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Calling on a Performance Security: As Good As Cash?

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Introduction

Over the past several decades, performance securities have become a common and critical part of commercial dealings throughout Australia and around the world. While they feature across the panoply of transactions from sale of goods (domestic and international) to commercial leases, and surface in cases concerning the same, perhaps a disproportionate number of judicial decisions have been devoted to performance securities arising from construction contracts and disputes over recourse to them. Consequently, this paper will reflect that balance, in its consideration of:

a) reasons for security;
b) the essential nature of performance securities;
c) types of performance securities;
d) examples of contract provisions for security and recourse to it;
e) calling on a security;
f) injunctions to restrain the calling on a security; and
g) recent cases.

Reasons for Security

Performance securities serve a number of purposes, including:

a) to provide security to the beneficiary against default by the other party in the underlying contract (sometimes described as the "account" party);
b) to secure an advance payment required under the underlying contract;
c) where the payment obligation arises without proof of default, to protect the beneficiary from carrying credit risk during the course of any dispute with the account party under the underlying contract;
d) in lieu of money that would otherwise be retained under the contract (e.g. cash retention in a construction contract).

Fundamentally, performance securities are instruments of risk allocation.

The essential nature of performance securities

Reduced to its simplest definition, and bearing in mind the range of different types of security on equally different terms, a performance guarantee requires the issuer or 'surety' (usually a bank or insurer from whom the account party or 'grantor' has established the security) to pay the beneficiary up to a specified sum, on demand, or otherwise in accordance with its terms.

In order to effectively achieve any one or more of the above aims, most securities are expressed to be irrevocable and unconditional, or, 'as good as cash'.

That nature is reflected in what has become known as the "autonomy principle". It meansthat a beneficiary is entitled to demand payment on the security ("calling it up" or "cashing" it), and the bank is obliged to meet that demand, regardless of whether or not the account party is in breach of the underlying contract.

The principle has been considered in many oft-cited and seminal decisions in this area of jurisprudence, such as *Wood Hall Ltd v The Pipeline Authority* (1979) 141 CLR 443; *Olex Focas Pty Ltd v Skodaexport Co Ltd,* [1997] ATPR (Digest) [46-163]; *Reed Construction Services Pty Ltd v Kheng Seng (Australia) Pty Ltd* (1999) 15 BCL 158; *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 VR 420 and *Fletcher Construction Australia Limited v Varnsdorf Pty Ltd* [1998] 3 VR 812. More recently: *Boral Formwork & Scaffolding Pty Ltd v Action Makers Ltd* [2003] NSWSC 713 and *Vos Construction & Joinery Qld Pty Ltd v Sanctuary Properties Pty Ltd & Anor* [2007] QSC 332.

As will be explored further below, despite what is often pellucid language, many account parties have sought, through debates on the construction of the terms of the security or underlying contract provisions governing recourse to it, to impose qualifications on the entitlement of the beneficiary to call upon the guarantees., to introduce a would be to deprive them of the quality which gives them commercial currency.

In *Clough Engineering Limited v Oil and Natural Gas Corporation Limited* [2008] FCAFC 136, the Court rehearsed the words of Stephen J in *Wood Hall* (at 457):

> *"Not only does the clear, indeed empathic [sic], language of these guarantees preclude the introduction of any such qualification: to introduce such a qualification would be to deprive them of the quality which gives them commercial currency. Once a document of this character ceases to be the equivalent of a cash payment, being instantly and unconditionally convertible to*

> *cash, it necessarily loses acceptability. Only so long as it is 'as good as cash' can it fulfil its useful purpose of affording to those to whom it is issued the advantages of cash while involving for those who procure its issue neither the loss of use of an equivalent money sum nor the interest charges which would be incurred if such a sum were to be borrowed for the purpose. Being 'as good as cash' in the eyes of those to whom it is issued is essential to this function."*

Types of performance securities

Among the variety of types of performance securities deployed in modern commercial arrangements, are often found the (non-exhaustive) following[1]:

Documentary Letter of Credit

A documentary letter of credit is an agreement between an account party and a bank under which a bank irrevocably undertakes to pay the beneficiary upon production of stipulated documents. The primary purpose of a documentary letter of credit is to ensure that the supplier of goods or services (the beneficiary) will be paid upon supply or delivery by presenting the documentary letter of credit to the bank. Once the bank pays, it is reimbursed by the purchaser.

Stand–By Letter of Credit

A stand–by letter of credit requires the production of documents which evidence money owing but unpaid by an account party to a beneficiary under an underlying contract, normally suggesting a breach of the underlying contract. The documents required are listed in the terms of the instrument, such as a judgment, arbitral award or a certificate of default.

Surety Bonds

A surety bond (sometimes known as a 'performance bond' or 'insurance bond') is issued by an insurance company or specialist surety company rather than a bank. Usually, the surety guarantees to the beneficiary the performance of the account party under the underlying contract. If the account party defaults, normally the surety will have a right to complete the transaction or engage another party to complete the transaction rather than pay out money to the beneficiary. A surety bond is conditional and therefore a true guarantee because it is a

[1] I am indebted to Reese Allen of Gadens Lawyers in Brisbane for his article "Performance and Payment Security– Boral Formwork v Action Makers [2003] NSWSC 713", ACLN Issue #94 p29.

secondary obligation on the part of the surety should the account party default. In the context of construction contracts, most likely due to their conditional nature, surety bonds are not common.

Unconditional Bank Guarantee

Arguably, the most common form of third party security, particularly in service contracts such as in construction projects, are unconditional bank guarantees. Also called 'first demand guarantees' or 'on demand guarantees', unconditional bank guarantees are similar to letters of credit except that they do not normally require the production of any documents. Rather, they are an unconditional undertaking by a bank to pay an amount of money to the beneficiary upon the beneficiary making a demand for payment to the bank, usually up to a stipulated amount.

The unconditional bank guarantee is not conditioned by the terms of the underlying contract. A proper unconditional bank guarantee is unconditional, irrevocable (in that it cannot be revoked by the account party or the bank until expiry) and autonomous.

Although they perform a similar function to a guarantee, bank guarantees are not guarantees at all because there is no surety (i.e. guarantee of performance) given by the bank. Rather, they are simply instruments where once a demand is made on them within the terms of the instrument, payment must be made by the bank.

Examples of contractual provisions

While clearly not an exclusive realm, Australian Standard form building contracts contain model provisions for the creation of, and recourse to, performance securities. They have also provided fertile ground for a substantial body of case law on the subject.

Generally, security in construction contracts will take one of, or a combination of, two forms – cash retentions from progress payments, and bank guarantees.

Set out below are excerpts from but two examples of such contract provisions:

5 SECURITY, RETENTION MONEYS AND PERFORMANCE UNDERTAKINGS

5.1 Purpose

Security, retention moneys and performance undertakings are for the purpose of ensuring the due and proper performance of the Contract.

5.2 Provision of Security

If it is provided in the Annexure that a party shall provide security then the party shall provide security in the amount stated in the Annexure and in accordance with this Clause.

5.3 Form of Security

The security shall be in the form of cash, bonds or inscribed stock issued by the Australian Government or the Government of a State or Territory of Australia, interest bearing deposit in a trading bank carrying on business in Australia, an approved unconditional undertaking given by an approved financial institution or insurance company, or other form approved by the party having the benefit of the security.

The party having the benefit of the security shall have a discretion to approve or disapprove of the form of an unconditional undertaking and the financial institution or insurance company giving it or other form of security offered. The form of unconditional undertaking attached to these General Conditions is approved.

If the security is not transferable by delivery, it shall be accompanied by an executed transfer or such other documentation as is necessary to effect a transfer of the security. The costs (including all stamp duty or other taxes) of and incidental to the transfer and retransfer, shall be borne by the party providing the security.

5.4 Time for Lodgement of Security

Security shall be lodged within 28 days of the Date of Acceptance of Tender.

5.5 Recourse to Retention Moneys and Conversion of Security

A party may have recourse to retention moneys and/or cash security and/or may convert into money security that does not consist of money where—

(a) the party has become entitled to exercise a right under the Contract in respect of the retention moneys and/or security; and

(b) the party has given the other party notice in writing for the period stated in the Annexure, or if no period is stated, five days of the party's intention to have recourse to the retention moneys and/or cash security and/or to convert the security; and

(c) the period stated in the Annexure or if no period is stated, five days has or have elapsed since the notice was given.

