1. Introduction

A performance bond, which is mostly used under international construction contracts, may be equally used to guarantee obligations arising under the international sale of goods\(^1\). Goode, when explaining the performance bond, is using the term of "pseudo guarantee"\(^2\) and after giving short explanation for guarantee, he is saying about performance bond that "there are some (commercial) instruments that do not require in any real sense issue of a certificate of default by the creditor or even his only demand for payment is enough to impose on the guarantor (issuer) the duty to pay." These types of obligations are called unconditional or on-demand performance bonds\(^3\).

The guarantee and performance bond are used in two different entirely meaning. The word guarantee denotes a suretyship contract\(^4\). In


\(^3\) These are independent obligations from underlying contracts. M. Lawson, *Performance Bonds-irrevocable Obligations JBL* (1987) p. 259

\(^4\) The guarantor or surety assumes a liability to answer for the debtor's default

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reality, a bond itself is written form of guarantee and where the bond is to secure the performance it is called performance bond\(^5\). They can be issued in conditional form as well as unconditional form. In early period of performance guarantee, conditional form was preferred by insurance companies, unconditional form which is becoming the most commonly used form, is being issued by banks. To issue the performance bond, issuers' main interest is the skill and experience of the contractor or seller to guard against risk of contract so that primary concern should be financing ability of contractors on behalf of issuer-guarantor\(^6\). From historic point of view, performance bond was used conditionally for a long time, but after 1970s as a new form, on-demand performance bond has been becoming mostly used form which is by simple demand or "call" and without proof of default must be paid to employer\(^7\) or buyer. In performance bond there are always three or four parties, but sometimes more parties may get involved. Normally the underlying contract depends on buyer-seller or employer-contractor relationship in which seller or contractor is called "principal" in performance bond. Principal needs to guarantee his performance to contract with buyer\(^8\) or employer, called as "beneficiary" in performance bond. To answer the requirement of beneficiary, principal wants from his bank, called "issuer-guarantor", to issue performance bond on behalf of beneficiary. Therefore performance bond is issued by bank to beneficiary. In international contracts, beneficiary requires that issuer must be in his country and that bank wants counter-indemnity from principal's own bank, called instructing or/and indem-

\(^5\) Penn, Shea & Arora, Law & Practice of International Banking, ch.12 p.261-264

\(^6\) Lord Atkin in Trade Indemnity Co.Ltd. v. Workington Harbour & Dock Board (1937)1.AC. pp.17-18 is giving his opinion in this frame.


nifying bank⁹ who guarantees the rights of issuer. There might be seen some types of performance bonds on the classification basis of guaranteeing performance¹⁰.

Main problems with performance bonds seem to depend on its autonomy character and unfair demand for payment by beneficiary. Preservation of unfair calling and after unfair demand, some remedies must be looked for principal and issuer bank. Furthermore, in International Chamber of Commerce publication of "Uniform Rules for Demand Guarantees" performance bond is being explained¹¹ and given remedies for parties in a performance bond. These rules might be incorporated with contract by parties to find some solution to future problems.

2. The Principle Of Autonomy

2.1. Generally

The issuer of the performance bond undertakes an absolute obligation to pay to the beneficiary according to bond¹². Although the aim of performance bond is to guarantee performance of the underlying construction or sale contract, a performance bond gives a primary liability on its issuer unlike the guarantee obligations¹³. Performance bonds can not be revoked by the contractor and remain in force until full performance or full payment under the bond. However, depending on

¹⁰ Giving information more about these is out of scope f this essay. See for figures and explanation ibid # 2 p.1035
¹¹ ICC. publication no:458 Art.2/a
¹² However in City of Glasgow Distric Council v. Excess Insurance Co. Ltd. SLT:(1986) p.585 problem was about prescription period and held that it was a cautionary obligation and subject to the five-year prescriptive period. It should not be understood that on-demand performance bond is cautionary obligation.
¹³ ibid.#1.p.574
wording it can be extended. Exact autonomous character of bond will be defined by construction of the bond. A performance bond is a primary obligation, completely different from underlying contract. If a main obligation is affected either by discharge, voids, frustrating events or force major, the performance bond still remains enforceable.

In Edward Owen Engineering Ltd. v. Barclays Bank International Ltd. Case, Lord Denning stated that "The performance guarantee stands on a similar footing to a letter of credit. A bank that gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with relations between the supplier and the customer, nor with the question whether the supplier is in default or not." In another performance guarantee case, Kerr J. stated that performance bonds "...simply provided that payment would be made on the buyer's-first demand- without any safeguard..."

