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Performance bonds: Tradigrain v State Trading Corp of India.

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This is an electronic version of an article published in the Journal of International Maritime Law, 11 (5). pp. 325-327, 2005.

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PERFORMANCE BONDS

Tradigrain v State Trading Corporation of India
[2005] EWHC 2206 (Comm) (19 October 2005)

Facts

T had sold a quantity of wheat to the respondent buyers, S. The sale contract provided for the quality of the wheat to be final in accordance with independent inspection certificates issued at loading. It also required T to put up a performance bond in the amount of 5 per cent of the contract value. That performance bond was subsequently issued by a bank in India. The bond, as is consistent with general practice, was backed by a counter-guarantee from T's bank.

After the goods had been discharged in India, S claimed that the goods were not of contractual quality. They claimed US$908,250 which was the full amount guaranteed under the bond. That amount was paid by the Indian bank. Neither T nor its bank had paid under the counter-guarantee. The Indian bank brought proceedings in India against T, its bank and S to recover what it had paid under the bond.

The contract of sale contained a GAFTA arbitration clause. The GAFTA board of appeal held that S's call on the bond had been wrongful because the quality claim, it alleged, was not valid. It was invalid because the contract provided for quality to be final as certified at loading. Even if the discharge quality was relevant, S's evidence had not shown that the quality on discharge was non-contractual. Additionally, there was, in any event, no justification for calling the whole amount of the bond. If at all

entitled to call on the bond, it was entitled to no more than US$100,669.55 which was the amount admitted to by T.

The board found that the retention by S of the amount of the bond, save for the figure for despatch, was wrongful, but that T was not entitled to the return of the balance of $807,580.45 (being the difference between US$908,250 and US$100,669.55) because neither it nor its bank had yet paid it.

T contended that the award was wrong in law and that the authorities established that in such circumstances it was entitled to the return of the overpayment as a debt due to it. S contended that T's entitlement was only to an indemnity in respect of loss caused by the wrongful call and retention. There was clearly only one principal issue in this case:

> Where it has been determined that a buyer under a sale contract has called upon a performance bond provided by the seller in an amount exceeding the buyer's true loss, is the seller entitled to immediate repayment of the amount overpaid or does the seller's entitlement to repayment depend upon whether the seller can show that he, rather than an intermediate bank, has suffered an actual loss as a result of the buyer's call upon the performance bond?

Decision

Christopher Clarke J allowed the appeal. He ruled that there was an implied term in the contract of sale that S would account to T for any amount that had been paid under the bond to the extent that the amount paid exceeded the true amount of S's loss. That amount was due to T as a debt, whether or not T had indemnified either the paying bank or the indemnifier of the paying bank (*Cargill International SA v Bangladesh Sugar & Food Industries Corp* [1996] 4 All ER 563; *Comdel Commodities v Siporex Trade SA* [1997] 1 Lloyd's Rep 424).

The court went on to state that the overpayment was due when the fact that it was an overpayment had been established either by agreement or judgment. The board of appeal had made an error. The overpayment was due to T as a debt, and T would be obliged to restore that money to the Indian bank directly or indirectly. There was no need to determine the precise nature of the obligation owed by T following the overpayment.

Comment

The tribunal's finding that the call had been wrongful was not in dispute (it should, however, be noted that from the facts, that the question was primarily whether overpayment needed to be repaid immediately or whether it should be repaid after true actual loss had been determined. S argued that T was merely entitled to an indemnity as regards the overpayment – that meant that only after the actual loss had been determined should S be required to reimburse T with the overpayment. Against this, was T's submission that the overpayment was due back to it as a debt, not an indemnity. This issue has a direct bearing on the legal nature of a performance (demand) bond.

Any overpayment on the performance bond must be accounted for as an implied term of the contract between the buyer and seller. This has been the position since *Cargill International SA v Bangladesh Sugar & Food Industries Corp*. There, it was held by Morrison J that if there has been a call on the bond which turned out to exceed the true loss sustained, then the party who provided the bond would be entitled to recover the overpayment. On that basis, it would also seem to follow that the account party may hold the amount recovered in trust for the paying bank (where, for example, the bank has not been paid by him). That said, that should not affect his right to bring the claim in his own name. A prudent bank would normally have required its customer to provide it with appropriate security for the giving of the bond, which would be called upon as soon as the bank was required to pay. In principle, it seems to be the position that the account party should always be entitled to receive the overpayment since his entitlement was founded on the contract between himself and the beneficiary. The analysis here is that, while the autonomy of the performance bond is a matter of an undertaking by the paying bank, the right to receive any overpayment is founded on the contract of sale between the applicant and beneficiary. That right is thus one based on contract and

not quasi contract, as far as Morison J was concerned. That analysis has since been recognised in *Comdel Commodities v Siporex Trade SA* and *TTI Team Telecom International Ltd v Hutchison 3G UK Ltd* [2003] EWHC 762. Indeed, when Morison J's judgment was appealed against before the Court of Appeal, the judge's pronouncement on the nature of the right to receive overpayment was not challenged.

An extension of that proposition, as far as Christopher Clarke J was concerned, meant that in the present case, it did not matter whether or not the sellers had indemnified either the paying bank or the indemnifier of the paying bank. The duty to account for overpayment is based on a debt – as such, by calling for too much under the bond, S had procured payment to itself from the paying bank (acting, for this purpose, on T's behalf) of an amount that was not due and must return to its contractual counterparty from whom it should not have been procured in the first place. If that were not the case, S would have been handed a windfall since, to the extent of the overpayment, there has been either no breach or no loss entitling S to retain it.

It was argued by S that the liberal terms of the demand bond should be honoured – as such, although the amount guaranteed was larger than the actual loss (as admitted to by T, the seller), S was entitled to make a claim to the full amount. It would only need to repay any repayment once T had proved its loss, but S argued T had not sustained any loss because T had not repaid the paying bank. The court rejected the argument holding that it was not consistent with the general principle in *Cargill International SA v Bangladesh Sugar & Food Industries Corp*. As regards the bank's position, Christopher Clarke J held that banks would normally have taken some form of security from the applicant so their risk of a loss arising from the applicant's failure to reimburse them would be minimised. In the scheme of things, the judge was inclined to place the risk of commercial loss on the bank. As far as T was concerned, it would appear that although he had a preferential position (after all it was entirely possible for T to receive the overpayment and then abscond with those proceeds without repaying the bank) that was a commercial reality that any guaranteeing bank would be deemed to expect. It is submitted that there is, however, a practical difficulty in that if the beneficiary repays the overpayment before the paying bank has itself been repaid by the applicant, the beneficiary could find itself exposed to a possible claim for restitution by the paying bank. Matters might be made worse if that claim is brought by the foreign bank using foreign law.

It might also be noted that, although not in issue, the arbitral tribunal had made an obvious error by holding that the claim under the bond was in breach of contract – that is inconsistent with principle that a call made under the bond is not in itself a breach of contract, unless made in bad faith (*Deutsche Ruckversicherung v Walbrook Insurance Co* [1995] 1 WLR 1017).

JC