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Reneging on a promise? Rejecting demands under advance payment bonds under English Law

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It is commonplace in construction projects, either off- or on-shore, for an employer to seek protection for any advance payments made to a contractor or for a failure to perform.[1] These will often be in the form of "on demand" or "unconditional" payment guarantees or bonds from a bank or other financial institution. Under English law, these differ from traditional or "true" guarantees in that they impose an obligation on the bank to pay upon receipt of a written demand. Unlike a true guarantee, the beneficiary does not have to demonstrate a breach or other default in respect of the underlying contract. As such, they provide much greater security to an employer.

They are complex instruments and their effect will be determined by their terms. Such terms may require the presentation of certain specified documents with any demand, or the inclusion of specific statements or other details in either the demand itself or any notice of rejection in response. On demand guarantees therefore, act almost identically to standby letters of credit. However, US banks, for example, will often be more comfortable providing the latter. Indeed, in a recent case we obtained and successfully drew upon a standby letter of credit from a US bank, which our opposing party was required to provide by an arbitration panel by way of security in order to be allowed to run its claims against our client.

In international contracts, parties will often incorporate in to the guarantee internationally agreed rules, a number of which have been produced by the International Chamber of Commerce. The ICC Uniform Customs and Practice for Documentary Credits (UCP 600) and the Uniform Rules for Demand Guarantees (URDG) being the most commonplace. As their names suggest, UCP 600 applies to documentary credits (such as standby letters of credit), and URDG to demand guarantees. They are incorporated where the text of the relevant guarantee expressly states as much. However, due to the similarity between the operation of a demand bond and a standby letter of credit, the latter sometimes also incorporates the URDG.

Whenever a demand is made under such instruments it is, of course, not unusual for the guarantor to seek any available route to avoid payment. Traditionally, while cases of fraud have long been the only clear way to avoid payment, other routes could occasionally be found due to the fact that English law required strict compliance with the terms of the guarantee in the making of a demand, and even minor mistakes might permit non-payment. Scrutinising every word and every comma is accordingly an essential step before making payment. However, as the recent case of *Técnicas Reunidas Saudia v Korea Development Bank* [2020] EWHC 968 (TCC) has made clear, the English Courts are increasingly moving away from a literalist approach and many of these mistakes may no longer be sufficient to invalidate a demand. In this article, we look at the details of this case and provide practical drafting advice arising from it. Such points are of growing importance in light of the ongoing Covid-19 pandemic which has led to an increase in such demands being made and a corresponding increase in the potential for disputes.

[1] Where the project has included a tender phase, a "bid bond" may also be used to prevent a contractor from tendering a bid, but not executing or accepting the contract, once it has been awarded to them. Such instruments would usually require that a demand include a declaration that the relevant agreement had not been entered into by the bidder within the required time frame.

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The *Técnicas* case

The particulars of the *Técnicas* case are worth reviewing in detail, in that they help provide a good example of the sorts of technical points that can be taken with regard to demands, and the judgment also sets out a helpful *precis* of the relevant case law.

Tecnicas ("TRS"), a Spanish entity, was the main contractor employed in relation to a major construction project in Saudi Arabia. TRS concluded a subcontract with Sungchang, pursuant to which Sungchang provided an on demand guarantee from Korea Development Bank ("KDB") as security for advance payments made to it by TRS. The guarantee was stated to be "*governed and construed in accordance with the laws of England and Wales and … subject to the [URDG]"*. If there was any conflict between these two, the guarantee stated that the URDG would prevail.

After the sub-contractor effectively walked off-site without warning in the middle of 2019, TRS terminated the subcontract and made a demand on KDB, who refused to pay. Alongside and in conjunction with proceedings in Korea brought by Sungchang, TRS sought summary judgment against KDB at the Technology and Construction Court in London.

KDB's primary argument against making payment was that the wording of the demand guarantee required the advance payments to be paid into a bank account held by HSBC, which they were not. A number of other arguments were also raised during proceedings which related to the meaning of certain requirements set out in the URDG. The demand had been served the day before expiry of the guarantee and, as such, it had since expired, and no further demands could be made.

In rejecting KDB's case, the judge found against them in three important and distinct ways:

(1) Contractual Interpretation

The relevant wording from the demand guarantee was as follows:

"*It is a condition for any claim and payment under this guarantee to be made that the funds paid as advance payments subject to the terms of the subcontract must have been received by the sub-contractor on its account number 042-117994-03 held with HSBC.*" (our emphasis)

Payment was made to the correct account number, but this turned out to be held by SABB Bank, not HSBC. However, SABB Bank was 40% owned by HSBC and there was no other retail HSBC bank in Saudi Arabia. Its logo was almost identical to HSBC's and it had been described as an "associate" bank in HSBC literature. The dispute therefore, turned on the meaning of the phrase "*held with HSBC*".

