INJUNCTIVE RELIEF AGAINST CALLS MADE ON UNCONDITIONAL BANK GUARANTEES

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Introduction

1. Unconditional bank guarantees are commonly provided in the construction industry, by contractors to principals either as security for the due and faithful performance of the contract work or more commonly as security in lieu of retention monies which would otherwise be deducted from progress payments. [1]

Nomenclature

2. The description "bank guarantee" was criticised by Barwick CJ in *Wood Hall Limited v Pipeline Authority (1979) 141 CLR 443, 445*, as a misnomer:

> "*The description "guarantee" commercially applied to the bank documents in this case is, in my opinion, a complete misnomer. The relationship of the bank to the owner or to the contractor has, in my opinion, none of the elements of suretyship. The circumstances that the purpose of the cash deposit or its documentary substitute is as a security for the due performance of the contract or the contract work does not, in my opinion, involve either the bank or the owner in any of the obligations or rights of suretyship".*

3. In *Hortico (Aust) Pty Ltd v Energy Equipment Co (Aust) Pty Ltd (1985) 1 NSWLR 545, 551,* Young J explained the bank guarantees as follows:

> *"I do not really believe it matters what label one puts on the document, though probably "performance bond" is the nearest label one can get. A performance bond is a promise by a bank that it will pay, usually on production of documents, without reference to any other contract there may be between the parties. In Edward Owen Engineering Limited v Barclays Bank International Limited [1978] QB 159 at 170-171, Lord Denning MR said:*
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> > *"……. these performance guarantees are virtually promissory notes payable on demand …… the performance guarantee stands on a similar footing to a letter of credit. A bank which gives a performance guarantee must honour that guarantee according to its terms. It is not concerned in the least with the relations between the supplier and the customer; nor with a question whether the supplier has performed his contracted obligation or not; nor the question whether the supplier is in default or not. The bank must pay according to its guarantee, on demand, if so stipulated, without proof or conditions. The*

[1] Refer for example the case of *Wood Hall Limited v Pipeline Authority (1979) 141 CLR 443* where both types of these bank guarantees were provided by the contractor. The case of *A.D.I. Limited v State Electricity Commission of Victoria (1997) 13 BCL 337* was another case where both a performance guarantee and a retention guarantee were provided to the principal.

only exception is where there is a clear fraud of which the bank has noticed".

4. French CJ in *Simic and Others v New South Wales Land and Housing Corporation and Others (2016) 260 CLR 85, 89, [2]*, described bank guarantees as follows:

> *"Performance bonds, sometimes misleadingly called "bank guarantees", are typically issued by a financial institution at the request of one party to a contract in favour of another party pursuant to a requirement of the contract. They are frequently used in relation to construction contracts. They take the form of a promise by the issuing institution that it will pay, to the beneficiary named in the bond, an amount up to the limit set out in the bond unconditionally or on specified conditions and without reference to the terms of the contract between the parties".*

Letters of credit and bank guarantees

5. There have been two significant Victorian cases where the form of security was an irrevocable standby letter of credit as opposed to a bank guarantee - refer *Fletcher Construction Australia Limited v Varnsdorf Pty Ltd [1998] 3 VLR 812;* and *Bachmann Pty Ltd v BHP Power New Zealand Limited [1999] 1 VR 420.*

6. In *Fletcher v Varnsdorf* Callaway JA said (pg 830):

> "*First, the analogy between bank guarantees and ordinary, as opposed to standby, letters of credit has been questioned. …….. I would acknowledge that there is a difference, which may have to be examined in more detail on some future occasion. It is easy to see why a confirmed irrevocable letter of credit in connection with an international sale of goods is functionally equivalent to money. The seller parts with the goods, or the documents, in return for the benefit of the letter of credit. The same is true where a person has foregone the benefit of money in hand accepts a guarantee in lieu. …….. There is a much more remote analogy where the proprietor under a building contract accepts the risk of non-performance in return for a guarantee ……"*

7. Notwithstanding what Callaway JA said, neither he nor the other members of the Court of Appeal in *Fletcher v Varnsdorf* suggested that different principles apply in relation to the operation or effect of irrevocable letters of credit and bank guarantees.

8. In *Simic* at [5], French CJ observed that:

> *"Principles governing the legal effect and operation of performance bonds are similar to those applicable to letters of credit".*

9. *Ellinger and Neo* in *The Law and Practice of Documentary Letters of Credit,* [2] describe the emergence of performance bonds in the second half of the twentieth century:

> *"Traditionally, letters of credit were considered the only available bankers' irrevocable promise, except those enshrined in negotiable instruments. But a new category became prevalent during the second half of the twentieth century. It encompasses performance bonds and first-demand guarantees issued by banks in the context of international trade transactions as well as in some domestic transactions such as building contracts and margin trading contracts."* [3]

10. The authors also described the emergence amongst American banks of a similar facility known as a standby credit which achieved the same objective as a performance bond:

> *"American banks, which traditionally did not have the power to effect guarantees, use a similar facility known as a standby credit. From a practical point of view, a standby credit achieves the same object as a performance bond. Conceptually, the difference between the two facilities is that the standby credit uses the terminology of letters of credit and not of guarantees".*[4]

11. The authors describe the historically based differences between stand-by credits and performance bonds:

> *"Despite their legal similarities, there are differences in banking practice relating to stand-by credits as compared to other types of independent guarantees. Some of these can be traced back to their distinct historical origins. Although they are functionally similar, the stand-by credit evolved as a type of a letter of credit whilst the other forms of independent guarantees such as performance bonds developed as a variant of the suretyship guarantee. This is sometimes reflected in the terminology used, although usage is not consistent. Say for instances, a transaction involving a stand-by credit might refer to the issuer/issuing bank and the applicant/account party, whereas in an undertaking labelled as an independent guarantee or a demand guarantee, the same parties might be referred to as the principal and guarantor respectively".* (footnotes not included)[5]

<u>The use of letters of credit in international trade and the influence that may have had upon the Courts' approach to performance bonds</u>

12. John Lurie in his learned article *On-Demand Performance Bonds: Is Fraud the only ground for restraining unfair calls?* [2008] The International Construction Law Review, 443, 447-448 made the following observations concerning the influence upon the law governing bank guarantees, of the historical use of letters of credit in the conduct of international trade in the United Kingdom:

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[2] Refer Peter Ellinger and Dora Neo, *The Law and Practice of Documentary Letters of Credit,* Hart Publishing, Oxford and Portland Oregon 2010, at page 5
[3] Ibid
[4] Ibid
[5] Ibid at page 304

"The law governing on-demand performance bonds is unsettled. It is therefore difficult to identify a coherent body of principles applicable to the grant of injunctive relief. Much of the difficulty arises from the tension between two competing considerations:

(i) The importance attached to England's reputation as a centre of international trade and commerce; and

(ii) The need to ensure that the pursuit of international trade and commerce does not compromise England's reputation for upholding the principles of justice.

The result of this tension is that, on the one hand, too much Court intervention may interfere with the progress of trade and commerce. On the other hand, England's reputation as a law abiding country may suffer if trade and commerce is simply left to its own devices.

