued but recent English case law appears to row back from this exception as being one that is generally applicable. This third exception has been termed as the "underlying contract exception". In the following sections of this article each exception is considered having regard to English law and other commonwealth case law. I also briefly look at the "unconscionability" exception which forms part of Australian and Singapore law.

Conditions Precedent to a Call on the Bond

Some on-demand bonds include conditions precedent to the call on the bond. These conditions precedent may be expressly stipulated within the bond itself or may be incorporated by reference. They may require specific wording for the call or that specific documents be annexed to the call. In the FIDIC Example Form of Performance Security – Demand Guarantee in the 1999 FIDIC forms, the bond is stated to be subject to Uniform Rules for Demand Guarantee ("URDG") published as number 458 by the International Chamber of Commerce. In the 2017 FIDIC forms the rules stated are URDG 2010 Revision, ICC Publication No. 758.

A call on a bond which is subject to the URDG No. 458 must be supported by a written statement stating: (i) that the contractor is "in breach of his obligations under the underlying contract", and (ii) "the respect in which" the contractor is "in breach". This is mirrored in the express wording of the Example Form of Performance Security in FIDIC's Red Book 1999. Similarly, URDG No. 758 states that the demand (or a

supporting document) must state in "what respect the applicant is in breach of its obligations under the underlying relationship."⁵ A failure to include such statements or any documents expressly required to be annexed to the demand would therefore make the call non-compliant. In such a case the court may grant an injunction to restrain (a) the beneficiary from making a call on the bond, where it is in breach of an express obligation,⁶ or (b) the bank or other surety making payment when a call has been made.

Users of FIDIC's Pink Book should note that at Annex H of the Sample Forms, the Advance Payment Security is worded so that the written statement making a call on the demand bond must state that: "the Contractor is in breach of its obligation under the Contract because the Contractor used the advance payment for purposes other than the costs of mobilization in respect of the Works." Again, this is a condition precedent and a failure to include this statement in the call will make the call invalid.

The Fraud Exception

English law considers that on-demand bonds are equivalent to cash and that an injunction preventing the call on a bond would undermine this principle. It is therefore immaterial whether there is a dispute or not regarding the entitlement of the beneficiary to call the bond. However, an English court will restrain a call on an on-demand bond if (a) the beneficiary could not honestly believe that it was entitled to make the demand; and (b) the bank was aware that the demand was fraudulent.⁷

In order to succeed in alleging fraud a party must show that there is a strong case. This is often referred to as the "enhanced evidentiary standard".⁸ Proof of the fraud will have to be established and obvious.⁹ In many cases, therefore, a party will fail to provide the requisite proof of fraud.¹⁰

⁵ See Article 15 of URDG No. 758. In *Shanghai Co Ltd v Reignwood International Investment (Group) Co Ltd* [2021] EWCA Civ 1147 at [24] the Court of Appeal referred expressly to the ICC Uniform Rules for Demand Guarantees as creating a condition precedent.

⁶ *Sirius International Insurance Co v FAI General Insurance Ltd* [2003] EWCA Civ 470; and *MW High Tech Projects UK Ltd v Biffa Waste Services Ltd* [2015] EWHC 949.

⁷ *Edward Owen Engineering v Barclays Bank International Ltd* [1978] 1 QB 159; and *United City Merchants (Investments) Ltd v Royal Bank*

of Canada & Ord [1982] 2 Lloyd's Rep 1; and *Alternative Power Solution Ltd v Central Electricity Board & Anr* [2014] UKPC 31

⁸ *Sharpoorji Pallonji & Co Pvt Ltd v Yumn Ltd and Standard Charter Bank* [2021] EWHC 862 (Comm)

⁹ *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159 at 169

¹⁰ *Permasteelisa Japan KK v Vouyguesstroi and Banca Intesa SpA* [2007] EWHC 3508



The Underlying Contract Exception

The underlying contract exception provides that a "court will generally grant an injunction to restrain a beneficiary from breaching an express obligation contained in the underlying commercial agreement not to make demand other than in defined circumstances."¹¹ The obligation must be express and does extend to a dispute on the facts of the case. In this regard an Employer will need to have regard to FIDIC's Clause 4.2¹² which sets out when a call can be made.

In *Potton Homes Ltd v Coleman Contractors Ltd*¹³ the Court of Appeal considered whether a failure to pay, for example, an advance payment under the underlying contract would be a material fact to consider in restraining a call on a performance bond. The court thought it would. Eveleigh LJ stated: "If the contractor was unable to perform because the employer failed to provide finance, it would seem to be wrong to me if the court was not entitled to have regard to the terms of the underlying contract."

