COVID-19 and Interim Relief for Stay of Enforcement of Bank Guarantees

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The COVID-19 crisis is having a significant impact on the construction sector, with many contractors unable to comply with their contractual obligations in a timely fashion. Given the exceptional nature of the COVID-19 pandemic and the actions taken to prevent its spread and effects, both of which underpin the declaration of a state of emergency in several countries, the resulting situation could legitimately be classed as a force majeure event or warrant the application of the *rebus sic stantibus* doctrine. In this context, many owners of construction works may believe themselves to be entitled to enforce the bank guarantees granted by contractors under the relevant construction contracts.

This article analyses whether it is possible to prevent enforcement of a bank guarantee to secure contractors' obligations under a construction contract by obtaining interim relief to stay enforcement. It considers: (i) the two types of bank guarantee typically found in most construction contracts; (ii) the general requirements that arbitral tribunals and courts take into account when deciding on an application for staying enforcement; and (iii) the particular features of this analysis when enforcement is sought as a reaction to breaches of contract due to the COVID-19 crisis.

Typical Guarantees in Construction Contracts

In practice, a typical construction contract includes two standard bank guarantees: (i) advance payment security; and (ii) performance security.[1]

Advance payment security: owners usually make an advance payment to the contractor of between 5% and 10% of the price so that it can start the works. Advance payment security is intended to protect this outlay and guarantee its return to the owner.[2]

The advance payment is commonly repaid through proportional reductions in interim payments during the contract. Therefore, the advance payment security should remain valid and enforceable until the advance payment has been repaid in full, although its amount will probably be reduced progressively as the advance is repaid.

Owners may enforce the guarantee upon termination of the contract or if unable to obtain repayment of part or all of the advance payment in certain circumstances.

1 It is also general practice for construction contracts to establish cash retentions operating as a deduction in stage payments, to be released once the works are accepted by the owner. Although also designed to ensure completion of the works, they are not addressed in this article, as they are technically not securities.

2 Since the contractor's initial outlay to get the works started entails a significant disbursement, it is common for the owner to be required to make an advance payment, in the form of an interest-free loan and for the purposes of mobilization or design, which facilitates the contractor's initial cash flow.

Seeking interim measures before judicial courts is not considered a waiver of the arbitration clause

Performance security: this guarantee is granted to secure proper performance of the contract by the contractor, as the owner will normally only return the performance security once it has provisionally or definitively accepted the works. Contractors should therefore ensure that the performance security is valid and enforceable until they have completed (or substantially completed) the contracted works. The performance security is usually around 10% of the contracted price.

The performance security can normally be enforced when a serious event of default occurs due to an action or omission of the contractor. This event of default will also frequently enable, but not compel, the owner to terminate the contract. As the only requirement is usually that the owner considers that the contractor has breached its contractual obligations, this can lead to enforcement claims being made without much notice.

One common feature in practice of both bank guarantees is that they are enforceable on first demand. As explained in the following section, this feature makes it difficult to obtain a stay of enforcement in practice and means interim relief must be sought as soon as the risk is identified (if there are sufficient grounds to do so).

