Unconditional and Irrevocable Guarantees : Substance over label in restraining call on performance bond / guarantee

KNM PROCESS SYSTEMS SDN BHD V LUKOIL UZBEKISTAN OPERATING COMPANY LLC
[Appeal No. W-02(C)(A)-1504-07/2018

ISSUES

Since the Federal Court case of **Sumatec Engineering & Construction Sdn Bhd v Malaysian Refining Company Sdn Bhd [2012] 3 CLJ 401** ("**Sumatec**"), the Malaysian Courts have recognised unconscionability as a "*separate and independent ground*" apart from fraud, in restraining a beneficiary from calling on or receiving proceeds from bank guarantees / performance bonds.

Would a bank guarantee labeled as unconditional be automatically treated as such? Or would one still need to inspect the terms of the underlying contract to determine if the guarantee was indeed unconditional?

What if the underlying contract contains an arbitration clause and the application to restrain the beneficiary of the guarantee was made pursuant to section 11 of the Arbitration Act 2005? Would the test be different? How can the applicant show strong prima facie case of unconscionability?

These issues arose in the recent Court of Appeal case of **KNM Process Systems Sdn Bhd v Lukoil Uzbekistan Operating Company LLC [W-02(C)(A)-1504-07/2018].**

BRIEF FACTS

The brief facts of the case are as follows:-

(a) There were 2 contracts between the Appellant and the Respondent, i.e. the "Gissar Main Contract" dated 03.12.2010 and the "Khauzak Main Contract" dated 03.10.2011.

(b) The Appellant was to provide the following 3 guarantees for the respective contract:-

Gissar Main Contract (totaling USD37 Million)

(i) Performance Guarantee;
(ii) Guarantee for Refund of Advance Payment;

Khauzak Main Contract (USD3 Million)

(iii) Warranty Guarantee.

(c) On 27.11.2017, the Respondent simultaneously demanded on all 3 guarantees.

(e) Both the Gissar and Khauzak Main Contracts contained an arbitration clause and the Respondent applied to stay the Civil Suit and to refer the disputes to arbitration.

(f) The stay order was granted by consent. By agreement of parties, the Appellant filed this Originating Summons pursuant to section 11 of the Arbitration Act 2005 ("**AA 2005**"), to determine whether an interim injunction may be granted to restrain the calls on the guarantees and/or receipt of proceeds from the guarantees.

(g) The Appellant contended that the calling of the guarantees were fraudulent and unconscionable based on, inter alia, the following grounds:-

i) The Guarantee for Refund of Advance Payment under Gissar Main Contract is not an unconditional on demand bond;

ii) The call was not in compliant with the terms of the Gissar Main Contract;

iii) The call was only available upon termination which did not arise in this case;

iv) Contemporaneous evidence and conducts of parties show that there is no objective entitlement for the Respondent to call on the guarantees and the Respondent is well aware of this;

v) On the Khauzak Main Contract, after multiple agreed extension of the guarantee until 31.10.2017, the Respondent agreed to return the Warranty Guarantee without further extension pending the Appellant attending to some miscellaneous matters under the warranty period;

vi) There were simultaneous calls on the guarantees issued under 2 unrelated and separate contracts.

(h) The Respondent contended that the application was an abuse of process and that the principles of interim injunction pending arbitration were not met. The Respondent further contended that the Respondent must not be prevented from enjoying its rights to payment under the guarantees.

HIGH COURT

The High Court dismissed the injunction application. Thus, the Appellant appealed to the Court of Appeal.

COURT OF APPEAL

The Court of Appeal allowed the Appeal and granted "*a restraining order on all three calls so that the validity of the calls may be finally determined at the arbitration*."

A. Section 11 and Maintaining Status Quo

The Court of Appeal observed that section 11 of the AA 2005, as amended, is no longer focused on the type of interim measure but rather "*the effect or intent of the measure*".

In the instant case, the Court of Appeal noted that "*the interim remedies were sought for the purpose of maintaining status quo pending determination of the dispute at arbitration*" to "*prevent one party from bringing about a change of circumstances adverse to the other which the arbitrators cannot adequately remedy*."

