WHOSE RISK IS IT ANYWAY? PERFORMANCE SECURITY REVISITED

By Sean Wilken QC

Mention financial security to most contentious projects and infrastructure lawyers and the chances are that they will roll their eyes. Mention performance bonds and with the eye roll there will be an additional muttering about "obscure wording", "gibberish", "who really ever relies on them". Mention letters of credit or the UCP 600 (Uniform Customs and Practice for Documentary Credits) or the URDG (Uniform Rules for Demand Guarantees) and the reaction may be even more derogatory. The reaction to the question of whose risk it is has been, being crude and argumentative, therefore, no-one's.

Yet, as the global financial system moves into a time of considerable stress and uncertainty, when so many major projects are on foot, it is worthwhile revisiting the basic principle which underlies these securities and some recent cases on point. After all, if the global financial system has been based on various assumptions as to risk and liability, and if those assumptions are being tested to breaking point, the allocation of risk is worth consideration.

Ultimately, financial security (if one is not talking about charges, debentures and the like) comes in two forms: equivalent to cash and not equivalent to cash. Equivalent to cash: letters of credit (standby and others) and on demand bonds. They are equivalent to cash because they are negotiable as cash and the banks are required to respond to them as if they were cash (subject to fraud). Not equivalent to cash: all forms of guarantee. These are not negotiable and require a process of claim and proof as per their conditions. Put crudely, which type of financial security is provided by the instrument is a matter of contractual construction applying the standard applicable tools.[1]

That said, it is worthwhile recalling what these securities have in common – which stems from the principle that all these securities are autonomous instruments.

As Donaldson MR put it in *Bolivinter Oil SA v Chase Manhattan Bank NA*[2]:

> *"The unique value of such a letter, bond or guarantee is that the beneficiary can be completely satisfied that whatever disputes may thereafter arise between him and the bank's customer in relation to the performance or indeed existence of the underlying contract, the bank is personally undertaking to pay him provided that the specified conditions are met. In requesting his bank to issue such a letter, bond or guarantee, the customer is seeking to take advantage of this unique characteristic. If, save in the most exceptional cases, he is to be allowed to derogate from the bank's personal and irrevocable undertaking, given be it again noted at his request, by obtaining an injunction restraining the bank from honouring that undertaking, he will undermine what is the bank's greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined."*[3]

This is often stated a as truism – but there are three important consequences which are often ignored.

As the instrument is autonomous, anyone seeking to restrain the Bank/Guarantor[4] will need both to have an independent cause of action and grounds for impugning payment under the instrument as against the Bank/Guarantor. This is usually expressed as a fraud exception.[5] Yet, even with the fraud exception, where the Bank/Guarantor is not the obligor's own bank,[6] it is difficult to see what the cause of action the Beneficiary has against the

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1 See eg *Trafalgar House Constructions (Regions) Ltd v GSGC Ltd* [1996] 1 AC 199

