Bank Guarantees and Injunctive Relief In Construction And Engineering Contracts: A Shift In Emphasis

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The opening sentence of the Victorian Supreme Court of Appeal's decision in *Bachmann Pty Ltd v BHP Power New Zealand Ltd* (1997) BC 9706712 says it all:

> "*Again we find the contractor or supplier under a building or engineering contract trying to stop the owner demanding payment under a security given by a financial institution.*"

Proceedings to obtain injunctive relief to restrain the calling of "*bank guarantees*" are commonplace in the buildng industry these days. Recently, these proceedings have often been successful. Two recent Court of Appeal decisions in Victoria, *Bachmann* and *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* ((1998) BC 9804700) may signal a reverse in this trend.

GROUNDS FOR RELIEF

A contractor seeking injunctive relief to protect a bank guarantee provided as security for the performance of its obligations under a building conract may seek this relief:

1. against the issuer of the security; or
2. against the principal under the building contract.

(i) Security

The circumstances in which the issuer of the security will be restrained from honouring a demand by the principal are limited where the security is unconditional in nature. The cases reflect that the following circumstances may suffice:

1. where the demand is fraudulent, or would clearly be fraudulent, and the issuer knows this (*United Trading Corporation SA v Allied Arab Bank Ltd* [1985] 2 Lloyds Rep 554, 561);
2. where the demand is "*specious or fanciful*" (*Hortico v Energy Equipment* (1985) 1 NSWLR 545, 550);
3. where there is an illegality affecting the security (*Fletcher Construction*, supra at 33);
4. where there has been a total failure of consideration under the building contract (*Patten Homes v Coleman* (1984) 28 BLR 19, 28); or
5. where the demand is unconscionable pursuant to s.51AA of the Commonwealth *Trade Practices Act* 1974 and there is clear evidence that the issuer had knowledge of the unconscionable conduct (*Skodaexport Co Ltd v Olex Focas Pty Ltd* (1997) BC 9604384).

Fraud is difficult to establish because the issuer is not obliged to inquire into the dealings of the underlying contract (*Discount Records v Barclays Bank* [1975] 1 WLR 315, 318) and, even if the issuer is aware of matters whereby the principal may not be justified in making a claim, the issuer will still be obliged to pay (*R D Harbottle v National Westminster Bank* [1978] 1 QB 146); these are considered to be matters to be settled between the contractor and the principal under the underlying contract. Further, payment, or a demand for payment, when knowing that the claim is disputed or when the demand is made in order to apply pressure, does not constitute fraud (*Olex v Skodaexport* 1997 ATPR (Digest) [46-163]).

In addition, it is respectfully doubted whether the exception for "*specious or fanciful*" claims referred to in *Hortico* remains of any relevance following the decision in *Skodaexport*. To the extent that a demand is fraudulent or unconscionable under the *Trade Practices Act*, the exception in *Hortico* does not advance matters. If the demand falls short of fraudulent conduct or the TPA does not apply, the trial judge in *Skodaexport* rejected common law unconscionability as a ground for intervention.

(ii) The Contract

It is by reference to the building contract itself that contractors have most commonly obtained injunctive relief.

This mode of attack had its genesis in the comments of Stephen J in *Wood Hall Ltd v Pipeline Authority* (1979) 141 CLR 443 ("*Wood Hall*"). The relevant term of the purpose drawn contract was a follows:

> "*The contractor shall ... pay to the owner as security for the contractor's due and faithful performance of the work the sum of $1,500,000. The Contractor shall be entitled to provide by way of alternative to a cash security a bank guarantee ...*"

Gibbs J stated that the ultimate question for decision was whether the **bank** was bound to make payment to the Pipeline Authority **under the guarantee.** The court held that the guarantee was unconditional and that there were strong policy considerations for upholding the unconditional nature of the guarantee.

Stephen J noted, however, that:

> "*had the construction contract itself contained some qualification upon the Authority's power to make a demand under a performance guarantee, the position might well have been different. In fact, the contract is silent on the matter.*"

Subsequent cases have concentrated on the issue of whether there is usually an implicit term in the underlying contract qualifying the principal's right to call on the security.

These cases are revisited later in this article.

Fletcher Construction

The contract in *Fletcher Construction* was purpose drawn but many of the relevant clauses were substantially similar to those commonly found in standard form building contracts.

The question for consideration of the court was whether the principal (Varnsdorf) was entitled to take steps to call upon two irrevocable standby letters of credit issued in its favour pursuant to clause 6.6 of the contract.