For completion, section 11(1)(i) of the AA 2005 provides that:-

> *11. (1) A party may, before or during arbitral proceedings, apply to a High Court for any interim measure and the High Court may make the following orders for the party to—*
>
> *(i) maintain or restore the status quo pending the determination of the dispute;*

Whilst the facts need to be carefully examined, the Court of Appeal cautioned that the Court must exercise restrain from determining the dispute in any definitive manner:-

> *"[36] The exercise of discretionary power under section 11 requires a careful examination of the relevant material facts against the allegations made, with a cautious restrain of determining the dispute in any definitive manner since that is a matter for determination at the arbitration and not for the Court. The Court is only approached to grant an interim remedy which will ultimately support or aid that arbitration."*

B. The Test

The test to be applied for such application is as per the case of Keet **Gerald Francis Noel John v Mohd Noor bin Abdullah [1995] 1 MLJ 195** and as the interim measure involves performance bond, guarantees and warranties, "*the applicant must in addition, show a strong prima facie case of fraud or unconscionability but the merits and substantive arguments of such an allegation is to be determined at the arbitration, and not by the Court*."

Having considered the authorities on restraining calls on performance bonds, guarantees and warranties, the Court of Appeal noted that where the parties in disputes are contracting parties themselves, regard must be given to the terms of the contract, especially the provisions governing guarantee, bond and warranty and "*not just to look at the labels given to such instruments*":-

> *"…There must be a thorough consideration of the relevant facts as viewed in the context of the case, taking into account the competing allegations weighed against the conduct of the parties leading up to the calls on the guarantees in order to determine whether there is a strong prima facie case of abuses arising out of the contract or unconscionability, that there is lack of good faith or unfairness, and that the totality of circumstances warrant a restrain on the call to avoid injustice. Context is critical. That is only logical as a case of fraud or unconscionability is almost invariably premised on the understanding and agreement as reflected in the underlying contract between the contracting parties…"*

C. Performance Guarantee – Terms of Contract Over Labels of Guarantees

Having examined the underlying contracts and the guarantees, the Court of Appeal found that the guarantees were not on demand unconditional and irrevocable guarantees despite its labels:-

> *"[60] In the first place, the three guarantees were not on demand unconditional and irrevocable guarantees despite the labels appearing… The Guarantee for Refund of Advance Payment No: 5789175 provided under the Gissar Main Contract certainly does not bear such characteristics while the guarantee under the Khauzak Main Contract was actually a warranty.*

> *[61] As for the Performance Guarantee provided under the Gissar Main Contract although described as "unconditional and irrevocable", on the contrary it is a conditional guarantee. The guarantee, inter alia states that "From the date of this Guarantee stated above..." payment of the whole guaranteed amount will be in full "upon first written request of the Client, if the Contractor cannot fulfil the conditions of the Contract", thus qualifying and rendering the guarantee from a seemingly unconditional and irrevocable guarantee to one which is conditional – see page 180 of CBD. We agree with learned counsel for the appellant that the call thus cannot be made unless and until breach of the underlying contract has been established as held in Sumatec.*

After examining the terms of the Gissar Main Contract, the Court of Appeal finds that the Respondent is entitled to liquidated damages ("**LAD**") if the Appellant cannot fulfill the conditions of the Gissar Main Contract. However, such damages may only be deducted from the relevant guarantee after meeting certain conditions, i.e. the Appellant failing to pay the LAD after the Respondent claimed for the same in writing.

In relation to the above, the Court of Appeal finds that the Respondent did not fulfill these conditions and consequently found that the call to be in breach of the Gissar Main Contract.

> *"In other words, despite the label appearing on the Performance Guarantee, the guarantee is actually a conditional guarantee... This renders thus the call on the Performance Guarantee a call which was in breach of the underlying contract, that is, the Gissar Main Contract."*

In light thereof, the Court of Appeal finds that:-

> *"[65] Absence or "lack of good faith" has long been accepted as a basis to restrain a beneficiary from calling a bond or guarantee... We are of the view that the above circumstances display a seriously arguable and realistic inference case of want of good faith on the part of the respondent such that an interim injunction restraining the respondent's substantive rights is warranted…*
>
> ***…Not meeting those pre-conditions, or retreating to them after making the call, as was done in this case, show the presence of "elements of unconscionability that question the real purport of the call…***
>
> *[68] These material distinctions as evidenced by the terms of the underlying contract are quintessential and relevant requisites when dealing with applications for interim injunctions between the contracting parties as opposed to applications involving the issuing bank where the commercial viability of such instruments are paramount considerations…"*

D. Guarantee for Refund of Advance Payment – Trigger Event Under Contract

In relation to the advance payment guarantee, the Court of Appeal finds that the "*essence of such a guarantee is that there has to be a calculation of works not performed before a call can be made. The calculation of the amount under the call is dependent on and adjusted according to the value of works unperformed and proof of an advance from or by the respondent. This is evident from the terms of this guarantee itself… which clearly shows that this is not even an unconditional and irrevocable on demand guarantee to begin with.*"

