

CONSTRUCTION : BULLETIN

Is Security Certain When Demanding Payment Under A Performance Bond?

Beneficiaries of on demand performance bonds enjoy the security of not being required to prove any loss before demanding payment. However, the two recent Scottish Court of Session cases of *East Ayrshire Council v Zurich PLC* and *South Lanarkshire Council v Coface SA* have indicated that where a beneficiary deviates from the agreed contractual procedures for making a demand, they may not be entitled to payment.

Background

Both cases concerned the 2013 insolvency of Scottish Coal Company Limited ("SCC"). A bond in support of SCC's open cast coal mine restoration obligations had been granted in favour of the relevant local authority in each case. Following its insolvency, SCC defaulted on its restoration obligations and in both cases the local authority made a claim on the performance bond.

East Ayrshire Council v Zurich PLC

In order to claim on the performance bond, East Ayrshire Council ("EAC") served a demand for £3.3 million, in the form of a certificate of default, on Zurich.

The court held that the certificate of default was invalid. This was because it did not contain confirmation that EAC had provided a 60 day written notice to SCC of its failure to comply with its restoration obligations. This was information which the performance bond expressly stated was necessary. Failure to provide SCC with such a notice had potentially resulted in SCC omitting to remedy the breach.

EAC unsuccessfully argued that in the circumstances, the service of a 60 day

notice upon SCC was of no practical necessity. It claimed SCC's liquidators had made it clear that there would be no compliance with the restoration commitments, preventing any realistic compliance with a written notice and remedying of the breach.

The court endorsed commercial certainty by stating that the normal principles of interpretation of contracts apply to the construction of performance bonds. It emphasised the importance of acting consistently with agreed procedures for making a demand under a performance bond, regardless of whether or not they appear to have significant practical effect.

An important consideration for the court was that where a demand is not made in accordance with the agreed bond requirements, a bond provider such as Zurich should not be obliged to pay because they may have difficulty in enforcing any counter indemnity obligation against the defaulting party.

This case clearly confirms that it is unacceptable for a party to decide that contractual requirements, expressly agreed by the parties and included in a bond, are unnecessary and capable of being ignored due to the specific circumstances.

South Lanarkshire Council v Coface SA

Following SCC's insolvency, South Lanarkshire Council ("SLC") claimed under a performance bond in order to cover some of the costs of restoring land which had been affected by SCC's mines. In an echo of *EAC v Zurich*, the bond provider, Coface contended that the notice served by SLC to trigger



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the bond was invalid. However, in this case, the court upheld SLC's claim under the bond for payment of £4.5 million.

The first issue determined by the court was the proper construction of key provisions in the bond wording concerning how liability arose under the bond. The bond's provisions on the triggers for liability were very unclear. Confusingly, it made mention of a "call", a "notice in writing", a "claim" and a "written demand for payment", without clarifying whether these referred to the same document or different documents which needed to be submitted by SLC in order to claim payment from Coface.

As in *EAC v Zurich*, the court endorsed the need for commercial certainty by repeating that the normal principles of interpretation of contracts apply to the construction of performance bonds. It considered that, in the absence of any definition of the various different terms used, a reasonable commercial person would not significantly differentiate between them. Consequently, the terms were treated as synonyms and SLC only had to serve one notice on Coface to successfully trigger liability under the bond.

Secondly, the court had to establish whether SLC's notice seeking payment complied with the express terms of the bond. Coface argued that the notice failed to expressly state that it was a demand for payment and that this was a requirement that could be construed into the bond based on the words used (the bond required "*a written demand for payment*"). Coface argued that the scope of the notice was limited to simply notifying Coface of its liability under the bond as no specific amount had been requested by SLC.

The court rejected this argument on the basis that in relation to commercial documents, "*courts should avoid technical constructions that involve an undue emphasis on the niceties of language*". It held that the SLC's notice had to be viewed objectively in its context. SLC had informed Coface four weeks previously that it would seek payment of the sum guaranteed under the bond, and therefore the letter of

claim could only be construed by Coface as a notice from SLC seeking the maximum sum due under the bond.

Practical application

Although these cases concerned open cast coal mine restoration in Scotland, they provide valuable insight into the commercial interpretation of construction performance bonds in England and Wales.

Despite their differing results, the court adopted a very commercial approach to resolving both disputes by stringently applying the normal principles of interpretation of contracts to the construction of performance bonds. The court was keen to stress in both cases that it will not re-write the parties' agreement on the basis of what seems fair and equitable.

These cases demonstrate the importance of rigorously following the specific claims procedure described in an individual bond. It is clear that bond providers are prepared to try to resist bond claims on the basis of a failure to follow the agreed procedure for making a claim.

Claiming parties must contemplate how the notice is to be communicated, where and who notices are to be communicated to, and what the form and content of the notice should be.

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