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SECURITY FOR PAYMENT: BONDS AND GUARANTEES – FIVE PITFALLS AND PROTECTION

By Jonathan Hosie

In the current economic climate, security for payment is key. Although banks have started to lend money again, they remain cautious and those construction firms with weak balance sheets remain at risk of insolvency. *This article will discuss five pitfalls in the context of some relevant case-law and will suggest how to protect against these.*

Bonds and guarantee provide a form of security for the contractor's performance and also a measure of protection against insolvency. In the construction sector, there are a number of different types of bonds and guarantees available, the most common of which are parent company guarantees and performance bonds. The precise nature of a guarantor's obligations pursuant to a guarantee or a bond depends upon whether, on construction of the document, it operates as either a **"guarantee"** or an **"on-demand"** payment obligation. It may be useful to provide the reader with a brief summary of this distinction.

"Guarantees" versus "on demand" payment obligations

A guarantee is a promise to answer for the debt, default or miscarriage of another. The obligation to make payment under the guarantee is dependent on the beneficiary establishing the principal's liability under the underlying contract. The guarantor's liability is co-extensive with that of the principal so the guarantor can rely on all rights, counterclaims and

defences available to the principal. The contract of guarantee must be evidenced in writing and signed by the guarantor or his agent: section 4, Statute of Frauds 1677.

Pursuant to a bond, the bondsman promises to pay the beneficiary a sum of money up to the value of the bond if the debtor fails to perform the underlying contractual obligation. There are broadly two types of bond; the default and the on-demand form. In the former, the beneficiary has to prove that there has been a breach of the underlying contract and the amount of loss caused by such breach. In the latter on-demand form, the beneficiary does not need to prove that this breach has occurred or that it incurred any loss in order to call the bond and receive the payment. As a matter of law, the only basis on which an on-demand bond can be resisted is if the call is made fraudulently.

Pitfalls and Protection

1. Variations to underlying contract

As a guarantor's obligations are co-extensive with the principal's obligations under the underlying contract, the guarantor will be discharged if there is a material variation or alteration in the underlying contract without the guarantor's consent. A material variation is one which cannot be seen to be unsubstantial or is one that could be prejudicial to the guarantor. This is the rule in *Holme v Brunskill* (1878) 3 QBD 495.



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The defendant in *Holme v Brunskill* entered into an arrangement to guarantee that the tenant of a farm would deliver up the farm and the associated flock of 700 sheep at the expiration of the lease in good condition and order. The lease was later varied without the knowledge of the guarantor and the tenant agreed to surrender a small field in exchange for a reduction in the rent. At the end of the term the sheep had reduced in number and had deteriorated in quality and value. The Court of Appeal held that the guarantor was discharged because it was possible that the surrender of the field could have affected the tenant's ability to care for the sheep and therefore the guarantor may have been prejudiced by the variation. In brief, the tenant's final obligations (by virtue of the variations) was not something that the guarantor had agreed to cover.

To avoid the application of the rule in *Holme v Brunskill*, guarantees usually contain clauses in which the guarantor gives advance consent for variations and amendments to the underlying contract. These are sometimes referred to as "indulgence clauses".

However, a decision of the Court of Appeal, *Triodos Bank NV v Dobbs* [2005] EWCA Civ 630, highlights that there are limits to the extent to which a guarantor's advance consent to variations to the underlying contract pursuant to an indulgence clause can make him responsible for those obligations as varied.

In *Triodos* the defendant director executed a personal guarantee in 1996 whereby he agreed to pay all monies due and owing to the claimant bank "under or pursuant to" two loan agreements made between the company and the bank. The guarantee was limited to £50,000 and the total amount under the loan agreements was £900,000. The guarantee included an indulgence clause. The bank entered into further loan agreements which were stated to 'replace' the earlier agreements up to a sum of £2.6 million. The defendant knew about the terms of the facilities but had not countersigned the agreements. When the bank came to call for the repayment of the monies there

was a shortfall and the bank sought to call on the guarantee.