The emphasis on international trade and commerce is highlighted by the following remarks of Lord Denning MR in relation to the enforcement of a letter of credit:

> *The striking fact is that Courts here in London are asked to enforce a letter of credit opened by buyers in Kuwait in favour of sellers in the United States for payment in the United States. But this is because London is an important centre of international trade. Merchants from all other the world come here to settle their disputes. Banks from all the world over have branches here to receive and make payments. So far as we can be of service to international trade, we will accept the task and fulfill it to the best of our ability.*

It is not surprising that, when faced with disputes relating to payment under on-demand performance bonds, the English Courts have often been reluctant to intervene in the absence of a real threat to justice. This arguably explains their traditionally conservative approach where fraud was once considered the only exception justifying intervention. It may also explain the reluctance of Courts, lawyers and commentators to openly acknowledge the existence of exceptions other than fraud. However, an examination of the cases, which follows in this paper, reveals that many of the exceptions which apply in Australia are equally applicable in England.

The great bulk of cases emanating from the English Courts involve international disputes. Conversely, many of the Australian cases relate to purely domestic disputes. At the same time, it has been observed that international trade and commerce is less influential in Australian than it is in England. The Australian Courts are therefore less affected by matters of international trade and commerce. These differences perhaps explain the more open acknowledgement of Australian Courts, lawyers and commentators to exceptions other than fraud.

Matters of trade of and commerce, both international and domestic, have played a significant part in shaping the law of on-demand

performance bonds. However, principles of fairness and equity are increasingly finding favour with English and Australian Courts such that the prospects of injunctive relief are now less likely to be averted by commercial considerations.

Does this mean greater levels of Court intervention are justified where the dispute is purely domestic? After all, this approach has generally been adopted in the context of arbitration. It might be suggested that all on-demand performance bonds are instruments of international trade and, therefore, the nature of the dispute is irrelevant. However, international considerations are surely less important where the dispute is purely domestic. Where construction projects and their participants are all based in the one country, the relevance of international trade and commerce can arguably be discounted" (footnotes not included)

The contracts associated with unconditional bank guarantees issued in respect of construction projects

13. There are typically three contracts made in relation to a bank guarantee provided by a contractor under a construction contract:

(a) the contract between the contractor and its bank under which the bank agrees to issue the bank guarantee in favour of the principal, and in consideration of which, the applicant agrees to pay the bank's costs and fees, and to reimburse the bank in the event that the guarantee is called upon by the principal;

(b) the underlying construction contract between the contractor and principal under which the contractor is required to provide a performance guarantee and/or a bank guarantee in lieu of retention. The construction contract also details the circumstances in which the principal may call upon the bank guarantee;

(c) the contract between the bank and principal as the beneficiary under the guarantee. The question arises as to whether this contract fails for want of consideration moving from the principal to the bank. However, the Courts have been resolute in refusing to entertain such a proposition, based, it seems upon the importance over a very long time of the use of letters of credit as a well established form of trade financing in international commerce. [6] In *Simic* Gageler, Nettle and Gordon JJ said in their joint judgment:

"77. *The Undertakings contain a contractual promise to pay, not under seal. They are contracts, although of a specific kind. When and how a contractual promise to pay, not under seal, in favour of a named principal establishes a binding contract has been the subject of debate and discussion since at least the first half of the 20th century. For present purposes, however, that debate and discussion may be put to one side. Consistent with established banking practice, no party contended that the Undertakings were to be construed otherwise than in*

[6] Refer Hamzah Malas & Sons v British Imex Industries Limited [1958] 2 QB 127, 129

> *accordance with ordinary principles of contract construction." (footnotes not included)*

Ordinary principles of contract construction apply in relation to bank guarantees

14. As is made clear in the above excerpt from the joint judgment in *Simic*, the ordinary principles of contract construction apply in relation to bank guarantees.

15. With respect to the vexed question of whether evidence of surrounding circumstances is admissible in construing bank guarantees, Gageler, Nettle and Gordon JJ said in *Simic*:

> *"78. The proper construction of each Undertaking is to be determined objectively by reference to its text, context and purpose. As was stated in Electricity Generation Corporation v Woodside Energy Limited:*
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> *"[T]he objective approach [is] to be adopted in determining the rights and liabilities of parties to a contract. The meaning of the terms of a commercial contract is to be determined by what a reasonable businessperson would have understood those terms to mean ……. [I]t will require consideration of the language used by the parties, the surrounding circumstances known to them and the commercial purpose or objects to be secured by the contract. Appreciation of the commercial purpose or objects is facilitated by an understanding "of the genesis of the transaction, the background, the context [and] the market in which the parties are operating." (footnotes not included)*

16. What the Justices said at paragraph [78] of *Simic* is important because it is further support for the contention that the "*true rule*" ennunciated by Mason J in *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales (1982) 149 CLR 337, 352,* does not operate to exclude evidence of surrounding circumstances in relation to the construction of commercial contracts.

17. In *Codelfa*, Mason J famously said:

> "*The true rule is that evidence of surrounding circumstances is admissible to assist in the interpretation of the contract if the language is ambiguous or susceptible of more than one meaning. But it is not admissible to contradict the language of the contract when it has a plain meaning".*

18. The statement by Mason J has given rise to a litany of cases where Courts have wrestled with the question whether evidence of surrounding circumstances is not admissible unless the language is ambiguous or susceptible of more than one meaning.

19. In *Mount Bruce Mining Pty Ltd v Wright Prospecting Pty Ltd (2015) 256 CLR 104, 116-117, [46]-[51]*, French CJ, Nettle and Gordon JJ set out the

legal principles concerning the interpretation of written contracts, noting at [52] that:

> *"These observations are not intended to state any departure from the law as set out in Codelfa Constructions Pty Ltd v State Rail Authority (NSW)".*

20. Unfortunately the statement by the Justices of the applicable legal principles did not provide certainty as to whether there is an "*ambiguity gateway"* to the admissibility of evidence of surrounding circumstances.

21. The clarification provided by the members of the joint judgment in *Simic*, was repeated by the members of the High Court in *Ecosse Property Holdings Pty Ltd v Gee Dee Nominees Pty Ltd [2017] HCA 12; 91 ALJR 486*, where the Justices said that in the case of commercial contracts evidence of surrounding circumstances is admissible whether or not the language is ambiguous (refer Kiefel, Bell and Gordon JJ at [16] and Nettle J at [73]).

22. Based upon *Simic* and *Ecosse* it can be stated with some degree of confidence that with respect to bank guarantees, evidence of the circumstances surrounding the issuing of the bank guarantee is admissible in construing the document.