5.6 Substitution of Security for Retention Moneys

The Contractor shall be at liberty at any time to provide in lieu of retention moneys, security in any of the forms permitted in Clause 5.3. To the extent that such security is provided, the Principal shall not deduct retention moneys and shall forthwith release retention moneys.

5.7 Reduction of Security and Retention Moneys

Upon issue of the Certificate of Practical Completion, the Principal's entitlement to security and retention moneys shall be reduced to the percentage thereof stated in the Annexure or, if no percentage is stated, to 50 per cent thereof.

Subject to the first paragraph of Clause 5.7, if in the opinion of the Superintendent it is reasonable to further reduce the Principal's entitlement to security and retention moneys, that entitlement shall be reduced to the amount which the Superintendent determines to be reasonable.

The Principal shall, within 14 days of the Superintendent making such a determination, release security and retention moneys in excess of the entitlement.

5.8 Release of Security

If the Contractor has provided additional security pursuant to Clause 42.4, the Principal shall release that additional security within 14 days of the incorporation into the Works of the unfixed plant or materials in respect of which the additional security was furnished.

If the Principal has provided security, then when the Contractor has been paid all moneys finally due to the Contractor under the Contract or a Separable Portion, the Contractor shall release the security lodged by the Principal in respect of the Contract or the Separable Portion, as the case may be.

If the Contractor has provided security, then the Principal shall release it when required by Clause 42.8.

5.9 Interest on Security and Retention Moneys

Alternative 1

A party holding retention moneys and/or cash security shall forthwith deposit the moneys in an interest bearing account in a bank. That party shall nominate the bank and the type of account. The account shall be in the joint names of the Principal and the Contractor and shall be one from which moneys can only be drawn with the signatures of two persons, one appointed by each of the Principal and the Contractor. The moneys shall be held until the Principal or the Contractor is entitled to receive them.

Interest earned on security lodged by the Contractor and on retention moneys belongs to the Contractor. Interest earned on security lodged by the Principal belongs to the Principal.

Upon the Principal or the Contractor becoming entitled to receive any moneys, including interest in the account, the other party shall forthwith have that party's appointee sign all documentation necessary to withdraw the moneys and shall give the signed documentation to the other party.

Alternative 2

A party holding retention moneys or cash security shall own any interest earned on the retention moneys or security. Except where retention moneys or cash security are held

by a government department or agency or a municipal, public or statutory authority, retention moneys or cash security shall be held in trust by the party holding them for the other party until the Principal or the Contractor is entitled to receive them.

5.10 Deed of Guarantee, Undertaking and Substitution

Where—

(a) a party is a corporation that is related to or is a subsidiary of another corporation as defined in the Corporations Law as amended from time to time; and

(b) the Principal has included in the tender documents a form of Deed of Guarantee, Undertaking and Substitution;

that party shall, if requested by the other party in writing within 7 days after the Date of Acceptance of Tender lodge with the other party within 14 days after that request having been made a Deed of Guarantee, Undertaking and Substitution in the form included in the tender documents duly executed by the first party and that other corporation for the performance of the obligations and the discharge of the liabilities of the first party under the Contract.

For the purpose of Clause 5.10, the terms `corporation' and `subsidiary' have the meanings defined in the Corporations Law.

…

42.10 Set Offs by the Principal

The Principal may deduct from moneys due to the Contractor any money due from the Contractor to the Principal otherwise than under the Contract and if those moneys are insufficient, the Principal may, subject to Clause 5.5, have recourse to retention moneys and, if they are insufficient, then to security under the Contract.

42.11 Recourse for Unpaid Moneys

Where, within the time provided by the Contract, a party fails to pay the other party an amount due and payable under the Contract, the other party may, subject to Clause 5.5, have recourse to retention moneys, if any, and, if those moneys are insufficient, then to

security under the Contract and any deficiency remaining may be recovered by the other party as a debt due and payable.

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1 Interpretation and construction of Contract

security means:

a) cash;

b) retention moneys;

c) bonds or inscribed stock or their equivalent issued by a national, state or territory government;

d) interest bearing deposit in a bank carrying on business at the place stated in *Item* 9(c);

e) an approved unconditional undertaking (the form in Annexure Part C is approved) or an approved performance undertaking given by an approved financial institution or insurance company; or

f) other form approved by the party having the benefit of the security;

5 Security

5.1 Provision

Security shall be provided in accordance with *Item* 13 or 14. All delivered *security*, other than cash or retention moneys, shall be transferred in escrow.

5.2 Recourse

Security shall be subject to recourse by a party who remains unpaid after the time for payment where at least 5 days have elapsed since that party notified the other party of intention to have recourse.

5.3 Change of security

At any time a party providing retention moneys or cash *security* may substitute another form of *security*. To the extent that another form of *security* is provided, the other party shall not deduct, and shall promptly release and return, retention moneys and cash *security*.

5.4 Reduction and release

Upon the issue of the *certificate of practical completion* a party's entitlement to *security* (other than in *Item* 13(e)) shall be reduced by the percentage or amount in *Item* 13(f) or 14(d) as applicable, and the reduction shall be released and returned within 14 days to the other party.

The *Principal's* entitlement to *security* in *Item* 13(e) shall cease 14 days after incorporation into *the Works* of the plant and materials for which that *security* was provided.

A party's entitlement otherwise to *security* shall cease 14 days after *final certificate*.

Upon a party's entitlement to *security* ceasing, that party shall release and return forthwith the *security* to the other party.

5.5 Trusts and interest

Except where held by a government department or agency or a municipal, public or statutory authority, any portion of *security* (and interest earned thereon) which is cash or retention moneys, shall be held in trust for the party providing them until the *Principal* or the *Contractor* is entitled to receive them.

Interest earned on *security* not required to be held in trust shall belong to the party holding that *security*.

5.6 Deed of guarantee, undertaking and substitution

Where:

a) a party is a related or subsidiary corporation (as defined in the applicable corporations law of the jurisdiction); and

b) a form of *deed of guarantee, undertaking and substitution* was included in the tender documents,

that party shall, within 14 days after receiving a written request from the other party, provide such *deed of guarantee, undertaking and substitution* duly executed and enforceable.

Calling on a security

The circumstances in which a beneficiary may call on a security will be dictated by the terms of underlying contract and the security itself.

For example, and as seen above, most unconditional bank guarantees will have been born from fairly sophisticated underlying contract provisions, particularly in relation to recourse. On the face of the bank guarantee itself though will often be very simple terms: the name of the issuing bank; the name of the beneficiary; the amount of security; an expiry date; and, most importantly, a statement from the bank to the effect that it irrevocably agrees to pay the beneficiary the amount of the security, on demand.

With such unconditional security, the bank is not and cannot be concerned with the merits or otherwise of the beneficiary's motivation or underlying contractual entitlement to call up the bank guarantee. The only event which concerns (or ought concern) the bank is whether a demand has been made.

Experience however shows that often the bank, keen to protect its relationship with its account client, might consider it prudent to make enquiries of its client before paying (the beneficiary owner or principal in construction contracts) to see if all is in order. More often than not, at least according to the stunned and infuriated client (contractor), the bank will be told all is not in order and not to pay. Faced with being the unenviable meat in the sandwich, stories abound of bank managers taking sometimes several hours to consider the unconditional demand, which is usually just enough time for the contractor client to have raced off to court to seek an urgent interim injunction (discussed further below).

In one sense, calling on conditional guarantees, somewhat quizzically, is a simpler affair. Whilst the beneficiary has to prove that a breach of contract has occurred before presenting the bank guarantee for payment, more often than not, the instrument as a reflection of the underlying contract provisions governing recourse, will stipulate the form of evidence required to prove the relevant breach. The 'ace' will usually be a curial judgment or arbitral award, leaving little or no room for protest from the contractor.

Hence, the process of calling on a performance security such as a bank guarantee, ought be as smooth and simple as an Eftpos transaction. Alas, the law reports amply record that we lawyers, have a different view.

Injunctions to restrain calling on a security

In the urgent circumstances painted above, an aggrieved account contractor, who for whatever reason wishes to resist the calling of the guarantee, will seek an injunction.

The type and object is a matter of timing. If the bank is yet to pay, but the beneficiary has given notice that it intends to make demand (most astute drafters will include a notice period in the recourse provisions of the underlying contract), then the contractor will seek an order restraining or enjoining the principal from making the demand.

