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for the NSW Law Society

Specialist Accreditation Programme 2020

Commercial Stream

RESTRAINING CALLS ON BANK GUARANTEES

Contents and References/ Citations

- References to "*Jacobs*", are to my loose leaf service *Injunctions: Law & Practice*, published by Thomson Reuters. Case law citations are in that service; and as such, I will not burden this paper with those citations, where I extract the key principles.

  However key cases have their citations at the end of the slides.

TOPICS COVERED IN THIS SEMINAR

- What exactly is a “bank guarantee”?
- What is the relevance to tactics of whether a “bank guarantee” is viewed as a risk allocation device?
- *Bachman* and *Clough* line of authority: the approach to construction/interpretation is that bank guarantees/LC’s are “risk allocation” devices
- *Kawasaki NSWCA*: steps back from *Bachman* towards general principles of construction; assists beneficiaries seeking to enjoin a call

TOPICS COVERED IN THIS SEMINAR

- Future trends
- Citations / references
- Letters of credit are not covered in this paper but are covered in *Jacobs*

WHAT IS A BANK GUARANTEE?

- When a contract such as a construction contract calls for the provision of a “bank guarantee”, the document called for is not, strictly speaking, a guarantee.
- A guarantee is (generally speaking) a promise by one person (the surety) to pay a creditor if the primary debtor does not pay.
- The documents contemplated in this area of the law are written instruments embodying a promise by a bank or some other surety e.g. a parent company , to a person (such as a head contractor) who may only have to assert, *bona fide*, an entitlement to make the call and the documents (whether called a bank guarantee or letter of credit) may thus serve the purpose of being a *risk-allocation device* to determine which party is out of pocket whilst a dispute is on foot.

WHAT IS A BANK GUARANTEE?

- The words “bank guarantee” are used not to describe the identity of the issuing party, but rather to suggest its unconditional nature. This is important to two matters.

  First, it is relevant to the construction of the agreement.

  Second, it is relevant to the *balance of convenience, if an injunction is sought to restrain or countermand a call.*

  Jacobs [7: 10]

REASONS FOR ANTIPATHY OF COURTS TO INTERVENE

- There was once a general judicial antipathy to interfere where beneficiaries call on bank guarantees and letters of credit. Some of those reasons were articulated in *Hortico*

  "Although this Court is a court of equity and concerns itself with equitable remedies, it is also a court through which most of the commercial paper in the South Pacific flows. It is a court which has always recognized that there is a time to interfere in commercial activities, but that more often than not, commercial life is better served by a "hands off" policy on behalf of the courts. This policy has clearly been maintained with respect to bank guarantees and commercial letters of credit. It is also clear that equitable doctrines which were invented to protect the gullible and uneducated from predators are not necessarily to be applied in transactions between merchants or members of the commercial community in their ordinary trading……."

CLOUGH

- The proposition that courts were reluctant to intervene in calls on bank guarantees and like documents, became closely associated with *Clough* (2008) FCAFC; discussed more fully at *Jacobs* [7.200]

- *Clough* reasoning is consistent with UK cases such *Cargill* [1998] UK Court of Appeal

THE *PERSON BRIDGE* LINE OF AUTHORITY

- On the other hand, there is a line of cases associated with *Pearson Bridge* (1982) which held that where*, as a matter of construction*, a contract contains an *implied negative stipulation* that such a call can only be made where the beneficiary demonstrates an underlying entitlement, then that affords a basis for intervention, at least where the call has not yet been made or, if made, not yet acted on.
- Byrne J, writing extra-judicially, pointed out that there developed an irreconcilable conflict between cases such as *Pearson Bridge* and cases such as *Bachmann*

SEARCHING FOR A THIRD WAY

- In a 2017 update to *Jacobs*, I posited that:

  (i) both the *Clough* and *Pearson Bridge* approaches to construction were , with respect, strained, in an attempt to give effect to two different and equally cogent policy considerations: the desire not to fling sand in the wheels of commerce and the desire to ensure fair play in commerce;

- (ii) the proper balance would include weighing the following factors:

  the applicant should be required to undertake to the court that the bond will be kept on foot until (at least) the end of the trial/arbitration;

  the applicant ought undertake to prosecute its case with expedition; a similar undertaking ought be extracted from the respondent.

- (iii) before a call is allowed, the beneficiary should have to demonstrate more than mere bona fides, but also how it will suffer prejudice if the call is countermanded. Risk allocation by way of actual payment under the security should only be given effect to if the beneficiary can identify with precision the risk it faces of being out of pocket, pending resolution.

TACTICAL ADVANTAGE TO BENECIARY WHEN *CLOUGH* APPROACH IS TAKEN

- Critical aspects for injunctions for an approach whereby a bond/guarantee is a risk allocation device, is that it favours submissions that the guarantee is:

  (i) in the category of 'pay now, argue later' instruments such that the issuing party's liability to respond to a claim under them is not subject to any defence, set-off or counterclaim: see *JKC* [2020] para [3]; and

  (ii) that refusing an injunction to restrain a call, carries with it the lower risk of injustice:

  Sugar Australia (2015) VSCA at [67].