The requirements of the some documents by provisions in the bond will not change character of the performance bond. Issuer readily accepts obligation to pay against documents which must be inspected in order to verify conformity of the payment under the performance bond. Under a documentary bond, the issuer's payment obligation is triggered by the presentation of such documents as may be stipulated in the bond. When the performance bond is incorporated with

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15 W.S.CHONG, Abusive Calling of Performance Bonds JBL,(1990)p.414-pp.416 says that "The demands of mercantile practice have caused the development of an instrument with the same economic function as a guarantee, but with characteristics which elevate it from a secondary obligation to a primary obligation"

16 (1978) Q.B. p.159-pp.171


18 ibid # 16. pp.150

19 ibid # 1 pp.577
URDG;20 article 20 requires the written demand to state the fact and nature of the breach by the principal for his obligations under the underlying contract. The strength of the autonomy principle in Power Curber International Ltd. v. National Bank of Kuwait SAK. Case, about documentary credit, was defined by Griffiths LJ. that these credits "...are regarded by merchants the world, over as equivalent to cash; they have rightly been described... as the life blood of international commerce..."21.

2.2. Rationale behind the Autonomy Principle

Generally the issuer bank does not want to be drawn into an extremely complicated factual and/or legal dispute on the underlying contracts. However, before 1970s performance bonds were mostly issued by insurance companies or other financial institutions22. Nevertheless merchantile practice and requirements have created on-demand performance bond as a bank issue. Issuer's function in performance bond is very simple upon the issue of the bond. Moreover function of the performance bond in the eyes of the beneficiary as good as cash, in other words unconditionally and instantly convertible to cash23.

In Edward Owen Engineering Case Lord Denning24 stated that the performance bonds in question were "...virtually promissory notes payable on demand...". Wording of the performance bond can give power that he has right to liquidate the bond. As a result of this right, principal is under uncertainty and considerable disadvantage for reasons coming from the intransigence or insolvency of the beneficiary. Performance bond, however is explained as a risk-distributing device25, risk of principal depends on more uncertain the requirements of the bond and the less certain the right of reimbursement.

21 ibid. # 7 para.17.03 p.1497
22 ibid. # 1. Author of the article is quoting from Australian case; Wood Hall Ltd. V The Pipeline Authority (1979) 141 LLR p.443-pp.457
It is the only essence of unconditional performance bond that it is likely the cash in hand with respects to the drawing of parallels between documentary credit. Furthermore performance bond is a creature to answer the commercial requirements different from other instruments of commerce. Performance bond finds its reasoning at the parties' right of acting independently in the commercial arena.

2.3. The Exceptions to the Autonomy Principle

It can be said that there are only three exceptions to the autonomy principle and absolute divorce of performance bonds from their underlying contracts. These are namely: -infringement of an international obligation, -fraud and -express contractual provisions in the performance bond. Except fraud, the other two is based on performance bond itself. Fraud seems as a main exception in the fact.

In United City Merchants (Investments) Ltd. v Royal Bank of Canada\textsuperscript{26} case, about documentary credit, underlying contract was violated by Peruvian exchange control laws and was unenforceable in the United Kingdom as in contrast to treaty obligations. House of Lords held that the documentary credit was enforceable to the extend that it covered the amount genuinely due to the seller. There were not any exceptional situations for them, and documentary credit must remain enforceable unlike main contract. Whether there is fraud or not will be defined by courts and when the principal hears any unjustified calls on the bond, he must seek an interlocutory injunction either against the issuer to prevent the payment or against the beneficiary to prevent the making of a call to the issuer\textsuperscript{27}.

In United Trading Corporation SA v. Allied Arab Bank Ltd.\textsuperscript{28} Court of Appeal stated that strong corroborative evidence of the beneficiary failing to take advantage of an opportunity to respond to the principal's allegation, the court should prepare an injunction where the fraud is realistic inference. However this is not the same as proving "...serio-

\textsuperscript{26} (1982) 2 WLR. p.1039
\textsuperscript{27} Themehelp Ltd. v. West & Others (1995) 3. WLR. p.751. Principal got the injunction for beneficiary not to make call for payment.
\textsuperscript{28} (1985) 2.Lloyd's Report note Court of Appeal p.554
usly arguable case that there is good reason to suspect in that the dem-
mands on the performance bonds have not been honestly made..."29. An inescapable fact remains that the court has hardly ever accepted the presence of fraud30. In RD. Harbottle v. National Westminster Bank, Kerr J. defined that ". this is not a case of an established fraud at all. The plaintiffs may well be right in contending that the buyers have no contractual right to payment of any part, let alone the whole of the guarantee in any of these cases, but all these issues turn on contractual disputes. They are a long way from fraud..."31

