PERFORMANCE BONDS AND GUARANTEES: CONSTRUCTION OWNERS AND PROFESSIONALS BEWARE

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ABSTRACT: Performance bonds and guarantees have been the subject of considerable litigation in recent years in not only the United Kingdom but also some other common law jurisdictions. The aim of the research reported in this paper is to identify the issues most commonly in dispute and the legal principles governing their resolution. Possession of knowledge of the issues and principle should alert the construction and engineering industries and their legal advisers to the matters that need serious attention in the drafting and negotiation of these instruments. Clarity in the legal principles should also contribute to a reduction in litigation. The issues identified include: (1) Whether an instrument is a conditional or an on-demand bond; (2) the effect of failure on the part of the beneficiary to give notices; (3) availability of an injunction to restrain the surety from paying after a call has been made by the beneficiary; (4) availability of an injunction to restrain a beneficiary from receiving payment after a demand has been made; (5) availability of an injunction to restrain a beneficiary from making claim; (6) availability of a Mareva injunction to freeze the fruits of a call; (7) meanings of certain phrases used in the instruments; and (8) a duty to account for proceeds of a call. The principles governing their resolution were also identified. Particular attention must be paid to (1) any ambiguity whether a surety is liable is always construed in the surety's favor; and (2) prejudicial conduct by the beneficiary releases the surety unless the instrument provides expressly to the contrary.

INTRODUCTION

Performance bonds and guarantees have been the subject of considerable litigation in recent years, in not only the United Kingdom but also some other common law jurisdictions. This suggests some confusion in the construction and engineering industries about the nature of these instruments. Williams (1983), after a study of the policies and practices of the estates departments of United Kingdom universities, concluded that their knowledge of bonds was lacking, and that, as a result, decision making in this area was based on false assumptions. Russell (1991) observed in the U.S. construction industry that these instruments and their procedures were unfamiliar to many project owners, design professionals, and contractors.

This problem is by no means confined to the construction and engineering professions because, according to Goode (1992), this misunderstanding is even found among experienced lawyers. Judicial comments also portray disturbing evidence of fundamental differences, even among judges of the appellate courts as to their understanding of various aspects of this subject. For example, in *Trafalgar House Construction v. General Surety & Guarantee Co. Ltd.* (1995) 73 BLR 32, the English Court of Appeal unanimously construed a standard form of bond as an unconditional instrument, i.e., it becomes automatically payable on a simple demand by the project owner. The House of Lords unanimously held that it was a conditional bond, i.e., the project owner had to prove default by the contractor before the bondsman became liable to meet the claim. Wallace (1996), editor of the redoubtable *Hudson's Building and Engineering Contracts* (*Hudson's* 1995), sees a more fundamental problem, for he wrote:

> there is a real philosophic gap between construction contract lawyers, together with the judges of the Official Referees' Division of the High Court, on the one hand, who are in constant touch with the commercial background to construction projects, and aware of the inaccuracies and anomalies of the real life standard forms and the documentation brought together in the hurry of preparing for construction projects, and on the other the judges of the Commercial Court, the High Court and Court of Appeal and the House of Lords.

Case law suggests that notice requirements in bonds are often calculated to allow the bondsman to escape the obligations under the instruments. Wallace (1986) warned of this danger to project owners over a decade ago. The litigation in *Perar PV Ltd. v. General Surety and Guarantee* (1994) 66 BLR 72, provided a dramatic demonstration of the reality of this danger. In that case, a bondsman relied on the owner's failure to give required notice to avoid liability when the bonded contractor became insolvent. In a critical examination of that case, the worthlessness of bonds with notice requirements was again highlighted by Wallace (1996). However, other subsequent litigation suggests that the construction owners' naivety, or even carelessness, in accepting such instruments is matched only by the bondsmen's assiduity in escaping from obligations they must have know as theirs at the time of executing bonds (Wallace 1998). Wallace's incredulity and frustration are captured succinctly by this extract from the article last referenced:

> there seems no limit to the managerial or professional apathy and the incompetence which permits premiums to be paid to commercial bondsmen for the minimal and haphazard protection afforded by bonds containing notice provisions of this kind (or indeed which leads beneficiaries so often to accept bonds blindly without taking advice). Elaborate seals and archaic language seem to have a mesmerizing effect in the 1990s.

AIM AND OBJECTIVES

The aim of this paper is to examine the issues commonly in dispute through analysis of reported court decisions and to identify the principles governing their resolution. Possession of such knowledge should alert the construction and engineering industries and their legal advisers to the matters that need serious attention in the drafting and negotiation of these instruments. Clarity in the legal principles should also contribute to a reduction in litigation. It is this writer's belief that,

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Note. Discussion open until May 1, 2000. To extend the closing date one month, a written request must be filed with the ASCE Manager of Journals. The manuscript for this paper was submitted for review and possible publication on December 14, 1998. This paper is part of the ***Journal of Construction Engineering and Management***, Vol. 125, No. 6, November/December, 1999. ©ASCE, ISSN 0733-9634/99/0006-0428–0436/$8.00 + $.50 per page. Paper No. 19853.

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as long as the subject is covered exclusively in publications primarily intended for lawyers, the desired awareness on the part of the construction professions will not be realized.

The examination is based mainly on cases decided by English courts. However, these are complemented with relevant cases from other jurisdictions.

RESEARCH METHODOLOGY

The research on which this paper is based followed a five-stage methodology:

1. Analysis of the problem.
2. Identification of issues commonly in dispute.
3. Finding of primary sources of relevant law.
4. In-depth examination of the individual cases to extract the relevant legal principles.

