Conditions precedent in on demand bonds

Gateley Plc

2015

MW High Tech Projects UK Ltd -v- Biffa Waste Services Limited

In 2010, West Sussex County Council contracted with Biffa Waste Services Limited (Employer) for the management and disposal of waste (MRMC Contract). The MRMC Contract included the design, construction, installation, commissioning and testing of a plant near Horsham (EPC Contract), which was awarded to M+W (Contractor).

Clause 43 of the EPC Contract required the Contractor to procure a Parent Company Guarantee (PCG), a performance bond and a retention bond in favour of the Employer. The PCG was provided by M+W GmbH (Parent) upon a form agreed between the Employer and the Parent, whilst the retention bond was issued by a surety company (Surety).

Condition precedent

The EPC Contract stated that it was a condition precedent to the Employer's right to make a call under the performance or retention bond/s that the Employer had first called upon the PCG. The EPC Contract also stated that in the event that the Parent had not accepted in writing each and every aspect of such a call on the PCG including any requirement to make payment within 10 business days then the condition precedent would be discharged.

The retention bond

The retention bond had a conventional procedure set out to call on the bond, i.e. the demand had to be in writing and to contain a statement by the Employer stating that the Contractor had failed to perform the EPC Contract and/or had failed to satisfy its liabilities under the EPC Contract and/or that an insolvency event had occurred and it had to specify the amount claimed by the Employer. The Surety was obligated to pay the Employer within 7 days of receipt of any such demand. It was an express term of the retention bond that any demand made by the Employer in accordance with the terms of the retention bond would be conclusive evidence that the sum stated in the demand was properly due and payable to the Employer under the retention bond.

The facts

The Employer wrote to the Parent, making a call under the PCG. The letter made it clear that the Contractor had committed a breach and failed to fulfil the terms of the EPC Contract in relation to liquidated damages and requested the Parent to make payment of liquidated damages.

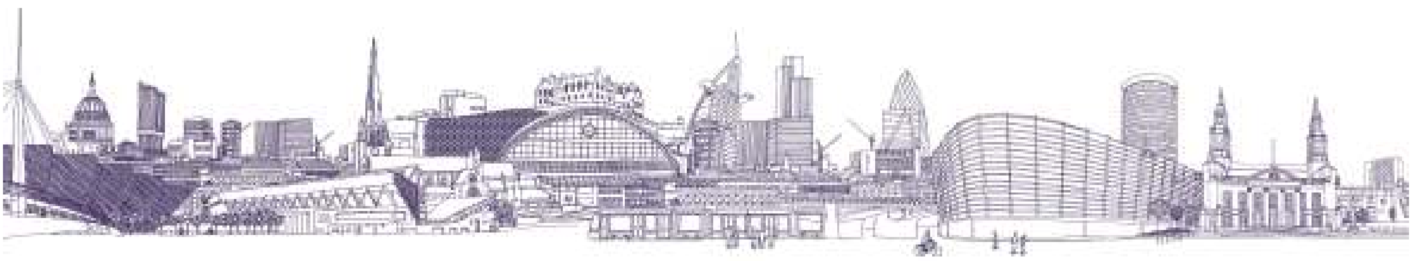
The Parent did not accept the call on the PCG in writing within 10 business days of receiving it, claiming that such call was not 'valid'.

The parties agreed that it was a condition precedent to the Employer's right to call the PCG before it could call the retention bond.

On 14 January 2015, the Employer wrote to the Surety demanding payment under the retention bond. On 26 January 2015, the Contractor made an urgent ex-parte application to the court to restrain the Employer from calling upon the retention bond and a temporary injunction was granted in the terms requested by the Contractor. The court gave directions for a return date on 30 January 2015 at which the Contractor and the Employer were both represented.

It was common ground that:

1. the retention bond was in the form of a typical on demand bond, payment of which could only be restrained on limited grounds;
2. the Employer had purported to call on the retention bond and the PCG;
3. it was a condition precedent to the Employer's right to call on the retention bond that the Employer had first made a call on the PCG;
4. the Parent did not accept the call on the PCG.



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The issues

The Contractor submitted that the Employer should be restrained from pursuing a call on the retention bond because the purported call on the PCG was not 'valid' and, therefore, did not constitute a call within the meaning of the EPC Contract so as to satisfy the condition precedent.

The Contractor said it was invalid because no demand for liquidated damages had been made before the EPC Contract had terminated and that the Employer was not entitled to liquidated damages under clause 22 of the EPC Contract.

The word 'valid' did not appear in the contractual structure relating to the PCG but the Contractor asserted that it should be implied into the condition precedent that there had first to be a valid call on the PCG.

The decision

The Judge referred to the relevant principles and previous decisions of the courts in relation to bonds citing the following wording which is often quoted in on demand bond cases: "*It is only in exceptional cases that the courts will interfere with the machinery of irrevocable obligations… they are the life-blood of international commerce".*

Those exceptional cases where the court will intervene were stated to be those where (i) there is obvious fraud or, (ii) where the underlying contract precludes the beneficiary from making a call in which case it must be established that he was not entitled to draw down under the underlying contract.

The Judge said that the point which had not been expressly considered was whether the court can or should intervene if it is positively established that the asserted substantive breach of the underlying contract was unfounded. In this case, the Contractor was seeking to undermine the procedural requisites for calling on the retention bond by attacking the substantive basis for the call on the PCG.

The Judge accepted the Employer's submission that there was no justification for implying a term that the call on the PCG must be 'valid'. He said that the EPC Contract terms relating to the condition precedent worked adequately without the addition of the word 'valid' so there was no need to imply such a term.

As to the second issue, no fraud was alleged in this case. Even if the call in this case could be described as 'ill founded' there was no suggestion that it was fraudulent and there was nothing new in calls on guarantees being controversial, objectionable or misconceived. The notion that there should be a preliminary dispute about whether the underlying demand is justifiable went directly against the normal approach to on demand bonds: pay now, argue later.

The court ruled in favour of the Employer's approach, which was to characterise the condition precedent as giving the Parent the opportunity to pay the underlying demand without recourse to the Surety via the retention bond.

Implications for Sureties

The normal rule is that on demand bonds must be honoured, save in exceptional circumstances. Exceptional circumstances are (i) fraud or (ii) a demand which is not compliant with the requirements of the on demand bond itself.

The court will not look behind the on demand bond nor concern itself with any underlying contractual disputes, nor will it imply words into the on demand bond when it is not necessary to do so.

The parties may agree a two tier approach to demands to enable a parent company to pay without recourse to the bonds issued by third party financial institutions as in this case. It may be commercially desirable to do so.

Where that is the case, Employers should not be restrained from pursuing calls upon on demand bonds and the court would not impose some additional requirement that the underlying demand had to be justifiable.

The courts again acknowledged the commercial benefits of on demand bonds.

If parties want there to be a valid call on a parent company - as opposed to merely a call - as a condition precedent before calling upon a surety bond, then the wording needs to expressly state that it is a condition precedent that there must first be a 'valid call' on the parent company guarantee.

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