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# International Quarterly

Issue 05, 2013

Our newsletter provides informative and practical information regarding legal and commercial developments in construction and energy sectors around the world.

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# Contract Corner:

*A review of typical contracts and clauses*

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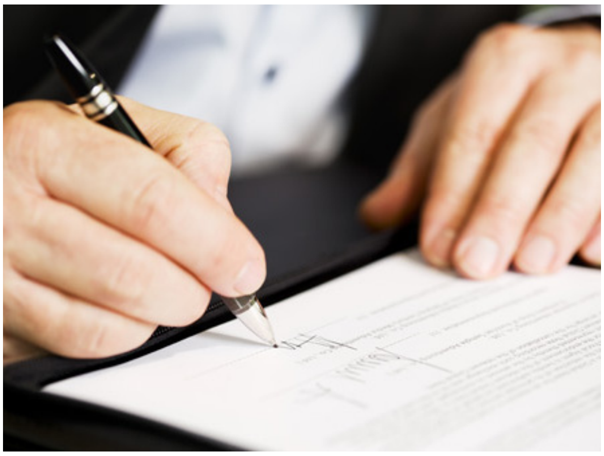
## Can you imply good faith into agreements made under English Law?

*This issue's contract corner discusses good faith.*

**By Jeremy Glover**
**Partner, Fenwick Elliott**

Good faith might be a strange topic to find in contract corner, especially one written by an English lawyer. However, the recent case of *Yam Seng Pte Ltd (a company registered in Singapore) v International Trade Corporation Ltd*[1] suggests that there may be a small change in the approach of the English courts to the question of whether or not English law does or should recognise a general duty to perform contracts in good faith. The general view is, of course, that traditionally under English contract law there is no legal principle of good faith. Two reasons for this are said to be found, the first in the general principles of freedom of contract whereby parties are free to pursue their own goals in both negotiating but also in performing contracts provided they do not act in breach of a term of the contract. Second there is concern that the concept of good faith is too vague and subjective and therefore uncertain.

As Mr Justice Legatt noted, this approach, in refusing to recognise any such general obligation of good faith, would appear to be an example of "swimming against the tide" of both civil and common law jurisdictions. Good faith appears in most civil codes and, for example, in Australia the existence of a contractual duty of good faith is reasonably well established.[2] The Judge concluded that he doubted that English law had reached the stage, however, where it was ready to recognise a requirement of good faith as a duty implied by law, even as a default rule, in all commercial contracts. However, the Judge further noted that there seemed to him to be no difficulty in adopting the established principles of English law for the implication of terms in fact, depending on the facts of course, in implying such a duty in any ordinary commercial contract based on the presumed intention of the parties.



Under English law, the two basic and principal criteria used to identify terms implied in fact are that the term is so obvious that it goes without saying and that the term is necessary to give business efficacy to the contract. What would the contract, read as a whole against the relevant background, reasonably be understood to mean? In the case here, the Judge noted that the relevant background was important, not only in terms of matters of fact known to the parties but also shared values and norms of behaviour. These may include norms that command general social acceptance or that may be specific to a particular trade, commercial activity or even the particular contractual relationship in question. The Judge stressed that commerce takes place against a background expectation of honesty. Such an expectation is essential to commerce, which depends critically on trust. However, as he adroitly recognised, such an expectation is seldom, if ever, made the subject of an express contractual obligation. To seek to do so might actually damage the parties' relationship by the lack of trust that this would signify. The Judge concluded that as a matter of construction, it would be hard to envisage any contract which would not reasonably be understood as requiring honesty in its performance.

There were also other similar standards of commercial dealing which are so generally accepted that the contracting parties would reasonably be understood to take them as read without explicitly stating them in their contractual document. The Judge had in mind the concept of "fidelity to the parties' bargain". Contracts can never be complete in the sense of expressly providing for every event that may happen. To apply a contract to circumstances not specifically provided for, the language must accordingly be given a reasonable construction which promotes the values and purposes expressed or implicit in the contract.

Mr Justice Legatt stressed that what good faith requires is sensitive to and depends on context. That includes the core value of honesty. Some contracts, including joint venture agreements, may require a high degree of communication, cooperation and predictable performance based on mutual trust and confidence, which are not legislated for in the express terms of the contract but are implicit in the parties' understanding and necessary to give business efficacy to the arrangements. The case at hand involved a long-term distributorship agreement

1. [2013] EWHC 111 (QB)
2. The Judge's judgment provides a useful summary of the position worldwide.