  See the further observations of Hasluck J in *Roehampton Developments (2000) at* [101].

THE UNBEARABLE PROSPECTS OF ADVERSE COSTS; and sand in the wheels of commerce

- In *Fletcher Construction* 1998 VR , Calloway JA warned that it might be appropriate to award solicitor/client costs when a grantor fails to obtain an injunction restraining payment on an irrevocable standby letter of credit:

  "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."

  This is a serious enough consideration to bear in mind in any application for interim relief ; but even more so when the subject matter is a letter of credit or bank guarantee **("LC").**

  Practice tip: when considering an application for an injunction to restrain or countermand a call, advise as to this apparent rule of practice – and make a careful file note!

EXCEPTIONS TO THE *CLOUGH* PROPOSTION

Prior to the reading down of *Clough* in cases culminating *in Kawasaki* [2017], there were three recognised exceptions to the judicial antipathy to enjoin the call on a bank guarantee, and these are as follows:

(i) where the party in whose favour the performance guarantee has been given, has acted fraudulently;

(ii) where the party in whose favour the performance/bank guarantee has been given has acted unconscionably in contravention of s 51AA of the TPA (now contained in s 20 and s 21 of the *Australian Consumer Law*);

(iii) whilst the court will not restrain the issuer of a performance guarantee from acting on an unqualified promise to pay:

> "if the party in whose favour the bond has been given has made a contract promising not to call upon the bond, breach of that contractual promise may be enjoined on normal principles relating to the enforcement by injunction of negative stipulations in contracts. *Reed Construction Services* 15 BCL at 164"

See further *Jacobs* [7.150]

KAWASAKI [2017] NSWCA

- The occasion arose for the NSW Court of Appeal to review the landscape in this regard in *Kawasaki Heavy Industries Ltd v Laing O'Rourke Australia Construction Pty Ltd* (2017) 96 NSWLR 329; [2017] NSWCA 291 and where it was unanimously concluded at [60] that:

  "*Clough* does not stand for the proposition that there is a special rule of construction relating to all contracts in which there is a reference to a performance bond."

  As observed at [63] of *Kawasaki*, this understanding of *Clough* is consistent with the following judgments:

  -that of Macfarlan JA (with whom Campbell JA agreed) in *Lucas Stuart* [2010] NSWCA 283 at [34] and [37] – [43];
  -*Universal Publishers* [2013] NSWSC 2021 at [58] – [61];
  -*CPB Contractors* [2017] WASCA at [87] – [89].

  See more fully [7.230.4] of *Jacobs*

Kawasaki (contd)

- This brings NSW (*Kawasaki*) in line with Western Australia (*CPB)*.

As the discussion both immediately above and more fully below demonstrates, more recent cases have suggested that the unconditional nature of a financial institution's promise to pay the principal has 'limited relevance' to the construction of the underlying contract and could be seen as serving merely the purpose of protecting the principal from the risk of the contractor's insolvency.

Kawasaki: putting the constructional cart before the horse

- *Kawasaki* [2017] NSWCA afforded the opportunity for the New South Wales Court of Appeal to consider the appropriate constructional approach to bank guarantees & performance bonds.

At [59], the court observed that describing a performance bond as a being by its very nature a “risk allocation device”, is a description which “expresses a conclusion after a process of construction has been worked through and does not, of itself, provide any real assistance in addressing the question here”.

Kawasaki (contd)

- And at [60], their honours stated that *Clough* [2008] FCAFC:

  "does not stand for the proposition that there is a special rule of construction relating to all contracts in which there is a reference to a performance bond".

  The NSW Court of Appeal then cited from *Clough* (see *Jacobs* [7.225]) and observed at [62] that those paragraphs apply "when, *on the correct construction of the contract between the parties*, it may be concluded that there is "an agreed allocation of risk as to who is to be out of pocket pending resolution of the dispute about breach".

Kawasaki: facts

- Kawasaki and Laing O'Rourke were parties to a contract with a head contractor, JKC, which had been retained to install a cryogenic tank near Darwin. Each of Kawasaki and Laing O' Rourke (LOR) were to provide part of the work required to be performed by JKC. They entered into a number of inter related agreements, relevant features of which were as follows:

  (i) there was a regime for the determination of *all* disputes by international arbitration in Singapore (cl 19 of the Consortium Agreement);
  (ii) that regime allowed for interlocutory relief to be sought from the court;
  (iii) Kawasaki agreed to provide the performance bonds and advance payment bonds to JKC, which JKC required from each of Kawasaki and LOR;
  (iv) LOR provided certain bonds to Kawasaki (i.e. not directly to the head contractor, JKC). The form of the bonds that needed to be provided, were attached to the contract.

  The bonds totalled almost $50m, so a significant amount was at stake.

Kawasaki (contd)

- Pausing, here one sees that the facts of the case take it out of the usual scenario where there is a single sub-contractor which provides a performance or like bond to a head contractor.

  There was a blowout in time and completion of the cryogenic project was delayed.

  Kawasaki and LOR fell into dispute and even though JKC, the head contractor, had not called on the bonds provided by Kawasaki, Kawasaki called on the performance bonds issued to it by LOR.

