

Nature, enforcement, practical issues and court interventions

Introduction

All major standard forms of construction contracts require the contractors or sub-contractors (contractor) to provide performance guarantees for securing the performance of the contracted work. More often than not, contractors procure performance guarantees in the UAE from local banks.

The typical process is for the contractor's bank (guarantor) to issue a letter of guarantee to the contractor's employer (employer) undertaking to pay the employer a sum of money specified under the guarantee, subject to the terms and conditions stated therein. The most obvious pre-condition to the guarantor's duty to pay the employer is the occurrence of an event of non-performance of the underlying contract by the contractor. Customarily, performance guarantees are issued for 10% of the value of the underlying contract between the contractor and the employer.

Depending on its wording, a performance guarantee can be either an on-demand guarantee, also known as an unconditional bond, or a conditional guarantee also known as a conditional bond.

A pure on-demand guarantee, as the name suggests, is payable immediately upon the employer's first, often written, demand for payment. Under an on-demand guarantee, the employer is not required to prove or provide details of the contractor's breach of the underlying contract or non-performance of works.

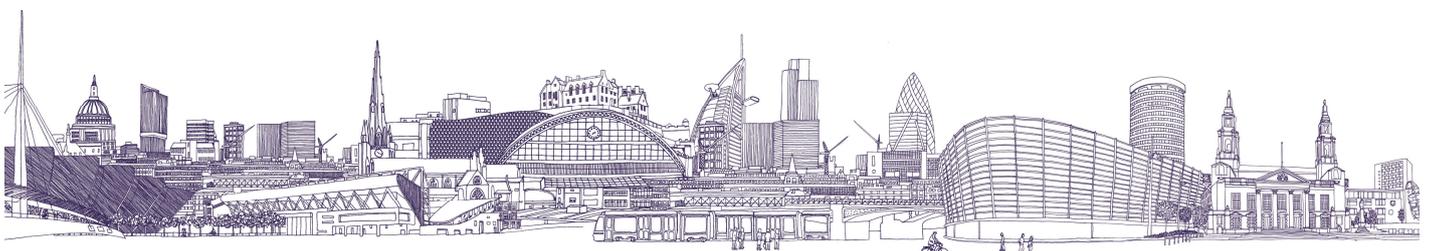
In contrast, a conditional performance guarantee is payable subject to the fulfillment of the conditions specified under the guarantee. Conditions may include: (i) complying with certain procedures when calling upon the guarantee; (ii) proving the contractor's breach of the contract or non-performance of contracted works; or (iii) furnishing of evidence of the amount of resulting damages. The liability of the guarantor to release the payment is not triggered until all the conditions under a conditional performance guarantee are fulfilled.

The obvious advantage of performance guarantees is to give the employer immediate access to the guaranteed funds to rectify or complete construction works in the event the contractor fails to perform the works or performs it defectively. However, as will be seen below, access to guaranteed funds may not be so immediate in practice.

Practical considerations

The purpose and advantage of performance guarantees can be defeated for numerous reasons. A poorly drafted guarantee could make it difficult to identify whether the guarantee is on-demand or conditional. Ambiguity could lead to the bank interpreting the guarantee differently from the employer, creating a dispute that is hardly resolvable without lengthy court proceedings. Employers also often call the guarantee in haste and miss out on fulfilling conditions or procedural requirements at the time of making a call. In any of these events, the guarantor can refuse to release the payment thus defeating the obvious purpose and advantage of bank guarantees. Disputes over bank guarantees not only defeat the purpose of the guarantee i.e. immediate access to funds; but are counter-productive leading to expensive and lengthy legal battles.

In order to ensure that payments under performance guarantees are released swiftly, any employer calling upon a performance guarantee should carefully and neutrally construe the wording of the guarantee at hand. The wording of a performance guarantee is the predominant determining factor of the nature of guarantor's liability. Being a contractual



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undertaking, interpretation of guarantor's obligation under performance guarantees is subject to the rules of interpretation under the UAE Civil Transactions Law [1] .

Experience shows that employers are very quick to assume that the performance guarantee is unconditional in nature when the objective interpretation of the guarantee could be obscure, causing the bank to interpret it as conditional, or even expressly subject to satisfaction of conditions.

If it appears from the wording of the guarantee that the guarantee is on-demand in nature, the guarantor must release the funds immediately, without any inquiry or objection. A guarantee is likely to be on-demand if it includes wording to the effect of:

- a. "upon your first written demand"
- b. "notwithstanding any disputes pending before any court, arbitral tribunal or other authority"
- c. "without exception or objection"
- d. "without any further proof or conditions and without any right of deduction, set-off or counterclaim"

If the guarantee is on demand, the guarantor's obligation will trigger upon the employer's first demand.