23. However it is only the circumstances surrounding the issuing of the bank guarantee that are relevant in construing the document. The circumstances surrounding the making of the underlying building contract are not relevant or admissible. In the joint judgment of Gagler, Nettle and Gordon JJ in *Simic* they said that the building contract which was expressly referred to in the guarantee was irrelevant or of not assistance in construing the guarantee:

> *"85. Second, although the "contract or agreement" referred to in the third paragraph of each Undertaking provides a link to the Corporation which, as will be seen, is significant for the purposes of rectification, it is either irrelevant or of no assistance for the purposes of construction. That is because, subject to fraud perpetrated by a beneficiary, an instrument of this nature (unconditional promise to pay on demand) is independent of any underlying transaction and any other contract. That principle - the principle of autonomy - reflects that those instruments, by their nature, stand alone. Not only are they equivalent to cash, but, by their terms, they also required that the obligations of the issuer are not determined by reference to the underlying contract. The principle of autonomy dictates that the surrounding circumstances and commercial purpose of the Construction Contract are different from those of the Undertakings". (footnotes not included)*

<u>An injunction sought by a contractor to restrain the bank from honouring an unconditional bank guarantee, and an injunction sought by the contractor to restrain the beneficiary Principal calling up the guarantee.</u>

24. The cases dealing with unconditional bank guarantees issued in relation to Construction Contracts fall into two categories - cases in which a contractor seeks to restrain the bank from honouring a demand upon the

guarantee by the beneficiary Principal, and cases in which a contractor seeks to restrain the beneficiary Principal calling up the guarantee.

25. In *Fletcher v Varnsdorf* Callaway JA (at page 826) described an important difference between the two categories:

> "*There is nevertheless an important difference between restraining a bank from honouring a guarantee and restraining the beneficiary from calling upon it. In the former case the moving party seeks to prevent the bank from performing its contract; in the latter case the moving party seeks to prevent the beneficiary from breaching a provision of the underlying contract."*

26. The remainder of this paper deals with these two categories of case.

The principles regarding the granting of an interlocutory injunction

27. In *Sugar Australia Pty Ltd v Lend Lease Services Pty Ltd [2015] VSCA 98, [108],* Kaye JA summarised the principles governing the grant of an interlocutory injunction:

(a) the applicant must demonstrate that there is a serious issue to be tried as to its entitlement to relief at trial. The applicant must make out a prima facie case as to its entitlement to that relief, in the sense that it must show a sufficient likelihood of success at trial to justify, in the circumstances, the preservation of the status quo pending trial;

(b) the applicant must also demonstrate that if interlocutory relief is not granted, it is likely to suffer injury for which an amount of damages would not be an adequate remedy; and

(c) that the balance of convenience favours the granting of an injunction.

Injunctions sought by a contractor to restrain the bank from making payment to the beneficiary Principal in response to a call upon the guarantee by the Principal

28. Where a bank issues a bank guarantee to a beneficiary principal under which the bank unconditionally undertakes to the principal that it will pay on demand any sum up to the limit specified therein, a Court will not enjoin the principal from having recourse to the guarantee save for the following exceptions:

(a) **Fraud** - where the principal has acted fraudulently, - refer *Clough Engineering Limited v Oil and Natural Gas Corporation Limited (2008) 249 ALR 458, 478 [77];* and *Dedert Corporation v United Dalby Bio-Refinery Pty Ltd [2017] VSCA 368, [102];*

(b) **Unconscionability** - where the principal has acted unconscionably in making the demand - refer *Olex Focas Pty Ltd v Skoda Export Co Limited [1998] 3 VR 380, 400-403;* and *Clough at 478 [77].* This may include unconscionable conduct under s20 of the Australian Consumer Law, formerly s.51AA of the Trade Practices Act - refer *Olex Focas at 400-403;* and *Dedert at [102].* Whether this exception would also include a general law form of unconscionability or

equitable unconscionability, is uncertain - refer *Olex Focas at 400-403*. It is interesting to note that in *Olex Focas* Batt J made reference to *Wood Hall Limited v The Pipeline Authority (1979) 141 CLR 443 at 449-450,* where Gibbs J said that there was evidence suggesting that The Pipeline Authority in making the demands, was acting pursuant to a "*strategy"* to put pressure on the contractor in the hope that the dispute between the parties might be settled more advantageously to the Authority. Batt J (at page 403) intimated that the apparent equanimity with which Gibbs J noted this in his judgment, would suggest that such conduct would not amount to unconscionable conduct for the purposes of this exception;

(c) **Illegality of the bank guarantee** - in *Fletcher v Varnsdorf* Callaway J said that illegality affecting the bank guarantee itself "*such as an exchange contract regulation prohibiting its being called upon"* (at page 828), would entitle a bank to withhold payment in respect of a demand made by the principal upon the bank guarantee. Callaway J expressly reserved "*for another day",* the question whether illegality of the underlying construction contract would be an impediment to calling upon the bank guarantee;

(d) **The demand not in compliance with the requirements stipulated in the bank guarantee** - this is more a requirement to be observed by the principal in making a demand upon the bank guarantee, rather than an exception. There are two relevant principles relating to this requirement, the principle of strict compliance and the principle of autonomy. French CJ explained both of them in *Simic* at [6]-[8]:

> *"6. Two complementary principles apply to letters of credit and performance bonds alike - the principle of strict compliance and the principle of autonomy or independence. According to the principle of strict compliance, a bank paying on a letter of credit or performance bond only has an obligation to do so and only has an entitlement to claim indemnity for the performance of that obligation if the conditions on which it is authorised and required to make payment are strictly observed. A demand for payment cannot be accepted on the basis that near enough is good enough. The principle of autonomy requires that the letter of credit or performance bond be treated as independent of the underlying commercial contract. The principles of strict compliance and autonomy serve the immediate commercial purpose of such instruments of providing an equivalent to cash and the further purpose of performance bonds of allocating risk between the parties to the underlying contract until their dispute, if there be one, is resolved.*
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> *7. The strict compliance principle requires that the party making demand on a performance bond be the party named in bond as the beneficiary and that any conditions on payment set out in the bond are satisfied. It does not describe an obligation imposed on the issuing or accepting institution. Rather, it delimits the issuing institution's obligation to make payment and, correspondingly its right to claim on an indemnity promise by the party requesting the issue of the*

> *bond. Where a performance bond is expressed, as in the present case, to be unconditional, strict compliance at least requires that the beneficiary making demand for payment be the beneficiary named in the bond. Unlike the autonomy principle, it is not a rule of construction of the bond.*
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> *8. The autonomy principle requires that the obligations of the issuing or accepting bank under the bond not be read as qualified by reference to the terms of the underlying contract. That said, it does not prevent a party to a contract who procures the issue of a performance bond claiming as against the beneficiary that the beneficiary's action in calling upon the bond is fraudulent or unconscionable or in breach of a contractual promise not to do so unless certain conditions are satisfied. However, this is not such a case. The primary question in this case concerns the obligation of the issuing bank to pay on demand of a party claiming to be the beneficiary which, due to error on the part of the requesting party, is not the beneficiary named in the bond."*