Problem Analysis

The ultimate aim of this part of the research was to identify and formulate the legal questions to which answers were to be sought in its later parts. As a necessary precondition, the basic concepts relevant to the study had to be understood. This understanding was acquired from textbooks, starting from the most basic to the practitioner's texts. The subject of guarantees and bonds is still very specialized. This has the implication that, there being little market for basic textbooks dedicated to the subject, those in existence are aimed at the legal practitioner. What basic material is available is in the form of chapters in textbooks on subjects such as ''commercial law,'' ''business law,'' ''banking law,'' ''construction law,'' and ''insurance.''

Having understood the basic concepts, works designed for practitioners were identified. Armed with a good understanding of the basic concepts and the general legal terrain of the subject, key terms likely to be used to refer to specific aspects were examined. This involved trawling through the indexes of the major law reports and noting those applicable to the study. The final list of terms arrived at consisted of ''contract,'' ''guarantee,'' ''bond,'' ''performance guarantees,'' ''performance bond,'' ''security,'' ''performance security,'' ''banking,'' ''suretyship,'' and ''construction law.''

Identification of Disputed Issues

Some general awareness of the disputed issues was developed during the analysis phase of the research, albeit in an informal way. The present stage was essentially a formalization of the issue identification process through references to relevant law reports and articles in journals. The use of indexes of legal journals and law reports ensured the identification of every relevant case and article.

The issues most commonly raised in litigation have two main sources. The first concerns the interpretation of the particular instrument, i.e., the nature and extent of the obligations undertaken by the bondsman or surety, whereas the second is about the circumstances in which a court may restrain a claim on the instrument or dealing with the proceeds of a successful claim.

Identification of Relevant Case Law

The outcome of the earlier stages was identification of the relevant questions and the establishment of trails of the law on each issue in the form of some relevant cases. This stage of the research was essentially one of following up the trail methodically to the current position. Citators were used to pinpoint subsequent cases in which each case already identified was affirmed, applied, approved, considered, disapproved, distinguished, doubted, explained, extended, followed, not followed, overruled, referred to, or reversed. Citators are serial publications listing references to each case in subsequent litigation. Correct and efficient use of the citators and other case-finding aides were ensured by prior careful reading of several publications on that part of legal research methods (Holborn 1993; Jeffries and Miskin 1993; McKie 1993).

Terminology

Guarantees

A guarantee has been defined as an accessory contract by which the promisor (the guarantor) undertakes to be answerable to the promisee (the creditor) for the debt, default, or miscarriage of another person (the debtor), whose primary liability must exist or be contemplated (*Halsbury's* 1993). For example, when an owner engages a contractor to carry out a construction project, the owner may stipulate, as a condition for the award of the contract, the provision of a guarantee either from the parent company of the construction firm, its directors, or other approved third party. In the event of nonperformance or defective performance of the contract, the owner can then require the guarantor either to carry out and complete the outstanding work or to pay for any loss arising from the breach. Unlike that in the United States, it is not common practice in the United Kingdom for the guarantor to be given any right to have the bonded project completed.

Bonds

In its broadest sense, a bond is a promise by deed by one party to pay another a sum of money. A guarantee executed as a deed in which the guarantor undertakes to answer for the debt, default, or miscarriage of another by a monetary payment is therefore a bond. The bond may make payment unconditional, i.e., payment must be made on a demand by the promisee or it could be conditional on defined events. The former type are referred to as a ''first conditional bond'' or an ''on-demand bond,'' whereas the latter type is called a ''conditional bond.'' In practice, a conditional bond is commonly referred to as a guarantee or performance guarantee, whereas the terms ''performance bond'' or even just ''bond'' is reversed for unconditional bonds.

Strictly, the term ''surety'' applies to a provider of a guarantee, whereas a ''bondsman'' provides a bond. However, for simplicity, the term surety is hereafter used to refer to both unless the discussion is specific to bonds.

ISSUES OF INTERPRETATION

On the issue of interpretation, the general principle is that every instrument must be construed on its own terms and surrounding circumstances. However, previous case law throws some light on the general approach followed by the courts in their construction, the meanings of certain words and phrases, and particular types of difficulty. Specific issues of construction raised in the case law are as follows:

- Archaic language.
- The surety as a darling of the law.
- On-demand or conditional bonds.
- Meaning words and phrases describing claim triggering events.
- Effect of contractual requirements for the owner to notify the surety of breaches of the construction contract.
- Duty to account for the proceeds of the bond.

Archaic Language

There is a long line of judicial comments decrying a penchant on the part of sureties to draw up instruments that are

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unnecessarily long and use archaic language that obfuscates their true purpose to such an extent as to invite litigation on their true meaning. Not surprisingly, it was a Scottish judge who first confessed bewilderment at the English employed in these instruments. Lord Johnson in *Clydebank and District Water Trustees v. Fidelity Deposit Company of Maryland* (1915) SC 362, said:

> The surety bond is in English form and is somewhat confusing to the Scottish mind, as it seems most unnecessarily involved, and instead of going straight to the point, to turn things upside down, but I have doubt that there is some reason for its form.

About two decades later, Lord Atkin, one of the most eminent English judges of all time, also found the English used in a bond equally frustrating to deal with. In *Trade Indemnity Co. Ltd. v. Workington Harbour and Dock Board* (1937) AC 1, he stated:

> I may be allowed to remark that it is difficult to understand why businessmen persist in entering upon considerable obligations in old-fashioned forms of contract which do not adequately express the true transaction. . . . Why insurance of credits or contracts, if insurance is intended, or guarantees of the same, if guarantees are intended, should not be expressed in appropriate language, passes comprehension. It is certainly not the fault of lawyers.