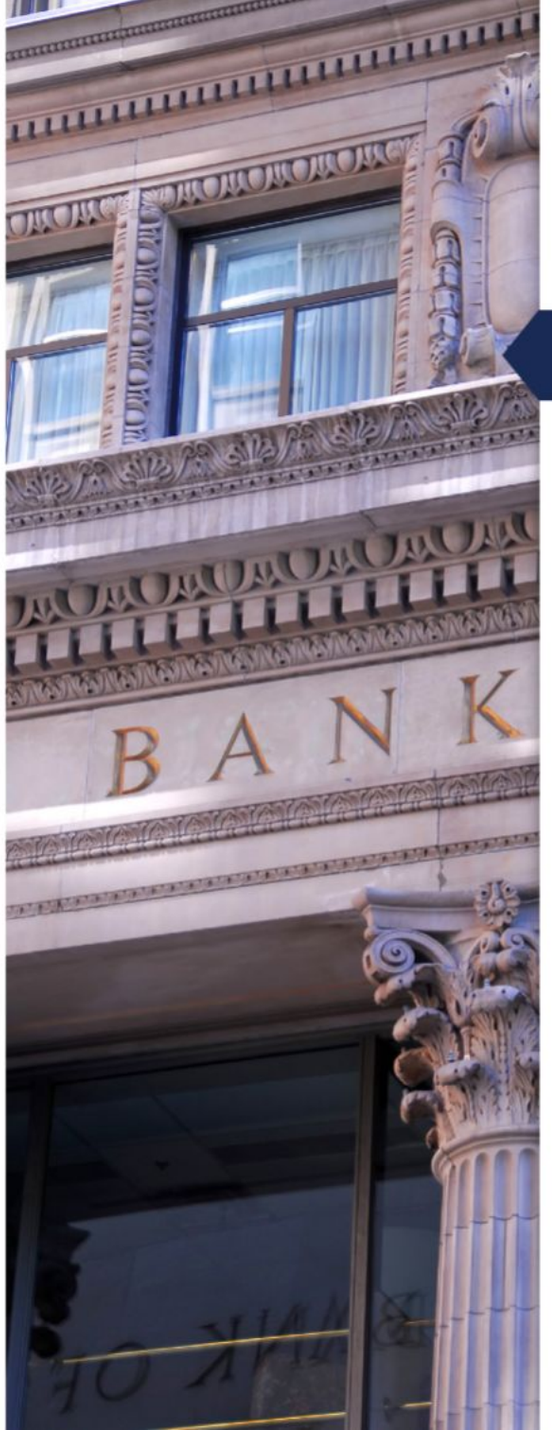
Is it Possible to Stay the Enforcement of Bank Guarantees by Obtaining Interim Relief Before an Arbitral Tribunal or the Courts?

Enforcement of Contractual Guarantees Against the Contractor

Owners usually enforce bank guarantees when a serious dispute arises concerning the contract in question. It is relatively straightforward to enforce a bank guarantee and does not tend to entail a negative impact for the owner, at least until proceedings on the merits commence (before either an arbitral tribunal or a court). Typically, bank guarantees can be classified in two types in terms of their enforcement:

(i) An unconditional and abstract or first-demand security may be called (cashed) on demand merely by stating that the contractor has breached certain obligations, without having to provide any evidence of that breach. International banks commonly prefer this kind of security because they do not need to read the contract, investigate the contractor's alleged default or assess the owner's entitlement to compensation.

(ii) A conditional security requires the fulfilment of certain conditions before it may be called. The owner is generally



Once the arbitral tribunal has been constituted, interim relief should generally be sought before the tribunal

required to provide some form of evidence of the contractor's breach of the contract.

As mentioned above, the fact that advance payment and performance securities are usually abstract or first-demand means that they are easily enforceable (by mere communication from owner to bank). This makes it even more necessary to resort to interim relief to obtain a stay of enforcement when the contractor considers that the owner is enforcing unduly.

General Requirements to Request a Stay of Enforcement of Guarantees

Most arbitration laws worldwide permit applications for interim relief in support of arbitration procedures, either to national courts or to arbitration tribunals. In this regard, seeking interim measures before judicial courts is not considered a waiver of the arbitration clause.[3]

Notwithstanding the above, once the arbitral tribunal has been constituted, interim relief should generally be sought before the tribunal. And even before the arbitral tribunal has been constituted, the rules of most international arbitral institutions (including the ICSID Arbitration Rules, ICC, LCIA or CAM)[4] allow interim relief to be sought from an emergency arbitrator appointed before the constitution of an arbitral tribunal specifically to rule on the interim relief application. The claimant is normally required to demonstrate two things in order to obtain interim relief: (i) *prima facie* entitlement to the remedy on the merits in the main proceedings (*fumus boni iuris*); and (ii) the urgent need to rule on its request, in the sense that the situation may prove irreversible for the claimant if the interim relief is not granted (*periculum in mora*).[5] The claimant is also sometimes required to provide a bond as security for the damage that granting interim relief may cause to the defendant if the claimant ultimately does not prevail on the merits.[6] These requirements must be satisfied regardless of whether the interim relief application is made in the judicial or the arbitral sphere. While the first requirement is essential, the second (*periculum in mora*) usually proves to be the decisive factor in determining whether the interim relief is granted.[7]