The judge at first instance declared that the guarantee extended to the borrowing under the later loan agreements. However, the Court of Appeal disagreed and held that the later loan agreement was not an amendment or variation of the original loan agreements which was within the purview or general scope of the original loan agreement. This was because the language of the indulgence clause was found not to extend to such matters.

The decision illustrates the importance of casting the terms of indulgence clauses sufficiently wide so as to try to ensure that changes to the underlying contract would fall within the purview of the original guarantee.

PROTECTION: The solution to the problem identified in *Triodos*, is to obtain the guarantor's written agreement confirming that the existing guarantee remains in force and covers the amendment or variation of the underlying agreement or obtain a new guarantee. The mechanism for this will need to be in the original guarantee. In addition, parties may wish to tailor any indulgence clauses so as to provide for the types of variations that may be foreseen, particularly where significant scope change is possible. If there are step-in rights in the underlying contract, parties may also wish to include an obligation for the guarantor to enter into a new guarantee upon novation of the underlying contract because such novation will be a "new" contract, not a simple variation of the original one.

2. Is insolvency an act of default?

In *Perar BV v General Surety & Guarantee Ltd* (1994) 66 BLR 72, the building contract automatically terminated because the contractor went into administrative receivership. However, the employer treated that event as a "default" and made a claim under a performance bond. The Court of Appeal held that the non-performance of the contractor after the automatic termination was not a breach of the contract enabling the employer to call upon

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the bond; the form of contract (JCT with contractor's design 1981 edition) provided a code for what would happen in the event of insolvency and each party's liability to the other but this did not mean that an act of insolvency, by itself, was a "default".

Similar clauses appear under standard forms used in the civil engineering sector. Thus, Clause 65 of the ICE Conditions of Contract Design and Construct 2nd edition September 2001 and Clauses 90 to 93 of NEC core clauses (3rd edition) both provide (broadly) that where there has been a termination of the contractor's employment for insolvency, further payment is postponed. However and unlike under the JCT forms, the ascertainment process is not necessarily postponed until after completion of the works and making good of defects. Rather, under the ICE and NEC forms, the Employer's Agent or Project Manager (depending upon the form) has the power to certify a final payment earlier. However, the risk remains that the obligation for the contractor to account may be after the date of expiry of the performance bond if this has a fixed date duration.

PROTECTION: If you want to be able to call on the bond for an event of insolvency, the underlying contract should make it clear that this will be a "default" so as to trigger liability under the bond. Note that it is doubtful that the ABI form of bond would respond to contractor insolvency so this should be amended. As to the duration of the bond, it should also be made clear that this is co-extensive with the determination of any account following termination due to insolvency.

3. Guarantees by email

It is increasingly common for parties to correspond almost exclusively by email and therefore it is more common that documents said to evidence a promise to stand as guarantor have been generated electronically.

A recent case has confirmed that although a promise to act as guarantor in an email was "evidence in writing" for the purposes of

section 4 of the Statutes of Frauds¹⁶⁷⁷, an email address in the header of a message did not constitute a signature by the guarantor for the purposes of section 4: *Mehta v J Pereira Fernandes SA* [2006] 1 WLR 1543. However, the judge in *Mehta* said that "if a party or a party's agent sending an e-mail types his or her or his or her principal's name to the extent required or permitted by existing case law in the body of an e-mail, then in my view that would be a sufficient signature for the purposes of s4."

PROTECTION: Be aware of the potential to enter into a obligation as a result of an email and where on the receiving end of such a guarantee, take steps to ensure the document is validly "signed".

4. Adjudication decisions

In the absence of explicit words, a guarantor is not liable to pay any amount which may be awarded against the principal debtor by a third person, be it by a judge, jury or arbitrator (*Re Kitchen* [1881] 17 ChD 668 and *The Vasso* [1979] 2 Lloyd's Rep 412). This is the case regardless of whether the underlying contract provides for such resolution of disputes. The rationale behind this is that the guarantor was not a party to those proceedings.