Unfortunately, this judicial concern has gone unheeded as the comments have had to be repeated in many subsequent cases, e.g., *Tins Industrial Co. Ltd. v. Kono Insurance Ltd.* (1988) 42 BLR 110 (a decision of the Court of Appeal of Hong Kong); *The Wardens and Commonality of the Mystery of Mercers of the City of London v. New Hampshire Insurance Co. Ltd.* (1992) 60 BLR 26 (hereafter called *Mercers v. New Hampshire*); *Trafalgar House Construction (Regions) Ltd. v. General Surety Co. Ltd.* (1995) 73 BLR 32; and *Oval Ltd. v. Aegon Insurance Co. (UK) Ltd.* (1997) 85 BLR 97.

Surety as Darling of Law

A surety has long been regarded in English law as a ''favored debtor.'' Many court decisions suggest that the courts construe contracts of suretyship strictly in favor of the surety, i.e., the contract is not construed to put liability on the surety unless its terms clearly and distinctly provide for such liability. Any doubt is to be resolved in favor of the surety. Lord Campbell, in *Blest v. Brown* (1862) 4 De G F & J 367, rationalized the favored position as follows:

> It must always be recollected in what manner a surety is bound. You bind him to the letter of his engagement. Beyond the proper interpretation of that agreement you have no hold upon him. He receives no benefit and no consideration. He is bound, therefore, according to the proper meaning and effect of the written agreement he has entered into.

This draconian approach has been attributed to the historical development of suretyship from the well-developed concept of debt as a time when there was, at best, only a rudimentary concept of a contract (*Chitty* 1997). In those circumstances, the surety gratuitously undertook his obligation to answer for the default of another either as a consequence of family connection or other equally worthwhile concession to human sentiment. In such circumstances, the instrument was most often drafted by the creditor and the *contra proferentem* rule therefore worked against him. This is a rule that any ambiguity in a contract is construed against the party responsible for its drafting.

This is a far cry from the modern surety who is not only remunerated very well for a virtually riskless undertaking, but represents one of the most hard-nosed commercial undertakings known to man. Furthermore, commercial sureties have their own standard forms that they steadfastly refuse to amend. In the *Mercers v. New Hampshire* case, Parker LJ expressed the view that ambiguity in a bond put forward by the bondsman should be construed against him, notwithstanding the general prosurety approach. Unfortunately, this plea has not been taken up by the judiciary.

This prosurety approach manifests itself in a readiness to discharge the surety on the mere possibility of prejudicial conduct by the beneficiary. Types of conduct that would be considered prejudicial in a construction context include the following:

- Misrepresentation by the owner.
- Failure to serve notices required under the terms of the bond.
- Varying the terms of the construction contract without the consent of the surety.
- Extension of time to which the contractor is not entitled under the terms of the construction contract.
- Overpayment or advance payment.
- Alteration of the work content.

Many instruments avoid this problem by providing expressly that the surety has consented to this type of conduct.

On Demand or Conditional Bond

Whether a bond is conditional or unconditional is essentially a matter of interpretation of its terms. A redeemable feature of most unconditional bonds is the remarkable extent to which their drafters go to avoid any doubt as to their intended effect. Some light was thrown by the House of Lords in *Trafalgar House Construction (Regions) Ltd. v. General Surety & Guarantee Co. Ltd.* (1995) 73 BLR 32, on the likely approach of the courts where there is doubt. In that case, Trafalgar House Construction were the main contractors on a contract for the construction of a leisure center. A subcontract required the subcontractor to provide a bond to the value of 10% of the subcontract sum (which was £1,012,851.31). To comply with this requirement, the subcontractor and General Surety entered into a bond with the main contractor, which stated, *inter alia*:

> Now the condition of the above-written Bond is such that if the Sub-contractor shall duly perform and observe all the terms provisions conditions and stipulations of the said sub-contract on the Sub-contractor's part to be performed and observed according to the true purport intent and meaning thereof or if on default by the Sub-contractor the Surety shall satisfy and discharge the damages sustained by the Main Contractor thereby up to the amount of the above-written Bond then this obligation shall be null and void but otherwise shall be and remain in full force and effect but no alteration in terms of the said Sub-contract made by agreement between the Main Contractor and the Sub-contractor or in the extent or nature of the Sub-contract Works to be constructed and completed thereunder and no allowance of time by the Main Contractor under the said Sub-contract nor any forbearance or forgiveness in or in respect of any matter or thing concerning the said Subcontractor on the part of the Main Contractor shall in any way release the Surety from any liability under the above-written Bond.

One of the issues in dispute was whether an instrument in these terms amounted to an ordinary guarantee or to an unconditional bond. The Court of Appeal unanimously rejected

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the argument that the bond was a guarantee. It was decided, also unanimously, that it amounted to an unconditional bond. Two reasons were given for this interpretation. First, the fact that the subcontractor was a party to the contract indicated that it was not a guarantee because of the illogicality of a party guaranteeing its own performance in this sense. Second, as the commercial purpose of a bond is to provide instant funds to make good any default of the subcontractor, it had to be construed as an on demand bond.

In the House of Lords, it was held that the bond amounted to a guarantee and that the surety was entitled to raise counterclaims and setoffs that would have been available to the subcontractors. It was emphasized that clear and unambiguous words to that effect must be used if an unconditional bond is intended. Factors considered as pointing toward a guarantee rather than an unconditional bond were that: (1) bonds in similar form have existed for more than 150 years and have been treated by the parties and courts as guarantees; (2) the instrument used the term surety; (3) the provision in the bond that no alteration in the terms of the subcontract should release the surety, a provision commonly made to get over the normal effect of such alterations on guarantees.