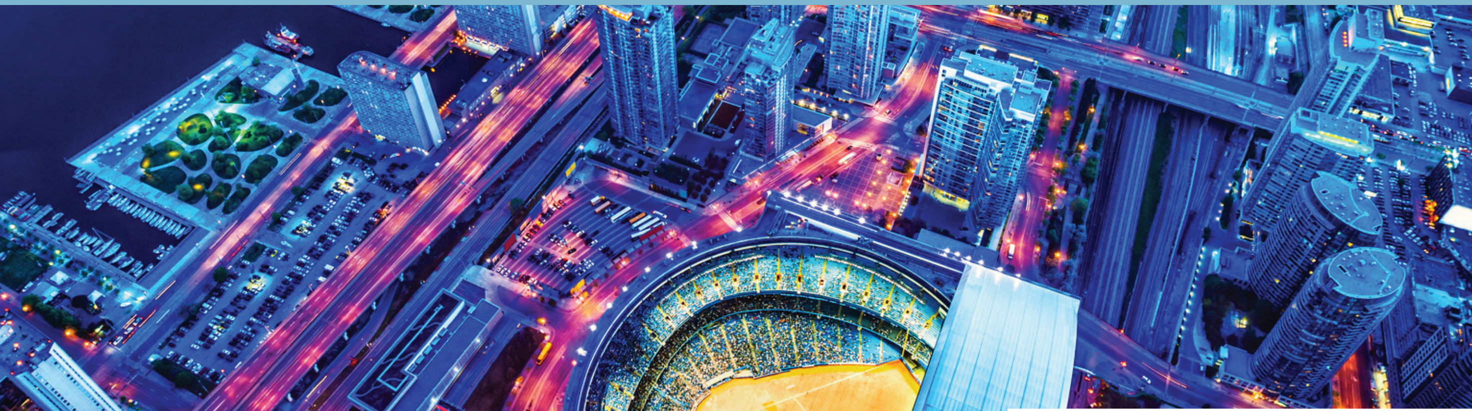
2 [1984] 1 WLR 392

3 See also *Tetronics (International) Ltd v HSBC Bank Plc* [2018] EWHC 201 (TCC) at [26]

4 In the following discussion, I refer to the party that issued the instrument and will pay against it as the Bank/Guarantor; the party making the claim as the Beneficiary and the party in default triggering the claim against the instrument as the Obligor.

5 Recently reiterated in *Alternative Power Solution Ltd v Central Electricity Board* [2014] UKPC 31 at [56 ff] but a long standing principle in English law.

6 Where the Obligor can rely on the bank mandate between it and the Bank/Guarantor.



Bank/Guarantor is.[7] Allied to that is a further principle, however, which perhaps is even less appreciated. At least where one is dealing with an on-demand bond or letter of credit, absent fraud or potentially a demand in breach of the underlying contract,[8] there can be no injunction to restrain the Beneficiary from calling on the instrument – for that would violate the principle of autonomy.[9]

Thus, the risk of failure lies with the banks.

Yet, whilst it is true that that instrument is legally autonomous, it is rarely commercially autonomous as the Bank/Guarantor will almost inevitably have underlying security ultimately biting against the Obligor's assets. That underlying security will, in all likelihood, immediately bite as soon as there is any call on the instrument. This is, of course, why Obligors seek to block payments on the instrument. Thus, and unsurprisingly, what is packaged, legally, as the Bank/Guarantor's risk of payment is in fact the Obligor's risk of the underlying security being called.

Thus, the risk of failure lies with the Obligor.

It is as a result of that risk, that Obligors seek to undermine the autonomy principle. That can only be done, absent fraud, if: a) as set out above, the demand is presented in contradiction to the underlying arrangements; or b) the instrument explicitly makes reference to those underlying instruments.

The most obvious example of the latter is the ABI Performance Guarantee wording which requires (at clause 1) the amounts to be paid under the instrument to be "established and ascertained" as per the underlying contract. This expressly therefore requires reference to the underlying contract.

What this entails was recently considered in *Yuanda v Multiplex Europe & ANZ ("Yuanda")*[10]. Here, Yuanda (the Obligor) sought to injunct Multiplex (the Beneficiary) and ANZ (the Bank/Guarantor) from paying out on a modified ABI-type Performance Guarantee. Yuanda had two arguments: the Beneficiary had called on the Guarantee as if it were an on-demand guarantee and that the Performance Guarantee would only ever respond after there had been a resolved Final Account including any adjudication, arbitration or litigation. Yuanda succeeded, as a matter of fact, on the first and failed on the second.

The underlying contract in *Yuanda* was a JCT Design and Build (2011). Under this contract, the employer/main contractor – rather than some third party – issues notices as to what payments are due and when. The Judge rejected an argument that those notices were sufficient to sums being established and ascertained[11] – leaving open whether, where the contract did have a third party certifier, such certifications would suffice.

The Judge did, however, find that an adjudication would serve to ascertain and establish loss[12]– pointing out that given an adjudication could found an application for summary judgment, it would be strange if the instrument did not respond.[13] This sufficed for Multiplex's purposes, having had an adjudication in train.

That then, however, led to a discussion about what would happen should the Adjudication be delayed. This was relevant because the instrument had an expiry date of 4 April 2020; the hearings were on 20; 27 January and 19 February with judgment (the court accelerating its processes to permit such) on 28 February. The Adjudicator was due to provide a decision on 6 March 2020. Slippage could therefore take completion of the process of a decision, failure to pay and the making of a claim past 4 April 2020. This discussion centred on clause 4 of the instrument.

Clause 4 (as the Judge found) was not a standard ABI wording.[14] As a result, Yuanda's argument based on the standard ABI wording and the commentary to that wording could not succeed.[15] The Judge went onto find that the wording of this instrument was, in essence, there to allow the mechanical process of a claim to be gone through – bearing in mind the international nature of the underlying securities.[16] It goes without saying that this is a narrower approach to the expiry of ABI instruments than had previously been suspected to be the correct one. The approach did, however, turn on the wording of this instrument. It remains to be seen whether a narrower approach would also be adopted to the ABI wording.