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which required the parties to communicate effectively and cooperate with each other in its performance.

This led the Judge to conclude that there was in his view nothing novel or foreign to English law in recognising an implied duty of good faith in the performance of contracts. He referred to the body of cases in which duties of cooperation in the performance of the contract have been implied and the authorities which show that a power conferred by a contract on one party to make decisions that affect them both must be exercised honestly and in good faith for the purpose for which it was conferred, and not arbitrarily or unreasonably. Another example is that frequently found in a construction context where the consent of one party is needed to an action of the other and a term is implied that such consent is not to be withheld unreasonably.


To the Judge, the essence of contracting is that the parties bind themselves in order to co-operate to their mutual benefit. The obligations that they undertake include those which are implicit in their agreement as well as those which they have made explicit. Further, the Judge saw no objection in describing the duty as one of good faith "and fair dealing". Such a duty does not involve the court in imposing its view of what is substantively fair on the parties. What constitutes fair dealing is defined by the contract and by those standards of conduct to which, objectively, the parties must reasonably have assumed compliance without the need to state them. The inclusion of fair dealing would draw attention to the fact that the standard is objective. As such there should be nothing unduly vague or unworkable about the concept. The application involves no more uncertainty than is inherent in the process of contractual interpretation. This is important because, in the Judge's view, the content of the duty is heavily dependent on context and is therefore established through a process of construction of the contract, in other words on the typical English case-by-case approach.

In conclusion Mr Justice Legatt said this:

*"In the light of these points, I respectfully suggest that the traditional English hostility towards a doctrine of good faith in the performance of contracts, to the extent that it still persists, is misplaced."*

In the case here, it was said that the relevant duty was captured by two more specific terms which Yam Seng argued were to be implied into the Agreement. These were (i) the duty not to give false information and (ii) the far more specific duty not to undercut duty free prices. The problem with the first issue was the failure to distinguish between encouraging expenditure in the expectation that products would be supplied by providing false information dishonestly, and doing so innocently. To lead a party to expect that products were going be supplied, believing that you would be able to supply them and were intending to do so, would not show a lack of good faith. However, if you wilfully led another to expect that products would be supplied in circumstances where you either did not intend to supply them or knew that you would be unable to do so, would be contrary to standards of commercial dealing. The second term was factually specific to the case in question although the Judge noted that the usual reasonable commercial expectation would be that a party would be free to sell its products to others on such terms as it chose unless it had expressly agreed otherwise. However, on the facts, the term was implied into the agreement between the parties.

This led the Judge to imply two terms into the agreement, the implied duty of honesty in the provision of information and the implied duty not to approve a domestic retail price for a product which undercut the duty free retail price. On the facts, the Defendant was found to be in breach of the first term.

## Conclusions

We have highlighted this case because of the careful and clear comments made by Mr Justice Legatt about the implication of good faith into agreements made under English law. Clearly he is not saying that you would be able to imply good faith into each and every agreement. It all depends on the context of the contractual arrangements made between the parties. However, the Judge has potentially opened a pathway which others will follow and which suggests that perhaps English law is not so different, in this context, from other jurisdictions. No doubt this is a development that will be watched with interest and which will feature in future editions of *IQ*.

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# Amending Clause 13.1 of FIDIC – protracted negotiations

**By Jatinder Garcha**
**Associate, Fenwick Elliott**

Having negotiated contracts on a number of internationally financed projects over the past year, the reluctance of employers (or more likely of their lenders) to progress projects on the standard FIDIC conditions of contract is clear to see. There are a number of provisions that will inevitably always be subject to protracted negotiations, for example the Clause 17.6 limitation on liability cap and, almost more importantly, which liabilities fall outside of the overall cap, and also the removal of the conditionality wording in Clause 4.2 and substitution with wording making it clear that the bonds are purely "on-demand". Developments in respect of on-demand bonds are discussed separately in this edition.