Although this decision was greeted with sighs of relief by both the surety industry and contracting organizations, it demonstrates the futility to the project owner of bonds of this type. Settling setoffs and final accounts between the owner and the contractor in this setting is likely to involve arbitration or litigation that can take years. Unless the owner has alternative sources of immediate funds, this would bring the project to a standstill. Why an owner should pay large sums for this type of service is difficult to see.

Meaning of Phrases Describing Claim Triggering Events

It is not uncommon for bonds to contain terms to the effect that the liability of the surety is conditional on a ''default'' of the contractor or his ''nonperformance or nonobservance'' of the stipulations and provisions of the underlying contract.

The meaning of default was considered by the Court of Appeal in *Perar BV v. General Surety and Guarantee Co. Ltd.* (1994) 66 BLR 72, which concerned the effect of such a term in a contract incorporating the Joint Contracts Tribunal's Standard Form of Building Contract, with Contractor's Design (''Standard'' 1981). Clause 27.2 of this contract provided for automatic determination of the contractor's employment in the event of his administrative receivership, but with an option to the owner to reinstate the contractor's employment. On June 7, 1991, before completing the contract, the contractor went into administrative receivership. On June 11, 1991, the owner notified the receiver that the contractor's employment would not be reinstated. On June 21, 1991, the owner gave notice of his intention to make a claim under the bond. When proceedings were commenced, the pleadings stated that the claim was for breaches of the contract committed on or after June 10, 1991.

Both the first instance court and the Court of Appeal decided that after June 7, 1991, the date of commencement of the administrative receivership, the contractor no longer had any obligation to carry out and complete the design and construction of the building, and therefore, that no breach of contract had been committed on or after June 10, 1991. By equating default with breach of contract, both courts then concluded that there had been no notice of a default on which the owner could rely to make the claim. The owner could have, in theory, relied on breaches that would undoubtedly have preceded the contractor's formal insolvency. However, this route was closed to the owner because those breaches had occurred earlier than 14 days from the notice.

The Court of Appeals rejected the owner's argument that the term default should be given a wider interpretation than a breach of contract. The implication of this decision was that, on the occurrence of the very event against which the employer had sought protection by requiring the bond, the protection was unavailable. Commenting on the judgment, Wallace (1996) wrote:

> An officious but reasonably intelligent bystander from Clapham (or anywhere else) would be likely to conclude that the lawyers and judges had all danced happily on the head of a pin; that the person directly or indirectly paying for the premiums on the bond (i.e., the construction owner) had been cleverly and legally persuaded, as so often, into paying for a valueless bond; and that the bondsman had been permitted, as so often, to pocket his premiums and escape scot-free from his obligation without anyone expressing a word of regret and, so far as anybody could tell, with the blessing of the Court of Appeal.

The response of this decision was to amend relevant standard forms to remove automatic determination clauses of the type involved in that litigation. A special bond insolvency bond, drafted to allow an effective claim in the event of insolvency, was also advocated.

Requirements to Notify Surety of Breaches of Underlying Contract

Some bonds provide for notification of every breach, default, and nonperformance as a condition precedent to a valid call. This was the type notice required by the bond in *Clydebank & District Water Trustees v. Fidelity and Deposit Company of Maryland* (1915) SC 362, and which Wallace (1986) described as ''particularly obnoxious.'' He went on to explain that:

> because of apathy or inexperience of owner's advisers, modern bondsmen still succeed in inserting notice requirements into bonds, well aware that, in the probable circumstances of most construction contracts prior to a contractor's default, many earlier indications of actual or potential defaults will have occurred from time to time, thus affording a defense that notice under the bond should have been given earlier.

Sometimes, it is not clear enough from the wording of the bond whether all breaches are to be notified. It is often argued by contractors that, where the contract does not expressly cover all breaches or defaults, there is a duty to give notice only where the breach in question is the grounds of a prospective claim. The argument is premised on an assumption that the surety needs the notice for only two reasons: (1) To decide on steps to avoid insolvency of the contractor, e.g., persuading bankers and other creditors to waive their rights or provide more funds or credit; and (2) to persuade the contractor's management to put more resources on the project or change key personnel. This argument was rejected by the Court of Appeal in *Perar BV v. General Surety and Guarantee Co. Ltd.* (1994) 66 BLR 72.

It would appear that, where the list of occurrences to be notified is prefixed by ''any,'' the owner must serve notice of each occurrence regardless of whether or not the owner intends to make a claim on account of the occurrence concerned, i.e., where there have been several notifiable breaches the notice requirement runs from the earliest breach. These issues were raised in the *Oval (717) Ltd. v. Aegon Insurance Co. (UK) Ltd.* (1997) 85 BLR 97, which arose from a contract for the construction of new student halls of residence at Bristol University

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let on the Joint Contracts Tribunal's Standard Form of Building Contract (''Standard'' 1980). The bond provided for, as a condition precedent to recovery of payment under it, written notification of:

> any non-performance or non-observance on the part of the contractors of any of the stipulations or provisions contained in the said Contract and on their part to be performed and observed within one month after such non-performance or non-observance shall come to the knowledge of the Employer or his authorised representative(s) having supervision of the said Contract.