To get injunction and define fraud, principal must give evidence about breach of faith which goes further than subsequent case law32. Secondly, the principal must surmount, in order to prevent payment, the fraud proved must be that of beneficiary himself not that of third parties.33 Thirdly, due to interlocutory nature of injunction, before a court may grant such an injunction it must be considered whether the balance of convenience in favour or against the grant. Normally the principal will not approach the issuer in the international relation, but he will deal with the instructing bank. This fact results in the complete absence of any contractual relationship between issuer and injunction seeking principal. Therefore, issuer may not obey the injunction34.

In the United Kingdom Commercial Law, fraud is being interpreted very strictly and requirements to prove the fraud are always very formal and difficult to supply35. If the principal pass through these formal procedures, he will get his wish which is to restraint of payment to beneficiary.36

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29 ibid. pp.565
30 There are very rare court decisions about presence of fraud due to evidencing difficulties. See ibid #25
31 (1978) Q.B. p.146-155
32 ibid #1 pp.584
34 United Trading Corp. SA v Allied Arab Bank Ltd. (1985) 2 Lloyd's Report p.554
35 On the other hand in the USA., Courts appear to have been much readier to give relief where the fraud is alleged. Some cases is cited by author in ibid.# 7 ch.17.069 -pp.1552
3. Preservation Of Unfair Calling

3.1. Generally

Due to the autonomy principle, unfair and abusive calling of the bond value seems main problem in the performance bonds. To prevent this problem, construction of contract and the conformity of call on bond requirements carries main importance\(^{37}\). Instead of to require breach of underlying contract as a fact, performance bond would only be conditioned on documents. Indeed, it is common to find the calling used as a tactical weapon by employers or buyers to discourage the contractor from interim remedies\(^{38}\). Therefore, contractors or sellers must hesitate to accept on-demand performance bond rather than guarantee or conditional form. If an employer insist on an on-demand performance bond, it must be considered that bond value might be called up unfairly, even if beneficiary himself in breach of contract.\(^{39}\) Only clear fraud and issuer’s knowledge about fraud can release the issuer from payment under the bond. However provisions of bond carry main importance for some other exceptions for calling, so that issuer bank must receive the calling which is in conformity of provisions in the bond.\(^{40}\)

3.2. ICC Uniform Rules for Demand Guarantees

To redress the balance between beneficiaries and principals, ICC published a set of uniform rules for contract guarantee in 1978\(^{41}\). Due to the these rules beneficiary had to present a court decisions, arbitral ward or principal’s written approval of the claim and its amount. These rules could not answer to the mercantile practice in the performan-

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\(^{37}\) ibid # 7 ch.17.064 p.1549  
\(^{38}\) ibid.#7 ch.17.076 p.1557  
\(^{39}\) Stair Memorial Encyclopaedia Vol.3 para.18  
\(^{40}\) Esal (Commodities) v Oriental Credit Ltd. (1985)2.lloyd’s Report, p.546-552  
\(^{41}\) Lord Ackner stated that whenever a demand is made under performance bond, it is made on the basis that the contractor has failed to axacute the contract.  
\(^{42}\) International Chamber of Commerce publication no:325 (1978)
ce bonds\textsuperscript{42}. In 1992 ICC published a new set of rules for performance guarantee\textsuperscript{43} which is relevant to market needs for the on-demand guarantees. These rules when incorporated with the bond, they will provide some safeguard against unfair calling\textsuperscript{44}.

The most important rules for unfair calling are found in Article 20 of URDG. Where the URDG applies to a performance bond, it is always necessary for the demand to specify the nature of the breach. Unless otherwise there is no indication in the bond it can not be gone beyond the bare demand-call\textsuperscript{45}. Under Art.20 of URDG, there are some requirements to call performance bond fairly:

a. Any demand for payment under the performance bond shall be in writing and shall be supported by a written statement in addition to such other documents as might be specified in bond. Statements can be separate, attached or within demand stating that the principal is in breach of his obligations.

b. Any call under counter-guarantee shall be supported by a written statement like main call in performance bond.

c. Paragraph (a) of this article applies except to the extend that it is expressly excluded by the terms of the guarantee, paragraph (b) also has same exception for terms of counter-guarantee.

d. This paragraph says that the requirements do not affect the autonomous and irrevocable character of performance bonds.

