Courts confirm “pay now and argue later” basis of on demand bonds

A number of recent cases concerning enforcement of “on demand” bonds confirm that they still feature as a requirement of many projects in the UK.

Typically engineering and construction contracts for all but the smallest projects in the UK require the Contractor to provide security by way of a “default” performance bond. In order to trigger payment, the Employer must prove breach of the underlying contract by the Contractor or (if appropriately drafted) its insolvency. However, a number of recent cases concerning enforcement of “on demand” bonds confirm that these more onerous bonds still feature as a requirement of many projects, typically in the energy and process engineering sectors (in which civil engineering of course plays a vital part). Anecdotal evidence suggests that on demand bonds are also being required by a number of public authority clients in relation to their “pure” civil engineering projects.

It was confirmed by Mr Justice Stuart-Smith in the case of MW High Tech Projects UK Limited v Biffa Waste Services Limited (2015) that the Courts will adopt a “pay now, argue later” approach to on demand bonds and they will not restrain the calling of such bonds unless (i) there is a seriously arguable case of fraud, or (ii) the Employer is prevented from making a call by the terms (express or implied) of the underlying contract.

As regards the first ground, the Courts rarely uphold allegations of fraudulent behaviour in civil proceedings and impose a high standard of proof owing to the stigma attached. The difficulty of obtaining indisputable evidence of this type of behaviour means that it can be ruled out for most purposes.

As regards the second ground, it is rare for a construction contract to impose conditions on the calling of an on demand bond, since this would undermine its purpose from the employer’s point of view. In the recent case of Murphy & Sons Ltd v Beckton Energy Ltd (2016) the Court declined to restrain the call of an on demand bond which had been provided in connection with an EPC contract for a CHP plant at Beckton in East London. The Employer had demanded payment from the Bondsman of an amount claimed in respect of
liquidated damages for failure to complete the Works within the Time for Completion. The Contractor maintained that there had been no agreement or determination by the Engineer in respect of liquidated damages as required under the relevant terms of the construction contract, and that the bond had therefore been called in breach of conditions under the construction contract. The Court disagreed, and held that on the correct construction of the relevant terms (which were an amended version of the FIDIC Yellow Book), the bond call provisions could be triggered independently of the claims procedure under the construction contract.

The cases demonstrate that signing an on demand bond can be compared with signing an undated cheque, to be cashed at a future date by the Employer up to the maximum bond amount if it considers that it is entitled to do so, on the “pay now, argue later” basis referred to above. As Mrs Justice Carr stated in her judgment in the Murphy case, this assumes that there will be an “accounting” between the parties at some future date when their rights and obligations under the construction contract will be finally determined. There was an express “accounting” provision in the contract between Murphy and Beckton, but in other cases the judge considered that this would be “implicit in the nature of a performance bond… in the absence of some clear words to a different effect”.

The Contractor is typically required to provide a bond counter-indemnity, usually backed up by cash in an account which can be withdrawn by the Bondsman if the bond is called. The onus is then on the Contractor to issue proceedings against the Employer under the construction contract to require the Employer to account for the bond proceeds, to the extent that it can be established that the Contractor was not liable to pay the amount concerned.

Owing to the higher risk involved, the premium cost of an on demand bond can be several times higher than that of a default bond. The additional project overhead cost, combined with the limited availability of on demand bonds in the UK market, mean that it is often possible to negotiate an acceptable alternative form of security where the Employer is not willing to accept a more standard default bond. This may, for example be by way of “enhanced” retention provisions, which confer protection on both parties by means of a joint account or trust account mandate. Beale & Company can provide advice on appropriate security mechanisms to meet the needs of all interested parties.

For further information please contact:

Tom Pemberton
Partner
T: +44 (0) 20 7469 0416
E: t.pemberton@beale-law.com

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