In *Simic* the New South Wales Land and Housing Corporation ("the Corporation") entered into a building contract with Nebax Construction Australia Pty Ltd ("Nebax"). Under the terms of the contract Nebax was required to procure the issuing of an unconditional bank guarantee in accordance with the form attached to the contract. Mr Simic, a director of Nebax attended the ANZ Bank. In error, Mr Simic gave the details of the Corporation as the "New South Wales Land and Housing Department trading as Housing NSW (ABN 457 54121940)". This was a non-existent entity and the ABN was different from the Corporation's ABN. Based on the information provided, the ANZ Bank issued two unconditional Undertakings, both in the name of the non-existent beneficiary, and with an ABN different from the Corporation's ABN. During the course of the contract works, the Corporation made a demand on the ANZ Bank under each Undertaking. The bank refused to accept that a valid claim had been made and did not pay out on the demand. The High Court held that based upon the principle of strict compliance, the bank was not obliged to pay out in response to the Corporation's demand because the Undertakings were issued in favour of another named entity. And even though the "Contract or Agreement" referred to in the Undertakings provided a possible link to the Corporation (albeit that the contract number did not match the contract number in the Building Contract), the Court held that based on the autonomy principle, the obligations of the bank in respect to the Undertakings were to be determined by reference to the Undertakings alone, and not the underlying Building Contract. The members of the joint judgment noted in this regard that:

> *"85. ……. The principle of autonomy dictates that the surrounding circumstances and commercial purpose of the construction contract are different from those of the Undertakings".*

Accordingly, the Corporation failed upon its claim based upon the Undertakings in their unrectified form. However the Corporation was

successful in its equitable claim for rectification of the Undertakings. The Court held that all parties to the transaction intended that the Undertakings should enure to the benefit of the party with which Nebax entered into the construction contract, namely the Corporation.

Injunctions sought by the contractor to restrain the beneficiary Principal from calling upon the bank guarantee

29. The far more common scenario which occurs in relation to unconditional bank guarantees is where the contractor seeks to restrain the principal from making a demand upon the bank to pay out the guarantee amount. Many contracts require the principal to give the contractor a short period of written notice of its intention to have recourse to the guarantee. This enables the contractor to apply to the Court for injunctive relief should it wish to do so, prior to the bank paying out the guarantee sum.

30. Sometimes where notice is not required and the principal makes a demand upon the bank in respect of the guarantee, the bank will, in an attempt to assist its client, refuse to comply with the demand and will notify the contractor of the demand thus giving the contractor the opportunity to apply to the Court for an injunction enjoining the principal from making a demand upon the guarantee.

31. There are many reported cases dealing with applications made by contractors in the above circumstances.

32. The basis upon which a contractor seeks to restrain a principal from making a call upon the guarantee is invariably that the construction contract contains a fetter upon the principal's right to do so, and that there is a serious issue to be tried as to its entitlement to such relief at trial.

33. The many cases dealing with this issue include both standard form and bespoke contracts. Whilst the Court must construe the contract as a whole, the main focus of the Court's attention will be a relatively small selection of its terms.

34. The term requiring the contractor to procure an unconditional bank guarantee, the form of which will often be attached as a schedule to the contract, is obviously important.

35. But the terms of paramount importance are those which state the circumstances under which the principal is entitled to have recourse to the bank guarantee. On most occasions it is the wording of these clauses which is of vital importance in the determination of the injunction application.

36. Examples of these type of clauses are as follows:

    (a) *Pearson Bridge (NSW) Pty Ltd v State Rail Authority of New South Wales (1982) 1 Australian Construction Law Reports 81* - Clause 5.5 of the contract:

        "*5.5 Conversion of Security*

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."

(b) *Hughes Brothers Pty Ltd v Telede (1991) 7 PCL 210:*

"Availability 10.5 Any security provided by the Builder in terms of this Agreement shall be available to the Proprietor whenever the Proprietor may be entitled to the payment of monies by the builder under or in consequence of this Agreement ……";

(c) *Bachmann Pty Ltd v BHP Power New Zealand Limited [1999] 1 VR 420:*

"5.5 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 the security ……"

(d) *Clough Engineering Limited v Oil and Natural Gas Corporation Limited (2008) 249 ALR 458:*

"3.3.3 The company shall have the right under this guarantee to envoke the Banker's guarantee and claim the amount thereunder in the event of the Contractor failing to honour any of the commitments entered into under this contract ……."

(e) *ADI Limited and Bains Harding Limited v State Electricity Commission of Victoria (1997) 13 BCL 337:*

"4.3 If the Commission becomes entitled to exercise all or any of its rights under the Contract in respect of the Security Deposit, the Commission may convert into money or otherwise take the benefit of such part of the Security Deposit ……"

(f) *Barclay Mowlem Construction Limited v Simon Engineering (Australia) Pty Ltd (1991) 23 NSWLR 451:*

"5.6 Conversion of Security. 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 ……."

(g) *Sugar Australia Pty Ltd v Lend Lease Services Pty Ltd [2015] VSCA 98:*

"5.2 Any security provided by the Contractor in accordance with the Contract shall be available to the Principal whenever the Principal may claim (acting reasonably) to be entitled to:

(i) the payment of monies or an indemnity by the Contractor under or in consequence of or in connection with the Contract;
(ii) reimbursement of any monies paid to others under or in connection with the Contract; or
(iii) other monies payable by the Contractor to the Principal (whether by way of set-off or otherwise)."

(h) *Dedert Corporation v United Dalby Bio-Refinery Pty Ltd [2017] VSCA 368:*

> *"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.*
>
> *"39.7 The Principal may set-off any amount due and payable by the Contractor to the Principal against any amount that the Principal owes the Contractor under the Contract.*
> *If the monies payable to the Contractor insufficient to discharge the liability of the Contractor to pay such sum to the Principal, the Principal may have recourse to the security provided by the Contractor.*
>
> *39.9 Where, within the time provided by the Contract, the Contractor fails to pay the Principal an amount due and payable under the Contract, the Principal may have recourse to security under the Contract and any deficiency remaining may be recovered by the Principal as a debt due and payable from the Contractor to the Principal".*

Fletcher v Varnsdorf and its application in subsequent cases

37. The Victorian Court of Appeal's decision in *Fletcher Construction Australia Limited v Varnsdorf Pty Ltd [1998] 3 VLR 812* was significant in terms of its approach to determining applications by contractors to restrain Principals calling up bank guarantees. The approach by the Court in *Varnsdorf* has been applied by various appellate Courts throughout Australia.[7]

The facts in Varnsdorf

38. Varnsdorf entered into a contract with the Minister for Health of Victoria under which it agreed to provide thermal (steam) and electrical energy to six of Victoria's major public hospitals.

39. Varnsdorf engaged Fletcher to design and construct cogeneration plants to each of the hospitals. Under the design, gas fired turbine engines made by Rolls Royce were to be used in the generation of both steam and electricity for use by each of the hospitals.

40. Under the contract, Fletcher was to achieve Handover by the Date for Handover which in respect of the six hospitals was fixed at various dates between 25 September 1994 and 25 March 1995.