Yuanda dealt with one further issue. The nature of the financial security provided

7 As the Court of Appeal recognised in United Trading Corp v Allied Arab Bank [1985] 2 Lloyd's Rep 554 at 561

8 Sirius International Insurance Co v. FAI General Insurance Ltd [2003] EWCA (Civ) 470 at [26 – 7]; MW High Tech Projects UK Ltd v Biffa Waste Services Ltd [2015] EWHC 949 (TCC) at [28 – 34]

9 Group Josi Re v Wallbrook [1996] 1 Lloyd's Rep 35 casting significant doubt on Themehelp Ltd v West [1996] QB 84

10 [2020] EWHC 468 (TCC)

11 At [70 – 1]

12 At [83 ff]

13 At [91]

14 At [96]. In fact, it was closer to the URDG wording.

15 At [97]. Leaving open, of course, whether the argument was correct on the standard ABI wording.

16 At [101]

> *"Now, it appears, there is beginning to emerge a proper law and practice as to what autonomous financial security means and what it can achieve".*

by this type of instrument. In *Yuanda*, the Judge concluded that the instrument was performance security – that is security which is on-going throughout the project which would respond on default.[17] The nature of the security provided by instruments of this nature was, however, specifically considered in another case featuring Multiplex – *Multiplex v R&F One (UK) Ltd ("Multiplex").*[18]

Here, Multiplex was entitled, under its contract with the developer to financial security to cover the developer's payment obligations to Multiplex. The developer defaulted on numerous occasions both in payment and provision of the security. As a result, a CPR24 application was made. To settle that, the developer offered once again to provide security, in default of which Multiplex could suspend works on the Nine Elms development. The developer defaulted again in provision of the security but paid sums into court. Multiplex argued that it could still suspend, but the developer argued that doing so would be repudiatory breach due to the monies in court providing sufficient security.

Thus, the argument turned on what type of security was created by what might be termed a traditional financial security as opposed to payment into court.

The developer argued that, relying on *Halvanon Insurance Co Ltd*[19] and *Re Peak Hotels & Resorts Ltd (In Liquidation); Crumpler & Another v Candey Ltd*[20] ("Re Peak") that money paid into court gave the Beneficiary a "security interest" – as the Court of Appeal in *Re Peak Hotels* had recognised.[21] The question was what sort of security interest.

Whether a payment into court was the same as the financial security provided by the financial instruments being discussed here was considered in *Liberty Mercian No 3*[22] (*"Liberty Mercian"*). In this case it was accepted that no bond could be provided but there were funds in court. Thus, the Court considered whether those monies in court could be used. The Court considered – but did not set out the scheme – that the monies in court could be so used but only if they were subject to some court devised scheme.[23] Thus, the Court in *Liberty Mercian* tacitly accepted that funds into court were not equivalent to a bond.

In *Multiplex*, the Court was more explicit as to the position: Multiplex would be a secured creditor in respect of the funds in the event of insolvency, the payment into court being equivalent to an equitable charge.[24] The Court also referred to the payment into court as a procedural security. The former – insolvency security with a secured creditor ranking – will be familiar to many. The latter - a procedural security – is absolutely consistent with the Court's abilities to control its own procedures and, for example, to require payment in to govern against default or as a precondition to continuing to have access to the court process.[25]

The Court was also clear that a payment into court was not the same security proffered by the instruments being discussed here. As the Court said:[26]

> *Therefore, it [payment into court] does not provide the same payment security as would a bank guarantee or bond, pursuant to which the claimant would have access by way of an appropriate demand to immediate payment of cash funds.*

This is clear statement as to how autonomous financial securities operate in building and infrastructure projects. In the law of international trade, letters of credit are a one shot security for payment obligations against proof documents. In financial transactions, letters of credit are ultimate recourse documents. In infrastructure and projects, the usual pattern has been for law and practice to follow these precedents. Now, it appears, there is beginning to emerge a proper law and practice as to what autonomous financial security means and what it can achieve.

Returning to the first or second theme of this piece – risk. These cases return ultimate risk to the defaulting party. That is undoubtedly correct. Yet, in these times, another question arises – who is the risk taker, or funder, of ultimate default?

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17 At [92]
18 [2019] EWHC 3464 (TCC)
19 [1988] 1 WLR 1122
20 [2018] EWCA Civ 2256
21 [2014] EWHC 3584. At [82]
22 At [56 ff]
23 As yet no court has attempted the thought experiment to create the same
24 At [24]
25 For example, an order that a Defendant have permission to proceed with its defence, conditional on the payment into court.
26 At [24]