August 23, 1994, was the properly extended completion date. The plaintiff owner did not notify the surety that the contractor had failed to complete on that date. On October 18, 1995, administrative receivers were appointed, resulting, in accordance with Clause 27.2 of the contract, in automatic determination of the contractor's employment. The owner had the work completed by other contractors. Under Clause 27.4.5, the extra cost incurred was recoverable as debt from the original contractor. When its receivers were presented with the bill, they replied that they were unable to pay the amount. The plaintiff then relied on the contractor's failure to pay as required under Clause 27.4.5 as nonperformance and nonobservance and demanded payment of the amount from the surety.

The judge started his analysis by examining the interest of the surety served by notice requirements in bonds. To the two already referred to above, he added the surety's need for information for broader purposes than dealing with the particular claim, e.g., use in setting future premium levels either generally or for specific types of projects or parties and in deciding on future suretyship facilities to provide to the particular contractor. He then concluded that, in this commercial context and considering the use of any to describe the occurrences to be reported, the words should be construed as they stand without any need to consider the seriousness of the consequences of the nonperformance or nonobservance or whether the owner intends to make a call. This interpretation meant that the owner had, in breach of contract, failed to notify earlier breaches, which was prejudicial conduct entitling the surety to avoid the bond.

Duty to Account for Proceeds of Call

There is always the possibility that the loss suffered by the beneficiary turns out to be much less than the amount received from a claim on the bond or that no loss is suffered at all. There is therefore the question of whether the beneficiary is entitled to keep the windfall or whether the contractor or surety is entitled to recover any overpayment.

A long line of cases suggested that the general approach of the courts both here and in some commonwealth jurisdictions is that, in the absence of clear words to a different effect, when a bond is called there will be, at some stage in the future, an ''accounting'' between the parties to the underlying contract in the sense that their rights and obligations will be finally determined by trial or arbitration. This principle was referred to with approval by the Court of Appeal in *Comdel Commodities Ltd. v. Siporex Trade SA (1997)* 1 Lloyd's Rep 424, and *Cargill International v. Bangladesh Sugar* (1998) CILL 1358. It was stated in the latter case that only the clearest language will be effective in displacing this general principle.

INJUNCTIVE RELIEF

An opportunity for improper conduct by a beneficiary of an on-demand performance bond, e.g., calling the bond when there has been no breach or when he is himself in breach of the underlying contract, is only too apparent. For reasons of simplicity, on-demand performance bonds are hereafter referred to as performance bonds. The issuer is assumed to be a bank for the same reasons and the fact that it is the most common practice. It is also to be noted that in some of the cases to be referred to, although the judgments referred to performance guarantees, the instruments involved were performance bonds.

Injunctions against Bondsman

Letters of credits are treated as absolute undertakings by the banks and autonomous from the contract between the seller and the buyer who procured it. Any dispute between the seller and the buyer does not affect the bank's obligation to pay on presentation by the sellers of the right documentation in accordance with the terms of the letter of credit. This principle is often referred to as the ''autonomy'' principle of letters of credit. The special treatment of this type of instrument has been justified in the case law on a perceived need to avoid interfering with established practices of international commerce and the machinery of the banks. This policy-based justification has generally been adopted as applicable to performance bonds. A good example of this approach to performance bonds is this now famous statement by Kerr J. in *R. D. Harbottle (Merchantile) Ltd. v. National Westminster Bank Ltd.* (1978) 1 QB 146 (hereafter called *Harbottle*):

> It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations assumed by the banks. They are the lifeblood of international commerce. Such obligations are regarded as collateral to the underlying rights and obligations between the merchants at either end of the bank chain . . . Except possibly in clear cases of fraud of which the banks have notice, the courts will leave the merchants to settle their disputes . . . The courts are not concerned with their difficulties to enforce such claims; these are risks which the merchants take . . . The machinery and commitments of banks are on a different level. They must be allowed to be honoured, free from interference by the courts. Otherwise, trust in international commerce could be irreparably damaged.

In the *Intraco Ltd. v. Notis Shipping Corporation (The Bhoja Trader)* (1981) 2 Lloyd's Rep 25, Donaldson LJ said that letters of credits and bank bonds are the lifeblood of commerce and that thrombosis will occur if, unless fraud is involved, the courts interfere with the mercantile practice of treating such instruments as equivalent of cash in hand. This underlying argument against interference is hereafter referred to as the ''thrombosis argument.'' It is important to note that within this general policy of protecting international commerce, the decisions refer to two separate ways in which the thrombosis can be brought about: (1) Damage to the reputation of banks, and (2) undermining the commercial value of bonds. There are therefore two separate strands of the thrombosis argument: the ''reputation argument'' and the ''value argument.''

From the authorities, an applicant invoking the fraud exception for injunctive relief against payment by a bank must overcome the following hurdles:

- Knowledge of the call.
- Manifest fraud.
- The surety (bank) has notice of the fraud.

As will soon become only too apparent, these are hurdles are incredibly difficult for the contractor to surmount. Indeed,

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in the *United Trading Corporation v. Allied Arab Bank Ltd.* (1985) 1 Lloyd's Rep 554 (hereafter called *United Trading*) case, Ackner LJ noted that it had never been successfully invoked in practice in English law. Thus, although Bennett (1994) classifies *Elian and Rabbath v. Matsas and Matsas* (1966) 2 Lloyd's Rep 495, as a case in which the fraud exception was successfully invoked, Lord Ackner must have thought otherwise. The situation has not changed in the English courts. It may therefore be concluded that the fraud exception to the enforcement of performance bonds is only an illusion.

