Legal Briefing

Simon Carves Ltd v Ensus Ltd

[2011] EWHC 657 (TCC), per Akenhead J

The Facts

This case concerned an "on demand" performance bond, and raises issues rarely addressed as to the extent to which a beneficiary may be prevented from seeking payment under a demand bond by the terms of the contract in respect of which the bond is provided.

Simon Carves Limited ("SCL") was employed by Ensus UK Limited ("Ensus") to construct a Bioethanol Plant at a site at Teesside. The Contract incorporated the General Conditions of Contract for Lump Sum Contracts published by the Institution of Chemical Engineers in 2001, known as the "Red Book", with some bespoke special conditions. One of those conditions required SCL to provide Ensus with a performance bond as security for its performance of the contract. This was issued by SCL's bank, Standard Chartered, to Ensus, and was initially in the sum of £18.4m. The bond itself was an unconditional autonomous document as between Standard Chartered and Ensus, and allowed Ensus to make a call on the bond at any time for any reason before its stated expiry date of 31 August 2010.

Importantly, the special conditions to the contract also provided that on the issue of the Acceptance Certificate by Ensus' Project Manager, the bond would "*become null and void (save in respect of any pending or previously notified claims)*". The conditions further provided that the bond should be returned to SCL as soon as it became null and void, "*save where there are pending claims (including previously notified claims), in which case it shall be returned following final determination and (if applicable) payment of such claims and shall in the meantime remain valid*". If the bond was subject to a fixed expiry date, SCL should extend or replace the bond if it had not yet been returned by Ensus. If SCL failed to extend the bond, Ensus could call the outstanding balance of the bond and hold it as security, making any deductions for the amount of any outstanding claims.

On 19 August 2010, once all testing was complete, Ensus' project manager issued an Acceptance Certificate stating that the plant was accepted from that date. As expressly contemplated by the contract, this listed a number of known defects which SCL was bound to make good. One or more of these defects related to odour emissions from the plant. This was a historical problem which had occurred since Ensus took over and began operating the plant in February 2010, and had given rise to complaints from local residents and the Environment Agency issuing Ensus with two Enforcement Notices.

In short, Ensus asserted that that the odour was attributable to a fault with the plant's dryer system and the height of the stack caused by SCL. SCL on the other hand argued that the odour was attributable to the way in which Ensus had chosen to operate the plant (i.e. not in accordance with the O&M principles), the dryer system installed at the plant was imposed on it by Ensus, and in any event no claim had been made. SCL accordingly asserted that the bond was null and void and that it should be returned along with any retained monies because Ensus had not made any "claims" under the Contract. Ensus sought approval for return of the bond from its financiers – they declined, on the basis that Ensus needed the security for the list of defects attached to the Acceptance Certificate.

In late August 2010, with the bond due to expire on 31 August 2010, SCL and Ensus entered into discussions about extending the bond, while SCL reserved its position as to the assertion that the validity of the bond. At the eleventh hour, under threat of a call from Ensus, the bond was extended in the lesser amount of £2.3m to the end of 2010, and subsequently extended again to 28 February 2011.

In February 2011, there were a number of discussions and exchanges between the parties as to the return of the extended bond. SCL maintained that it expected return of the bond at the end of the month. In the meantime, on 15 February 2011, Ensus issued a "claim" under the Contract in respect of the odour problem. On 25 February 2011, SCL sought an injunction restraining Ensus from making any demand under the bond, which was granted. Unbeknown to SCL, Ensus had already made a call on the bond earlier that week (but Standard Charted had not yet paid out on it), so SCL had to return to Court on Monday 28 February 2011 seeking a variation to the injunction, requiring Ensus to withdraw its call, which was also granted. The matter was adjourned for a full hearing and argument before Mr Justice Akenhead in the TCC on 15 March 2011.

The Issues

(i) The extent to which Ensus could legitimately make a demand under the bond; and

(ii) Whether the injunction preventing Ensus from making a call on the performance bond could be maintained in circumstances where there was no allegation of fraud on the part of Ensus.

The Decision

Mr Justice Akenhead held that the injunction was valid and that it should continue in its current form. He recognised that there was little authority addressing circumstances where there are contractual provisions between a contractor and purchaser/employer which impose restrictions or prevent calls being made by the purchaser/employer on bonds or letters of credit provided by a contractor. He summarised the law in this area as follows:

(i) Unless fraud is established, the Court will not prevent a bank from paying out on a demand bond provided the conditions of the bond itself have been complied with (such as formal notice in writing). However, fraud is not the only ground upon which a call on a bond can be retrained by injunction;
(ii) The same principles apply in relation to a beneficiary seeking payment under the bond;
(iii) There is no legal authority which permits a beneficiary to make a call on the bond when it is expressly disentitled from doing so;
(iv) If the underlying contract clearly and expressly prevents the beneficiary from making a demand under the bond, it can be restrained by the Court from making a demand under the bond; and
(v) The Court did not need to make a final determination on whether the underlying contract prevented payment at the interim injunction stage. It only needed to satisfy itself that the party resisting the demand had a "strong case". It can not be expected that the Court at that stage will make in effect what is a final ruling.

In reaching his decision, the Judge recognised there was a real risk of damage to the commercial reputation, standing and creditworthiness of SCL which would be very difficult to quantify, and there was a very real risk that SCL would not pre-qualify for tenders because often tenderers have to disclose whether there have been recent calls on bonds and if so the grounds for such a call. In these circumstances, the balance of convenience favoured the injunction being maintained. Moreover, an award of damages would be an adequate remedy for Ensus should SCL not succeed in the substantive dispute.

Comment

The purpose of a performance bond is to ensure a third party delivers goods or performs services in accordance with the terms of an underlying contract. The issuer of the bond (usually a reputable trading bank) undertakes to pay to the beneficiary a sum of money if the third party fails to comply with its obligations under the contract.

Unsurprisingly, because of the level of comfort and security performance bonds afford employers, they are widely utilised and important instruments in the construction and engineering sectors. Given their importance to commerce, the Courts are usually loath to interfere with irrevocable obligations assumed by banks in the form of performance bonds and related instruments except in circumstances where fraud is alleged. However in this case, SCL demonstrated that it had a 'strong case' that the bond had expired by virtue of the underlying contract. This, coupled with the concern about the effect a call on the bond would have on SCL, warranted the injunction being maintained.

Some might argue that this decision means that employers will no longer be able to rely on bonds to cover problems created by recalcitrant contractors. But that cannot be so. An employer cannot in effect agree to withhold from making a call on a bond by contract and then make a call; that is profoundly unfair and cannot be in the interests of commerce. If anything, this case serves to add a string to a very lean bow for contractors seeking to rely on the terms of an underlying contract as to the validity of a performance bond.

Simon Tolson and Rebecca Saunders
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