However, there are other provisions that appear to be reasonable and uncontroversial but again are sought to be amended, which can lead to lengthy negotiations as a result of contractors attempting to "stay in line" with the standard FIDIC provisions. One such provision is Clause 13.1 which relates to the variation procedure set out in the FIDIC Yellow Book. There are three issues in Clause 13.1 that cause particular discussion. First, the employer will attempt to delete the last sentence of the first paragraph which states that *"A Variation shall not comprise the omission of any work which is to be carried out by others."*

This provision is aimed at ensuring that the employer cannot remove works from the contractor's scope and have them carried out by a third party at perhaps a lower price. The contractor will have priced the contract works on the basis of a complete EPC wrap and therefore it is unfair to compare its prices for individual elements of the works with those of other contractors who do not have to price the full EPC risk. The obvious concern for the contractor is that removal of any scope of its works will result in a reduction in its contract price and therefore its profit. Contractors acknowledge that, if for commercial viability reasons the project works have to be scaled back, then the works under their contract can accordingly be reduced without any penalty. It is not acceptable, however, for works to be omitted just so that they can be carried out by another contractor. The employer will argue that for reasons of flexibility it needs an unrestricted right to be able to change the project works and how they are undertaken. Employers will vigorously argue that they require this flexibility and that the contract provisions need amendment in order to be acceptable to lenders.

If the deletion is insisted upon, contractors should consider putting a proposal to the employer that the contractor be entitled to payment of its loss of profit in respect of the element of works omitted where the omitted works are to be undertaken by a third party. Any such provision would need to be specifically carved out of the exclusion for loss of profit under Clause 17.6.

The second issue that arises relates to the ability of the contractor to object to a variation proposed or initiated by the employer. The FIDIC contract allows for an objection in three limited circumstances only, but even that is considered far too wide by employers who require an unrestricted ability to instruct variations of any kind. Employers will look to delete the standard FIDIC rights of objection, arguing that they have to ensure that any modification in the project to reflect commercial changes can be forced upon the contractor, and that the project is not held to ransom by the contractor. One of the three rights of objection under the FIDIC contract is if the variation *"will have an adverse impact on the achievement of the Schedule of Guarantees"*. The rationale for this provision, which is occasionally amended to refer to failure to pass completion tests, is well understood. Employers, on the other hand, will argue that just because there is

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an impact this should not necessarily result in an automatic right to object. Employers consider that the contractor should assess the consequences of the variation and if necessary propose changes, redesigns, or other modifications that will result in the Schedule of Guarantees being achieved. As far as employers are concerned, it is for the contractor to come up with the necessary solutions as part of its proposal in response to the employer's request. For the employer it is just a matter of cost and time to the contractor.

Logic dictates that contractors are more than willing to accept variation orders (as variations increase the contract price and, accordingly, profit); however, there will inevitably be occasions when for good reasons a contractor may be unable to execute a variation. Being unable to execute a variation has to be distinguished from a variation which is merely more difficult to execute. Added difficulty can be addressed through the compensation procedure, but impossibility can not. Such factors should be taken into account when discussing what events should entitle the contractor to object.

After lengthy discussions over the variation objection events, the final issue to be discussed is the wording of the last sentence of Clause 13.1. This states that upon receiving from the contractor an objection notice to a proposed variation the engineer "*shall cancel, confirm or vary the instruction*". It is the express right to "confirm" the instruction that causes contractors some concern. If a contractor has objected to a variation that will cause it to be in breach of laws or a consent, or will lead to the contractor's failure to achieve the Schedule of Guarantees, then how is it appropriate that such a variation proposal can be confirmed? What is the effect of such confirmation on the contractor's obligations under the contract (especially where the contractor knows that being forced to comply with the variation will put it in breach of another express provision of the contract)?

The FIDIC contract does not specifically address this issue. One would expect that such confirmation would absolve the contractor from any responsibility or liability to the employer for the consequences of the contractor's failure to perform an express obligation under the contract which results by virtue of compliance with such variation. Whilst it is likely that this assumption would be implied into the contract under English law, it is prudent to incorporate wording to this effect, especially if the contract is to be governed by the laws of a jurisdiction other than England.

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*International dispute resolution & arbitration*

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## Is arbitration confidential?

**By Richard Smellie**
**Partner, Fenwick Elliott**

*Introduction*

It is generally assumed as a matter of commercial dealings that arbitration proceedings will be both private and confidential.

The first assumption is essentially correct. Arbitrations are private in that third parties who are not a party to the arbitration agreement cannot attend any hearings or play any part in the arbitration proceedings.

The second assumption, since the 1990s, is not. Confidentiality – which is concerned with the parties' obligation to each other not to disclose information concerning the arbitration to third parties (and the arbitrator's like obligations to the parties) – does not apply to arbitration as an all-encompassing rule, and indeed in some circumstances will not apply at all. Generally speaking, however, parties to arbitration agreements assume that it does. Indeed, surveys suggest that confidentiality is one of the main reasons commercial parties choose arbitration over court proceedings (along with the flexibility of the process and the ability to nominate an arbitrator of choice).

