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Protection Against Counterparties

When Financial Problems Rise

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This article considers how parties can protect themselves against credit and performance risk in the context of construction projects. Such issues have been prominent in Brazil recently, with major companies such as Petrobras and Eletrobras facing cash flow issues, resulting in delays and placing considerable pressure on the supply chain. It should be remembered, however, that these issues are not only relevant where the other side is in some kind of financial difficulty: recent crises have demonstrated that a company's financial position can change quickly. The key message is to not assume financial strength, and always consider the issues set out below.

Payment Schedule

The payment schedule defines where credit risk exposure lies and impacts on the contractual protections and guarantees required, so it warrants serious consideration. A contractor can reduce payment risk by anticipating payment, while a client or purchaser can mitigate performance risk by deferring payment until work is completed. In big projects, however, contractors rely on the cash flow generated from performance to finance the works: if deprived of this, their borrowing costs or costs of capital will be passed on to the client, increasing the total project costs. Most negotiations therefore aim for cash flow neutrality, with payments financing a contractor's costs as they are incurred. This can be achieved through appropriate payment milestones (for lump sum contracts) or measurement criteria (for unit rate contracts). Milestones can be combined with earliest payment dates to give the employer some certainty regarding its funding requirements; or with drop dead dates, if the milestones include elements outside the contractor's control.

Transfer of Title

Generally, property transfers upon delivery, though a supplier may retain title pending full payment. Where significant payments are made before delivery, however, title may transfer progressively as materials are prepared, delivered, incorporated or used. In any case, risk should remain with the party in possession, who will usually be required to insure. Where a contractor retains possession after title has passed, it may have a lien allowing it to keep possession until payment in full: otherwise, the owner has the right to possession and can obtain a court order to take it. For international projects, it is important to consider the enforceability of such court orders: whereas most countries respect international arbitral awards for damages, it can be more difficult to obtain an injunction requiring one party to deliver up possession. In Brazil, the Arbitration Act does not limit the enforcement of arbitral awards regarding possession, though there is no conclusive jurisprudence on this point.

Termination and Suspension Rights

The right to terminate a contract when the other party is suffering financial difficulties can be important to both parties. Unless the contract otherwise provides, under English law termination is only available for a breach depriving the other party of substantially the whole of the benefit of the contract: a high threshold and potentially difficult to determine. Article 475 of the Brazilian Civil Code (BCC) allows termination for breach. For the sake of certainty, however, it is always preferable to include express termination provisions. When doing this, careful thought should be given to materiality thresholds and cure periods. It is common to allow for termination where any steps are taken relating to the insolvency of the other party, even if it is not in breach, since it is often important to act quickly when a company is in financial difficulty.

Contracts may also allow termination upon deterioration in the financial circumstances of the other party, determined by credit rating or particular financial criteria. They may also include a clause allowing one party to demand ‘further financial assurances’ if it considers that the financial position of the other has deteriorated, and allowing termination unless the other party provides security. It is important to note that the Brazilian Civil Code provides a similar right automatically, unless excluded by agreement. A number of other remedies might be available, such as the right to suspend performance of the contract if payments have not been made on time. In contrast to Brazilian law, there is no automatic right to do this under English law, so contractors should set it out expressly in common law contracts.

Consequences of Termination

The contract should clearly specify the consequences of any termination event. From the employer’s perspective, it should require the contractor to preserve the works and any employer property in its custody, and to safely transition services to a replacement contractor. The employer should also negotiate appropriate step-in rights: certain rights, such as the right to use contractor property, may be contentious, but could be indispensable to the employer for termination to be a viable remedy. Following a contractor’s default, it would be liable at law for any increase in the company’s costs of completion from those agreed in the contract, though contractors will usually insist on a liability cap. On employer default, the contractor will be paid for work performed and may receive a percentage of the unperformed contract value, as compensation for loss of profit.

Another important remedy is set-off, which allows the deduction of claims against a party from amounts owed to that party. English law generally allows set-off of amounts under the same contract, and Article 368 BCC provides a general right of set-off, which is available unless the parties agree to exclude it. Courts are generally supportive of set-off rights, so any exclusion of these rights must be drafted carefully.