Having scrutinized the terms of the underlying Gissar Main Contract, the Court of Appeal finds that for the guarantee to be triggered, there needs to be a trigger event and in this case, the trigger event in accordance to the contract is the termination of the Gissar Main Contract:-

> *"[72] But, for all that to happen, there must be a trigger event, that is, there must be a termination of the underlying contract, as provided under clause 17.4.1 of the Gissar Main Contract. In this appeal, there was no termination; the respondent did not terminate the Gissar Main Contract."*

To this end, the Court of Appeal finds that the call on the Guarantee for Refund of Advance Payment to be premature and in breach of the Gissar Main Contract, which amounts to a seriously arguable case with strong prima facie evidence of unfairness and unconscionability, for which the demand must be restrained-

> *"[74] Thus, the appellant's contention that this call was in fact premature and in breach of the underlying contract was also of merit. The trigger event for such call, whether clause 17 or any other provisions of the Gissar Main Contract has been fulfilled is a matter of strict construction of the demand and of the contract… This issue of the validity of the call on such a refund guarantee stands unresolved and is for determination in the arbitration.*
>
> *[75] At this point, it would be fair to say that a premature call not made in accordance with the agreed terms of contract amounts to a seriously arguable case with strong prima facie evidence of unfairness and unconscionability has been made out in respect of the Guarantee for Refund of Advance Payment for which the demand must be restrained... This guarantee is actually a conditional guarantee which is not subject to the same considerations as the other two guarantees; yet was treated in like manner by the respondent..."*

E. Warranty Guarantee – Circumstances of Call

The Warranty Guarantee was originally set to expire in June 2016. Upon the Respondent's request, it was extended several times to deal with remedial works. On 17.03.2017, the Appellant was asked to extend the guarantee until 30.06.2017, failing which the Respondent "*will have to recover the full amount of the Bond*".

The guarantee was thereafter extended a few times with the Appellant imposing an additional term that the guarantee "*shall be returned to KNM for cancellation, when it* expires". The final extension was to 30.11.2017. However, on 27.11.2017, the Respondent called on the full amount under the Warranty Guarantee.

Having considered the circumstances and terms of the guarantee against the contract, the Court of Appeal finds that:-

> *"The extensions of the Warranty Guarantee were obtained under threat, and the call was made just shortly before the guarantee expired without the respondent first calculating the amount due… such call under such conditions raises strong questions of unconscionability on the respondent's part which ought to have weighed with the learned judge in favouring an exercise of discretion granting an interim injunction restraining the call pending final determination at the arbitration."*

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G. Further Compelling Reasons

Further to the above, the Court of Appeal "*found even more compelling reasons, again meeting the applicable tests.*"

In relation to this, the Court of Appeal noted that:-

1) The Respondent made simultaneous calls on all 3 guarantees when parties were still meeting to iron out the details on completion of works. In fact, 3 such meetings took place in short succession.

2) "*At none of those meetings nor in the correspondence exchanged was there any intimation that the calls would be made; that the respondent was dissatisfied with works under both the underlying contracts; that relationship between the parties had broken down and that disputes had arisen between the parties.*"

3) Although the call as made on 27.11.2017, the Appellant was not aware of the same until 04.12.2017. Although much had been exchanged by parties during the intervening period, the Appellant was unaware of the calls.

4) The 2 underlying contracts are "*completely unrelated, made at different times and for different purposes*."

5) In fact, there "*were different start times and schedules with both contracts being substantially if not entirely completed*."

In the upshot, the Court of Appeal finds that the "*balance of convenience leans in granting a restraining order on all three calls so that the validity of the calls may be finally determined at the arbitration. Such a restraining order will in our regard, surely aid, support and facilitate the arbitration of the substantive dispute that started before the High Court in the first place*."

MOVING FORWARD

Following the decision, it is important to note that:-

1) Whilst the performance bond, guarantee or warranty may labeled as “unconditional”, a detailed examination of the underlying contract is necessary to discover the true nature of such guarantees;

2) Where the underlying contract provides for certain pre-conditions to be met before the calling of the guarantee, such pre-condition must first be met to avoid a wrongful call / call in breach of the contract, which may be unconscionable;

3) An extension of the bond, guarantee or warranty obtained under threat together with hasty call just before its extended expiry may give rise to strong questions of unconscionability.

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