The traditional assumption that arbitrations are confidential is, on the face of it, a fair one, given that arbitration arises through private agreement: it is the contractual agreement to arbitrate (and usually to do so using a pre-agreed set of arbitration rules and with the assistance of an administrating body, such as the International Chamber of Commerce ("ICC") or the London Court of International Arbitration ("LCIA")) that provides the necessary legal framework for arbitration. This is inherently different to taking a dispute to a local court, which is a formal dispute resolution process provided and mandated by the state, and therefore, to varying degrees, open to the public and the press.

This traditional assumption was, however, dealt a severe blow in the 1990s, when, with the growth in the use of international arbitration, a closer consideration of various aspects of arbitration began to take place. Those considerations included the extent to which arbitrations were confidential, and when the issue came before the courts in Australia and Sweden in the mid- to late 1990s, the courts in those jurisdictions rejected the concept of an overall duty of confidentiality in arbitration. This led to a debate about confidentiality in arbitration in many jurisdictions, and new legislation in some places. It also led to many of the recognised arbitral institutions amending their rules to clarify the position on confidentiality.

Unfortunately, however, there has been no common approach amongst legislators and arbitral institutions, other than to recognise, and seek to reflect in different ways, the important arbitral mainstay that the parties should have considerable autonomy to decide the rules which will regulate their arbitration. In some instances, therefore, legislators and arbitral administrative bodies moved to make the default position that there was no confidentiality in arbitration (leaving it entirely a matter of the parties' agreement), whilst others included such a duty, but covering differing scopes. Further, serious questions arose as to the extent to which confidentiality obligations, particularly those imposed through the rules of an arbitral institution as opposed to state legislation, can be enforced.

Whether an arbitration is confidential or not, therefore, depends upon the law at the seat of the arbitration, and the rules (if any) that have been agreed by the parties as part of their agreement to arbitrate. The issue of confidentiality is made complex by the various persons involved in the

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arbitration process, and the ability of the parties to the arbitration to impose rules upon persons such as witnesses, translators and transcribers who will know of and have access to private and confidential information through their involvement in the arbitration, but who, unlike the parties themselves, are not contractually bound or obliged by the arbitration agreement.

### *Different aspects of confidentiality*

As touched on above, the issue of confidentiality is made complex by the different types of information and documentation that are created and/or become available in the arbitration process.

To give a flavour of the problem, consider the question of documentation generated as part of the arbitral process by the parties and the arbitrators, including the award, as against pre-existing documentation made available as evidence. The former is perhaps in a similar category to the private and closed nature of arbitration hearings, and therefore readily considered confidential, save that in some instances there may be a third party, like a witness of fact, who knows the content of the document and regards it as theirs. Pre-existing documentation that was not created for the purposes of the arbitration might also be thought to be confidential because it might concern or involve parties other than the parties to the arbitration agreement, but equally some or all of it might already be in either the public domain, or certainly a wider domain, having, for example, been issued to various parties on a complex construction project.

Then there is also the question of the many different people involved in the arbitration, and whether a duty should be – or, in the case of arbitration rules rather then state legislation, can be – imposed on them. Who should a duty of confidentiality extend to? Whilst it is probably fair to expect it to extend to the Tribunal, and to the staff of the arbitral administrative body, to do so requires legislation, or agreement, as the people concerned are not parties to the arbitration agreement and therefore have not agreed to the rules that have been agreed to by the parties to the arbitration itself. Further, what about witnesses of fact, who are also not parties to the arbitration agreement, and who might not be entirely willing participants, and may well regard what they hold by way of documents, and the knowledge they have, as being theirs to do with as they wish. Expert witnesses are more obvious candidates for a confidentiality obligation, but it would have to arise through agreement, and the expert may wish, at least to some degree, to be able to let the fact of his or her instruction be known for marketing purposes.

Questions also arise as to whether any confidentiality should attach to arbitral proceedings if they are challenged in the local courts.

### *Legislation and arbitration rules: no common approach*

As noted above, both countries and the arbitral institutions that administer international arbitration have not taken a consistent approach to "legislating" for confidentiality in arbitration proceedings.

Each country and set of arbitral rules has taken its own approach, and there is not room in this article to cover them all. We look here, therefore, at a handful of countries and institutional rules.