The approach of the English courts was followed by the High Court of Singapore in *Kvaerner Singapore Pte Ltd v UDL Shipbuilding (Singapore) Pte Ltd*.¹⁴ The facts were that Kvaerner was asked to provide a banker's guarantee for \$300,000 which it did. The defendant was to provide an irrevocable letter of credit for \$700,000. The defendant provided a letter of credit for \$300,000 but failed to provide a letter of credit for the remainder. The defendant made a demand on the banker's guarantee which had been provided by Kvaerner. An injunction was granted restraining the call on the bond on the basis that the provision of the letter of credit for \$700,000 was a condition precedent to Kvaerner's obligation to ship the goods.

In *Sirus International Insurance Co v FAI General Insurance Ltd*¹⁵ the English Court of Appeal looked at the question of whether a call on a letter of credit was valid where there was an express requirement in the underlying agreement regarding the entitlement to make that call. The court held that if that express

requirement had not been met it would have been entitled to injunct the call. The court, however, found that the express requirement was satisfied. May LJ held that:¹⁶

"The terms included express contractual restrictions on the circumstances in which Sirius would be entitled to draw on the letter of credit. To that extent the letter of credit was less than the equivalent of cash and Sirius's security was correspondingly restricted."

In the case of *Simon Carves Ltd v Ensus UK Ltd*¹⁷ Akenhead J considered whether he should continue to restrain a call on a bond, where an acceptance certificate had been issued which should have resulted in the return to the contractor of the performance bond. Akenhead J held that there was a strong case on the evidence that the bond was null and void and should have been returned to the contractor.¹⁸ He therefore ordered that the injunction should continue. Akenhead J suggested that the failure to return the bond might in fact be considered to be a type of fraud. He then gave the following example where a court might restrain a call on an on-demand bond:

"One can pose this example: on a commercial contract in which there is a bond in favour of the beneficiary party, the parties reach a full and final settlement which expressly requires the bond to be returned to the other party and no further calls to be made on the bond. If the beneficiary party in those circumstances seeks to call on the bond, in breach of the settlement terms, the Court could properly restrain the beneficiary from doing either because it is committing a straight breach of contract or because it is or should be taken to be clear fraud by the beneficiary."

¹¹ *Sharpoorji Pallonji & Co Pvt Ltd v Yumn Ltd and Standard Charter Bank* [2021] EWHC 862 (Comm) at [20]

¹² See Clause 4.2.2 under FIDIC's Red Book 2017

¹³ (1984) 28 BLR 19 (CA)

¹⁴ (1993) 2 SLR 350; and see also *Royal Design Studio Pte Ltd v Chang Development Pte Ltd* [1991] 2 MLJ 229 [2003] 1 WLR 2214

¹⁵ [2003] 1 WLR 2214

¹⁶ *Ibid* at [27]

¹⁷ [2011] EWHC 657 (TCC)

¹⁸ *Ibid* at [37]



The approach adopted by Akenhead J in the *Simon Carves* case was applied in *Doosan Babcock v Comercializadora de Equipos ("MABE")*,¹⁹ where an injunction was granted preventing the call on two on-demand type bonds. In this case the judge found that the employer's refusal to take over two units of the plant was itself a breach of contract and that its entitlement to make a call on the bonds was dependent on its wrongful refusal to take over the two units.

A similar situation arose in the case of *Aveng (Africa) Pty and Strabag International GmbH v South African National Roads Agency SOC Ltd*.²⁰ This was a case based on a FIDIC contract which came before the Supreme Court of Appeal in South Africa. The contractor alleged that a force majeure event had rendered the performance of the contract impossible and asserted that it was therefore released from future performance. The employer disagreed and demanded performance failing which it would terminate the contract, which it did subsequently. In accordance with clause 20 of the contract, the dispute was referred to arbitration. The contractor thereafter sought an assurance from the employer that it would not call upon the bond. The employer declined to give this assurance and notified its intention to make a call. The contractor sought an injunction from the court to restrain the employer making a call pending the arbitration proceedings. At first instance the court decided that the contractor had failed to make out a claim that a force majeure event had occurred.

