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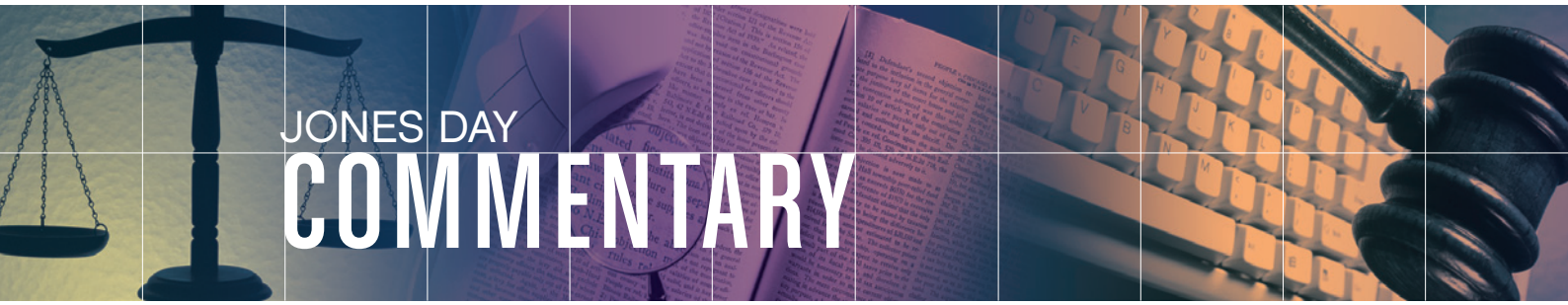

PERFORMANCE BONDS: A CHINK IN THE ARMOUR?

Described as the "life-blood of international commerce", irrevocable payment obligations undertaken by banks through the issue of performance bonds appear potentially less immune from interference by the courts following the Technology and Construction Court's ruling in *Simon Carves Ltd v Ensus UK Limited*[1].

This ruling challenges the established view that a court will only interfere in a beneficiary's right to make a demand under a performance bond where there is clear evidence of fraud by concluding that a court can also intervene where it feels that there is a "strong case" that a call on the performance bond would amount to a breach of an underlying contract.

NATURE OF A PERFORMANCE BOND

On-demand performance bonds provide comfort to a party (the "beneficiary") that, if its counterparty under a contract breaches that agreement, the beneficiary need only inform the provider of the performance bond (usually a bank) in writing of the default and the bank will pay out.

FACTS

In 2006, Simon Carves Ltd ("SCL") was engaged by Ensus UK Ltd ("Ensus") to construct a bioethanol processing plant.

The contract incorporated the industry standard Red Book[2], which lays down specific procedures for the completion of applicable projects and required that SCL provide an on-demand performance bond (the "Performance Bond") to Ensus (which was duly procured from Standard Chartered Bank (the "Bank") with an initial expiry date of 31 August 2010).

Additionally, the contract provided that:

- upon the project approaching completion, Ensus would take over the works by issuing a Take-Over Certificate (and SCL would, for the next 12 months, be required to make good any defects of which Ensus had given it notice);
- in the event that SCL failed to remedy any such defects, Ensus would be entitled to perform any necessary remedial work on its behalf;

1 [2011] EWHC 657 (TCC)
2 The General Conditions of Contract for Lump Sum Contracts published by the Institution of Chemical Engineers in 2001.

- as soon as the plant had passed all relevant performance tests, Ensus would issue an Acceptance Certificate listing any known defects which SCL would be bound to make good; and
- upon the issue of the Acceptance Certificate, the Performance Bond would become "null and void" and Ensus would be unable to make any calls under it save in respect of any pending or previously notified "claims" (a term which was undefined in the Red Book).

The Take-Over Certificate was issued on 17 February 2010, following which Ensus took over the operation of the plant. In March 2010, Ensus issued two "defects notices" and a "variation notice". Although there was some discussion between the parties, no substantive remedial work occurred before the Acceptance Certificate was issued on 19 August 2010. The Acceptance Notice scheduled a number of defects, including those notified in March.

While discussions as to liability for the defects continued between the parties, Ensus carried out certain remedial works. At the same time, SCL asserted that, because the Acceptance Certificate had been issued without any "claims" being notified, the Performance Bond was, in accordance with the contract, null and void and should therefore be returned to the Bank.

Under severe time pressure, SCL, whilst maintaining that the Performance Bond was null and void and generally reserving its rights, arranged for the maturity of the Performance Bond to be extended pending resolution of the dispute.

Discussions as to responsibility for the defects remained ongoing. However, SCL wrote to Ensus reasserting that, because the Acceptance Certificate had been issued without any claims being notified, the Performance Bond was null and void and sought (and was granted) injunctive relief to prevent any demand being made under the Performance Bond by Ensus. At the hearing, both the court and SCL were unaware that Ensus had in fact already submitted a written demand to the Bank. The initial injunction was therefore modified and an order was given that the demand on the Performance Bond be recalled. The matter was then adjourned for a full hearing.

THE ARGUMENTS

Ensus asserted that previous case law had established that the only ground upon which a call on an on-demand bond could be restrained was "a clear case of fraud". It also submitted that the court had traditionally imposed a higher level of proof on the applicant than was required for other interim injunctions. This was generally considered to be a restatement of the then-understood position.

SCL challenged this, arguing that there was no legal authority to suggest that it was *only* in cases of fraud that the court could award injunctive relief. It further asserted that the test for the award of injunctive relief in the case of a performance bond should be the same as for any other interim injunction, namely, that the applicant had a 'strong arguable case'[3].

THE JUDGMENT

The judge found in favour of SCL, holding that, while there was no great line of authority supporting the award of injunctive relief in the absence of fraud, there was also no authority to suggest that fraud was the only ground on which a court could make such an award. He noted that, given there is no legal authority which permits a beneficiary to make a call on a bond when it is expressly barred from doing so in the underlying contract, the court was entitled to intervene to restrain it.

In his consideration of the level of proof required, while acknowledging the importance of on-demand bonds in the commercial world, the judge found it unpragmatic to have more than one set of rules in relation to interim injunctions. He was therefore content to find that the relevant threshold was whether the applicant had a "strong case".

CONCLUSION

The court's previous hesitancy in intervening to injunct calls under on-demand bonds was borne of a concern that such intervention would damage trust in instruments widely used in international commerce. However, whilst it will be rare for a court to prevent a claim under a performance bond

3 *American Cyanamid Co v Ethicom Ltd* [1975] AC 396

other than in the case of fraud, the court has now shown a willingness to intervene in cases where a party breaches a clear contractual provision which restricts its ability to claim under a performance bond, particularly where (as was the case here) damages would not be an adequate remedy. Consequently, before a beneficiary of a performance bond can be certain that a demand under a performance bond can be effected, he must consider the effect of any underlying contractual arrangements which may limit this right.

LAWYER CONTACTS

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