Asia Pacific Projects Update

PERFORMANCE SECURITY: BONDS, GUARANTEES AND LETTERS OF CREDIT

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INTRODUCTION

When considering security requirements to support project contracts, parties often wonder what form of security is appropriate - a performance bond, parent company guarantee, bank guarantee or letter of credit. Each of these instruments is used to achieve the same goal, namely to increase confidence and manage risk between the parties in order to facilitate the underlying transaction. However, each instrument carries nuances that may impact upon its operation and utility, and therefore its appropriateness in different commercial contexts.

These issues were brought into sharper focus following the UK Court of Appeal's decision in *Wuhan Guoyu Logistics Group Co Ltd, Yangzhou Guoyu Shipbuilding Co Ltd v Emporiki Bank of Greece*[1] (**Wuhan Case**). In the Wuhan Case a decision was made as to whether a payment guarantee in relation to a shipbuilding contract provided by a bank was properly classified as a guarantee or an 'on demand bond'. As will be discussed, the distinction between a guarantee and an 'on demand' bond is an important one, with significant consequences for both those seeking to rely on the security and those providing it.

This paper sets out the key differences between the various forms of security commonly used in the Asia Pacific market to help you determine which instrument is most appropriate for your projects.

INSTRUMENTS ISSUED BY FINANCIAL INSTITUTIONS

Banks and financial institutions can be called upon to secure the performance of a party's obligations under a project contract.

A major benefit of using such securities is that the parties can normally be assured that the institution has the credit-worthiness to satisfy the security in the event of default.

However, such securities normally carry fees and charges, which may add to the overall cost of the transaction. Such securities can also be difficult to obtain if the contract party has poor credit or if the secured amount is too great and typically specify a maximum cap.

Such securities can sometimes be substituted with similar instruments issued by insurers, such as insurance bonds. Insurer-issued securities can free up working capital that

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[1] [2012] EWCA Civ 1629.

is ordinarily tied up under a financial institution security. In addition, such securities are treated as 'off balance sheet' meaning that they do not impact upon the company's financials. However, there is additional risk when using a using an insurer-issued securities in terms of the issuer's credit-worthiness and its willingness to pay out the security on demand.

The two main bank-issued instruments are letters of credit and bank guarantees.

Letter of Credit

A Letter of Credit (**LOC**) creates an obligation on the bank to pay a beneficiary a specified sum of money once the beneficiary satisfies the bank of certain conditions.

LOCs are commonly used in international trade transactions, where the LOC operates as both a means of payment and security for the transaction. A purchaser will normally procure an LOC from a bank in the vendor's jurisdiction. The vendor will then cash the LOC after it ships or delivers the goods. The LOC ensures that the vendor is paid promptly and in the correct currency. The conditions stipulated in the LOC can also be used to protect the purchaser against non-delivery.

The conditions in an LOC can be as simple as requiring the beneficiary to issue a demand on the bank, however the contract party will normally push for more stringent obligations. For example, in a standard shipping arrangement, the LOC will usually require the vendor to present a certificate of receipt to the bank in order to protect the purchaser from non-delivery. Beneficiaries of an LOC should pay particular attention to the proposed conditions. If the beneficiary cannot comply with the conditions then the LOC is essentially worthless.

The key point to note with LOCs is that the terms of the primary agreement are of no concern to the bank granting the LOC. It is the LOC alone that governs the relationship between the bank and the beneficiary. The bank is legally obliged to pay the beneficiary once the conditions in the LOC are satisfied irrespective of any instructions or objections from the contract party.

The form of a general LOC is standardised by the *Uniform Customs & Practice or Documentary Credits 2007* (**UCPs**) published by the International Chamber of Commerce. The UCPs are usually expressly incorporated into the terms of an LOC. In some instances it may be more appropriate to adopt other rules such as the ICC's *Uniform Rules for Demand Guarantees.* Similarly, if the LOC in question is a standby LOC, these tend to be standardised by the *International Standby Practices 1998*.

Bank Guarantee

A bank guarantee requires a bank to assume liability in the event that the contract party breaches an obligation under the project contract and is unable to rectify the default itself. As guarantor, the bank is technically required to subsume the performance of the contractor's primary obligation (usually to make a payment). However, in practice, it is more common for the guarantee to be worded so that the beneficiary can rectify the default itself and claim the face value of the bank guarantee as damages from the bank in turn.

Without specific drafting to achieve the contrary, a bank guarantee imposes a secondary obligation on the bank and the beneficiary has no right of action against the bank unless the contract party has breached an obligation under the project contract.[2] Thus, the beneficiary can be prevented from cashing the guarantee if there is a question over whether there has been a breach or a question over the amount of damages claimed. In *Walton Construction (Qld) Pty Ltd & Anor v Venture Management Resources International Pty Ltd & Anor*[3] the Queensland Supreme Court granted an injunction preventing a financial institution from paying out a bank guarantee because there was a serious issue to be tried in relation to the amount claimed by the beneficiary.

However, if carefully worded, a bank guarantee can be drafted as a primary obligation in terms that require the bank to make payment unconditionally and upon demand. This indemnity structure allows the beneficiary to claim directly against the bank without first having to pursue the contractor or prove the contract's breach. This form of bank guarantee is most commonly used in the Asia Pacific market.