As can be seen the purpose of the Art.20 of URDG is to impose some constraint on unfair calling\textsuperscript{46}. To avoid the misunderstanding model forms of ICC can be adopted by parties. In the bond provision to adopt URDG is enough to ask requirements from beneficiaries.

\textsuperscript{42} ibid.# 2 pp.1033

\textsuperscript{43} Uniform Rules for Demand Guarantee, (1992) ICC publication no: 458 & Model Forms ICC, publication no:503

\textsuperscript{44} GOODE, Guide to the ICC Uniform Rules for Demand Guarantees (1992) ICC publication

\textsuperscript{45} I.E. Contractors Ltd. v. Lloyd's Bank plc(1990) 51 BLR.p.1 C.A.

\textsuperscript{46} ibid.# 44 pp93-94
3.3. Contractual Requirements to Call

Parties can decide to issue performance bond on the condition that court decision or arbitral award\(^{47}\). However conditional performance bonds are not used as much as on-demand ones\(^{48}\). Principal contract between the parties may on its proper interpretation, be limited or restricted the calling by implied or express terms.

In Potton Homes Ltd v. Coleman Contractors (overseas) Ltd. Eveleigh LJ\(^{49}\) said that "...I do not see why as between seller and buyer, the seller should not be able to prevent a call upon the bond by the mere assertion of the buyer that bond is to be treated as cash in hand." In Esal (Commodities) case\(^{50}\) the buyers called the amount of the bond or alternatively extension of the date which was about to expire. Held by the Court of Appeal that along with the calling, beneficiary must inform the bank that he has right to call on the basis provided for the performance bond. In other words requirements of bond has exact significant importance in defining the call, fair or unfair. Nevertheless in I.E. Contractors Ltd. v. Lloyds Bank plc. and Rafiaddin Case\(^{51}\), Court of Appeal has given judgement that there was less need for the doctrine of strict compliance in the case of performance bonds rather than in the case of letters of credit\(^{52}\). Calling need not to follow exact wording of the bond since the demand is substance. It implied that what it claimed was damages from breach of contract\(^{53}\). In Siporex Trade SA v. Banque Indosuez, it was stated by Hirst, after mentioning strict compliance in documentary credit; that "...whereas in (performance bond) the bank is dealing with no more than a statement in the form a declaration to the effect that a certain event has occurred"\(^{54}\).

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\(^{47}\) ibid # 14 p.8 "...This type of bond is termed conditional performance bond, payment i conditional upon non-performance..."

\(^{48}\) Banks do not want to have problems with underlying contract reasons and prefer to issue on-demand bonds.

\(^{49}\) (1984) 28. BLR. p.19

\(^{50}\) (1985) 2. Lloyd's Report p.546

\(^{51}\) (1990) 51. BLR. p.1

\(^{52}\) Court of appeal overruled Leggatt J, and followed the decision of Siporex Trade SA v. Banque Indosuez (1986) 2. Lloyd's Report p.146.

\(^{53}\) ibid # 7 pp.1550 paras17.065-066

\(^{54}\) (1986) 2. Lloyd's Rep. p.146-pp.159
This distinction must not be taken account strictly. Main problem is in both cases identical that promise that the bank made to the beneficiary and his call enough to pay\textsuperscript{55}.

Although strict compliance is not being taken account strictly, parties should write down some requirements on the bond. It is submitted that once requirements for a valid call have been defined by a term of bond, no one can say these requirements need not to comply. The degree of compliance is strict or not, problem remains with wording of bond\textsuperscript{56}. To sum up, parties in performance bond or counter guarantee must be careful in the period of drafting and when call is made, bank should inspect that bond requirements exist or not for payment.

4. Remedies Against Unfair Calling

4.1. Generally

Since the issuer's liability to pay arises on presentation of the demand with or without other required documents, and does not depend on the existence of actual default by the beneficiary\textsuperscript{57}, issuer always asks and gets counter indemnity from its customer which is principal or instructing party. In the construction of bond period, the risk of unfair calling can be reduced by stipulating in the bond for a distinct certificate that there has been default by the principal, reinforced certificates or reports by third parties such as engineers or architects\textsuperscript{58}. Although the documentary requirements clearly afford a considerable degree of protection for the principal contractor who can not complain when the bank makes payment following on independent report that the principal is in default of the underlying contract.