Applications for injunctions to prevent the issuing bank from paying on an irrevocable and unconditional bank guarantee are historically doomed to fail - *Washington Constructions v Westpac Banking Corporation* [1983] QdR 179. As Charles JA said in *Olex Focas Pty Ltd v Skodaexport Co Ltd*, (unreported, Vic Sup Ct, CA, No 7050/1996, 17 September 1996 at pp 2-4):

> *"The courts will intervene to prohibit a bank from paying under a performance guarantee in very limited circumstances. The wholly exceptional case in which an injunction might be granted at common law is where it is proved that the bank knows that any demand for payment already made, or which may thereafter be made, will clearly be fraudulent; Bolivinter Oil SA v Chase Manhattan Bank and Ors [1984] 1 Lloyds Rep 251, at 257 per Donaldson MR. Otherwise the whole commercial purpose of such guarantees (or, for that matter, irrevocable letters of credit) would be destroyed and the international reputation of a bank issuing such documents would be at risk of serious damage when the bank is caught between the competing demands of the guarantor (its customer) and the beneficiary of the guarantee. The bank is in no way concerned with any dispute the guarantor may*

> *have with the beneficiary; Power Curber International Ltd v National Bank of Kuwait [1981] 3 All ER 607 per Lord Denning MR at 612-613, and per Griffiths LJ at 614."*

If the bank has already paid, the application will be aimed at preventing the principal from dealing with the proceeds. Beyond that, orders are often sought for repayment of the funds to the bank in return for a fresh or reinstated guarantee.

The contractor's motivation/necessity in seeking an injunction, might include:

a) there is a genuine dispute as to whether he is in breach of his underlying obligations or whether he 'owes' (debt due and payable) the principal – put simply, he considers he is being bullied or ripped off by the owner;
b) the adverse impact on his cash flow or security position with his bank (irrespective of the existence of (a) above); and/or
c) potential harm to his professional and financial reputation in the marketplace.

Often, the procedure will commence with an urgent application (sometimes oral) for an interim injunction. If granted, usually for a relatively short period like 7 or 14 days, the contractor will be required to institute formal proceedings articulating all final relief, and put on material to substantiate the interim grant and justify an extension on an interlocutory basis. The principal, once served, will be given an opportunity to respond.

It is at the hearing of the interlocutory application that most of the applicable legal principles are examined and applied to the facts as revealed by the competing affidavit material. If an interlocutory injunction is granted, the final hearing will rarely concern solely the issue of the pulling of the guarantee but will by then often involve a complete reconciliation of all claims and counterclaims for time and money in relation to the project as a whole. That outcome will then determine the ultimate fate of the security.

What then are the principles governing injunctions, particularly on an interlocutory basis, to restrain recourse to security? The examination below concerns cases mostly involving unconditional bank guarantees arising in the context of construction contracts.

As a starting proposition, traditionally, the approach of the courts is to allow the beneficiary proprietor to call on a bank guarantee in its favour.

With equal tradition, the courts have repeatedly decreed that, as a general proposition, they will not intervene to prevent a party from calling upon a bank guarantee, except in cases of:

a) ***fraud*** - a court may grant an injunction restricting a party accessing a bank guarantee where there has been fraud on the part of the beneficiary, such as a dishonest intent or recklessness as to the truth of a statement;

b) ***unconscionability*** - generally involves 'taking advantage of a special disadvantage of another' or 'unconscientious reliance on strict legal rights' or 'action showing no regard for conscience, or that are irreconcilable with what is right or reasonable'. In *Olex Focas Pty Ltd v Skodaexport Co Ltd* and *ACCC v Samton Holdings Pty Ltd* (2002) 117 FCR 301, unconscionability was held to include:

   (i) exploitation of vulnerability or weakness;

   (ii) abuse of a position of trust or confidence;

   (iii) insistence upon rights in circumstances which make that harsh or oppressive; and

   (iv) inequitable denial of legal obligations.

c) ***breach of a negative stipulation in the underlying contract*** - where calling on the security would be in breach of an express or implied negative stipulation in the underlying contract, the courts may restrain a beneficiary from invoking the financier's autonomous obligation.

See *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812; *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 VR 420

The last exception is a common basis for contractors challenging a principal's entitlement to call upon the guarantee. A contractor needs to prove that there are terms in the contract that restrain the calling of security. The main focus is the "proper construction of the contract".

Examples of negative stipulation and non-negative stipulation clauses include:

a) *Pearson Bridge v State Rail Authority of NSW* [1982] 1 Aust Const LR

A contractual requirement that "*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*" was held to be negative in substance in that the Principal was not entitled to call upon the security because he had not become entitled to exercise all or any of his rights under the contract.

b) *Clough Engineering v Oil & Natural Gas Corp Ltd* [2008] 249 ALR 458

The court held in respect of a clause which entitled to he Principal to have recourse to the guarantee "*in the event of the Contractor failing to honour any of the commitments entered into under this contract*", that clear words will be required to support a construction which inhibits a beneficiary from calling on a performance guarantee where a breach is alleged in good faith. There were no clear words in the clause to inhibit the principal from calling on the guarantee, and therefore the contractor was not entitled to challenge the principal's rights.

c) *Rejan Constructions Pty Ltd v Manningham Medical Centre Pty Ltd* [2002] VSC 579[2]. There, the contract provided, relevantly, that the principal could have recourse to the security if it "became entitled to exercise a right under the Contract in respect of the security, retention moneys or both". The principal contended that by reason of its lawful termination of the building contract, it was entitled to recover losses from the contractor, which it had assessed in its "draft interim claim" at $697,747. Byrne J considered that the allegations of the principal could not be dismissed as "being specious, fanciful or not bona fide". Clause 42.9 of the contract provided that the principal may also have recourse to the security where, "within the time provided by the Contract, a party fails to pay the other party an amount due and payable under the Contract". Byrne J found that cl 42.9 on its proper construction, did not give the principal an "immediate unqualified right in respect of the security" and that that right only arose where an amount was "due and payable under the building contract", and there had been a failure to pay that amount within the time prescribed under the building contract. He found that the amount of the principal's claim had not been determined under a mechanism provided for under the contract. Further, Byrne J found

[2] Referred to recently in *Redline Contracting Pty Ltd v MCC Mining (Western Australia) Pty Ltd* (No 2) [2012] FCA 1 (6 January 2012) at [33].

that the principal's claim for damages did not fall within the ambit of "money due...otherwise than under the contract" for the purposes of cl 42.8. Byrne J observed at [24]:

> *"As a matter of terminology, it is difficult to characterise as "money due" a sum which is asserted by a party in a dispute to be owing by its adversary in a draft interim claim without substantiation and without detail, and of course, without any determination by adjudication, arbitration or otherwise."*

The cases through the 1980's and 90's reminded us that injunctions are a form of equitable relief which is granted by a court in rare circumstances. It is discretionary in nature. Despite the well settled general rules, and *in addition* to the fundamental exceptions described above, the court may grant an injunction preventing a principal from making a call on a bank guarantee if:

a) there is no underlying contract - as the underlying contract describes the scope of the beneficiary's right to present the guarantee or letter of credit for payment, if there is no underlying contract on foot, such as where the contract is void due to illegality or where there never was a contract, then it is logical that the beneficiary has no right to present a security instrument for payment. Similarly, where a contract has been terminated or frustrated, there may not be a right to present a guarantee for payment, unless that right arose prior to the effect of date of termination or frustration;
b) there has been a defective demand - if a bank pays a beneficiary, or proposes to pay a beneficiary in circumstances not contemplated by the terms of the bank guarantee or letter of credit, then the account party may seek an injunction restricting such a payment;
c) there is a dispute between the parties as to whether circumstances have occurred;
d) lack of good faith/absence of reasonableness – where an underlying contract contains ether express or implied obligations of good faith, arguably, recourse to a guarantee or other security may constitute a breach of good faith, or an absence of reasonableness, particularly where the underlying contract does not permit such access;
e) damages would not be an adequate remedy for a breach of the negative covenant;
f) there are possibilities of alternative remedies (such as, obviously, damages);
g) there has been any delay in seeking the relief;
h) there is inadequate strength in the grounds of the Contractor;

i) any party is prepared to give, and if so, what undertakings; and

j) the balance of convenience weighs in favour of the grant.