A bank guarantee is normally governed by the law of the country in which the guarantee is issued, normally the domicile of the bank. Parties should be mindful that certain jurisdictions may impose specific requirements for the form of guarantee. For example, a guarantee must be in writing signed by the guarantor where the *Statute of Frauds 1677* (Imp) or some local equivalent applies. In jurisdictions with roots in English law it is also recommended that guarantees are drafted in the form of a deed to overcome any issues of insufficient consideration.

THIRD-PARTY SECURITIES

It is sometimes more appropriate to obtain security from a third-party that is not a financial institution, for instance, a parent company of the contracting party.

Third-party securities are often easier and less costly to obtain than bank securities, particularly when the security comes from another entity in the contracting party's

[2] See for example *Turner Manufacturing MCO Pty Ltd v Senes [1964] NSW R692*

[3] [2010] QSC 31.

corporate group. Furthermore, in comparison to banks and unrelated third-parties, related entities are often more willing to provide more comprehensive security coverage.

Parties should be conscious of a number of risks when using third-party securities. Firstly, in comparison to a financial institution, there is greater risk that the provider of the security may not have the credit to meet its obligations under the security. This risk is particularly present when dealing with complex company group structures, where it can be unclear where the group's assets are held.

Secondly, a company providing security might need to comply with certain internal processes before granting the security, such as board or shareholder approval. These additional hurdles can pose additional risk to the validity of a third-party security and can also affect project timeframes. Provision of a legal opinion to cover due authorisation and enforceability may give further comfort to a recipient of a third-party security.

Two commonly used third-party securities are parent company guarantees and performance bonds.

Parent Company Guarantee

A parent company guarantee (**PCG**) is similar to a bank guarantee except it that it is issued by a parent of the contract party or another related entity.

A PCG has the same basic effect as a bank guarantee. Like a bank guarantee, a PCG can be drafted in terms of a primary or a secondary obligation. However, a parent company will often be more willing to offer the more onerous guarantee given that it has a vested interest in facilitating the project.

Given that a related party is not as concerned about limiting its potential liability, a PCG can have an unlimited monetary cap, thus allowing the parent company to fully underwrite all of the obligations contained in a project contract.

However, the efficacy of a PCG depends on whether the parent company is able to meet the contract party's obligations under the underlying contract. While the parent company may appear to hold sufficient assets to satisfy the security obligation, beneficiaries should be mindful that assets can be easily transferred within a corporate group. Transfer can occur after the guarantee has been entered into, meaning that the strength of the guarantor's covenant has the potential to be diminished. Provisions can be incorporated into a guarantee to protect against this.

Performance Bond

Performance bonds are provided by a third party for up to a stated amount, payable in the event that the beneficiary incurs loss as a result of the contract party's breach.

There are two main forms of performance bonds: a 'default' bond and an 'on demand' bond. A 'default' bond imposes a secondary obligation on the grantor. Similar to a guarantee, the beneficiary must prove that the contract party has breached the contract and caused damage in order to cash the bond. The issuer of the bond can object to payment if there is doubt over the primary breach or the amount of damages claimed.

In contrast, an 'on demand' bond creates a primary obligation on the issuer to pay the stated amount on demand, irrespective of any objections raised by the contract party. The bond is not conditional on the creditor proving the contract party's default and the beneficiary has a primary right of action against the issuer in the event of non-payment.

Generally speaking, performance bonds are limited for a specific duration and up to a maximum cap. Performance bonds will usually expire after a specified time, such as practical completion or after the defects liability period. In addition, a performance bond will rarely guarantee the performance of all of the contract party's obligations; rather it provides the recovery of financial loss up to the stated amount, often framed as a percentage of the contract price. This can be problematic where multiple issues or insolvency quickly exhaust the level of cover provided.

Performance bonds can be sought from non-related third parties if there is a concern over the credit-worthiness of the contract party's entire corporate group. This form of performance bond provides a buffer in case the guarantor and contract party become insolvent at the same time. However, the third party will usually charge a fee to issue the bond, adding to transaction costs.

The cost of obtaining an 'on demand' bond is generally much higher than the cost of obtaining a 'default' bond. In some markets 'default' bonds have become more common for this reasons, but in the Asia Pacific region, 'on demand' bonds and letters of credit remain the norm.

GENERAL COMMENTS

Some key factors to consider when choosing the right security for a transaction include:

- the **value** of the security required to address the commercial concerns of the parties;
- the **duration** that the security is required for;
- **who** can appropriately provide the security, taking into account the credit risk of the contracting party and its corporate group;
- the **cost** of obtaining security from financial institutions and other third parties; and

- the **enforcement** of a performance security, specifically whether the payment should be conditional and whether the security should be claimable 'on demand'.

It is also important to consider that a combination of securities can be used in order to manage performance risk under a project contract.

In addition, parties should be mindful that that courts will look at substance over form when construing security instruments. In the Wuhan Case, the Court of Appeal found that a document titled 'guarantee' was more properly construed as an 'on demand' bond in light of the commercial context and the precise wording of the document. Parties should be careful to word their chosen performance securities so that they carry their full intended effect.

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