Clause 6.6 of the contract provided as follows:

> "*6.6 Security*
>
> *(a) Security must be given in the amount in the Schedule of Contract Information and in accordance with this clause.*
>
> *(b) The security must be in a form and given by a financial institution approved by the Owner.*
>
> *(c) The Owner is not required to pay Fletcher until Fletcher gives this security.*"

In the Schedule of Contract Information the amount of security was expressed as follows:

> "*$5,000,000 in the form of an unconditional undertaking to pay in favour of the Owner. Form and provider of undertaking must be approved in advance by the Owner.*"

Pursuant to the contract, Fletcher provided security in the form of two irrevocable standby letters of credit drawn on State Bank of NSW for the sum of $2,500,000 and payable at sight.

On 19 August 1997, Varnsdorf made a demand by letter on Fletcher for the payment of liquidated damages. The demand was based on clause 3.13 of the contract, and Varnsdorf gave notice that if Fletcher failed to pay the sum claimed within 10 business days of the demand, Varnsdorf might have recourse to Fletcher's security to obtain the balance.

Clause 3.13 of the contract provided as follows:

> "*(a) If [Fletcher] does not reach Handover by the Date for Handover, it must pay Time Damages at the rate in Annexure A for every Operating Day after the Date for Handover until it reaches Handover or the Contract is terminated, whichever is first.*
>
> *(b) The Owner may deduct Time Damages from any money due from the Owner to [Fletcher] under the Contract and if that is insufficient, [Fletcher] must pay the balance of Time Damages to the Owner within 10 business days of delivery of the notice to [Fletcher] from the Owner demanding payment. If [Fletcher] fails to pay the balance within the 10 business day period, the Owner may have recourse to [Fletcher's] security to obtain the balance.*"

Fletcher Construction argued that resort to security under clause 3.13 was available to Varnsdorf only in the event of an undisputed entitlement to time damages; the right of resort required, as a condition of its exercise, the existence of any entitlement to the money claimed, and it was insufficient that there was a mere, or a contested, claim. Varnsdorf submitted that there was no express letter in clause 3.13 or elsewhere in the contract to the effect that Varnsdorf could not call upon the letters of credit until its entitlement to time damages had been established. Varnsdorf submitted that clause 3.13 expressly permitted it to make a call upon the unconditional letters of credit provided that two conditions were satisfied: first, that a notice containing a demand had been sent to Fletcher, and secondly, that there had been a failure to pay the amounts demanded within 10 business days.

Charles JA who gave the leading judgment of the court, stated that the critical question for the court to decide was whether the "*relevant commercial purpose of the agreement*" was:

1. to provide security to Varnsdorf, so that valid claims for damages (whether or not time damages) would be secured; or
2. whether the clauses of the contract made provision for an allocation of risk between Fletcher and Varnsdorf – showing which party was to be out of pocket pending resolution of any dispute.

If the first alternative was the intention, Charles JA held that clause 3.13 would not have given Varnsdorf authority to call upon the security pending resolution of any dispute. If the second alternative prevailed, a question would remain whether there was any relevant qualification or prohibition affecting Varnsdorf's ability to call on the security.

The court held that the second alternative prevailed, and that provided Varnsdorf's claim was bona fide there was no qualification on its ability to call on the security, even if there was a genuine dispute and a serious issue to be tried as to whether completion had been achieved.

The Court considered that the following matters were significant in reaching this conclusion:

1. commercial practice plays a large part in construing the contract; clauses in the contract that do not expressly inhibit the defendant from calling upon the security should not be too readily construed to have that effect. Callaway JA adopted with approval the comments of the trial judge that:

   "*It is likely that the parties intended that the security should be available to meet any bona fide claim by the Owner. If they intended that the availability of the security should be deferred until the final resolution process with respect to this claim was complete, it may be supposed that they should have so provided.*" (per Callaway JA at 29.);
2. it was of great importance that the form of security to be provided had to be an unconditional undertaking approved by Varnsdorf (per Charles JA at 17);
3. the parties had established a relatively simple procedure under which an independent party was to certify completion and disputes as to this process could be resolved by arbitration (per Charles JA at 18 and per Callaway JA at 29);
4. clause 3.13 gave Varnsdorf a "*right of self-help*" by entitling it to deduct liquidated damages prior to resolution of any dispute (per Charles JA at 19 and per Callaway at 34); and
5. Varnsdorf was not obliged to make any payment at all under the agreement unless and until Fletcher had provided the security (per Charles JA at 19).