41. Handover was defined as the state of work when the cogeneration facility was complete and the level of performance called "hospital performance"

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[7] Ideas Plus Investments Limited v National Australia Bank [2006] WASCA 215; 32 WAR 467; Clough Engineering Limited v Oil and National Gas Corporation Limited (2008) 249 ALR 458; Lucas Stuart Pty Ltd v Hemmes Hermitage Pty Ltd [2010] NSWCA 283; Miwa Pty Ltd v Slanten Properties Pte Ltd [2001] NSWCA 297; 15 BPR 29, 545; Lucas Drilling Pty Ltd v Armour Energy Limited [2013] QCA 111; CR O'Donnell Griffin Pty Ltd v Forge Group Power Pty Ltd (rec and mgr appt) (in liq) [2016] QCA 214

was achieved. That level of performance required the plant to be capable of being used for its intended purpose.

42. Under clause 6.6 of the contract between Fletcher and Varnsdorf, Fletcher was required to provide security of $5m in the form of an unconditional undertakings in favour of Varnsdorf. Fletcher provided that security in the form of two irrevocable standby letters of credit, each in the sum of $2.5m. They were unconditional save for certain requirements for making a demand thereunder.

43. Under clause 3.13 of the contract, Fletcher agreed that if it did not reach Handover by the Date for Handover, it must pay Time Damages. Under clause 3.13, Varnsdorf was entitled to deduct Time Damages from any money due by Varnsdorf to Fletcher, and if that was insufficient, Fletcher was obliged to pay the balance within 10 days of a notice by Varnsdorf to Fletcher demanding payment. Clause 3.13 further provided that:

> *"If [Fletcher] fails to pay the balance within the ten Business Day period, the Owner may have recourse to [Fletcher's] security to obtain the balance".*

44. On 19 August 1997, Varnsdorf made a demand under clause 3.13 on Fletcher for payment of Time Damages in the net sum of $2,601,633.10. 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.

45. Fletcher then sought an interlocutory injunction to restrain Varnsdorf from taking steps to call upon the letters of credit.

46. The primary Judge dismissed Fletcher's application for injunctive relief. Fletcher's appeal to the Court of Appeal was dismissed.

The Court of Appeal's reasoning

47. As at the date of Fletcher's application, the parties had been involved in an arbitration for nearly 3 years. The substantive hearing had not commenced. Both the primary Judge and the Court of Appeal were satisfied that there were a number of serious issues to be tried concerning Varnsdorf's entitlement to Time Damages including whether Fletcher had satisfied the requirements for Handover, the calculation of Time Damages, and whether Varnsdorf had properly claimed Time Damages.

48. Fletcher's primary submission (at pg 818 L20) was that resort to the security under clause 3.13 was only available to Varnsdorf if and when its claimed entitlement to Time Damages was established by an arbitral award or by a judgment.

49. Varnsdorf's response (pg 818 L35) was that there was no express fetter 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.

50. Varnsdorf submitted that there were only two pre-conditions to making a call upon the letters of credit, first that a notice containing a demand had

been sent to Fletcher and second, that there had been a failure by Fletcher to pay the amount within 10 business days.

51. The resolution of the opposing arguments turned upon the proper construction of clause 3.13 and other relevant clauses of the contract.

52. The main judgment in the Court of Appeal was given by Charles JA. The first question that he considered was whether the Court should determine the proper construction of clause 3.13, or alternatively not determine it at the interlocutory stage, and go no further than making a finding that the proper construction of the question itself was one issue upon which there was a serious issue to be tried.

53. Charles JA (at pg 821 L20) said that as there was no suggestion by the parties that there was evidence of the factual matrix not presently available "*the Court should, in my view now decide the question of law involved in the interpretation of the contract*".

54. Having determined that the contract construction question should be decided by the Court, both Charles JA and Callaway JA articulated the critical question to be asked in determining the proper construction of the clauses of the contract relating to the provision of the letters of credit and the right of Varnsdorf to have recourse to them under clause 3.13(b). They said that the Court must determine whether the commercial purpose of the recourse provisions was limited to providing security to the principal, or whether the provisions also operated as a risk allocation device pending the final determination of the dispute, allocating that risk to the contractor.

55. If the commercial purpose of the recourse provisions was to serve both those purposes, then subject to any contractual qualification of limitation upon the circumstances in which recourse may be had, the Court would be satisfied that the parties intended that Varnsdorf would be entitled to call on the security notwithstanding that there was a genuine factual dispute and a serious issue to be tried as to whether Handover had been reached.

56. Charles JA said (pg 821 L35):

> *"The critical question in which this must decide is whether the relevant commercial purpose of the agreement was to provide security to Varnsdorf, so that a valid claim to damages (whether or not Time Damages) would be secured or whether clauses such as 3.13 made provision for an allocation of the risk between Fletcher and Varnsdorf - showing which party was to be out of pocket pending resolution of any dispute. If the contractual intention of the parties was the first of these of these alternatives, clause 3.13 would give Varnsdorf no authority to call on the letters of credit pending resolution of any dispute. On the other hand, if the second alternative were to be preferred, a question would remain whether there was any relevant qualification or prohibition affecting Varnsdorf's ability now to call on the security".*

57. Callaway JA said (pg 826 L40):

"There are broadly two reasons why the beneficiary may have stipulated for a guarantee. One is to provide security. If it has a valid claim and there are difficulties about recovering from the party in default, it has recourse against the bank. The second reason, which is additional to the first, is to allocate the risk as to who shall be out of pocket pending resolution of a dispute. The beneficiary is then able to call upon the guarantee even if it turns out, in the end, that the other party was not in default. ……. It is a question of construction of the underlying contract whether the guarantee is provided solely by way of security or as a risk allocation device. Remembering that we are speaking of guarantees in the sense of standby letters of credit, performance bonds, guarantees in lieu of retention monies and the like, the latter purpose is often present and commercial practice plays a large part in construing the contract. No implication may be made that it 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 the security should not be too readily construed to have that effect. As I have already indicated, they may simply refer to the kind of default which, if it is alleged in good faith, enables the beneficiary to have recourse to the security or its proceeds".

58. Charles JA (pg 821 L45) (with whom Batt and Callaway JJA agreed), was of the opinion that the terms of the construction agreement between Varnsdorf and Fletcher showed that the commercial purpose of the agreement was to provide an allocation of risk such that Varnsdorf was entitled under clause 3.13 to call on the security provided by Fletcher notwithstanding that there was a serious issue to be tried as to whether handover had been reached.

59. Charles JA's reasons were as follows (pgs 821-822):

(a) that it was "*of great importance"* that the form of security to be provided under the construction contract was "*in the form of an unconditional undertaking to pay in favour of Varnsdorf";*

(b) the trigger for Varnsdorf's right to call on the letters of credit under clause 3.13 arose if Fletcher did not reach handover by a certain date. The parties had by their agreement put in place a system whereby the Contract Administrator was appointed as independent certifier to determine whether Handover had been reached. The contract further provided that if the Contract Administrator incorrectly refused to certify Handover, that dispute would be finally resolved at arbitration or by agreement;

(c) clause 3.13(b) gave Varnsdorf the right to deduct Time Damages - it had the right of self help to deduct Time Damages from any money due from Varnsdorf to Fletcher;

(d) there was no qualification in clause 3.13 that resort to the security was that was only available in the event of Varnsdorf having an undisputed entitlement to Time Damages.