Under the performance bond, after a formally valid call by beneficiary, issuing bank has to pay bond value notwithstanding the investigation of the fact in which there can be exact default of principal or not.\textsuperscript{59}


\textsuperscript{56} ibid #55 pp.210

\textsuperscript{57} GOODE, Surety and On-Demand Performance Bonds (1988) JBL p.87-pp.91

\textsuperscript{58} ibid #57 p.91

\textsuperscript{59} ibid #55. pp.207
Therefore the principal and the issuer must have some remedies against unfair calling of performance bond depending on the factual situation.

4.2. Remedies for Principal

When the principal hears that beneficiary will call the bond fraudulently, he must get injunction to prevent calling, and when the calling has been already made principal must get an injunction to prevent payment against unfair calling. Whether there is beneficiary's fraud or not will be defined after court's judgement for that interlocutory injunction. To get the injunction, fraud must be beneficiary's own fraud and there must be enough and sufficient evidence.

There are two main hurdles to be cleared by the applicant for an injunction restraining payment under the bond; first, to establish a serious issue to be tried that the fraud exception applies, and secondly to establish that the balance of convenience is in favour of the grant of an injunction. In United Trading Corp. case, Ackner LJ. stated that "...the evidence of fraud must be clear, both as to the fact of fraud and as to the bank's knowledge." After issuer bank's payment, to prevent counter indemnifying bank's payment, the principal must adduce clear evidence that the issuer bank's claim upon the indemnifier-instructing bank is also fraudulent in counter indemnity. In Harbottle Case, Kerr J. was explaining the difficulties which are in the way of a plaintiff seeking an injunction. "Alternatively, if the threat-
tended payment is in breach of contract, which the plaintiff's writs do not even allege and so as to which they claim no declaratory relief, injunction would be inappropriate... because they might cause greater damages to the bank than the plaintiffs could pay on their undertaking as to damages and because the plaintiffs would then have an adequate remedy in damages." However these difficulties could be avoided if the injunction is sought directly against the beneficiary. On the other hand if the beneficiary is based overseas, enforcement of injunction can be more difficult than getting injunction for the bank which is based in the same country as the principal.

When the principal can not succeed to restrain the payment, it is generally assumed that after bond is paid, the court will provide a remedy by way of repayment to the principal. In General Surety & Guarantee Co. Ltd. v. Francis Parker Ltd., Donaldson J. stated that "I do not doubt that in such an event the money would be repayable, but it is not so certain it would be repayable with interest." As can be seen, after payment against unfair calling, to get a decision of repayment depending on the whether there is factual breach or not will be possible. In these cases in first place, principal can claim a mareva injunction to restrain the beneficiary from using and transfer the assets that he has acquired as a result of calling the performance bond. This injunction may be given by less strict evidence than that required for interlocutory injunction.

4.3. Remedies for Issuer and Instructing Bank

Whilst the bank issues the performance bond or counter indemnity, they always require counter indemnity of the principal, in other words principal is the main party under the risk of unfair calling. However the principal after breach of underlying contract, might go into insolvency or might escape from its liabilities, so that banks must require insurance of performance of principal. After payment of bond value, bank will satisfy itself by insurance against breach of contract between bank and principal. Interest rates upon performance bond are

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68 (1977) BLR p.16-p.21
69 ibid.# 67 pp.241
changeable, before payment of bond value it is lower than commercial interest rate but after payment it increases to higher rate.

5. Conclusion

Autonomy principle\textsuperscript{70} of the performance bonds gives rises to unfair calling of bond value. Construction of the bond will define the future of the bond. In Trafalgar House Construction (Regions) Ltd v General Surety & Guarantee Co. Ltd Case,\textsuperscript{71} House of Lords held that proper construction of the bond has main importance and in order to establish liability, proof of damages was required and mere assertion was insufficient. To prevent the unfair calling, parties must require some documents as a proof of breach of underlying contract. Moreover limited value of performance bond, after each ended part of work must be reduced equally with the work.

Unfair calling of performance bond can not be very common in commercial practice, because a beneficiary, who calls unfairly, loses its respect and after that other parties can hesitate to contract with them. Even if they contract with that parties, they charge that parties at the highest prices. At the end, it can be seen that performance bond is necessary in commercial life and risk of unfair calling is being accepted by the parties in the contract beside the benefits of underlying contracts. Notwithstanding the improvement in performance bonds area, judicial authority has not been defined yet. There are still uncertain and contradictory matters to be further tested and to give courts opportunity.

\textsuperscript{70} n City of Glasgow District Council v. Excess Insurance Co. Ltd I(1986) SLT p.585 judgement was made for prescription period and held that performance bond was a cautionary obligation in the view of prescription periods and subject to the five-year prescription period.

\textsuperscript{71} (1995) 3.WLR p.204