In France, which has been the traditional home of the ICC for many years, with Paris a common arbitral seat, it is only the deliberations of the arbitrators that are said by the relevant provisions of the Civil Code to be confidential, although there is case law which suggests that there may be a limited general duty of confidentiality.

In contrast, in England, where London is another common seat and the home of the LCIA, there is no relevant legislation: the Arbitration Act 1996 is completely silent on confidentiality. But as a consequence of case law, three quite far-reaching rules apply. The first is that unless agreed otherwise, arbitration proceedings are held in private. The second is that there is an implied obligation of confidentiality which arises from the very nature of arbitration, and the third is that any duty of confidentiality is subject to the exceptions of consent, court order, reasonable necessity and public interest.

In Singapore, again a common seat for international arbitration and the home of the Singapore International Arbitration Centre ("SIAC"), it is only court proceedings under the relevant arbitration Acts that might be confidential, if requested by the parties. Like England, however, case law (following English common law) recognises a general obligation of confidentiality, implied into the arbitration agreement.

In several jurisdictions, arbitrators are liable if they disclose arbitration information without consent, including the Dubai International Finance Centre ("DIFIC"), which has rules that require that all information relating to arbitral proceedings be kept confidential, except where disclosure is required by order of the DIFIC Court.

In Hong Kong, another common place and seat for arbitration and the home of the Hong Kong International Arbitration Centre ("HKIAC"), unless otherwise agreed by the parties, a party is not entitled to publish, disclose or communicate any information relating to the arbitral proceedings or any award, unless required to do so by law or to pursue a legal right.

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In Sweden (home of the Stockholm Chamber of Commerce ("SCC")) and the United States, however, there is no legal duty of confidentiality imposed or implied in arbitration.

With regard to the arbitration rules, the position is equally diverse. Whilst many rules make the hearings private, awards confidential, and the duties of the administrating institution private, otherwise they vary significantly. As with countries, there are too many different sets of arbitration rules to cover them all here, but the following is a selection of the better known ones.

The UNCITRAL Rules do not extend beyond making the hearings private, and the award confidential:

> *"Article 38(3) – Hearings shall be held in camera unless the parties agree otherwise. …"*

and

> *"Article 34(5) – An award may be made public with the consent of all parties or where and to the extent disclosure is required of the party by legal duty, to protect or pursue a legal right or in relation to legal proceedings before a court or other competent authority."*

The SCC rules are also limited, simply obliging the arbitrators and the SCC to maintain the confidentiality of the award.

The ICC Rules make the hearings private, and the workings of the ICC Court confidential, but otherwise they simply provide for arbitrators to make orders in relation to confidentiality on the application of one of the parties. This followed considerable debate and deliberation in advance of the new rules which came into force in 2011. The relevant Article reads as follows:

> *"Article 22(3) – Upon the request of any party, the Arbitral Tribunal may make orders concerning the confidentiality of the arbitration proceedings or of any other matters in connection with the arbitration and may take measures for protecting trade secrets and confidential information."*

In contrast, the LCIA Rules include a specific agreement that the award, disclosed materials and the deliberations of the Tribunal are confidential, as follows:

> *"Article 30 – Confidentiality*
>
> *30.1 Unless the parties expressly agree in writing to the contrary, the parties undertake as a general principle to keep confidential all awards in their arbitration, together with all materials in the proceedings created for the purpose of the arbitration and all other documents produced by another party in the proceedings not otherwise in the public domain – save and to the extent that disclosure may be required of a party by legal duty, to protect or pursue a legal right or to enforce or challenge an award in bona fide legal proceedings before a state court or other judicial authority.*
>
> *30.2 The deliberations of the Arbitral Tribunal are likewise confidential to its members, save and to the extent that disclosure of an arbitrator's refusal to participate in the arbitration is required of the other members of the Arbitral Tribunal under Articles 10, 12 and 26.*
>
> *30.3 The LCIA Court does not publish any award or any part of an award without the prior written consent of all parties and the Arbitral Tribunal."*

Both the HKIAC and SIAC Rules go much further, making the process essentially confidential. Likewise the Dubai International Arbitration Centre Rules provide for confidentiality, as follows:

> *"Article (41) – Confidentiality*
>
> *41.1 Unless all parties expressly agree in writing to the contrary, the parties undertake as a general principle to keep confidential all awards and orders in their arbitration, together with all materials in the proceedings created for the purpose of the arbitration and all other documents produced by another party in the proceedings not otherwise in the public domain – save and to the extent that disclosure may be required of a party by legal duty, to protect or pursue a legal right or to enforce or challenge an award in bona fide legal proceedings before a state court or other judicial authority.*
>
> *41.2 The deliberations of the Tribunal are likewise confidential to its members, except where an explanation of an arbitrator's refusal to participate in the arbitration is required of the other members of the Tribunal under Articles 13, 14 and 15 of the Rules."*

When embarking upon arbitration, therefore, you can assume that it is private – that is to say, that third parties will not be allowed to participate without your agreement; but whether, and if so to what extent, the process might be confidential, depends upon the seat of your arbitration, and which rules, if any, you have agreed will apply.

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## Defining the difference between on-demand bonds and guarantees

**By Jeremy Glover**
**Partner, Fenwick Elliott**

Bonds, guarantees, performance security or whatever they are called form an important part of every major international contract. Despite this, there are a regular number of cases, in many different jurisdictions, where the courts are asked to decide what the nature of the particular project security actually is. Is the security an on-demand bond or guarantee? An on-demand security bond is an unconditional obligation to pay when a demand has been made. A surety bond or performance guarantee requires certain conditions to be met before payment is made.

Some contracts provide standard form security documents. For exmaple, the Annexes to the FIDIC Red Book 1999 set out seven recommended forms of security, of which six relate to different types of security which the Contractor might be required to provide. Of these, five are securities which are callable on demand. These standard securities incorporate the Rules produced by the International Chamber of Commerce. One advantage of incorporating these rules is that it will mean that there can be no argument over which laws govern the security or which jurisdiction will be competent to hear disputes in connection with it.

One reason why FIDIC has chosen to annex particular forms of security to the contract is that the terms "performance bond" and "guarantee" are often used synonymously in the construction industry but they are in fact quite different forms of security. Just because a document is headed a "guarantee" does not mean that it actually is one. In the case of *Vossloh Aktiengesellschaft v Alpha Trains (UK) Ltd*[1], Alpha argued that the guarantee given by Vossloh was in the nature of an "on-demand" bond in that it constituted an unconditional independent promise to pay on demand all amounts demanded, i.e. Vossloh's liability was triggered by a demand alone. Vossloh, on the other hand, argued that liability under the guarantee was conditional, being triggered upon proof of a breach of contract by a member of the Vossloh group.

In reaching his decision, the Judge, Sir William Blackburne, provided a helpful summary of the law in this area, as follows:

> *"there is in this field of law a spectrum of contractual possibilities ranging from the classic contract of guarantee, properly so called, at the one end, where the liability of the guarantor is exclusively secondary and will be discharged if, for example, there is any material variation to the underlying contract between principal and creditor, to the performance or demand bond (or demand guarantee) at the other end, where liability in the giver of the bond may be triggered by mere demand and without proof of default by the principal (and indeed where it may be apparent that the principal is not in default).*
>
> *There may be little to distinguish (and it may not matter) whether the obligation undertaken is in the nature of a guarantee (strictly so called) or an indemnity. Where it does matter, the question is whether the liability to be enforced is secondary (or ancillary) to that of the principal (however qualified that liability may be), in which case the obligation is in the nature of a guarantee, or primary, in which case it will be in the nature of an indemnity and, if the latter, may be enforceable merely on demand (as with a performance or demand bond) or conditional on proof of default by the principal or on satisfaction of some other event or requirement."*

This question arose again in the English courts at the end of 2012 in the case of *Wuhan Guoyu Logistics Group Co Limited & Others v Emporiki Bank of Greece SA*[2] where the Court of Appeal reversed the first instance decision of the Commercial Court that a security document was a guarantee rather than an on-demand bond. However, neither the first instance judge nor the Court of Appeal found the case particularly easy and so the guidance given by the Court of Appeal will be helpful in distinguishing on-demand bonds from guarantees in the future.

1. [2010] EWHC 2443 (Ch) (05 October 2010)
2. [2012] EWCA Civ 1629 and [2012] EWCA 1715 (Comm)

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The claimant sellers operated a shipyard in Yangzhou in the People's Republic of China. They entered into a shipbuilding contract with the buyer, and payment was made in five instalments. The shipbuilding contract required the second instalment to be payable within five New York banking days of receipt by the buyer of a refund guarantee, together with a certificate confirming the cutting of the first steel plates of the vessel. The seller was to:

> *"notify with a telefax notice to the Buyer stating that the 1st 300 mt steel plate has been cut in its workshop approved by the Buyer's representative and demand for payment of this instalment."*

The shipbuilding contract then contained the form of words for an irrevocable letter of guarantee, referred to as a "Refund Guarantee". There was also a separate irrevocable letter of guarantee in respect of the second instalment of the price. A "Payment Guarantee" was issued by a bank.