Mr Justice Ramsey in *Beck Interiors Limited v Dr Mario Luca Russo* [2009] EWHC B32 has extended the principle outlined above to adjudication awards. In this case, Dr Russo had given a personal guarantee on behalf of a company in which he was a 90% shareholder. The company had entered into a contract with the claimant to build a spa at Westfield Shopping Centre. The company terminated the contract with the claimant and the claimant started and succeeded against the company in adjudication proceedings. However, it was unable to recover sums awarded under an adjudication award because the enforcement proceedings against the company were stayed as the company was insolvent. As a result, the claimant sought to recover sums under the adjudicator's award from Dr. Russo under the guarantee. However, the application for summary

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judgement failed for a number of reasons including that Mr Justice Ramsey decided that Dr. Russo had a real prospect of successfully defending the claim on the basis that Dr Russo was not bound by the Adjudicator's decision.

PROTECTION: To overcome this difficulty, the guarantee should contain an obligation on the part of the guarantor to be bound by the decision of an adjudicator, arbitrator or the court as between the parties to the contract or other means under which an underlying dispute arises. Further and given that adjudication decisions are temporarily binding in nature, provision should also be made which says that the guarantor will satisfy and discharge an adjudicator's award subject to the repayment by the beneficiary of any amounts determined in subsequent proceedings not to be owing to the beneficiary.

5. Amount recoverable under on-demand bonds

The Court of Appeal decision in *Edward Owen v Barclays Bank International Ltd* [1978] QB 159 is authority for the proposition that on-demand bonds are enforceable notwithstanding objections about whether the principal debtor is in default; only proof of fraud on the part of the claimant can defeat a call on the bond. However, in *Cargill International SA v Bangladesh Sugar and Food Industries Corporation* [1998] 1 WLR 461, the Court of Appeal held that the principal debtor was entitled to recover any sum paid pursuant to an on-demand bond which represented overpayment once the full extent of the actual damage had been ascertained.

A recent decision of the Commercial Court has considered the perennial question as to whether the full amount under an on-demand bond can be recovered under the bond even though it exceeds the liability under the underlying contract or whether such a demand constitutes fraud. In the case of *Enka Insaat Ve Sanayi A.S. v Banca Popolare Dell'Alto Adige SPA and another* [2009] All ER (D) 61, Mr Justice Teare considered the authorities and held that the amount which a person is entitled to

demand under a bond depends upon the true construction of the bond in question. On the facts and the specific form of wording in the bonds ("accordingly ENKA is entitled to receive payment") he concluded that there was no requirement for the beneficiary to have suffered damage in the amount claimed. He also said that if the beneficiary could only claim such sums as it estimated represented the loss and damage suffered, the bond would have included express terms to that effect. On this basis, the principal debtor would have to commence proceedings to recover the difference once the actual extent of the loss had been ascertained.

PROTECTION: Enka is a reminder of the unique nature of on-demand bonds and that depending on the construction of the performance bond, beneficiaries may be able to call on the bonds in their entirety notwithstanding that their actual loss is far less than the amount of the bond. Parties should always consider whether an on-demand bond is appropriate in the circumstances. Further, clear words are required if the intention is to limit a call on the bond to that which represents the loss and damage suffered.

Summary of key points:

- A guarantor may be discharged by variations or other changes to an underlying contract notwithstanding an indulgence clause in the guarantee. Always consider the scope of the clause and draft this widely to try to capture future events. In addition, consider obtaining the guarantor's agreement to enter into a new guarantee in circumstances where the original contract is replaced altogether (typically where a novation is contemplated).
- Ensure that insolvency is recorded expressly as an act of default in the words of the bond or guarantee and check the terms of the underlying contract to ensure these are consistent.
- Remember that a guarantee has to be in writing but can be entered into by email and needs to be "signed" by the guarantor.

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- Note that guarantors are not bound by the decisions of adjudicators in respect of liability of the principal debtor unless there are express words to the contrary in the guarantee or bond.
- Be conscious of the risks associated with on-demand bonds. Fraud continues to be a very high hurdle to jump and depending on the wording, beneficiaries to an on-demand bond will be entitled to claim all monies under the bond regardless of whether this is commensurate with the loss or damage suffered. Where an on-demand bond is required, consider limiting it to the actual loss incurred at the point of demand so as to avoid costly and uncertain recovery proceedings later.