Specific Factors Affecting Enforcement of Guarantees in the Context of the COVID-19 Health Crisis

As mentioned in the introduction, the ongoing COVID-19 health crisis is causing delays for some contractors, as well as other contractual breaches. When those delays or breaches

3 See European Convention on International Commercial Arbitration (21 April 1961) (Geneva), art VI.4.

4 See ICC Rules, art 29 and Appendix V; LCIA Rules, art 9B; CAM Rules, art 37. See also ICSID Arbitration Rule 39(5), which provides that a party may seek provisional measures at any time after proceedings have been instituted. If the request is made before the tribunal has been constituted, the Secretary-General fixes a briefing schedule so that the tribunal may consider the request as soon as possible after constitution.

5 See UNCITRAL Rules 2013, art 26; CAM Rules, art 36; CIMA Rules, art 37.

6 See ICC Rules, art 28; UNCITRAL Rules 2013, art 26; CAM Rules, art 36; CIMA Rules, art 37.

7 It is important to bear in mind that the effectiveness of the provisional measure granted will be conditioned upon the petitioner subsequently initiating the arbitration proceeding. In order for the measure to be maintained, the petitioner is required to quickly take the necessary steps to commence the arbitration proceedings.

If the breach of contract is not attributable to the contractor, then the guarantee cannot be legally enforced

are genuinely attributable to the prevailing circumstances and not to the contractor's own fault, they may be considered force majeure events or lead to the application of the rebus sic stantibus doctrine or the like.

If the breach of contract is not attributable to the contractor, then the guarantee (even if abstract or first-demand) cannot be legally enforced. In that case, the contractor should be considered to have satisfied the *fumus boni iuris* requirement, which will increase the likelihood of successfully obtaining interim relief, subject of course to the second requirement (*periculum in mora*) being met.

In any event, in order to assess each situation, we must first refer to the specific provisions of the contract at hand (which may have modified or totally excluded any consequences arising from force majeure). In construction contracts, the existence of force majeure excuses a party from performing part or all of its obligations for as long as the force majeure event prevents such performance, provided that the affected party notifies the other party in due course. For example, if the contractor is affected by force majeure and gives notice of the suspension of performance of specific obligations, it could be entitled to an extension of the applicable deadlines and, in certain cases, compensation for the additional costs incurred.[8]

However, the existence of a force majeure event will be unlikely to excuse contractors from contractual obligations to renew guarantees. This is logical: force majeure covers aspects closely related to the performance of works, such as suppliers failing to provide goods or employees being unable to attend the construction site. But it does not usually affect compliance with financial obligations. As a result, contractors need to be aware that the guarantees they have provided will generally remain enforceable (if not renewed in due time) even if a force majeure event has occurred related to COVID-19.

Conclusions

The stay of enforcement of construction contract guarantees via an application for interim relief is a feasible course of action that can protect a contractor against unfair enforcement initiated by an owner when all the requirements to approve the stay are met and clearly reasoned and explained. The COVID-19 health crisis reinforces the contractor's position in terms of justifying the satisfaction of the *fumus boni iuris* requirement to obtain interim relief, as any potential contractual breach caused by the COVID-19 situation will in principle not be attributable to the contractor, and cannot therefore be cited as a legitimate basis for enforcing guarantees. Such breach would be covered by force majeure or other legal doctrines, such as *rebus sic stantibus*, devised under contract law systems to be applied to extraordinary circumstances.

However, two general observations should be borne in mind. The first is that if the parties have regulated force majeure in the contract, the relevant contractual provisions will apply. Therefore, the starting point for the analysis must always be the construction contract. Secondly, it is always necessary to undertake a case-by-case analysis of whether it is possible to obtain a stay, based on an examination of the applicable arbitration and other procedural rules and of the specific circumstances of the case and how they apply as regards *fumus boni iuris* and *periculum in mora*.

8 See for instance the force majeure clause of the FIDIC rainbow series (ed 1999 –cl 19.4- and 2017 –cl 18.4-).