Even an unconditional on-demand guarantee may at the least require that the call is made in writing and a statement is made that the contractor has breached the underlying contract, following which the funds will be payable. A contractor cannot sue the guarantor if it later turns out that no breach had been committed.

In comparison, conditional guarantees would require that the employer first satisfies all the conditions set out under the guarantee before liability to release payment can be triggered. As set out above, the most common condition is to give evidence that the contractor has indeed committed a breach of contract. This evidence can be provided in the form of a final judgment from the courts or a final arbitral award.

Secondary to the wording of the guarantee, the approach and attitude of local courts towards bank guarantees will also affect the way guarantees are handled by guarantors in that jurisdiction. By way of example, English courts are adamant on requiring proof of default by the contractor. English courts construe on-demand guarantees very narrowly [2].

Guarantees in the UAE

Nature of obligation

In the UAE, there is an inclination towards on-demand nature of performance guarantees. Performance guarantees issued in the form of bank guarantees are governed by Articles 411 to Article 419 of the UAE Commercial Transactions Law (CTL).

According to Article 414 of the CTL, performance guarantees issued in the form of bank guarantees will be prima facie construed as unconditional on-demand guarantees, unless the employer's entitlement is made dependent on the satisfaction of express conditions set out under the letter of guarantee.

The prima facie on-demand nature of bank guarantees is also confirmed under Article 417 of CTL, which provides "The bank may not refuse payment to the beneficiary on grounds concerning the bank's relationship with the person making the order or the relationship of the latter with the beneficiary."

As a result, the employer has a direct course of action against the guarantor who does not honor this contractual obligation without justifiable excuse. The law in this respect is settled in the UAE that performance guarantees issued by banks create an independent contract between the guarantor and the employer which is separate from the underlying contract between the contractor and the employer [3]. The liability of the guarantor is primary and the contractor is not privy to this contractual relationship.

The bank will usually request the employer to specify the breach or failure on the part of the contractor, which is why the employer should have the evidence of that specific breach should the call on the guarantee be challenged.

Performance guarantees in the UAE

Time of payment

There has been no time limit prescribed under the laws of UAE for the guarantor to make payment after invocation of the guarantee. This is governed by the terms of the guarantee and the guarantor will have to comply with the time limit provided in the Bank Guarantee for making payment. Therefore, it is between the guarantor, employer and the contractor to decide the time limit to be provided to the guarantor for making payments under the guarantee upon its invocation. Not providing a timeframe for payment may create uncertainties and lead to disputes between the employer and the guarantor.

Court intervention

Once a demand is made in the appropriate form and in satisfaction of the conditions (if any), the guarantor cannot decline the release of payment except if it is pursuant to a court order.

A contractor can seek an order of preservatory attachment on the amount of the guarantee from the summary court judge. The order, if granted, directs the guarantor not to release the amount of the guarantee and suspends the guarantor's right to release and the employer's right to receive payment.

Preservatory attachment of performance guarantees is only possible if the contractor, in the opinion of the court, has serious and exceptional grounds apparent from the documentation submitted before the court [4].

The contractor is permitted to seek such order in accordance with the provisions of Article 417(2) of the Commercial Code and Article 252 of the UAE Civil Procedures Law.

Article 417(2) of the Commercial Transaction Law provides: "In exceptional cases, the court may at the request of the person making the order, levy seizure on the guarantee amount with the bank, provided that the person making the order relies for his claim on serious and sure grounds."

The assessment of whether such exceptional circumstances exist is within the discretion of the trial court and is determined on a case by case basis, provided that the court's judgment is based on sound reasons.

Unlike some other jurisdictions that require a clear case of 'fraud', the terminology 'serious and sure grounds' is extremely wide and opens floodgates for par frivolous or mala fide applications for preservatory order by contractors solely for the purpose of avoiding or delaying payment.

The absolute discretion of the trial courts to assess whether such exceptional circumstances exist, coupled with the absence of a doctrine of binding precedent (stare decisis) in the UAE, leaves matters quite unpredictable for employers.

Employers should exercise caution both at the time of drafting the wording of the bank guarantee and at the time of calling upon it.

[1] UAE Federal Law No.5 of 1985

[2] Trafalgar House Construction Limited -v- General Surety Guarantee Company Limited (1195) HL

[3] Union Supreme Court, 644/Judicial Year 23 - 18 November 2013

[4] Commercial Court of Cassation held in Appeal No. 247/2007

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