Notice of Call

As an obvious precondition of any steps to obtain the injunction, the contractor needs to know either that a call is impending or that a claim has been made, but before it is met by the bank. In theory, it is possible to produce a contractual structure that prevents calling of the bond without specified notice to the contractor of the owner's intention to make a claim. However, it is commercial reality that such notice, as a condition in bond, would be unacceptable to owners who would usually, particularly in the context of the construction and engineering industries, be in a stronger bargaining position regarding the contents of the bond. Prior notice of default to only the bank is a more common provision.

It may be that the account party (the contractor) is informed of the call by the bank before making payment. However, under English law, unless provided for expressly in the contract with the bank, there is no obligation on the bank to do this: *Esal (Commodities) Ltd. and Relton Ltd. v. Oriental Credit Ltd. and Wells Fargo Bank N. A.* (1985) 1 Lloyd's Rep 546. Except where the account party is insolvent, there is no particular incentive for the bank to notify because it can always recoup any payment made under the counterindemnity. A reputation for such active involvement tends to make the particular bank less attractive to project owners for bonding purposes, thus resulting in a loss of business. For these reasons banks prefer to pay on demand without any objection. Penn et al. (1987) wrote that the banks will normally inform the account party of the demand only after payment has been made. However, they suggest that the bank may owe its customer a fiduciary duty to warn him of these inherent risks before issue of the bond.

Manifest Fraud

The case law suggests that the applicant must establish not only that the call is fraudulent, but also that the fraud is manifest. This raises an initial question of what constitutes fraud. In *GKN Contractors v. Lloyds Bank plc* (1985) 30 BLR 48 (hereafter called *GKN Contractors*), Parker LJ referred to fraud of the type alleged in *Harbottle, Edward Owen Engineering Ltd. v. Barclays Bank International Ltd.* (1979) 1 QB 159, and *Bolivinter Oil SA. V. Chase Manhattan Bank* (1984) 1 Lloyd's Rep 251 (hereafter called *Bolivinter*) as ''common law fraud,'' which he described as:

> a case where the named beneficiary presents a claim which he knows at the time to be an invalid claim, representing to the bank that he believes it to be a valid claim.

An intention on the part of the beneficiary to deceive is therefore inherent in this meaning of fraud. However, Parker LJ seemed to suggest another ground for departure from the autonomy principle in applications to enjoin the bank from meeting a claim. This is where the beneficiary wrongly believes that the claim is valid but the bank knows otherwise.

In *United Trading*, Ackner LJ gave some guidance on what constitutes ''clear fraud'' in the following terms:

> The evidence of fraud must clear, both as to the fact of fraud and as to the bank's knowledge. This mere assertion or allegation of fraud would not be sufficient. We expect the Court to require strong corroborative evidence of the allegation, usually in the form of contemporary documents, particularly those emanating from the buyer. In general, for the evidence of fraud to be clear, we would also expect the buyer to have been given an opportunity to answer the allegation and to have failed to provide any, or any adequate answer in circumstances where one could properly be expected. If the court considers that on the material available before it *the only realistic inference* (author's emphasis) to draw is that of fraud, then the seller would have made out a sufficient case of fraud.

In the *GKN Contractors* case, Parker LJ formulated the test of clear fraud to include instances where the *only reasonable inference* to be drawn from the circumstances of the call is that it is being made fraudulently. An inference can be realistic in the sense that it is conceivable in that someone might draw it, and yet it can be unreasonable in that the reasonable person would not draw it. It is therefore arguable that the Parker standard of proof is higher that the Ackner test. Whether that was the intention in *GKN Contractors* is not clear from the judgment. In a dissenting judgment in *Themehelp Ltd. v. West* (1995) 4 All ER 215, Evans LJ described the Ackner standard as too high.

It has been questioned in other jurisdictions whether, considering that the injunction usually sought is only interlocutory, i.e., it is of only temporary effect, clear fraud is not demanding a higher standard of proof more appropriate to final determination. For example, in *C.D.N. Research and development Ltd. v. Bank of Nova Scotia and Others* (1982) 136 DLR 3d 656, a Divisional Court of the Ontario High Court in Canada preferred a strong *prima facie* case of fraud.

Bank's Awareness of Fraud

It is a presumption that the bank is not required to investigate whether or not the claim is made fraudulently. In the absence of such a duty, as remarked by Lord Denning in *Edward Owen*, the banks will rarely, if ever, be in a position to know whether the claim is honest or not. However, it is clear from the above discussion that if the bank is not aware of the fraud, an injunction may still be granted on the grounds that the circumstances of the demand are such that the only realistic/reasonable inference is that the demand is fraudulent.

Injunctions against Receipt of Payment

On being informed that the owner has made a call on the bond, the contractor may choose to seek an injunction restraining the owner from receiving payment. This approach does not carry any risk of undermining the reputation of banks. The attitude of the English courts to applications for this type of injunction is difficult to state with any certainty because there has been no relevant reported cases. However, cases from other common law jurisdictions have involved such applications. In the Singaporean case of *Knaerver Singapore Pte v. UDL Shipbuilding (Singapore) Pte Ltd.* (1993) 3 SLR 350, the court granted an injunction restraining the defendants from receiving the payment. The availability of injunctive relief against receipt of the fruits of a call was also considered in the Malaysian case of *Esso Petroleum Malaysia Inc v. Kago Petroleum Sdn Bhd* (1995) 1 MLJ 149. An injunction granted by the High Court of Kuala Lumpur was set aside by the Court of Appeal on the grounds that such a injunction based on allegation of breach of the underlying contract would subvert the commercial value of performance bonds.