60. The other members of the Court agreed with Charles JA. Callaway JA added some further observations comparing letters of credit with bank guarantees (pgs 830-831)

61. Two of the more recent Victorian Court of Appeal decisions applying the approach taken in Varnsdorf are detailed below.

Sugar Australia Pty Ltd v Lend Lease Services Pty Ltd [2015] VSCA 98

62. This case arose out of a contract made on 20 June 2007 between *Sugar Australia Pty Ltd* as proprietor and *Lend Lease Services Pty Ltd* as the contractor for the design, supply, construction and installation of equipment for a new refined sugar station, as part of an upgrade at Sugar's existing facility in Yarraville.

63. The contract was an amended version of the AS 4910 2002 form of contract.

64. Under General Condition 5.1 and items 14(a) and 14(b) of Annexure Part A of the contract Lend Lease was required to provide Sugar with security in the form of two unconditional bank guarantees amounting to 5 percent of the original contract sum, being $2,095m ($4,190m in aggregrate).

65. The critical clause of the contract relating to the calling up of the bank guarantees was General Condition 5.2 which relevantly provided:

> *"Any security provided by the Contractor in accordance with the Contract shall be available to the Principal whenever the Principal may claim (acting reasonably) to be entitled to:*
>
> (i) *the payment of monies or an indemnity by the Contractor under or in consequence of or in connection with the Contract;*
> *(ii) reimbursement of any monies paid to others under or in connection with the Contract; or*
> *(iii) other monies payable by the Contractor to the Principal (whether by way of set off or otherwise).*
>
> *Recourse to security shall only be subject to the Principal having given the Contractor five days' notice of its intention to have recourse to the security ……."*

66. By the time the proceeding came before the Court in August 2014 it had already had quite a history of disputation in relation to the contract:

(a) Lend Lease did not reach practical completion by the extended date for practical completion of 27 February 2009;

(b) Lend Lease purported to terminate the contract on 28 September 2011;

(c) Sugar purported to terminate the contract on 3 November 2011;

(d) Lend Lease served a show cause notice upon Sugar on 31 May 2011;

(e) on 16 June 2011 Lend Lease suspended the works on the basis that Sugar had not shown cause in relation to the breaches alleged in Lend Lease's show cause notice;

(f) on 13 July 2011 Sugar's Principal's representative under the contract purported to withdraw directions made on 17 and 20 May 2011;

(g) on 23 August 2011 Sugar issued a show cause notice to Lend Lease alleging substantial breaches under General Condition 39 of the Contract;

(h) on 28 September 2011 Lend Lease purported to terminate the contract under General Condition 39.9;

(i) on 3 November 2011 Sugar purported to terminate the contract under General Condition 39.9;

(j) on 8 August 2014 Sugar gave written notice to Lend Lease of its intention to have recourse to the two unconditional bank guarantees. The notice summarised Sugar's claims for additional cost to complete and the cost of rectifying defects totaling $9,903,365.93;

(k) on the same day, 8 August 2014, Sugar commenced a proceeding in the TEC List claiming $9,443,291 consisting of $2,744,662 for increased costs of completing the works, $1,428,352 for the cost of rectifying defects, and $5,270,877 for the estimated cost of rectifying further defects;

(l) on 12 August 2014 Lend Lease commenced its own proceeding (before it became aware of Sugar's proceeding). In the general endorsement to the writ, Lend Lease claimed that it validly terminated the contract on 28 September 2011. It claimed payments totalling $17,904,746 in respect of inter alia, variations, reversal of negative variations, unpaid progress certificates and balance of the earned contract sum and delay costs. It also claimed project losses calculated on a quantum meruit basis totalling $67,171,483.50. It also sought declarations that Sugar had wrongfully purported to issue the recourse notice, that the recourse notice was invalid, and that it sought a permanent injunction restraining Sugar from having recourse to the unconditional bank guarantees;

(m) on 12 August 2014 Lend Lease issued a summons seeking an interlocutory injunction to restrain Sugar from having recourse to the unconditional undertakings;

(n) the application was heard before the primary Judge on 29 August. He delivered judgment on 24 September. His Honour granted Lend Lease an interlocutory injunction restraining Sugar from having recourse to the unconditional bank guarantees before the trial of the action or further order.

The primary Judge's decision

67. By way of a brief summary of the primary Judge's reasons (paragraphs [87]-[95])

(a) he concluded that there was a serious issue to be tried as to the proper construction of the contract, and in particular clause 5.2, namely:

(i) the correct construction of clause 5.2; and

(ii) whether, if the words "acting reasonably" involved an objective analysis, the matters raised by Lend Lease had the effect that Sugar was not acting reasonably by seeking to call up the bank guarantees;

(b) notwithstanding a submission by Sugar that His Honour should finally determine the question of the correct construction of General Condition 5.2, His Honour considered that that issue was best left to the trial of the proceeding for a final determination or alternatively the trial of a separate question within that proceeding;

(c) he was also satisfied that Lend Lease had demonstrated a serious issue to be tried in relation to the validity of the recourse notice on the bases that a notice was not addressed to Lend Lease but to a non existent entity (Lend Lease Services (Aust) Pty Ltd), also as to whether a call upon the bank guarantees could only be made in respect of monies presently due rather than for monies which may become due in the future, and finally on the basis that the notice sought to draw a sum greater than the available balance of a liability cap ($2,024,215);

(d) on the issue of balance of convenience the primary Judge considered that if no injunction were granted, but Lend Lease's claims were ultimately vindicated, Lend Lease would likely suffer irreparable harm because it would suffer damage to its reputation should the bank guarantees be drawn on, and because Sugar only had a paid up capital of $4.00 and did not own the land in which the project was being constructed;

(e) accordingly the primary Judge was satisfied that the balance of convenience strongly favoured the granting of the injunction.

Court of Appeal decision

68. The Court of Appeal (comprising Osborn, Ferguson and Kaye JJA) allowed the appeal and set aside the order made by the primary Judge. The main judgment was delivered by Kaye JA.

Serious issue to be tried

69. On the question of whether Lend Lease had demonstrate that there was serious issue to be tried as to its entitlement to relief at trial, the Court held that the primary Judge erred by failing to determine the question of law concerning the correct construction of clause 5.2 of the contract.

70. Kaye JA at [111] said that the authorities show:

> *"….. ordinarily, on an application for an interlocutory injunction to restrain recourse to a security provided under a building contract, a Court should determine a controversial issue of law, if the determination of that issue is a necessary step to a conclusion whether an applicant is entitled to the injunction, unless, in the particular circumstances of the case it is not practicable or appropriate to do so".*

71. He referred to what Young J said in *Hortico (Australia) Pty Ltd v Energy Equipment Co (Australia) Pty Ltd [1985] 1 NSWLR 545:*

> *"On an application for interlocutory injunction which raises questions of law, the approach of this Court has been, I believe, to decide questions of law which arise unless in the opinion of the Judge, those questions should be better left until later ……. I think that the only exceptions to that general rule are where time does not permit proper consideration of the questions of law at the interlocutory stage …… or whether determination of the points of law requires a factual matrix which is not available until the facts in the entire proceedings have been provided".*

72. Kaye JA said at [120] that there was no suggestion that the construction of General Condition 5.2 required evidence as to factual matrix. Nor was the resolution of the injunction application urgent, and the Judge had some time to consider the issues before handing down his decision.

