Article Information

Author: Ted Williams
Service: Banking & Finance, Corporate & Commercial, Insurance, Projects & Construction
Sector: Financial Services, Infrastructure

Bank Guarantees and Insurance Bonds in Construction Contracts: What's the difference? Are they as good as cash?

"Yes, if the judge says so, but it depends upon which judge is allocated to make the decision and on subtleties of language in the underlying contract and whether the judge thinks the beneficiary is acting unfairly." [1]

"Yes, if the judge says so, but it depends upon which judge is allocated to make the decision and on subtleties of language in the underlying contract and whether the judge thinks the beneficiary is acting unfairly." [1]

This article covers the practical differences between these different forms of security and explores circumstances by which a call on security may be prevented.

Purpose

Construction contracts commonly require provision of bank guarantees and the like to "secure" performance of a party's obligations. Typically, these are provided by contractors (or subcontractors) "upstream" to assure performance of construction and defects obligations, as well as in circumstances where there has been pre-payment for long lead items or where materials paid for by the principal / head contractor are being stored off-site. However security is not exclusively provided "upstream", it may also be provided by the principal / head contractors "downstream" to secure their (typically payment) obligations.

While security may take the form of cash (such as via retention), for larger amounts and for reasons of cash-flow, security is commonly provided by way of bank guarantee or insurance bonds.

Bank Guarantees and Insurance Bonds

A bank guarantee typically involves a party obtaining it by way of a cross-secured bank facility against which fees are paid and interest earned if the bank guarantee is secured by a cash deposit (which has its own cash-flow impacts). Insurance bonds are insurance products for which a premium is paid and cross-indemnities are given. As between the insurer and the party giving the bond, cash is usually not held as collateral. Insurance bonds accordingly provide cash-flow benefits to the party giving them, but may be more costly upfront and are generally considered riskier security by those to whom they are provided.

While there are no "standard" wordings of bank guarantees or insurance bonds, and every security issued should be considered on its own terms, the bank guarantee or insurance bond would need to be expressed as being unconditional and payable upon demand to satisfy its claim to cash equivalency.

"As Good as Cash"?

Following the mantra that "Cash is King", the gold standard for any form of security is that it should be "as good as cash". Whether this is the case ultimately will not be known until a call is made and cash is actually paid out. However, in assessing the value of a security, a number of factors should be taken into account including the reputation and credit rating of the issuer and the wording of the document being offered. Where such wording is heavily qualified or the obligation to pay may be qualified by reference to the contract or principles of law, generally the value will be assessed as lower.

"Unconditional payment on demand" means what it says

For principals, the benefits of 'cash equivalency' tend to have grown more illusory with the development of exceptions to the unconditional nature of a bank guarantee. Where a security is properly unconditional and intended to be the equivalent of cash, courts are reluctant to interfere with a beneficiary's right to convert to cash, however in limited circumstances courts will step in on behalf of the party giving the security to restrain a conversion into cash.

Considerations relevant to restraining a call

The starting position

The starting position is that the contract between the issuing bank and the principal as beneficiary (i.e. the unconditional bank guarantee) is completely independent of the underlying construction contract between the principal and contractor.

This follows what is known as the "autonomy principle" and recognises the autonomy of the bank to "unconditionally" respond to the call on an unconditional bank guarantee.

In view of this, courts have traditionally been reluctant to interfere on the basis that the parties have agreed to the unconditional nature, and that the contractor would have assessed, and accepted, the potential risk of a beneficiary calling on the bank guarantee.

Exceptions to autonomy principle

A court will restrain a call on a bank guarantee where there is:

1. Fraud on the part of the beneficiary;
2. Unconscionable conduct on the part of the beneficiary; or
3. An 'underlying contract exception'.

Diverging judicial authority has developed as to the right to restrain a call on a bank guarantee due to an 'underlying contract exception'. Until the matter is resolved, there exist a number of drafting pitfalls for principals and opportunities for contractors looking to restrain a call on a bank guarantee.

Fraud

A contractor would seek to restrain:

1. the beneficiary from calling on the bank guarantee on the bank guarantee because of fraudulent conduct on the part of the beneficiary; and / or
2. the issuing bank from making a payment where it can prove that the bank knows that a demand for payment which has been made or which will be made, will clearly be fraudulent.