On the basis of these provisions, the court also held that the balance of convenience favoured Varnsdorf as it had:

> "*expressly contemplated, as part of the allocation of risk, that Varnsdorf was to have as security an uncondtional undertaking to pay in its favour; and it was only after provision of such security by Fletcher that Varnsdorf was required to begin making, and in fact made, payments under the agreement to Fletcher. To prevent Varnsdorf now having recourse to such security would ... be to disturb the status quo with respect to the ability of Varnsdorf to call on the letters of credit.*"

Callaway JA agreed with Charles JA that it is a question of construction of the underlying building contract whether the "*bank guarantee*" is provided solely by way of security or also as a risk allocation device. He stated (at 29) that:

> "*no implication may be made that is inconsistent with an agreed allocation of risk as to who shall be out of pocket pending resolution of a dispute and clauses in the contract that do not expressly inhibit the beneficiary from calling upon their security should not be too readily construed to have effect.*"

It is submitted that this reasoning calls into direct question the line of authority commencing with the decision in *Pearson Bridge* ("*Pearson Bridge*") *v State Rail Authority* 1982 1 ACLR 81, in which clauses in construction contracts drafted in permissive or positive terms have been found to obtain in substance a negative stipulation limiting the circumstances in which resort might be had to security under the contract.

Callaway JA also considered that the balance of convenience arguments weighed in favour of Varnsdorf. While he acknowledged that in some cases damages are inadequate remedy in the case of wrongful recourse to a guarantee, this is not decisive if the guarantee was intended to be functionally equivalent to money.

His Honour also made some general comments concerning the recent trend to challenge the right of a principal to call upon security in a building contract. While noting that most of these cases were cases of pure conversion he stated that:

> "*If we are unwilling to restrain recourse, there may be a question whether it was right to discern a prohibition on conversion in the clause ... with which those cases were concerned. Guarantees are an efficient substitute for cash. It would be unfortunate if the law made them unattractive.*"

His Honour went on to note that it may be in the future that there are cases where an award of solicitor/client costs against a party who moves unsuccessfully to restrain conversion of, or recourse to, a guarantee should be made. While declining to decide the circumstances in which such an order might be made, His Honour noted that:

> "*It may be that there are no such cases, or that such an award should be restricted to obviously misconceived attempts to restrain the bank from honouring the guarantee. If solicitor/client costs are justified, they would not be given to mark disapproval of the course taken by the moving party but to ensure, so far as the process of the court can do, that sand is not thrown in the wheels of commerce.*"

Bachmann

This case concerned a dispute between Bachmann and BHP Power New Zealand. The general conditions of contract were based on the standard form AS3556-1988.

Clause 5.5 of the contract provided as follows:

> "*A party shall not convert into money security that does not consist of money until the party becomes entitled to exercise a right under the Contract in respect of this security. The parties shall not be liable for any loss occasioned by conversion pursuant to the contract.*"

Clause 22.4 of the contract provided that:

> "*The purchaser may deduct from monies otherwise due to the supplier, any monies due from the supplier to the purchaser and if monies are insufficient, the purchaser can have recourse to this security under the contract.*"

The court noted that these clauses were novel in the sense that they evidenced an express, albeit qualified, contractual prohibition in the underlying building contract on the conversion of security into cash. This was to be contrasted with the line of cases commencing with *Pearson Bridge* in which permissive clauses in the contract were held to be negative in substance.

The court referred with apparent approval to the decision in *Fletcher Construction* and to the discussions by Charles JA and Callaway JA concerning the allocation of risk under the contract in establishing which party was to be out of pocket pending resolution of a dispute.

The court held that in the present case the matters of conversion of and recourse to the security were dealt with by clauses 5.5 and 22.4 and that, when read in conjunction, they entitled the purchaser, as between itself and the supplier, to have recourse to this security where according to a bona fide claim made by the purchaser, monies were due to it from the supplier which exceeded any monies due from it to the supplier.

The court noted that clause 22.4, like clause 3.13 in the *Fletcher Construction* case, conferred a right of recourse against the security to obtain the balance if the exercise of the right of set off which it also conferred left the balance outstanding in favour of the purchaser. The court stated that:

> "*It would, as Charles JA said in Fletcher, be strange if the clauses concerned in that case and this that cl 3.13 and cl 22.4 – conferred the practical right of recourse only where monies were 'due' from the supplier to the purchaser in some such sense as actually or indisputedly due.*"

EFFECT OF THE DECISIONS

In recent years, contractors applying for injunctive relief to restrain the calling of bank guarantees have been quite successful. Decisions such as *Pearson Bridge* have allowed injunctive relief to contractors on the basis that unless a clause expressly permits recourse to security, an implicit prohibition exists denying the principal a right of recourse.

The decisions in *Fletcher Construction* and *Bachmann* arguably call into question these decisions. In future, unless clauses of the contract expressly prohibit recourse to security other than in clearly specified circumstances, the courts may be more inclined to determine that the commercial purpose of the contract is to permit the owner to have recourse to the security, especially where it is unconditional in nature.

While it is arguable that *Fletcher Construction* and *Bachmann* are distinguishable on the basis that they dealt with security in the form of standby letters of credit, practitioners and contractors should be aware that in future the courts may apply more stringent tests before granting injunctive relief. ❑