73. Kaye JA also made the point at [122] that resolution of the construction of General Condition 5.2 was a necessary prerequisite to determining whether Lend Lease had established that there was a serious issue to be tried as to whether Sugar had acted reasonably and claiming to be entitled to payment of money secured by the guarantee.

74. Each of the members of the Court explained why determining the correct construction of General Condition 5.2 was so important to the outcome of the injunction application. They said that recourse provisions such as General Condition 5.2 are commonly included in construction contracts and they serve an important commercial purpose in the construction industry. Depending upon the particular wording of the clause in question, recourse provisions serve two purposes. First, they provide security to the beneficiary so that in the event that the principal to the contract has a valid claim, it has security against which to recover recompense. But in addition the clause may serve a second purpose namely as a risk allocation device allocating which party will be out of pocket pending the resolution of the dispute. If the intention of the parties under the clause is that the risk be allocated to the contractor, then the principal is able to call upon the guarantee pending final determination of the dispute, even if there is a serious issue to be tried in relation to such a dispute, and even if it turns out that it was the principal who was in default and was liable in respect of the dispute.

75. In this case the members of the Court decided that General Condition 5.2 was intended by the parties to serve both purposes. Osborn and Ferguson JJA said:

"67. The primary Judge did not decide whether GC 5.2 was intended to allocate risk pending the resolution of a dispute. In our view it was so intended and this in turn constitutes a consideration of fundamental importance in assessing whether the grant of an injunction carries with it the lower risk of injustice.

68. The parties made a commercial agreement as to when and how the performance bonds might be called upon. In doing so, they effectively determined which of them would bear the financial risk (up to approximately $4.2m) without the need for the Appellant to prove an entitlement to be paid. The safe guard negotiated and agreed by the parties was that the Appellant must act reasonably when claiming an entitlement to payment and calling on the bonds. One important commercial effect of this was that the Appellant did not have to wait until trial for payment of some amount by the Respondent. This evident commercial purpose of GC 5.2, when viewed in the context of the acceptable principles governing the grant of interlocutory injunctions and the ordinary practice adopted in performance bond cases, required the primary Judge to resolve the construction issues raised in order to properly determine whether an injunction should be granted. If this were not done, in effect, the parties would be deprived of the commercial bargain they made".

76. Along similar lines Kaye JA said:

"141. In construing clause 5.2, it is important to bear in mind, first, that that provision does not require the Appellant to establish or demonstrate an entitlement to payment, indemnity or reimbursement referred to in that clause. Rather, it is sufficient that the Appellant has a "claim" to such an entitlement. In that respect, it is relevant that the clause only requires the Appellant to provide 5 days' notice to the Respondent of its intention to have recourse to the security. In that way, it is clear that the security, provided under clause 5.2 was intended to serve both purposes described by Callaway JA in Fletcher Construction, namely, to provide security to the Appellant and also to allocate the risk to the Respondent as the party which should be out of pocket pending resolution of any dispute between the parties."

77. However Kaye JA said at [142]) that there was a qualification to Sugar's right to access security. The qualification in clause 5.2 was expressed to require that Sugar be "*acting reasonably*" in making the claim:

"*…… it does not, in express terms, require that the claim itself be reasonable. In particular, the clause does not make it necessary that the claim, ultimately, to be a reasonable claim by the Appellant. Rather, what must be established is that the Appellant, in making the claim, was then "acting reasonably". In that way, the phrase "acting reasonably" has an important temporal aspect. It focuses attention on the conduct of the Appellant at the time at which the Appellant made the claim stated in the recourse notice."*

78. Kaye JA then undertook a very exhaustive examination of the claims made by Sugar in its recourse notice, namely the increased cost of completion of the works ($3,041,062.43), and the cost of rectifying various alleged defective works ($6,862,303) (refer paragraphs 154 to 198 and

212 to 223) in order to determine whether there was a serious issue to be tried in respect of any such claims.

79. He determined that Lend Lease had established that there was a serious issue to be tried with respect to many of the claims, the subject of Sugar's recourse notice (refer to paragraph 230 where he summarises the overall position).

Balance of convenience (paragraphs 231 to 237)

80. The primary Judge held that the balance of convenience favoured the granting of an injunction on three bases, first, that Lend Lease would suffer significant reputational harm if Sugar cashed the bank guarantees; second, that there was an appreciable risk that Sugar would not be able to satisfy an award of damages should Lend Lease ultimate succeed at trial; and third, because he was not satisfied that there was likely to be more than minimal inconvenience to Sugar in the event that it was restrained from acting on the recourse notice.

Reputational harm

81. Kaye JA rejected the reputational harm submission for the following reasons [233]:

(a) the matters deposed to in the Affidavits filed on behalf of Lend Lease were substantially mere assertions;

(b) secondly, Sugar had failed to demonstrate that there was a serious issue to be tried in respect of an amount totalling $1,999,951, and accordingly Lend Lease would sustain any such reputational damage in any event;

(c) thirdly, by agreeing to the recourse clause in General Condition 5.2, Sugar assumed the risk that a call may be made upon the security;

(d) finally, and importantly, Kaye JA doubted the notion of reputational harm in this case:

"I should add that it is notorious that disputes are commonly part and parcel of building contracts. I have some reservations as to the assertions made in the Affidavits of Mr Connor that the existence of the dispute in this case would have any substantial adverse impact on the reputation of the Respondent in the market place".

The risk that Sugar would not be able to satisfy an award of damages against it

82. Lend Lease had submitted that Sugar had a paid up capital of $4.00 and that Sugar was not the owner of the land on which the project was being conducted.

83. Any issue concerning these matters was averted by Sugar proffering an undertaking by Wilmar Sugar Refinery Investments Pty Ltd to repay the security within 14 days of a final judgment in favour of Lend Lease. The evidence showed that Wilmar was a major shareholder in Sugar and had

ample means to meet any obligations under the bank guarantee if called upon to do so by the Court.

Allocation of risk

84. The final point which Kaye JA made in relation to the balance of convenience was to reiterate the importance of the fact that under General Condition 5.2 the parties evinced an intention that it was to be Lend Lease who was to carry the risk of being out of pocket pending the resolution of the dispute between the parties:

> *"236. On the other hand, if the interlocutory injunction were granted, the Appellant would be held out of its rights to access the security until the trial of the principal building disputes between the parties. In that way, it would be deprived of the right, provided to it under clause 5.2 that the Respondent, and not the Appellant, carry the risk as to which party is out of pocket pending the resolution of the disputes between them."*

Dedert Corporation v United Dalby Bio-Refinery Pty Ltd [2017] VSCA 368

85. This case arose out of a contract made on 25 November 2014 between United Dalby Bio-Refinery Pty Ltd as proprietor, and Dedert Corporation as contractor, for the design, construction, supply and installation of a Swiss Combi ecoDry System at Dalby's Refinery.