Pearson Bridge v State Rail Authority of New South Wales [1982] lA CLR 81; *Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd* [1991] 223 NSWLR 451; *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812; *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 VR 420; and *Anaconda Operations Pty Ltd & Ors. v Fluor Daniel Pty Ltd* [1999] VSCA 214.

In 2006, the Victorian Court of Appeal in *Bradto Pty Ltd v State of Victoria; Tymbook Pty Ltd v State of Victoria* [2006] VSCA 89 'updated' the approach for all interlocutory injunctions. After an extensive review of the authorities, and a restatement of the traditional considerations of a ***serious question to be tried*** and the ***balance of convenience***, Maxwell P and Charles JA said [35]:

> *"In our view, the flexibility and adaptability of the remedy of injunction as an instrument of justice will be best served by the adoption of the Hoffmann approach. That is, whether the relief sought is prohibitory or mandatory, the court should take* ***whichever course appears to carry the lower risk of injustice*** *if it should turn out to have been "wrong", in the sense of granting an injunction to a party who fails to establish his right at the trial, or in failing to grant an injunction to a party who succeeds at trial."*

And so, in recent years, applications for interlocutory injunctions to restrain the pulling of bank guarantees have tended to be fought on:

1) whether there is a serious question to be tried – usually, whether the terms of the underlying contract permit recourse in the given fact scenario;
2) whichever course carries the lower risk of injustice;
3) the balance of convenience, including:
    i) whether damages will be an adequate remedy;
    ii) delay;
    iii) risk of reputational harm (discussed further below).

Consistent with the discretionary nature of the remedy, there can, and often will be, significant overlap between the above criteria.

In 2008, we received *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd* [2008] FCAFC 136. Clough entered into a contract with Oil and Natural Gas Corporation Limited (ONGC) for the development of oil and gas fields off the coast of India, as well as construction of onshore facilities. Clough provided three bank guarantees worth US$21,000,000.00 to CNGC. Following a series of disputes between Clough and CNGC, CNGC terminated the contract and called upon the bank guarantees on the same day. Clough applied for an injunction preventing CNGC from calling upon the bank guarantees and restraining the bank from making payment to CNGC. Clough sought the injunction on the basis that there was a genuine dispute between the parties as to whether it was in default under the contract. Clough also argued that if it were in breach of the contract, this was as a result of CNGC's failure to perform.

The court initially granted Clough an interim injunction. However, when the matter came before the Federal Court, the court refused to continue the interim injunction. Clough applied for a stay on the payment pending appeal. On appeal, the Full Court of the Federal Court revisited established authorities such as the High Court's statement in *Wood Hall* that to introduce a qualification on the entitlement of the owner to call upon guarantees would be to deprive them of the quality which gives them commercial currency. Further, the Court affirmed that a court would not prevent a party from calling upon a bank guarantee unless the party calling upon the bank guarantee is acting fraudulently or unconscionably or has made a contractual promise not to call upon the guarantee.

Recent cases

PRA Electrical Pty Ltd v Perseverance Exploration Pty Ltd & Anor [2007] VSC 74

On the question of whether there was a serious issue to be tried, Smith J was in an unusual situation where the issue to be determined, essentially an issue as to the construction of the contract, had already been the subject of a considered judgment by Habersberger J who had

ruled against the position sought to be maintained on the appeal by the appellant. It was "not a satisfactory situation". Nonetheless, he decided that he had to consider that question.

His Honour noted that judicial views could differ when it came to the construction of terms of agreements and the analysis of their consequences. He therefore proceeded on the basis that there was an arguable issue to be litigated on the appeal but that the appellant's case was not as strong as that of the first respondent. Therefore, the appellant had to demonstrate that the discretionary considerations were "strongly in its favour".

His Honour then turned to the competing prejudice to each of the parties. In granting the injunction, he considered that:

a) the effect of an injunction would be to delay, not deny, the respondent's access to the money;
b) the appeal would delay the arbitration;
c) the loss of the money would create significant financial pressures for the appellant and related companies and affect their capacity to draw on funding available from their bank;
d) that would adversely affect their capacity to tender for and negotiate for contracts, several of which were in the process of negotiation;
e) if loss was suffered, for example, through failure to obtain tenders, the assessment of damages would be a difficult and unsatisfactory process;
f) recourse to the bank guarantees carried with it a real risk of damage to the reputation of the appellant and its related companies;
g) if an injunction was not granted and the appellant succeeded in its appeal, it was likely to have difficulty in recovering the sums of money paid under the bank guarantees.

***Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd* [2008] FCAFC 136.**

Clough Engineering Ltd (Clough) entered into a lump sum contract in the amount of US$215 million with Oil and Natural Gas Corporation Ltd (ONGC) for the development of oil and gas fields off the coast of Andhra Pradesh in India.

Clough, in accordance with the contract, provided unconditional and irrevocable performance guarantees in the amount of US$21 million from three Australian banks (CBA, HSBC and BNP Paribas). The contract provided that the guarantee would continue until either final completion or the extended date of final completion. ONGC had the right under the contract to call on the guarantees '...in the event of [Clough] failing to honour any of the commitments... under the contract'. ONGC also had the right to terminate the contract if Clough failed to furnish a guarantee. Each guarantee provided by Clough had an expiry date.

Disputes arose between Clough and ONGC over time extensions and, consequently, Clough did not extend the validity of the guarantees, arguing that ONGC had contributed to the delays. ONGC terminated the contract and attempted to make a call on the guarantees held by the banks. Clough immediately commenced interlocutory proceedings seeking to restrain ONGC from calling on the guarantees.

Clough submitted that on a proper construction of the contract, ONGC was not entitled to call on the guarantees because:

1. The words 'failing to honour' required that ONGC establish that Clough had actually breached the contract and that a 'claim' by ONGC stating that Clough had breached the contract was not enough to trigger the entitlement.

2. The call on the guarantees was unconscionable under the *Trade Practices Act* 1974 (Cth) as ONGC had waived its right to call on the guarantees in correspondence between executives to settle the dispute.

Clough also submitted that the right to call on the guarantees was qualified, that is, ONGC could only make a call on them where there was an arbitral decision providing a right to call on the guarantees, or where Clough had failed to pay amounts for rectification works or liquidated damages.

ONGC argued that it was entitled to call on the guarantees where it had a 'bona fide belief' that Clough had breached the contract.

The Federal Court held that a performance guarantee generally imposes no obligation on a bank to enquire into the principal's rights under a construction contract, and that a Court will not intervene unless either of the below occurs:

a) The construction contract itself contains a qualification on the principal's power to call on the guarantee.
b) The principal acts fraudulently or unconscionably.

The Federal Court rejected Clough's arguments, finding that there was no qualification on ONGC's power to call on the guarantees and that ONGC did not engage in unconscionable conduct.

The Federal Court concluded that ONGC was entitled to call upon the guarantees even where a genuine dispute existed as to whether or not Clough was in breach.

The Federal Court found that Clough had breached the contract by not extending the guarantees and, accordingly, ONGC was entitled to terminate and call on the guarantees where it had a bona fide belief of a breach by Clough.

Clough immediately appealed to the Full Federal Court.

The Full Court held that:

a) the guarantees should be equivalent to cash, and that to introduce a qualification on the entitlement of the owner to call upon the guarantees would be to deprive them of the quality which gives them commercial currency;
b) the commercial background informed the construction of the contract but that the ultimate decision must be consistent with the agreed allocation of risk in the underlying contract;
c) there was no qualification, and the contract did not indicate an intention to have an actual breach before the guarantee could be invoked;
d) ONGC was entitled to call on the guarantees regardless of the existence of a dispute between Clough and ONGC on whether Clough had 'failed to honour' any of its commitments under the contract;
e) while ONGC's actions to call on the guarantees did not constitute unconscionable conduct under the *Trade Practices Ac*t 1974 (Cth), the Court did recognise that 'there may be extreme cases which would merge into the area of bad faith exercises of the power'.

Thiess Pty Ltd v Pacific National (Victoria) Pty Ltd [2009] VSC 670

Pacific called upon a bank guarantee, an unconditional performance bond, provided by Thiess pursuant to an obligation under an Access and Occupations Agreement. Thiess sought an interlocutory mandatory injunction requiring Pacific to repay the amount recovered under the bank guarantee on condition that a substitute guarantee would be provided but which could not be called upon until the hearing and determination of the proceeding or further order.