Enjoining Beneficiary from Making Claim

Although many earlier cases, *Elian and Rabbath v. Matsas and Matsas* (1966) 2 Lloyd's Rep 495, *Howe-Richardson Scale v. Polimex Cekop and National Westminster Bank* (1978) 1 Lloyd's Rep 161, and *The Bhoja Trader*, suggested the availability of injunctions to enjoin a beneficiary (owner) from calling a bond, it was not until *Themehelp Ltd. v. West* (1995) 4 All ER 215 (hereafter called *Themehelp*) that a clear answer was given by the courts. In that case the Court of Appeal decided, by a majority, that in appropriate cases the Court may issue an interlocutory injunction against the calling of a bond by a beneficiary. This type of injunctive relief is different from the ordinary injunction in that it lasts only until determination of a substantive dispute between the account party (contractor) and the beneficiary. It is available where, on the facts available to the court, it is arguable that the only realistic inference to be drawn from the circumstances is that the beneficiary has committed a fraud in connection with the underlying contract.

The Court of Appeal justified this category of departure from the autonomy principle on the grounds that the policy basis of the principle is not applicable where the injunction sought is only interlocutory and against the beneficiary rather than the bank. Waite LJ said:

> In a case where fraud is raised as between the parties to the main transaction at an early stage—before any question of enforcement of the guarantee (as between the beneficiary and the guarantor) has yet arisen at all—it does not seem to me that the slightest threat is involved to the autonomy of the performance guarantee if the beneficiary is injuncted from enforcing it in proceedings to which the guarantor is not a party. One can imagine, certainly, circumstances where the guarantor might feel moved to express alarm, or even resentment, if the buyer should obtain—in proceedings to which the guarantor is not a party—injunctive relief placing a restriction on the beneficiary's rights of enforcement. But in truth the guarantor has nothing to fear. There is no risk to the integrity of the performance guarantee, and therefore no occasion for involving the guarantor at that stage in any question as to whether or not fraud is established. It amounts to no more, in the final analysis, than an instance of equity intervening to restrain the beneficiary—until the day when his conscience stands trial to the main hearing—from enforcement of his legal rights against a third party.

There was strong dissenting comments from Evans LJ. His main objection was that allowing the account party to have what he described as ''preemptive strike'' at the bond would generally undermine the commercial value of that type of instrument.

Much earlier, the Singaporean judiciary had adopted an even more relaxed approach in granting an injunction against a beneficiary in circumstances that did not involve fraud. In *Royal Design Studio Pte Ltd. v. Chang Developments Pte Ltd.* (1991) 2 MLJ 229 (hereafter called *Royal Design Studio*), the plaintiff contractor contracted with the defendant owner to construct houses. Disputes arose concerning allegations of late payment by the owner and delay on the part of the contractor, leading to termination of the contract. An application for an injunction to restrain the owner from calling a performance bond procured by the contractor was granted by Thean J, who distinguished the English authorities on the autonomy principle along lines taken later by Waite LJ in *Themehelp*.

However, the subsequent decision in *Bocotra Construction Pte and Others v. Attorney-General* (1995) 2 SLR 733 (hereafter called *Bocotra*) suggests that the liberal approach adopted in the *Royal Design Studio* case was just a temporary blip. The *Bocotra* case also involved an attempt by a contractor to restrain a project owner from calling a performance bond. The High Court of Singapore refused to grant a declaration that the owner could only call the bond if it could prove actual default on the part of the contractor. Asserting the traditional dogma on autonomy of the performance bond, the Court of Appeal upheld the decision.

All of the above cases still leave open the question whether, under English law, an injunction is available directly against a beneficiary in circumstances not involving any fraud. Unfortunately, in *Themehelp*, Waite LJ expressly reserved judgment on the issue. The answer is therefore that time will tell.

Mareva Injunctions

The discussion so far highlights the difficulty of stopping an owner beneficiary of a performance bond from calling it. According to the autonomy principle, if there are disputes between the contractor and the owner concerning the underlying construction contract, they should be the subject of separate proceedings. While in theory this course of action as available, there is always the danger that the owner may frustrate execution of the judgment under the separate proceedings, even if the court decides for the contractor. This can be done either by dissipating his assets within jurisdiction or removing them from it.

The *Mareva* injunction, named after a case [*Mareva Cia Naviera SA v. International Bulk Carriers SA* (1980) 1 All ER 213], in which this remedy was recognized in English law, represents a method of stopping the owner from escaping in this manner. It is an interlocutory injunction to restrain a defendant from removing his assets from the jurisdiction of the court or from dissipating them pending a trial of an action against him. Its effect is to freeze temporarily the assets covered by it. The juridical basis of the *Mareva* injunction is now provided for by legislation. The main sanction against failure to comply with a *Mareva* is contempt of court proceedings leading to monetary fines and/or even imprisonment. This sanction does not bite unless the defendant is present in the jurisdiction of the court. Furthermore, unless the plaintiff is prepared to take steps to enforce the ultimate judgment in the foreign jurisdiction, the assets outside jurisdiction would be beyond his reach.

Various authorities suggest that in principle this type of injunction may be granted if the following occurs:

- The plaintiff has an accrued cause of action against the defendant: *Siskina (Cargo Owners) v. Distois Compania Naviera SA* (1979) AC 210; *Veracruz Transportation Inc. v. V C Shipping Co. Inc. and Den Norske Bank A/S, The Veracruz* (1992) 1 Lloyd's Rep. 353.
- The plaintiff is able to show a ''good arguable case'' in the proposed action against the defendant: *Ninemia Maritime Corpn. Trave Schiffahrtgesellschaft mbH, KG, The Niedersachen* (1983) 1 WLR 1412.
- There is real risk of the defendant dissipating or disposing of his assets, thereby frustrating execution of judgement: *Third Chandris Shipping Corporation. v. Unimarine SA* (1979) QB 645; and *Z Ltd. v. A-Z* (1982) 2 WLR 288.

