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On Demand Performance Bonds: How to Make them Less of a Threat

One concern of contractors who are required to provide a client with an on demand performance bond is that the bond might be called for no good reason. Until recently, the general view has been that unless it can be proved that a call on the bond is fraudulent, there is nothing to stop the bond being called. But as a result of a case decided in 2011, it now seems that if the underlying contract contains restrictions on the client's right to claim payment under the bond, the court may well grant an injunction if the client tries to call the bond in breach of those restrictions.

An on demand bond contains terms under which the bank (or bondsman) issuing the security undertakes with the client, sometimes called the' beneficiary '– to pay the client an agreed sum of money upon receiving the beneficiary's first written demand. The amount of the bond is usually expressed as a percentage of the contract price – normally 10%. In other words, the performance bond is, in some respects, similar to a Letter of Credit: it can be converted into money by the simple expedient of the beneficiary giving notice to the bondsman in the manner set out in the bond.

Usually the notice simply requires a statement by the client that the contractor is in default. Unless there are conditions attached to the call, the bond will then have to be paid irrespective of any dispute that might exist between the client and the contractor and regardless of whether the client is entitled to the money claimed.

The only potential remedy for a contractor faced with an unfair call is to seek an injunction from the court preventing payment. But this has rarely been successful. The classic case is that of Edward Owen Engineering v Barclays Bank. The contractor signed a contract with the Libyans for the supply of several acres of glasshouses and the Libyans called the bond before the contract work had even started! The Court of Appeal refused to prevent payment.

However Mr Justice Akenhead allowed an injunction in circumstances where the contract pursuant to which the bond was issued contained a restriction. In this case, Simon Carves Ltd v. Ensus UK Ltd, the contract required the contractor to provide an on

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demand bond and the contract terms stipulated that on issue of the acceptance certificate by the client, the bond would become null and void.

Ensus tried to call the bond following issue of the acceptance certificate because of alleged defects. The judge granted an injunction to Simon Carves, the contractor, and in his judgement came to a number of conclusions on the state of the law:

> (a) Fraud is not the only ground upon which a call on a bond can be restrained by injunction.
>
> (b) There is no legal authority which permits the beneficiary to make a call on the bond when it is expressly disentitled from doing so.
>
> (c) In principle, if the underlying contract, in relation to which the bond has been provided by way of security, clearly and expressly prevents the beneficiary from making a demand under the bond, it can be restrained by the court from making that payment.
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> (d) The court will be able to determine the issue finally at trial whether the underlying contract imposes restrictions on the beneficiary in calling the bond. The position is different at the interim injunction stage because the court can only very rarely form a final view as to what the contract means. However, given the importance of bonds in the commercial world, it would be necessary for the court to be satisfied that the party seeking the injunction has a strong case.

This case offers a way of mitigating the risk of an unfair call by including a clause in the contract between the client and contractor which restricts the client's ability to call the bond. A reasonable employer would be unlikely to object to a reasonably drafted clause.

Hopefully providers of standard contracts will consider including such a clause as an option in future editions of their documents. In the meantime contractors should consider suggesting one when negotiating with a client who insists on having an on demand bond by way of security. Banks could also perform a useful role: it is not in their interest any more than that of their customer to have to pay a call under a bond when it could be avoided.

Giles Dixon, May 2015

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