An invoice for the second instalment dated 4 May 2009 and a written demand for payment, together with a certificate stating that in April 2009 the steel had been cut, were then issued. There was a dispute about whether the steel cutting had taken place. A demand for payment under the Payment Guarantee was made on 22 June 2011. The demand stated that the steel plates had been cut.

The buyer sought to avoid immediate payment being made by the bank to the seller under the Payment Guarantee, on the following grounds:

(i) There was no proof that the first 300 mt of steel had ever been cut;
(ii) The condition of approval of the buyer of the cutting had not been met; and
(iii) The seller did not provide the Refund Guarantee required under the ship-building contract. This was on the basis that the Payment Guarantee actually issued differed slightly from the Refund Guarantee set out in the shipbuilding contract.

Longmore LJ noted the following points that might be thought to favour a conclusion that the document was a traditional guarantee:

(i) The document was called a "payment guarantee" not an "on-demand bond";
(ii) Clause 1 said that the Bank guaranteed "the due and punctual payment by the Buyer of the 2nd instalment";
(iii) Clause 2 described the second instalment as being payable (in terms different from the Building Contract) 5 days after completion of the cutting of the first 300 metric tons of steel of which written notice was to be given with a certificate countersigned by the Buyer;
(iv) Clause 3 guaranteed the due and punctual payment of interest;
(v) Clause 4 imposed an obligation on the Bank to pay "in the event that the Buyer fails punctually to pay the second instalment"; and
(vi) Clause 7 said that the guarantor's obligation was not to be affected or prejudiced by any variations or extensions of the terms of the shipbuilding contract or by the grant of any time or indulgence.

Against that, Longmore LJ thought the following points favoured the conclusion that the document was an "on-demand" bond:

(i) Clause 4, the clause which required payment by the Bank, provided that payment was to be made: (a) on the Seller's first written demand saying that the Buyer has been in default of the payment obligation for 20 days; and (b) "immediately" without any request being made to the Seller to take any action against the Buyer;
(ii) Clause 7 provided that the Bank's obligations were not to be affected or prejudiced by any dispute between the Seller and the Buyer under the shipbuilding contract or by any delay by the Seller in the construction or delivery of the vessel;
(iii) Clause 10 provided a limit to the guarantee of US$10.3 million representing the principal of the second instalment plus interest for a period of 60 days. This meant that it was not envisaged that there would be any great delay in payment after default as there would be if there was a dispute about whether the second instalment ever became due.

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It was Clause 4 which turned out to be key.

The Court of Appeal also referred with approval to the 11th edition of *Paget's Law of Banking* which it noted was supported by judicial authority and which states as follows:

> *"Where an instrument (i) relates to an underlying transaction between the parties in different jurisdictions, (ii) is issued by a bank, (iii) contains an undertaking to pay 'on demand' (with or without the words 'first' and/or 'written') and (iv) does not contain clauses excluding or limiting the defences available to a guarantor, it will almost always be construed as a demand guarantee.*
>
> *In construing guarantees it must be remembered that a demand guarantee can hardly avoid making reference to the obligation for whose performance the guarantee is security. A bare promise to pay on demand without any reference to the principal's obligation would leave the principal even more exposed in the event of a fraudulent demand because there would be room for argument as to which obligations were being secured."*

This led the Court of Appeal to the view that the document here was an on-demand bond, despite the fact that it was actually called a payment guarantee. Reading the document as a whole, and in particular clause 4, it was clear that the Bank had to make payment on written demand by the Seller. Longmore LJ noted that guarantees of the kind before the court here would be almost worthless if the Bank could resist payment on the basis that the foreign buyer was disputing whether a payment was actually due. That would be all the more so in a case such as the one here where the Buyer was able to refuse to sign any certificate of approval which may be required by the underlying contract.