The transnational nature of bonds and guarantees raises the question of the territorial scope of the *Mareva* injunction. Consider a bond payable overseas. Does the English court have jurisdiction to enjoin the beneficiary from dealing with the fruits of the call? *The Bhoja Trader* was decided on the unchallenged assumption that English courts have no jurisdiction to grant *Mareva* injunctions covering foreign assets. However, *Babanaft International Co. SA v. Bassatne* (1989) 2 WLR 232, *Republic of Haiti v. Duvalier* (1989) 2 WLR 261, and *Derby & Co. Ltd. v. Weldon (No. 1)* (1989) 2 WLR 276 (which were

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heard within weeks of each other), in each case the worldwide *Mareva* jurisdiction of the English court was asserted; although it was emphasized that the order should only be granted in only very exceptional circumstances. Collins (1989) details the background to this development.

CONCLUSIONS

There has been considerable litigation arising from bonds and guarantees issued in support of obligations under construction and engineering contracts. This has been attributed to lack of sufficient understanding of the exact nature of these instruments and the use of medieval language in their wording, compounded further by a miscellany of confusing terminology used virtually interchangeably.

The following conclusions can be drawn from the analysis of the case law:

1. Whether the issue is one of the validity, construction, or discharge of the bond or guarantee, the bondsman/guarantor has been treated as a darling of the law. Any slight prejudicial conduct by the beneficiary avoids the contract unless effectively and expressly addressed otherwise in the contract. Conduct that is potentially prejudicial to the surety's interest has the effect of releasing the surety from the obligation *in toto* and not just *pro tanto* to the actual prejudice. Whenever there is an issue of construction, the document is construed strictly so as not put liability on the bondsman/guarantor unless the instrument so provides clearly. This particular leniency is attributable to the fact that, historically, the surety gratuitously entered into the suretyship because of family ties or other worthwhile concession to human sentiment. In view of the fact that most of the sureties in the reported litigation in recent years have been of the compensated category, the time has come to make a distinction by providing for proportional release as is now the case in the United States and Canada.
2. Most of the standard forms of bond in use in the United Kingdom are conditional instruments. From an owner's point of view, their value is doubtful because disputes about quantum are likely to require years of arbitration or litigation, thus endangering continuation of the project unless the owner has alternative sources of immediate cash.
3. A bond that provides, as a condition precedent to making a claim, that the beneficiary is to notify the surety of defaults, on-performance, nonobservance, and the like of the underlying contract by the contractor is a complete waste of premiums. This is because the reality of construction contracts is such that, in the event of a default on which the owner intends to rely to make a claim, there would have been earlier defaults, thus affording a defense to the claim that the notice of the earlier defaults had not been served.
4. The position in law of an on-demand bond has largely been assimilated with that applicable to letters of credit. Together they form the lifeblood of international commerce. There is a risk of thrombosis in international commerce occurring if they are interfered with. The court must not therefore enjoin a bank from meeting its obligations under these instruments unless there is established fraud of which it is aware. Fraud in this context is common law fraud, which has been described as ''a case where the named beneficiary presents a claim which he knows at the time to be invalid but represents to the bank that it is valid.''
5. The court will accept that the beneficiary has been guilty of fraud only where, on the material before it, that is the only realistic inference to draw. The material should usually be in the form of contemporaneous documents from the alleged fraudulent party. The uncorroborated assertion of the contractor that there has been fraud is not enough. Suspicions of fraud, breach of the construction contract, and sharp practice are a long way away from fraud. The fraud exception has never been successfully invoked in English law.
6. Although injunctions have been granted in foreign common jurisdictions restraining the beneficiary from receiving payment after having made a claim, no English court has yet gone that far.
7. Where fraud is raised as being between the contractor and the owner at an early stage, and before the owner has made a demand, an injunction may available to restrain the owner from making the call where, on the material before the court, it is arguable that the only realistic inference to be drawn from the circumstances is that the owner has committed a fraud in connection with the underlying contract. The injunction lasts until determination of the substantive dispute between the parties. However, the principle has been criticized on the grounds that it tends derogate from the commercial value of the bond.
8. In appropriate cases the courts may grant a *Mareva* injunction to restrain a beneficiary from dealing with the fruits of a demand on a bond. In principle, this relief is available notwithstanding that the payment is made out jurisdiction. However, the use of the worldwide *Mareva* is exercised sparingly because of unacceptability of exorbitant extraterritorial jurisdiction and considerations of international judicial comity.
9. The event triggering off the right to make a claim against a bond has been described in the standard forms by phrases such as default, nonobservance, and nonperformance. In *Perar BV v. General Surety* the Court of Appeal held that default of a contractor did not include its insolvency, with the consequence that, on the occurrence of the event against which the owner had sought the protection of the bond, the bondsman escaped liability. Litigation has failed to clarify the exact meaning of the other phrases. A better way is to use certification by a third party as the triggering event.
10. There is a need to ensure that bonds supporting contracts with automatic determination clauses are not caught by the problem that came to light in *Perar BV v. General Surety*.
11. Although most of the problems have been highlighted in literature for lawyers, there has been insufficient coverage in the main journals read by the construction professionals. Unless this problem is redressed, the ignorance of the professionals is likely to continue to the benefit of the surety industry and the detriment of construction owners.

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