Pacific relied upon the well-known authorities in relation to performance bonds, including *Wood Hall* to contend that such obligations must be as good as cash and deprived of that quality, it is deprived of its commercial currency. Judd J observed though that:

a) those principles did not permit a beneficiary to cash a guarantee on a whim; and
b) in order to determine the circumstances under which a demand may be made, it is necessary to analyse the terms upon which the parties agreed that the guarantee would be provided and the circumstances in which it might be called upon.

Having reviewed the terms of the agreement, his Honour found there was a serious question to be tried as to whether the Access and Occupations Agreement limited Pacific's right to call upon the security in the absence of the resolution of any dispute. He then considered the *Bradto* principles (and authorities cited therein), noting in particular that:

a) the grant of a mandatory interlocutory injunction may be justified in a particular case notwithstanding that the court does not feel the requisite "high degree of assurance";
b) the remedy of injunction should be available whenever required by justice;
c) the court should take whichever course appears to carry the lower risk of injustice if it should turn out to have been "wrong".

The Court then found that the balance of convenience was perhaps the more significant issue. His Honour canvassed the financial implications for each party if an injunction was granted or refused. However, Thiess contended that quite apart from any suggestion that it might be experiencing financial difficulties, merely by calling upon the guarantee Pacific had exposed Thiess to damage to its reputation in the industry, which:

a) reflected on and may cast some doubt on its willingness or ability to perform its contractual obligations;

b) might affect Thiess adversely when negotiating contracts for future business; and
c) may give to its competitors an unfair advantage to use the occasion as an opportunity to differentiate themselves.

Despite initially describing the affidavit material on this issue as overstating the position, his Honour, after considering decisions such as *Austrak Pty Ltd v John Holland*, *Abigroup Contractors Pty Ltd v Peninsula Balmain Pty Ltd*, *Barclay v Mowlem*, *Reed Construction*, and *Walter Construction Group Limited v Secretary Department of Infrastructure*, was persuaded, notwithstanding his reservations, that:

a) authority was "firmly in favour of recognising the importance of the reputational damage that might be caused by conduct of the kind that occurred in this case"; and
b) considerable weight ought be given to the proposition that calling upon guarantees is very likely to cause significant reputational damage which is not capable of adequate compensation by an award of damages.

To the submission that the guarantee had been called and the money paid, i.e. the horse had bolted, such that any reputational damage had already been done, and that the injunction sought would not remedy Thiess's loss of reputation, his Honour held that the restoration of the status quo, or a position near enough to the status quo, would restore Thiess to a position where a guarantee would be reinstated and could be held by Pacific, subject to the supervision of the Court. That, he considered, would go some way to containing the damage done to Thiess's reputation pending trial.

Brady Constructions Pty Ltd v Everest Project Developments Pty Ltd [2009] VSC 622

Osborn J allowed an appeal from VCAT's refusal to grant an injunction restraining Everest from presenting a bank guarantee in the amount of $1,243,883.50. On the question of the balance of convenience below Brady pointed to (and Everest did not seek to contradict):

a) the only property interests of Everest were subject to mortgages and a debenture charge;
b) Everest was a sole purpose vehicle that developed properties, the sale of which would result in all moneys being paid to its mortgagee;
c) Everest was under external administration;

d) Everest's ultimate holding company remained under external administration pursuant to a deed of company arrangement;
e) the said deed of company arrangement would see the property of the Estate Property Group of Companies continue to be developed, and that all creditors of Estate Property Group Limited and the Estate Property Group of Companies would be paid from a single fund; and
f) if Everest was required to repay the bank guarantee or any part thereof, it was unlikely to have any assets or means to make such repayment.

In arriving at his decision, his Honour held that while the Tribunal had correctly stated the applicable legal principles by reference to *Bradto*, the Tribunal did not have regard to the combined strength of the material considerations advanced on behalf of Brady, establishing a strong prima facie case that if the guarantee was paid out, it could never be recovered thereafter, whatever might be the ultimate conclusion on the seriously triable issue concerning the enforceability of the guarantee.

Damage to reputation

It will be seen from the *PRA* and *Thiess* decisions above (and *Redline* below), that in recent years there has been a growing trend for contractors, seeking to resist a call on their guarantee, to invoke the ground that failure to restrain the call will cause irreparable harm to their reputation in the market place. So too, it appears, the weight being attached by courts to that consideration when determining the course of least injustice and where the balance of convenience lies, has been growing. The claim is relatively easy to make and difficult to refute.

Is that an accurate impression though of the strength of the reputational harm plea? If it is, one might fear that the essential discretionary nature of interlocutory injunctions might be supplanted by what some consider to be a 'knock out' blow. ***If*** that is the case, whenever reputational harm is raised, an injunction must almost always follow.

However, in *Clough* [73], his Honour accorded no significant weight to concerns as to the effect of payment under the performance bank guarantees on Clough's commercial reputation.

Further, the decision of the NSW Court of Appeal in *Lucas Stuart* also aids in clarifying, but not necessarily dispelling, that perception (or misconception).

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

Relevantly, Hemmes argued that because part of the security had already been cashed so that any damage to Lucas's reputation had already been done, no further such damage would result if Hemmes was not restrained from calling on the balance. In the majority judgment of Campbell and Macfarlan JJA, that submission was rejected. Further, their Honours held that where that was the only basis upon which a respondent sought to affect the balance of convenience, an injunction would likely be granted.

Campbell JA said [9]:

> *"In the present case, the prospect of damage to reputation provides a sufficient reason why the Applicant has established that there is a serious question to be tried concerning not only the existence of a breach of a negative stipulation requiring the Respondent not to call on the performance bonds in circumstances not justified by clause 16, but also that the only relevant legal remedy, namely damages, will not be an adequate remedy."*

In his dissenting judgment, Young JA said [66ff]:

> *"This practice of paying particular attention to this matter seems to have commenced with the decision of Rolfe J in Barclay Mowlem Construction Ltd v Simon Engineering (Australia) Pty Ltd (1991) 23 NSWLR 451 at 461-462. It is to be noted that before Rolfe J there was evidence on the point, though his Honour was concerned that that evidence might have been inadmissible; once it was admitted it needed to be taken into consideration. In any event, he considered he might have been able to infer the same matter from general experience.*
>
> *Austin J in Reed Construction Services Pty Ltd v Kheng Seng (Australia) Pty Ltd (1998) 15 BCL 158 took the same line.*
>
> *Although there has been citation of both the Barclay Mowlem case and the Reed Construction case in other States, interstate judges do not seem to have picked up at all on this particular point, though perhaps it was never argued; see eg Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd [1998] 3 VR 812 (CA) and Bateman Project Engineering Pty Ltd v Resolute Ltd [2000] WASC 284; (2000) 23 WAR 493, the court in each case being more concerned with not eroding the principle of commercial certainty of performance bonds and bank guarantees.*
>
> *It seems to me too that one must take into consideration when working out questions of balance of convenience that even though there may be some commercial opprobrium to a person who has its performance bond called up, there is also commercial opprobrium to a company against which this Court makes an injunction. Indeed, when sitting in Equity one always takes into account*

> *the fact that the application for injunction may be brought for just that purpose. Furthermore, it is a little difficult to pay much credence to a statement by a person against whom it is alleged that the building which it and its subcontractors constructed has over a thousand defects and is not watertight would suffer in its reputation any more if in addition to those facts being known by the general community, it was known that its performance guarantee had been called up in a manner which it disputed.*
>
> *…The second point is that the builder did not seek an injunction to hold the status quo pending the appeal and the proprietor in fact called up, I think it was expressed, one and a half of the securities. No-one has asked for restitution. This seems to me to make the case against granting an injunction even weaker than it would have been at first instance because: (a) to use a colloquial expression "the horse has bolted"; and (b) there has already been damage to the commercial reputation of the builder by the fact that some of the securities have in fact been called up."*

FMT Aircraft Gate Support Systems v Sydney Ports Corporation **[2010] NSWSC 1108**

In *FMT*, the relevant clause (based on AS4910-2002) regulating the entitlement of the defendant to have recourse to the security, provided that the purchaser may have recourse to the security where the purchaser has "***any claim or entitlement*** *to payment or damages, costs or an amount or debt due by the Contractor to it under this contract*". Each party had purported to terminate the contract.