Unconscionability

As the unconscionability exception is a statutory exception to the 'autonomy principle', the contractor must demonstrate that the Principal's call on the bank guarantee is "unconscionable" under the Australian Consumer Law (**ACL**). [2] The ACL provides two grounds of pursuing unconscionable conduct:

1. unconscionable conduct within the meaning of the unwritten law (ACL, s20); and
2. engaging in unconscionable conduct in connection with the supply or possible supply of goods or services or the acquisition or possible acquisition of goods or services from a person (ACL, s21)

Unconscionable conduct may take the form of "the knowing exploitation by one party of the special disadvantage of another". [3] However, unequal bargaining power does not give rise to such "disadvantage", and on the converse, taking advantage of a superior bargaining position would not meet the standards of unconscionable conduct. [4]

Unconscionable conduct may be demonstrated in circumstances where a party causes hardship to another by insisting on its strict legal rights beyond the reasonable expectations of the other party.

By way of example, a call on a bank guarantee was restrained on grounds of unconscionability in circumstances where a subcontractor had advanced a bank guarantee as security for advance payments which were made to it. The Subcontractor had 'largely repaid' this advance yet the contractor sought to call on the full amount of the bank guarantee in order to put pressure on the subcontractor to settle a dispute between the parties. [5]

On similar grounds, unconscionability has also been demonstrated in circumstances where a beneficiary sought to call on a letter of credit as satisfaction for a disputed sum despite the contracting parties having already settled their dispute. [6]

The key point in respect of this exception is that 'serious misconduct or something clearly unfair or unreasonable' or 'actions showing no regard for conscience, or that are irreconcilable with what is right or reasonable' must be demonstrated on the part of the principal in calling upon the bank guarantee. [7]

Underlying contract exception

The underlying contract exception is the most controversial as it provides the greatest scope to interfere with the autonomy principle and provides the most fertile grounds to attempt to restrain a call on a bank guarantee, given the high bar of demonstrating fraud or unconscionability.

The exception requires there to be "clear words" in the underlying contract (being the construction contract) which limits the principal's rights to call on the bank guarantee. [8] From a first glance at some of the examples given below, it is difficult to discern the so-called "clear words" underpinning the decision.

The way this exception plays out is that the contractor identifies that the principal has, or will, exceed the agreed upon contractual limitations in the construction contract of when the principal will exercise its right to have recourse to the bank guarantee and applies to the court for an injunction. The contractor's grounds in applying for an injunction are, in layman's terms, to stop the principal from reneging on what on what it said it would do (which is to only have recourse to the bank guarantee in limited circumstances).

This interferes with a key part of the autonomy principle – which is that the principal has recourse to the bank guarantee without regard to the underlying contract.

Clauses where a finding of an 'underlying contract exception' prevented a call

The following are examples of clauses where an 'underlying contract exception' prevented a principal from calling on its bank guarantee:

- *"Any security provided by the Contractor in accordance with the Contract shall be available to the Principal whenever the Principal may claim (acting reasonably) to be entitled to: […]"*This is an extract of a "bespoke" clause drafted by the parties. The court held that by including the words "acting reasonably" the parties intended to import an objective standard of reasonable conduct on the part of the principal at the time the principal claims its entitlement to security. This was held to be an express qualification on the principal's right to access the bank guarantee. [9]
- *"If the Principal becomes entitled to exercise all or any of his rights under the contract in respect of the security the Principal may convert into money the security that does not consist of money."*In this instance, the court considered that "if" qualified the circumstances in which the principal could have recourse to the security to the particular circumstances under the contract which provided for rights in respect of security. [10]
- Clause 16.3 of a Contract provided that the principal may call upon the undertaking if the Contractor did not comply with the terms of the principal's notice given under clause 16.2 of the Contract. Clause 16.2 provided:*"If the contractor has not materially complied with its obligations under this contract, the principal may give a written notice to the contractor stating: […]"*In this instance, the contractor sought to restrain the call on the basis that the principal's notice under clause 16.2 was invalid. Effectively, the contractor's argument was that its failure to comply was not material enough to trigger the right to give notice under clause 16.2. (The principal had provided the notice on the basis of defects in existence and the contractor's failure to rectify those defects.)The court accepted that there was some doubt over the materiality of the breaches and agreed to restrain the call on the undertaking. [11]

By way of comparison, an underlying contract exception was not found in the following clauses:

- *"If the Tenant fails to pay Rent or other money payable under this Lease or if the Landlord suffers loss or damage because of any other breach of this Lease by the Tenant, then the Landlord may use the security deposit towards paying the arrears of rent or other money or towards repairing the loss or damage."*The court held that 'failing to pay rent' or a 'breach' of the Lease did not need to be proved before the beneficiary could have recourse to the security. [12]
- *"The Company shall have the right under this guarantee to invoke the Banker's guarantee and claim the amount there under [sic] in the event of the Contractor failing to honour any of the commitments entered into under this Contract."*The contractor's argument was that the principal's right to invoke the bank guarantee arose only where there was an actual failure to perform the contract, rather than a bona fide belief that there were breaches.The Court read the terms of the underlying contract together with a clause of the performance guarantee which

provided that a demand under the performance guarantee was binding "notwithstanding any dispute(s) pending before" a court or tribunal. Consequently, the court did not accept the argument that there was an applicable 'underlying contract exception'. [13]

Purpose of security

The purpose for which security is provided forms a relevant part of the court's consideration in determining whether an underlying contract exception should be found to apply. There is commentary which suggests that a court's recognition (or lack thereof) of these purposes may explain the different outcomes reached by the courts.

The literature on bank guarantees recognises two aims for which bank guarantees are provided: [14]

1. To obtain prompt payment for amounts which the principal claims it is owed despite the claim being disputed by the contractor (in this context, it is known as a 'risk allocation device' because the intention is that the contractor bears the cost until the dispute is finally resolved); and
2. security in favour of the principal to recover in the event of default or insolvency of the contractor.

The contract may provide for one or both of these purposes.

The courts appear to be more agreeable to restraining a call where the bank guarantee is provided purely as security for an event of a default. Where it is determined that the bank guarantee is provided for the purpose of allocating the risks of a dispute, then a court is unlikely to restrain a call on a bank guarantee given that is clearly contrary to the parties' agreement. [15]

Conclusion

Bearing in mind that a contractor should be alive to the possibility of having its bank guarantees called upon, if a contractor expects the worst, but hopes for the best, the case law demonstrates there may be opportunities for contractors to restrain calls on bank guarantees.

On the other hand, principals relying on the fact that they have rights to an unconditional bank guarantee issued on their preferred terms may be in for an unfortunate surprise if insufficient attention has been paid to the drafting of the security clauses in the underlying contract.

****

[1] Bill Dixon 'As good as cash? The diminution of the autonomy principle' (2004) 32 *Australian Business Law Review* 391, 403 quoting Chesterman R, 'Bank Guarantees, Performance Bonds and Other Unconditional Obligations' (CLE, Securities VI, 1992) p 173, 179.

[2] *Boral Formwork v Action Makers* [2003] NSWSC 713, [79], [94].

[3] *Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd* (2003) 197 ALR 153, 157 citing *Australian Competition and Consumer Commission v Samton Holdings Pty Ltd* (2002)189 ALR 76, 92.

[4] *Australian Competition and Consumer Commission v CG Berbatis Holdings Pty Ltd* (2003) 197 ALR 153, 157.

[5] *Olex Focas Pty Ltd v Skodaexport Co Ltd* [1998] 3 VR 380, 403.

[6] *Boral Formwork v Action Makers* [2003] NSWSC 713, [82]-[87].

[7] *Boral Formwork v Action Makers* [2003] NSWSC 713, [82]-[87] quoting *Hurley v McDonald's Australia Ltd* [2000] ATPR 41,741 at 4,585.

[8] *Clough Engineering Limited v Oil and Natural Gas Corporation Limited* [2008] FCAFC 136, [83]; *Sugar Australia Pty Ltd v Lend Lease Services Pty Ltd* [2015] VSCA 98, [89].

[9] *Sugar Australia Pty Ltd v Lend Lease Services Pty Ltd* [2015] VSCA 98, [141]-[142].

[10] *Pearson Bridge v State Rail Authority* (1982) 1 ACLR 81, [14]; *Barclay Mowlem Construction Ltd v Simon Engineering* (Australia) Pty Ltd (1991) 23 NSWLR 451, 459.

[11] *Lucas Stuart Pty Ltd v Hemmes Hermitage Pty Ltd* [2010] NSWCA 283.

[12] *Otter Group v Wylaars* [2013] VSC 98, [22]-[25].

[13] *Clough Engineering Limited v Oil and Natural Gas Corporation Limited* [2008] FCAFC 136, [94]-[98].

[14] *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812, 821.

[15] Bill Dixon 'Bank guarantees and the reasonable expectations of beneficiaries' (2015) 43 *Australian Business Law Review* 462, 466-7.