At the end of his judgment, Longmore LJ noted that it was important that there should be a consistency of approach by the courts, so that all parties know clearly where they stand. This would seem to be a clear policy statement and one reason why the Judge quoted, again with approval, from the judgment of Ackner LJ in the case of *Esal (Commodities) Ltd v Oriental Credit Ltd*:

> *"a bank is not concerned in the least with the relations between the supplier and the customer nor with the question whether the supplier has performed his contractual obligation or not, nor with the question whether the supplier is in default or not, the only exception being where there is clear evidence both of fraud and of the bank's knowledge of that fraud."*

## Conclusions

There continue to be disputes about whether a security document is an on-demand bond, or a guarantee. An on-demand bond can be called immediately, and only fraud or very limited challenges have worked in the past (e.g. the bond has expired). A guarantee can only be called upon if a breach of the primary contract has been demonstrated, and the loss has properly crystallised but not been settled by the original contracting party.

The benefit, therefore, of an on-demand bond is that payment is made immediately, so improving cash flow, and without the need to demonstrate the full and proper loss under the primary contract. There is no need to pursue the original contracting party (who might be insolvent) in order to obtain a judgment or arbitration award.

Nonetheless, guarantees are common in the domestic UK construction market, because they are economic and they are usually readily available from most contractors. On-demand bonds, on the other hand, are much more common internationally, not just because of the nature of the cross-border risks involved, but also because the international contractors operating in those markets are more able to meet their bank's or bondman's requirements of counter-indemnity before issuing an on-demand bond.

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Fenwick Elliott
The construction & energy law specialists

International Quarterly

# News and events

*Trends, topics and news from Fenwick Elliott*

Issue 05, 2013

## This edition

We hope that you have found this edition of International Quarterly informative and useful. We aim to keep you updated regarding legal and commercial developments in construction and energy sectors around the world. Fenwick Elliott's team of specialist lawyers have advised on numerous major construction and energy projects worldwide, nurturing schemes to completion with a combination of careful planning, project support and risk assessment. From document preparation to dispute resolution, our services span every stage of the development process.

If you would like us to comment on a particular commercial issue or aspect of law that is affecting your business we would be delighted to hear from you. Please contact Jeremy Glover - jglover@fenwickelliott.com

We also offer bespoke training to our clients on various legal topics affecting their business. If you are interested in receiving bespoke in-house training please contact Susan Kirby for a list of topics - *skirby@fenwickelliott.com.*

## Fenwick Elliott Dictionary

Our recently launched publication - Fenwick Elliott's *Dictionary of Construction Terms*, continues to prove popular amongst out clients. The Dictionary offers a clear and concise explanation of the most commonly encountered legal and technical terms, phrases and abbreviations used throughout the construction industry.

It will save you valuable time when searching for an authoritative explanation of a frequently used term. It will become a practical reference for construction lawyers, practitioners and students as well as those in related industries including planning, property and insurance.

To obtain a copy click here.

## Fenwick Elliott supports CODEP's latest project in Sierra Leone


Fenwick Elliott's Jeremy Glover participated in the opening ceremony for the Chukuma Johnson Memorial Children's Library in Waterloo, Sierra Leone. The opening formed the centrepiece of CODEP's Literacy Festival and the library was opened by the Honourable Mamoud Tarawali, Deputy Education Minister, Sierra Leone on 20 February 2013. Fenwick Elliott holds twice yearly charity football tournaments in London in support CODEP's work. CODEP work to support the promotion of literacy and the equipment of schools and communities in the Waterloo and Lunsar regions of Sierra Leone through the provision of books, resources and training facilities - www.codep.co.uk.

## Follow us on Twitter and LinkedIn

Keep up to date with latest legal developments and Fenwick Elliott news by following Fenwick Elliott on Twitter (@FenwickElliott) and LinkedIn. We regularly update these accounts with articles and newsletters regarding construction and energy law and Fenwick Elliott news and events.

## About the editor, Jeremy Glover

Jeremy has specialised in construction energy and engineering law and related matters for most of his career. He advises on all aspects of projects both in the UK and abroad, from initial procurement to where necessary dispute avoidance and resolution. Typical issues dealt with include EU public procurement rules, contract formation, defects, certification and payment issues, disruption, loss and/or expense, prolongation, determination or repudiation and insolvency.

Jeremy organises and regularly addresses Fenwick Elliott hosted seminars and provides bespoke in-house training to clients. He also edits Fenwick Elliott's monthly legal bulletin, *Dispatch*.

**International Quartely is produced quarterly by Fenwick Elliott LLP, the leading specialist construction law firm in the UK, working with clients in the building, engineering and energy sectors throughout the world.**

**International Quartely is a newsletter and does not provide legal advice.**

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