Pembroke J considered that there was no serious question to be tried in support of the contention that the clause did not permit resort to the security, where there was a claim by the beneficiary of the security for an amount of unliquidated damages arising from defective workmanship. Further, that a liquidated claim for damages was not a necessary prerequisite for resort to the security.

In his enquiry into the meaning of "claim", his Honour made the following observations:

a) "claim" was clearly used in contradistinction to the word "entitlement";
b) most cases had turned on the meaning of the word "entitlement" where used in different syntactical and grammatical contexts: *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1998] VSCA 40; [1999] 1 VR 420 especially at paragraphs [30], [32] and [39] – [46] per Brooking JA;

c) whenever the language permits, the courts have, especially in more recent times, adopted a generous approach to the meaning of "entitlement" – to reflect the perceived commercial purpose;

d) in this contract, the drafter had endeavoured to remove any doubt by introducing an additional factor;

e) both parties were sophisticated, commercial, and well advised entities, taken to have been aware of the numerous disputes and judicial decisions in this country concerning such clauses, and taken to have entered into the contract against that background;

f) it was obvious that the words "has any claim or entitlement" were intended to broaden the circumstances in which the principal could have recourse to the security;

g) they reflected an allocation of risk that necessarily embodied a mutual accommodation of competing interests;

h) the evident commercial purpose was that, as long as there is a claim or entitlement within the meaning of clause 5.2, the contractor and not the principal would be the party who is out of pocket pending final resolution of the dispute: *Fletcher Construction Australia Ltd v Varnsdorf* [1998] 3 VR 812 at 826 (Callaway JA);

i) a valid claim must be non-fraudulent, genuine and bona fide;

j) on the other hand, a mere honest or bona fide "belief" in a claim is insufficient: cf *Clough Engineering Ltd v Oil & Natural Gas Corporation Ltd* [2008] FCAFC 136 at [102];

k) what is required is an arguable claim - one that is not specious, fanciful or untenable: *Hughes Bros v Telede Pty Ltd* (supra) at 216 (Cole J);

l) the test of what is a "claim" for the purpose of a contractual provision such as clause 5.2 is relatively undemanding, and is analogous to the criterion used for determining whether there should, or should not be, summary dismissal of a claim or proceeding: *General Steel Industries v Commissioner for Railways* [1964] HCA 69; (1964) 112 CLR 125;

m) in proceedings such as these, where the issue is whether the principal is entitled to have recourse to the security, it will almost always be unnecessary and inappropriate to determine the ultimate validity or quantification of the principal's claim. Those matters are for determination at a later stage. Proceedings of this nature should not involve a trial of the merits. As observed in *Wood Hall* at 461, the commercial effectiveness of unconditional undertakings would be destroyed "if all the legal and factual complexities

> of a building dispute were injected" into what should otherwise be a relatively straightforward analysis.

FMT also argued that the conduct of the defendant and its superintendent was unconscionable due to the failure of their letter to advert to the fact that liquidated damages were accruing, which thereby (in some indeterminate way, according to his Honour) ought to have prevented the Defendant from exercising its contractual right to have recourse to the security. At [35ff], his Honour said:

> *"Caution is required when equitable principles are sought to be imposed on well resourced and well advised commercial parties. In any given case, there might possibly be a proper basis to put submissions based on the equitable doctrine of unconscionability or its statutory equivalent in Section 51AA of the Trade Practices Act. However, the opportunities will be limited. That is because the state of affairs on which the application of equitable doctrines is usually predicated – vulnerability, dependence, mistaken assumption or inducement – will rarely exist in such circumstances.*
>
> *The Court has before it two groupings of substantial commercial enterprises, well resourced and advised, dealing in a commercial transaction having a great value. ... This is not, of itself, a reason for denying them the beneficial application of the principles developed by equity. But it is a reason for scrutinising carefully the circumstances which are said to give rise to the conclusion that an insistence by the appellants on their legal rights would be so unconscionable that the Court will provide relief from it.*
>
> *At least in circumstances such as the present, courts should be careful to conserve relief so that they do not, in commercial matters, substitute lawyerly conscience for the hard headed decisions of business people.*
>
> *That statement is, I think, a valuable touchstone in this area. In the choice between lawyerly conscience and the hard headed decisions of businessmen, I prefer the latter..."*

Ceresola TLS AG v Thiess Pty Ltd & John Holland Pty Ltd [2011] QSC 115

Thiess engaged Ceresola to provide eight tunnel forming machines for use in a construction project known as the Airport Link Project. Ceresola procured a bank guarantee for some EUR 360,000 in favour of Thiess. Thiess contended, and Ceresola contested, that it was entitled to liquidated damages from Ceresola as a consequence of late delivery of the machinery. Thiess,

however, indicated its intention to call on the bank guarantee and apply the proceeds to its claimed liquidated damages. Ceresola applied to Daubney J for an interim injunction.

His Honour accepted that there were "triable issues or serious questions to be tried with respect to the entitlement of the respondent to claim liquidated damages for late delivery, and with respect to the proper calculation of any such liquidated damages".

He then considered the authorities over the last 30 years or so, including *Wood Hall*,

Clough and *Fletcher Construction v. Varnsdorf* in noting the general rule that a Court will not enjoin the issuer of a performance guarantee from performing its unconditional obligation to make payment. He went on to recite the well-settled exceptions to that general rule namely, fraud, unconscionability and breach of negative covenant.

As in *Clough* and *Fletcher*, Daubney J then turned to consider the contract in question to determine whether the purpose of the bank guarantee was merely:

a) to provide security – "If [the beneficiary] has a valid claim and there are difficulties about recovering from the party in default, it has recourse against the bank"; or
b) to allocate the risk as to who shall be out of pocket pending resolution of the dispute.

After reviewing the contract, his Honour found that the bank undertaking was not only for the purposes of acting, in effect, as backup security for moneys which may be claimed by the respondent, but rather it was also an exercise in risk allocation particularly having regard to the unconditional nature of the bank undertaking in the unconditional form agreed to by the parties.

He added, referring again to *Clough* that the relevant provisions in the instant contract did not constitute clear words which would inhibit Thiess from making claim on the unconditional bank guarantee, and the application was dismissed.

Miwa Pty Ltd v Siantan Properties Pte Ltd [2011] NSWCA 297

Miwa was the lessee of commercial premises owned by Siantan. On entering into the lease, Miwa provided a bank guarantee in favour of Siantan pursuant to clause 15 of the lease, which provided:

> *"15.1 Prior to the commencement of this lease the lessee shall cause a bank guarantee irrevocable up until and including the date of expiry of the Term for the sum stated in item 15 of the reference schedule in favour of the Lessor to be provided to the Lessor to secure the Lessor against any failure by the Lessee to comply with the conditions of this Lease relating to the care or repair of the demised premises or the payment of rent, charges or any other moneys payable by the Lessee under this Lease.*
>
> *15.2 In the event of such failure the Lessor shall be entitled without further notice to the Lessee to forthwith call up such guarantee wholly or in part and to apply any moneys paid thereunder to any loss or damage sustained by the Lessor ... without prejudice to the Lessor's right to full reimbursement from the Lessee for such loss or damage sustained and the Lessor's right to claim payment for any deficiency."*

The lease was for a term of five years, with an option to renew for a further period of three years. The option was exercised. On commencement of the lease, the Miwa had been entitled to a sum of $45,000, described as the lessor's contribution to the fitout of the premises, in accordance with clause 17.7 of the lease. There was a dispute as to whether a similar payment was to be made on exercise of the option to renew the lease. Siantan refused to make the payment. Miwa gave notice that it intended to set off the unpaid amount against the rent, over a number of months, which it did. Miwa sought to restrain Siantan from calling on the Bank to pay the guarantee. Windeyer AJ dismissed the proceedings and dissolved an interim injunction. In allowing the appeal and granting the injunction, the Court of Appeal held, in summary:

a) whether the lessor could properly be injuncted from making a demand on the bank pursuant to the guarantee depended on whether there was a negative stipulation, expressed or implied in the lease, precluding the lessor from calling upon the guarantee;
b) the purpose of the guarantee, as reflected in clause 15 of the lease, was to provide security to the lessor in respect of its legal entitlements, it protected the lessor against the insolvency of the lessee and relieved it of the obligation to bring proceedings to enforce its entitlements;
c) it did not however absolve the lessor from the need to establish those entitlements if its right to call on the guarantee, or to retain moneys paid to it thereunder, was challenged by the lessee;
d) the lessor having no legal entitlement at the time it sought to call on the guarantee, the lessee was entitled to an order restraining it.