  LOR obtained an injunction from the Supreme Court , restraining Kawasaki from calling on the bonds on the basis that there was a serious question to be tried about whether Kawasaki was entitled to call on the bonds in circumstances where JKC had not called on the bonds provided to it by Kawasaki.

Kawasaki (contd)

- When the injunction was more fully argued before the primary judge, Kawasaki argued that its entitlement to call on the bonds was not fettered, because of *Clough*-type reasoning that security bonds were risk allocation devices.

The learned primary judge rejected Kawasaki's argument and held, as a matter of contractual construction, there was a serious question to be tried as to whether the key provision, cl 14, should be construed as making Kawasaki's entitlement to call on the surety bonds conditional upon JKC first calling on the Kawasaki Bonds – that is, that they were "back to back" bonds: [82]. His Honour intimated at [60] that this was "strongly arguable" as against Kawasaki.

Kawasaki (contd)

- The NSW Court of Appeal basically agreed with the above in its analysis. See e.g. [68] – [79] where their Honours emphasised that it all depended on the obligation or liability of LOR intended to be secured by the bonds: did they secure LOR's obligations to do the work; or did they secure against JKC making a call on Kawasaki ? Their honours on appeal agreed with the primary judge that on a true construction of the complex web of interrelated agreements, it was the latter.

RELEVANCE OF AN ARBITRATION CLAUSE: balance of convenience

- The primary judge gave six reasons for his conclusion that the balance of convenience favoured the continuation of the injunction including that:

  "no arbitral tribunal has yet been established to deal with the underlying dispute. Laing O'Rourke could not at this time approach the arbitral tribunal to seek an order restraining Kawasaki from calling on the bonds."

  - A dissolution of the injunction in these circumstances would see Laing O'Rourke "forever lose" the right to restrain a call on the surety bonds: [89];

LOOKING AHEAD: NSW & WA

Kawasaki has been considered in the following cases:

- *Siemens v Bulgana* [2019] VSC 771: this case is interesting as it considered whether a court , on an interim application to restrain a call, ought decide questions of the true construction of the contract/ guarantee, “as if” upon a final basis.
- *JKC* [No 2] [2020] WASCA:

  CH2M, the Subcontractor contracted with the head contractor, JKC to carry out works relating to the construction of an LNG power plant - a huge project. CH2M had to provide 3 forms of guarantees; the relevant ones for the case were bank and parent company guarantees.

  Disputes broke out, and the bank guarantee was called on – there was no dispute in the curial proceedings about that.

JKC WASCA [2020]

- The focus of the curial proceedings was (in essence) whether the Parent Company Guarantee was a risk allocation device/"as good as cash"; or (unlike the bank guarantees) was contingent on there first being a breach found on the part of CH2M and hence a liability triggered on it (CH2M) as the primary party responsible, before the Parent Guarantee was enlivened.

- This was the perfect platform to consider the correct constructional approach to guarantees and performance bonds; and underscores the *Kawasaki* approach applies even more where the guarantee is issued by a Parent Company as apposed to a bank. The majority characterised JKC's approach as "no more than a sloganistic bootstrap argument…": [234] - [235].

CITATIONS

- *Cargill International SA v Bangladesh Sugar & Food Industries Corp* [1998] 1 WLR 461; [1998] 2 All ER 406
- *CPB Contractors Pty Ltd v JKC Australia LNG Pty Ltd (No 3)* [2017] WASCA 132 at [87] – [89]
- *Clough Engineering Ltd v Oil and Natural Gas Corporation Ltd* (2008) 249 ALR 458; [2008] FCAFC 136
- *Fletcher Construction Australia Ltd v Varnsdorf Pty Ltd* [1998] 3 VR 812 at 831 per Callaway JA
- *Hortico (Australia) Pty Ltd v Energy Equipment Co (Australia) Pty Ltd* (1985) 1 NSWLR 545 incl at 553-554
- *JKC AUSTRALIA LNG PTY LTD -v- CH2M HILL COMPANIES LTD [No 2]* [2020] WASCA 112

CITATIONS

- *Kawasaki Heavy Industries Ltd v Laing O'Rourke Australia Construction Pty Ltd* (2017) 96 NSWLR 329; [2017] NSWCA 291
- *Lucas Stuart Pty Ltd v Hemmes Hermitage Pty Ltd* (2010) 5 BFRA 76; [2010] NSWCA 283; at [34] and [37] – [43]
- *Pearson Bridge (NSW) Pty Ltd v State Rail Authority* (NSW) (1982) 1 Aust Construction LR 81
- *Roehampton Developments Pty Ltd (in liq) v FAI General Insurance Co Ltd* [2000] WASC 235 at [101]
- *Siemens v Bulgana* [2019] VSC 771
- *Sugar Australia Pty Ltd v Lend Lease Services Pty Ltd* (2015) BCL 407; [2015] VSCA 98 at [67]
- *Universal Publishers Pty Ltd v Australian Executor Trustees Ltd* [2013] NSWSC 2021 at [58] – [61]