The Supreme Court of Appeal in the *Aveng* case set out the law, which was in all material respects identical to the position under English law. The contractor argued that the underlying contract exception restricted or qualified the beneficiary's right to make a call.²¹ It was argued that if, for example, the parties had agreed that a specific event would occur prior to the calling of the security then it would be fraud if a party made a call on the security if the event

had not occurred.²² The South African Supreme Court referred to the Australian case of *Kwikspace Modular Buildings Ltd v Sabodala Mining Co Sarl*²³ and the English cases of *Potton Homes* and *Simon Carves* as authorities supporting the underlying contract exception. Makgoka JA then stated that²⁴

"I am willing to assume that there is room in South African law to follow the same path as that taken in Australian and English law"

where if the contractor can show that a beneficiary would breach a term of the building contract if it made a call, this would be a basis for the granting of an injunction. However, on the facts the contractor failed to prove this exception.²⁵

It has, however, recently been suggested that the English courts are making a strategic retreat from the principles set out in the *Doosan and Simon Carves* cases.²⁶ In *MW High Tech Projects UK Ltd v Biffa Waste Services Ltd*²⁷ Mr Justice Stuart Smith refused to consider the underlying dispute. Mr Justice Stuart-Smith relied on recent Court of Appeal authority²⁸ that suggested that on-demand bonds and similar types of guarantees were autonomous contracts, independent of disputes between the buyer and seller. Mr Justice Stuart Smith emphasized that the only two grounds for making a call were under the fraud exception and where the conditions precedent for a call on the bond had not been met or where it has been "*positively established that he was not entitled to draw down under the underlying contract.*"

Similarly, in *Yuanda (UK) Company Ltd v Multiplex Construction Europe Ltd & Anor*²⁹ Frazer J in the Technology and Contract Court stated as obiter

¹⁹ [2013] EWHC 3201 (TCC)

²⁰ Case No 577/2019 [2020] ZASCA 146

²¹ *Ibid* at [9]

²² See *Union Carriage and Wagon Co Ltd v Nedcor Bank* 1996 CLR 724 (W)

²³ [2010] ZASCA 15

²⁴ [2020] ZASCA 146 at [17]

²⁵ For the approach of other jurisdictions see *Hamed Alavi Contractual restrictions on Right of Beneficiary to Draw on a letter of*

Credit; Possible Exception to Principle of Autonomy (2016) ICLR Vol 16, No 2 page 67

²⁶ See *On Demand Bonds: A Strategic Retreat*, Fenwick Elliot International Quarterly, Issue 14

²⁷ [2015] EWHC 949

²⁸ *Wuhan Guoyu Logistics Group Co Ltd v Emporiki Bank of Greece SA* [2013] EWCA (CIV 1679)

²⁹ [2020] EWHC 468 (TCC)



that the grounds for restraining a call on an on-demand bond were limited.³⁰

"Injunctions restraining banks from paying out under on-demand bonds or other similar instruments of primary obligation, such as letters of credit, are very rarely granted. For a claim to succeed against a bank, the facts must satisfy the fraud exception to the autonomy principle."

However, the underlying contract exception was not argued before Frazer J and his comments were therefore made without consideration of the authorities from both the High Courts and Court of Appeal.

Whether there has been a retreat in English law from the underlying contract exception is unclear. There are High Court and Court of Appeal decisions that support the exception and other authorities that reject it. Given the uncertainty within English law, it would now be helpful to have clarification from the Supreme Court on the position.

Unconscionability

Under Australian and Singapore law, a ground for injuncting a call on an on-demand bond is the unconscionability of the principal. Under Singapore law the unconscionability principle has been expressed as follows: "*where it can be said that the buyer has no honest belief that the seller has failed or refused to perform its obligation, a demand by the buyers in my view is a dishonest act which would justify a restraint order.*"³¹ While the unconscionability principle has not been adopted under English law, language similar to it can be found in a few cases. In *TTI Team Telecom International v Hutchinson 3g UK Ltd*³² it was argued that the person making the call did not honestly believe that it was entitled to make the call and this amounted to bad faith. The court stated that if bad faith is to be alleged it must be both significant and clearly established.³³ On the facts the application for an injunction failed.

³⁰ *Ibid* at [105].

³¹ *Samwoh Asphalt Premix Pte Ltd v Sum Cheong Piling Private Limited and Another* [2001] SGCA 79 at [21]

Conclusion

There are only a limited number of grounds where a court will restrain the calling of an on-demand bond under English law. In other common law jurisdictions, there are broader grounds on which an injunction will be issued. In civil law countries where obligations of good faith exist then the grounds can be even wider. An Employer under a FIDIC form of contract that wishes to restrict the grounds on which an injunction would be granted may be wise to require the on-demand bond be subject to the laws of England and Wales. Alternatively, clear words should be used in the bond to exclude any consideration of the underlying contract.

Please get in touch at taner.dedezade@howardkennedy.com with your thoughts or to discuss any concern

³² [2003] EWHC 762 (TCC); see also *Elian and Rabbath v Matsas* [1966] 2 LI R 495

³³ *TTI Team Telecom International v Hutchinson 3g UK Ltd* [2003] EWHC 762 (TCC) at [37]

