

UAE Bonds: Calling on a Bond or Performance Guarantee in the UAE¹

An increase in the demands made or rather the “calls” made for payment of bonds and guarantees can sometimes be a reflection of the economic situation within the construction industry. A tightening of expenditure or perhaps problems with resourcing can lead to a delayed or distressed project and ultimately a position where a call is made on the bonds or guarantees of the contractor or others in the supply chain. There are some important factors to consider when deciding whether to call on these security documents.

The first is to identify whether the security document is an on-demand bond, or a performance guarantee. The construction industry uses terms interchangeably, as does the banking world. It is not possible to rely upon the label on the document, and so a review of the terms of the security document is required. A classic on-demand bond is as good as cash. It is unconditional in that the beneficiary can make a written demand for payment with very few or any obstacles. The typical wording of an on-demand bond is:

“The bank undertakes to pay the beneficiary on receipt of its first written demand in writing on the bank stating that the Contractor is in breach of its obligations under the contract the sum not exceeding XXX. Such written demand being conclusive evidence of the Contractor’s breach.”

An on-demand bond therefore comprises two basic elements. First of all the beneficiary can make the written demand claiming an amount of money up to the cap of the bond, and secondly that written demand is conclusive evidence of the contractor’s breach.

It is the beneficiary themselves who decides whether the contractor is in breach and so makes the demand. The bank is in no position to know whether the contractor is really in breach, and so the on-demand bond wording allows the bank to rely upon the beneficiary’s notice as being conclusive evidence of that breach. From the bank’s perspective a written demand that simply meets the requirements of the on-demand bond can be safely paid.

It is extremely difficult for a contractor to stop that payment from being made by the bank. Typically, a court order is required, and a contractor would need to persuade a court that the beneficiary’s demand was not valid, or that the bank should not pay by treating the beneficiary’s demand as invalid. Many courts around the world have made it clear that the hurdle is extremely high. Fraud is often the only exception, and that is extremely difficult to prove.

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Attempts to argue that the call for payment must have been mistakenly made because the underlying contract has been entirely concluded such that there can be no breach have had some success, but cannot always be relied upon.

Performance guarantees are an entirely different species of security. They are based in the law of contract, and specifically on the principle that there are three parties and two contracts. The primary contract is the building contract between the employer and the contractor, whilst the secondary contract is a triparty contract between the beneficiary employer, the contractor and the bank (the contractor's bank or provider of the guarantee). They are fundamentally different from an on-demand bond. The guarantor is primarily liable to step in and complete the contract, or pay damages instead. Most banks simply pay the damages.

However, the important point is that the damages need to be fully identifiable and ascertained under the primary contract. This means that a call for payment under a guarantee might mean it takes much longer for the payment to materialise than with an on-demand bond. An on-demand bond is often paid out within a week or two. However, it may take years in order to ascertain and establish the loss under the building contract to the point where it is possible to make a full and proper call on the guarantee of the amount that is properly due.

This distinction is not as clear in the Middle East. For example, the UAE Federal Commercial Transactions Law No. 18/1993 (the Commercial Code) deals with letters of guarantee, and Article 414 describes them as:

"an undertaking issued by the guaranteeing bank on the request of his client to pay unconditionally and without restrictions, a certain specified or determinable sum to another person (the beneficiary), unless the letter of guarantee is made depending on a condition where payment is requested within the time limit set in the letter; the letter of guarantee shall state the object for which it has been issued."

Article 414 of the Commercial Code therefore recognises that a guarantee could be conditional or unconditional. If the document is an on-demand unconditional bond then the bank is obliged to pay. Article 417(1) states:

"The bank shall not be entitled to refuse payment to the beneficiary for reasons relating to the bank's relation with the client or the client's relation with the beneficiary."

This is usually taken to mean that the bank can ignore any dispute between the contractor and the employer or any other relationship issues that they might have. If the contractor considers that the employer's call on the bond is fraudulent or perhaps unjustifiable then recourse is limited by Article 417(2) of the Commercial Code, which provides:

"In exceptional circumstances, the court may on application of the client place an attachment on the amount of the guarantee with the bank provided that the client has serious and certain reasons for its request."

In practice it is very difficult in the Middle East to persuade a court to place an attachment order on the amount. The preference is simply to order the bank to make payment. This of course follows the approach of many courts around the world.

Notably, the action that the court might take, if persuaded, is to place an “attachment”. This term has a particular meaning under the UAE legal system, whereby one of the parties can seek to attach the assets owned by the other party. This, on the one hand, means that Article 417(2) recognises that the amount of the bond is an asset of the beneficiary, which is consistent with the concept that a bond is equivalent to cash. On the other hand, a contractor seeking to attach the amount of the bond may file its action before the summary judge, i.e. a fast track application on ex parte basis, and the decision is usually made on the same day of the application.

A further example is the Qatari Trade Law No. 27 of 2006, Banking Operations Chapter, Sub-Chapter VIII, No. Article 406 which provides:

“A letter of guarantee is an irrevocable written pledge issued by the bank at the request of its client, known as the applicant, to pay a certain amount or amounts to be specified to another person, known as the beneficiary if the beneficiary so requests within the period specified in the letter and without regard to any rejections. The purpose for which the letter of guarantee is issued shall be explained therein.”

While the English translation is slightly different from the UAE Commercial Code, the intent is certainly the same. Once again the bank cannot refuse payment under Article 406, based on the same principle as the UAE’s Commercial Code. However, unlike the UAE law, Article 410 of the Qatari Trade Law expressly prevents the court from placing an attachment over the amount of the guarantee. This is a distinctive feature of the status of guarantees under Qatari law. Securing the amount of a guarantee would therefore require either a substantive order or an interim measure on grounds other than those that can usually be relied upon to place an attachment; the threshold is higher and the court will likely request the applicant to provide security for damages.

The problem, therefore, for contractors is the ability to resist calls on their on-demand bonds in the Middle East in general. It is extremely difficult, if not impossible. Disputes in relation to extensions of time, money claims, failures to pay, the cost of variations, disputes in relation to engineer’s decisions, etc. are substantive disputes that need to be dealt with under the building contract. They are not sufficient grounds to stop a call being made against on-demand bonds. In reality, contractors are left with little choice but to pursue their claims under the building contract and then seek proper payment, taking into account any call made in relation to an on-demand bond.

Taking into account payment made by a bank between the employer and contractor under the building contract is not without difficulty either, because the on-demand bond is a separate document in its own right. A guarantee is a secondary contract linked to the primary building contract. That is not the case with an on-demand bond. On the positive side, a contractor might be entitled to further compensation for an incorrect call on a bond, although those claims are not entirely straightforward either.

There is a noticeable difference between the UAE and other parts of the world and that is the almost exclusive use of unconditional on-demand bonds. Domestic projects in many common law countries rely upon performance guarantees in relation to the work. On-demand bonds are common throughout the Middle East.

Whilst not necessarily the normal practice in the UAE or other parts of the Middle East, it is however extremely important for contractors to serve their notices under the building contracts, request extensions of time and progress those requests for time and money in order to protect their cash flow, financial position and ultimately their bonds. However, that does not lead to an automatic defence to a call on an on-demand bond.



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