Redline Contracting Pty Ltd v MCC Mining (Western Australia) Pty Ltd (No 2) [2012] FCA 1 (6 January 2012)

Redline provided MCC with four unconditional bank guarantees for the installation of pipelines for a resources project in Western Australia. Clause 5.2 of the contract provided:

> *5.2 Recourse*
>
> *Security shall be subject to recourse by a party who remains unpaid after the time for payment where at least 5 days have elapsed since that party notified the other party of intention to have recourse.*

MCC made several complaints against Redline, including that Redline failed to pay $1,290,000.00 in fuel charges. MCC called up the bank guarantees. Redline argued that MCC was not entitled to call upon the guarantees because:

a) there had been no determination under the contract that MCC was owed the amounts claimed, and if it were found that Redline owed MCC, the contract would allow Redline to offset that amount against amounts claimed by Redline; and
b) MCC had engaged in misleading and deceptive conduct through representations about the standard of pipelines to be used under the contract which caused it to enter a lower tender price for the contract than it would otherwise have done, and that MCC's attempt to resort to the security in respect of its unliquidated damages claim was unconscionable conduct in contravention of s 51AA of the TPA..

The Federal Court rejected both Redline arguments on the basis that it had failed to demonstrate a sufficient likelihood of success. The court applied the principles in *Clough*. The Court emphasised the importance of the construction of the contract:

> *"A contract is to be construed in its commercial context'; where it provides for a performance guarantee, the parties are taken to have contracted in the knowledge of the 'legal principles relating to the construction of contractual terms insofar as they affect the right of the beneficiary to call upon a performance bond'; and the contract must be construed 'in light of the whole contract and the language of the performance bond itself'."*

Siopsis J considered that the observations in *Clough* and *Olex Focas*, applied equally to this case. He expressed the view that:

> *"…a trial court is likely to find that MCC Mining is doing no more than enforcing its contractual legal rights to resort to the security consequent upon a disputed claim for unliquidated damages. There is no suggestion that in making the claim, or calling on the undertakings, MCC Mining is acting in bad faith."*

Having found that Redline had failed to demonstrate a prima facie case either on the grounds of an implied negative stipulation in the contract, or unconscionability, his Honour considered it unnecessary to have regard to the question of balance of convenience.

However, (as indicated above) the Court did consider Redline's contention that it would suffer reputational harm by the call upon the unconditional undertakings for the whole of the security. His Honour responded:

> *"In Clough, the Full Court, cited with approval the observations of Hobhouse LJ in Toomey v Eagle Star Insurance Co Ltd [1994] 1 Lloyd's Law Rep 516 at 520, to the effect that parties to a commercial contract are taken to have contracted against a background which included earlier authorities on the construction of similar contracts. The Full Court decision in Clough was delivered in July 2008, and this contract was made in December 2009. If, as Redline contends, a contractor's reputation is inevitably harmed in the industry when a performance bond or like instrument is called upon,* ***it was open to Redline to protect itself by concluding a contract which provided for, expressly and unequivocally, the more limited range of circumstances in which the unconditional undertakings could be called upon, for which it now contends****. In my view, it is unlikely that a trial court will find that in those circumstances, MCC Mining is acting unconscionably, in resorting to the security, by reason of any potential harm to Redline's reputation."*

ALYK (H.K.) Limited v Caprock Commodities Trading Pty Limited and Anor [2012] NSWSC 1558 (13 December 2012)

The issue before Slattery J was whether, in the events that happened, a buyer of commodities could restrain the seller from making demand upon a standby letter of credit issued for the seller's benefit under their mutual commodity sale contract. In the result, the Court refused the injunction.

The parties agreed to have a single final hearing, rather than an interlocutory hearing followed by a final hearing. His Honour described that course as "more consistent with the Court providing a 'just, quick and cheap' resolution of the real issues in these proceedings: *Civil Procedure Act* 2005, s 56." and "a better course where, as is the case here, the only matters in issue are questions, involving the construction of the parties' contract".

The contract (clause 6), a complex piece of drafting, required the Buyer to, inter alia, open an Irrevocable Transferable Documentary Letter of Credit (LC) and acceptable, at sight letter of credit to the Seller within 15 working days after signing the contract from one prime World Top 25 Bank in favour of the Seller by way of SWIFT MT700 with the Seller as first beneficiary for an amount in US Dollar sufficient to cover 100% of contract value each, including 95% contract value of provisional payment and 5% for balance payment. Further, the buyer was required to provide within 10 working days of signing of the contract extra cover the LC, a transferable Stand By Letter of Credit (SBLC) in a format acceptable to the Seller for the value of $20,000,000 being 1 month's shipment of 160,000MT. Within 14 banking days of receipt of buyer's swift MT700, the seller was required to issue the 5% CPB (Corporate Performance Bond) for non-delivery. The CPB was to be an irrevocable unconditional guarantee to the buyer for all the shipments through the Contract valid period. The buyer acknowledged that a claim under the performance bond will discharge the seller's obligations and will be adequate compensation against any loss or damage suffered by the buyer due to non-performance by the seller.

Clause 6 did not specify the form of the standby LC to be issued. His Honour noted that specifying the precise form of a proposed bank guarantee or a performance bond is not an uncommon contractual feature: see for example *Clough* ... at [30]. Here instead clause 6's first paragraph requires that the standby LC to be "in a format acceptable to the Seller [Caprock]". The form of the standby LC that was ultimately mutually adopted was "acceptable to the Seller".

The parties fell into dispute when the Bank did not issue an amended standby LC.

His Honour at [78] considered the relevant law in relation to payment under documentary credits such as the standby LC as being well settled, and could be shortly stated under three headings: the "Autonomy Principle", negative stipulations (although he also briefly acknowledged its cousins, fraud and unconscionability), and standby LC's. He observed that

the course of authority shows that contests in this area mostly arise in the application of this settled law to the terms and context of particular contracts. In relation to the third, the law on standby letters of credit, his Honour said:

> *"Caprock relies in argument upon well-accepted commercial differences between ordinary letters of credit and standby letters of credit in constructing the ALYK-Caprock Contract.*
>
> *A standby letter of credit is an undertaking by a bank to make payment to a third party, the beneficiary, provided that the beneficiary complies with the stipulations of the credit which, in international trade transactions, invariably include the tender of one or several documents. But as the learned authors of Schmitthoff's Law and Practice of International Trade, 12th Edition, 2012, Thomson Reuters, London, explain (at 11-032) there are differences between the two types of letter of credit, ordinary and standby:-*
>
> *"In international trade transactions the standby letter of credit, like the ordinary letter of credit, is activated by the tender of documents in accordance with the requirements of the credit. The two types of credit differ significantly however. The ordinary letter of credit is a payment instrument which normally obliges the beneficiary to tender, together with other specified documents, the transport documents. The standby credit is intended to protect the beneficiary in case of default of the other party to the (underlying) contract. In a standby credit the required documents need not include the transport documents; this type of credit may be activated by a document of any description, e.g. a demand by the beneficiary or a statement from him that the other party is in default. The standby letter of credit is thus often functionally similar in effect to a bank guarantee or performance bond."'"*

The Court held [104] that the parties agreed that the standby LC would operate according to its terms. His Honour accepted that Caprock would therefore be required to make the statements required under the LC before payment would be made. It could not do so fraudulently or unconscionably. But subject to such limits it was entitled to demand payment.