The judge referred to the case law on contractual interpretation under English law and, in particular, the Supreme Court's decision in *Rainy Sky*[2]. He quoted the following key statement from that judgment which sets out the relevant test:

"*the exercise of construction is essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract,*

[2] *Rainy Sky & Ors v Kookmin Bank* [2011] UKSC 50

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would have understood the parties to have meant. In doing so, the court must have regard to all the relevant surrounding circumstances. If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other."

While KDB tried to argue this approach only applied where there was ambiguity, and the clause was clear, the judge found that it had, in fact, more than one potential meaning. HSBC was not defined as any particular legal entity in the guarantee and both parties sought to interpret the clause by adding to it (KDB by stating it must either be an HSBC branch or a bank trading as HSBC, and TRS by saying it was sufficient for the bank to be "associated" with HSBC). If one interpretation would be inconsistent with business common sense or would lead to the contract being worthless or "*a commercial absurdity*", then it should be avoided. Payment had been made to the correct bank account number set out in the guarantee and to require this to be a non-existent HSBC branch would have rendered the guarantee useless. If KDB's argument was correct, the condition would have been impossible to comply with from the outset. In this respect, the judge referred approvingly to the judgment in *Lukoil Mid-East Ltd. v Barclays Bank Plc* [2016] BLR 162 where the Court interpreted a contract in a manner to avoid what it regarded as a nonsensical result.

In light of the above, the judge ruled that "*the Court should, if it can, strive for an interpretation which is open to it on the words of the guarantee and which will avoid pointlessness or absurdity.*" As such, TRS' argument was to be preferred and there had been no breach of the relevant provision.

(2) Article 7 of the URDG

Despite this finding, and therefore granting summary judgment against KDB, the judge went on to deal with the impact of the URDG in a detailed, but *obiter*, analysis. Article 7 of the URDG is what is known as the "documents principle" and stipulates that demand guarantees should not contain a condition other than a date or lapse of time without specifying a document to indicate compliance with the condition. If there is no document specified, then the condition will be disregarded. Therefore, as there was no indication of documentary evidence associated with the HSBC condition, Article 7 would operate to remove it and render it moot. As such, even had the court found that the wording of the guarantee did require the money to be paid into an HSBC branch, this would have served to negate that requirement.

This is a rare commentary on the URDG from the English Courts, but is an important reminder that, where it is incorporated into a guarantee, it will require both that documents to verify the relevant conditions are specified in clear terms, and that these are then provided at the relevant time. It is also important to note that, had the URDG not been incorporated, case law suggests that the usual position under English law would have been that such conditions are enforceable despite not having such documentary requirements.

(3) Formalities for Rejection

Article 24(d) of the URDG requires that any notice of a rejection of a call on a guarantee must be given "*to the presenter of the demand*" within 5 business days of the demand being made. In this case, while the rejection was served just within the time window, it was sent by SWIFT to the advising bank under the demand guarantee, rather than TRS. While this bank had presented demands on earlier occasions, the relevant demand for this dispute was served in person by TRS at the premises of KDB in Seoul. As such, the court found that the rejection had not been validly served and the time for rejection had subsequently expired. This is a useful reminder of the fact that, where a guarantee specifies a particular entity to which either demands or rejections must be sent, it is of vital importance that this is strictly observed.

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Practical conclusions

As can be seen from the judgment in this case, which was notably detailed and thorough in its analysis, the English Courts will take great care in interpreting the requirements of such guarantees. Even a seemingly minor issue such as the fact that the designated bank account was not strictly in an HSBC branch required cautious consideration. Of course, absent the effect of Article 7 of the URDG, had the payment been made to an incorrect bank account, or one with no connection to HSBC at all, then the result may have been different. The possibility of this sort of uncertainty should therefore be avoided in any drafting. Conditions should be clearly spelled out and details such as bank accounts and addresses double checked and confirmed.

The failure to do so can put a guarantor in an unenviable position. If it pays out in a manner inconsistent with its obligations in the guarantee, it is likely to render void any cross indemnity provided to it by the party who requested the provision of the guarantee. The guarantee in the *Técnicas* case specifically mentioned HSBC, and it is unclear how much detailed enquiry would have been sufficient for KDB to be satisfied of the position. As is often the case, the sensible course of action is therefore to seek to have the competent court rule on the issue. This will of course take time and money, and will delay repayment. It is therefore in the interests of both parties for such ambiguities to be avoided.

In light of the above, it remains the case that the only clear route for a guarantor to avoid payment is in cases where the demand is fraudulently made. It will be interesting to see if the increase in demands made in light of the Covid-19 pandemic and its economic impact leads to a similar increase in associated disputes. If this occurs, the present case foreshadows the likely approach of the English Courts, and particularly so where the underlying terms of the guarantee are to be construed against internationally agreed rules such as the URDG and UCP 600. As such, the advice remains that precision, clarity and accuracy are key for both sides.

For additional information, please contact Haynes and Boone lawyers, Andreas Dracoulis and Jonathan Morton.

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