Bonds and Guarantees

Bonds and guarantees help mitigate risks arising from the gap between payment and receipt of performance, which contractual remedies cannot fully eliminate. There are many different types available: one with which most people will be familiar is the corporate guarantee; usually granted by a parent company or affiliate to support another group company. These should always be considered when contracting with a special purpose vehicle or relatively minor subsidiary, as these may not have sufficient assets to satisfy any judgment made against them. Unlike bank guarantees and surety bonds, parent company guarantees usually cover the full value of the contract and have no fixed expiry date. The drafting and formalities of a guarantee will depend on the governing law: under English law, for example, a guarantee should generally contain specific drafting and take the form of a deed of guarantee and indemnity, so it survives changes to the underlying contract. If the guarantor is Brazilian, making the guarantee subject to Brazilian law and jurisdiction should be considered; enforcement of a foreign award may otherwise be delayed by requirements for homologation by the supreme court (STJ).

Surety Bonds

Another way of mitigating risk is the use of surety bonds. These are not ‘on-demand’, but a guarantee that will only pay out if the guaranteed party is liable under the underlying contract. Once the guarantor (or “surety”) has paid out, it is subrogated to the beneficiary’s claim against the guaranteed party. It is therefore unlikely to pay out until the guaranteed party’s liability has been proven or admitted, meaning that surety bonds do not have the same advantage as on-demand guarantees of anticipating payment. Since the surety’s liability is linked to the contract, it also has the benefit of all contractual defences, and its consent will be required for any material contractual variation. The maximum value that can be claimed under a surety bond is usually capped at a percentage of the contract value and surety bonds usually expire upon the occurrence of a significant contractual event, such as mechanical completion.

On-Demand Guarantees

In contrast to surety bonds, “on-demand” guarantees are financial instruments, for a fixed value and fixed duration, which pay out upon a demand issued in accordance with their rules. These rules may be set out in the instrument itself or incorporated from one of the sets of standard terms, such as the Uniform Rules for Demand Guarantees (URDG) published by the ICC. While these rules are often incorporated as a matter of course, it should be considered whether this is beneficial: they may not be necessary if a bank guarantee is properly drafted, and generally protect the guaranteed party, rather than the beneficiary. The beneficiary may, for example, want to exclude URDG Article 15, which requires the beneficiary to provide a statement indicating how the other party is in breach. Failure to provide this statement will invalidate the demand; but setting out the basis of a claim may provide grounds for the guaranteed party to seek to block payment. Demands should be rejected if they do not comply with the terms of the bond, but not by reference to the underlying contract.

Guarantor banks usually have 5 business days to make payment under an on-demand bank guarantee, and will commonly notify the guaranteed party before making payment. This can open a window for a guaranteed party to seek an injunction preventing payment. The grounds for granting such an injunction are a matter of procedural law, and so determined by the law in the country where the issuing bank is based (regardless of the governing law of the guarantee). The standard required to grant an injunction varies considerably by jurisdiction, though English courts will traditionally only prevent payment where the claim is manifestly fraudulent. In Brazil, the test considers whether the demand constitutes an abuse of a right and the guaranteed party may suffer irreversible damage if the bond pays out.

Recovering Payment From On-Demand Guarantees

The beneficiary of an on-demand guarantee will want to minimise the chances of payment being blocked. As well as the governing law of the guarantee and the procedural law of the jurisdiction in which the drawdown notice will be issued, the parties’ relationships with the issuing bank should be considered. Where the guarantor bank is the relationship bank of the guaranteed party, it is likely to give it immediate notice of the drawdown request and may prompt it to seek an injunction. If the issuing bank has a relationship with the beneficiary, however, payment may be made without waiting for a decision on any injunction.

The strength of an on-demand guarantee may also depend on whether it incorporates any international rules, such as the URDG or the ICC International Standby Practices, which provide certain safeguards against unfair calling. They require, for example, a guarantor to transmit a copy of the demand and any related documents to the guaranteed party, allowing them to seek the withdrawal of the demand or injunctive relief. The bank is not, however, allowed to delay payment while this takes place, and has only 5 business days to determine if a demand is compliant. In general, however, on-demand guarantees provide strong protection for the beneficiary and can dramatically strengthen its hand if claims arise. For this reason, contractors often resist giving any more than a surety bond or parent company guarantee. Whether this is possible depends on the parties’ relative bargaining positions, as well as market conditions and practices. As with all the issues considered above, it is vital to realise that decisions made at the outset will play a major role in determining a party’s ability to recover amounts owed. By being mindful of the risks at the time of contracting – even when a party appears financially sound – you can go a long way towards mitigating the risk of a counterparty later running into financial difficulties.

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