He also described [107] the standby LC as only payable on presentation of claim related documents as being a means of allocating credit risk in the course of an unresolved dispute. The five items of the beneficiary's statement in the standby LC did not require any dispute to be resolved before the Bank made payment. The standby LC could be inferred to operate in circumstances where any existing dispute remained unresolved. He went on [112]:

> *"…There is no express provision limiting the circumstances in which the standby LC might be called upon. In the absence of an express negative stipulation, an* ***implied negative stipulation*** *may qualify Caprock's making of a demand under*

> *the standby LC. The usual requirements govern the implication of such a term into a contract: (1) it must be reasonable and equitable; (2) it must be necessary to give business efficacy to the Contract so that no term will be implied if the Contract is effective without it; (3) it must be so obvious that "it goes without saying"; (4) it must be capable of clear expression; (5) it must not contradict any express terms of the contract:* BP Refinery (Westernport) Pty Ltd v Hastings Shire Council *(1977) 180 CLR 266 at 283. To give business efficacy to an agreement, clear necessity is required to imply a term, such that it is not enough that it is reasonable to imply a term; it must be necessary:* Codelfa Construction Pty Ltd v State Rail Authority of NSW *[1982] HCA 24; (1982) 149 CLR 337 at 346 per Mason J.*

In applying the above, his Honour concluded against implication of any negative stipulation as it was unnecessary, it would contradict an express term and it was not capable of clear expression.

In the result, he found that ALYK was unable to stay Caprock's call on the standby LC.

……..

Other more recent decisions in which allegations of "reputational harm" were significant considerations:

Metro Chatswood Pty Ltd v CRI Chatswood Pty Ltd (In Liquidation) (Receivers and Managers Appointed) & Ors [2012] NSWCA 49 (21 March 2012)

Meagher JA

Metro contended that if an injunction was not granted:

a) Suncorp would seek to recover the amount paid under that facility from the relevant borrowing entities within the Group of entities, of which Metro was a member, and if not from them, then from the guarantors of that facility which include Metro.
b) Metro did not have independent cash resources and relied on the financial support of other entities in that group to permit it to pay its debts as and when they fall due.
c) If the group was required to fund the amount paid it would be necessary to redirect funds presently committed to particular projects which would be likely to cause disruption and delay to the progress of those projects thereby presenting risks of

financial harm to entities within the Group adversely affecting its overall financial position and therefore its ability to continue to provide financial support to Metro.

d) Metro and the Group would suffer reputational damage because it would be regarded as a demand following a default and make it difficult for the group to obtain finance in the future at competitive commercial rates.
e) This prejudice or injury which it may suffer is real, difficult to quantify and not readily curable by an award for damages in the event that it is successful on the appeal and the Guarantee has been called.

His Honour held:

a) while the evidence relied upon by Metro was in fairly general terms, it sufficiently established that "*there are real risks of financial and, to the lesser extent, reputational detriment, to Metro both directly and indirectly because of its financial dependence on the welfare of the … Group*";
b) in circumstances where Metro was prepared to provide security for interest on the payment delayed, the balance of convenience as between the parties, clearly favoured the grant of an injunction.

Otter Group Pty Ltd v Wylaars & Anor [2013] VSC 98 (15 March 2013)

Hollingworth J

Bank guarantee provided to secure tenant's obligations under lease. Bank guarantee drawn down by landlord. Application by tenant for mandatory injunction seeking to compel landlord to reinstate bank guarantee until determination of dispute about existence of breaches.

The matter came on before both her Honour and Cavanough J several times within a short period. On each occasion, the Court commented on inadequacies in Otter's evidence relating to the balance of convenience, and on each occasion, it was permitted adjournments to "fix its evidence".

The Court was satisfied that:

a) there was a bona fide claim of breach[3];
b) the lease gave Wylaars a clear entitlement to draw down on the bank guarantee, pending resolution or determination of the underlying disputes;
c) there was no suggestion or evidence that Wylaars acted fraudulently or unconscionably;
d) the dispute was a *bona fide* one;
e) there was no contractual provision precluding Wylaars from using the proceeds of the bank guarantee prior to trial;
f) there was no good reason for the court to depart from the general rule that an interlocutory injunction should not be granted in these circumstances; and
g) given those findings, there was no serious question to be tried.

Nonetheless, her Honour went on to consider the balance of convenience and Otter's claims of financial and reputational harm if an injunction was not granted. Otter asserted that as a result of the drawing down of the bank guarantee:

a) its overdraft increased outside its current approved limit;
b) it would suffer "substantial interest and bank charges" in the order of $75,000 per annum;
c) it would also suffer from the reduction of working capital available to it as a result of the bank guarantee amount being treated by the bank as a drawn facility, which would inhibit further fund raising from the bank and might significantly impact on its ability to take advantage of trading opportunities as well as placing a strain on its overall finances;
d) there would be delay in launching of two new products (which were the subject of commercial confidence) which was likely to damage its reputation as an "innovative market-sensitive supplier proactively introducing new products to meets changing market needs", and that such damage to reputation was "difficult and time consuming to redress and would lead to [Otter] being regarded as a less favoured supplier".

Her Honour assessed Otter's evidence as:

[3] Hollingsworth J referred to *Rejan Constructions Pty Ltd v Manningham Medical Centre Pty Ltd*, supra, where Byrne J concluded that the party calling upon the security could only do so pursuant to the contract if an amount was actually due and payable under the building contract. Her Honour considered that to the extent *Rejan* may be inconsistent with the various appellate authorities to which she had referred, it should not be followed.

a) less than satisfactory;
b) full of sweeping assertions and comments, but largely unsubstantiated by actual evidence;
c) failing to provide any detail of its actual financial situation;
d) seeming to have "simply plucked the projected profit figures from the air".

Therefore, for the purposes of the application, the Court proceeded on the basis that:

a) the only likely financial effect to Otter if the injunction was not granted, was that it would have to pay approximately $75,000 per annum in additional bank fees and charges;
b) Otter had a cash shortfall of more than $1.7 million; and
c) Otter's failure to make proper disclosure to the court of its financial position caused serious concern as to the worth of its undertaking as to damages.

Whilst her Honour accepted that:

a) damage to reputation can certainly be a relevant matter in assessing where the balance of convenience lies; and
b) in principle, reputational damage may be caused by a call on a performance bond or guarantee, as that may call into question a person's ability to perform their obligations under a contract, as well as their financial viability,[4]

given the "flimsy state" of Otter's evidence as to the two new products; the absence of any substantial evidence about Otter's business performance; and that fact that apart from the ANZ bank, the Wylaars, and the parties' lawyers, there was no suggestion that anybody else was aware of the fact that the guarantee had been called upon, she was only prepared to give this factor little weight.

Blackwood v Erfurth (Domestic Building) [2013] VCAT 733 (13 May 2013)

The Tribunal found there was a serious question as to owner's entitlement to draw on the builder's guarantees and whether the procedural requirement in the contract was satisfied

4 *Barclay Mowlem Construction Ltd v Simon Engineering (Aust) Pty Ltd* (1991) 23 NSWLR 451 at 461-2; *Lucas Stuart Pty Ltd v Hemmes Hermitage Pty Ltd* [2010] NSWCA 283 at [46].

whereby the "*owner must notify the contractor and the architect in writing of the basis and amount of its entitlement"*.

The builder complained that:

a) the guarantees were issued on the security of his family home and that, with the bank paying on the guarantees, he now had a debt of $63,310.46 payable to the bank;
b) the bank had given him 90 days to pay the debt failing which a default would be recorded against him with the Australian Prudential Regulation Authority and the bank would call on the security of his home to satisfy the debt; and
c) he would likely suffer harm to his commercial reputation.

The Tribunal held [55]:

> *"On balance, I am not satisfied on the evidence before me that the builder is likely to suffer injury for which damages will not be an adequate remedy. While I accept that it is no small matter that the builder must now obtain a loan to pay the $63,310.46 debt to the WA Bank, there is nothing in the builder's affidavit material to suggest that he will be unable to obtain and service the loan. The WA Bank has provided a window of 90 days (from the date the bank paid out on the guarantees) for the builder to obtain the loan and avoid the recording of a default with the Australian Prudential Regulation Authority. The builder has produced no financial records of his business or details of any mortgage or charge over his family home. There is no evidence that the builder's commercial reputation will be further damaged if the injunctive relief sought is not granted. The builder says that if the injunctive relief sought is granted, he will use the money paid to him by the owner to repay the debt to the WA Bank. It is difficult to see how the payment of the debt to the bank by another means, namely through the obtaining of a loan, would be significantly more detrimental to the builder's commercial reputation…*
>
> *On all of the evidence, I find that the builder is unable to demonstrate that, in the event the injunctive relief sought is not granted, he will likely suffer injury for which damages will not be an adequate remedy. For this reason, the builder's application for injunctive relief does not succeed and it is not necessary for me to proceed to an assessment of further factors going to the "balance of convenience" as between the parties."*