86. The contract was an amended version of the AS 4902-2000 form of contract.

87. In accordance with clause 1.1(e) of the contract, Dedert provided security in the form of an unconditional bank guarantee issued by the Danske Bank.

88. A bank guarantee in the sum of $542,340 was provided in accordance with clause 5.1 of the contract, which simply stated that "*security shall be provided in accordance with Item 14 or 15"* of the contract.

89. The clause which was most relevant to the determination of the proceeding was clause 5.2 which provided the circumstances under which United Dalby was entitled to have recourse to the guarantee:

> *"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".*

90. Clauses 39.7, 39.9 and 46.3 (refer paragraphs 69 and 75 of the judgment) were other clauses which related to the security. Whilst they were not directly applicable to the demand made upon the guarantee, they were relevant in construing clause 5.2, to the extent that the wording of those clauses provided a contrast to the wording of clause 5.2 regarding the basis upon which United Dalby was entitled to call off the guarantee.

91. Subsequent to the supply and installation of the drying system, United Dalby alleged that the system was defective in a number of respects and that the cost of rectification would be $866,354.24. There had been no certification under the contract or other adjudication regarding that claim.

92. On 13 November 2017, United Dalby served a written notice to Dedert's solicitors giving 5 days notice of its intention to call on the bank guarantee in respect of losses which it alleged it had sustained as a consequence of the alleged defects.

93. Dedert immediately applied to the Court for an injunction restraining United Dalby from calling on or otherwise requesting payment under the guarantee.

94. The primary Judge refused the application for an injunction.

95. Dedert had argued before the primary Judge that United Dalby was not entitled to have recourse to the guarantee under clause 5.2 because the claim made by United Dalby was not in respect of an amount which "*remain[ed] unpaid after the time for payment [had] elapsed"* (per clause 5.2).

96. United Dalby had submitted to the primary Judge that clause 5.2 was not the only provision governing recourse to the guarantee. It submitted that clauses 39.7, 39.9 and 46.3 demonstrated that the parties intended that under clause 5.2 recourse to the security could be made in respect of amounts that had not yet become "*due and payable"* by the Applicant.

Decision of the primary Judge

97. The primary Judge held that clause 5.2 was permissive in its operation, not exclusive, viz. it was not an implied negative stipulation setting out the only circumstances under which United Dalby could call on the guarantee. His Honour said that clause 5.2 would clearly engage with respect to certified amounts which remained unpaid (which was not the position in this case), but that clause 5.2 "*does not explicitly exclude amounts reflecting bona fide claims for amounts which may become due from the contractor to the principal for breach of contract"*. (Refer to paragraph 83 of the Court of Appeal decision).

98. The primary Judge considered that the purpose of the guarantee was as security and also as a risk allocation device pending resolution of all disputes, and that the risk was allocated to the contractor.

99. Accordingly, the primary Judge held that there was a serious issue to be tried and that the balance of convenience favoured refusal of the injunction.

The Court of Appeal decision

100. The Court of Appeal (Kaye, Priest JJA, Whelan JA dissenting) allowed the appeal, granting Dedert an injunction restraining United Dalby from calling on or otherwise requesting payment under the bank guarantee. The main judgment was given by Kaye JA. He said that the primary Judge was correct to decide the application by reaching a concluded view as to the

meaning of the contract. There was no evidence of surrounding circumstances which needed to be taken into account in undertaking that task [100].

101. Kaye JA said that the Court of Appeal should reach its own concluded view as to the correct construction of the contract [101].

102. The majority came to a different view to that of the primary Judge on this issue. They held that there was clearly a qualification in clause 5.2 restricting the right of United Dalby to have recourse to the guarantee, namely an express prescription that recourse was only permitted under the clause "*where a party remains unpaid after the time of payment"*. The Court held that this, *"was an implied negative stipulation in a contract that the Respondent would not invoke recourse to the security in the absence of there being an account "unpaid" by the Applicant to the Respondent "after the time for payment"* [105].

103. United Dalby did not contend that the claim of $866,354.24 in respect of alleged defects was an amount "*due and payable"*. Clauses 39.7 and 39.9 were only engaged in respect of amounts certified by the superintendent or otherwise provided by the contract to be due and payable by Dedert to United Dalby [108].

104. Clause 46.3 was also not applicable [114].

105. Accordingly the only possible basis for recourse was under clause 5.2.

106. Kaye JA said [110] that it was axiomatic that "*according to plain usage of language, monies would not be understood to remain "unpaid after the time for payment" unless those monies have already become due and payable".*

107. Accordingly, because the claim of $866,354.24 made by United Dalby was clearly not *"due and payable"*, the qualification under clause 5.2 was not satisfied [121].

108. Kaye JA referred to the Queensland Court of Appeal decision in *RCR O'Donnell Griffin Pty Ltd v Forge Group Power Pty Ltd (rec and mgr appt) (in liq) [2016] QCA 214,* where the Court also considered clause 5.2 of the same form of contract. In that decision McMurdo JA (with whom Applegarth JA agreed) said:

> *"By cl 5.2 of the Subcontract in this case, the security was subject to recourse "where [the Principal] remains unpaid after the time for payment". On the ordinary meaning of those words, the precondition to recourse to the security was the fact of money being unpaid to the Principal. Clause 5.2 was not in terms which referred to a believe, or grounds for a belief, that money remained unpaid. Because recourse to the security was permitted only where in fact money remained unpaid, in my view it was necessarily implied that recourse was not permitted, and that the Principal should not attempt to have recourse to the security, where there was not money, which remained unpaid to it. There was thereby a negative stipulation which could be the basis for an injunction restraining Forge from making demand on the bank guarantees".*

109. Kaye JA also explained [124] that his decision was not inconsistent with the *Fletcher Construction, Bachmann a*nd *Clough Engineering* cases.

110. With respect to *Fletcher* United Dalby had submitted to the Court that clause 39.7 of the contract was analogous to clause 3.13(b) of the contract in *Fletcher Construction*. Kaye JA rejected this contention [127]:

> *"However, there is a relevant fundamental distinction between on the one hand, cl 3.13(b) in the Fletcher Construction case, and cl 39.7 in the contract in the present case. In Fletcher Construction, the contract, by cl 3.13(b) entitled Varnsdorf to deduct the prescribed Time Damages from any amount it owed to Fletcher, and to have access to the security for any balance after such deduction, 10 days after delivering to Fletcher a notice "demanding payment". That is, as Charles JA noted, cl 3.13(b) provided no qualification to the right to Varnsdorf to have recourse to the security, other than that it must first make a demand upon Fletcher for the Time Damages. By contrast, in the present case cl 39.7 specifically provided that the right of recourse by the Respondent to the security after any set off, was limited to any amount that was "due and payable" by the Applicant to the Respondent".*

Conclusion

111. The *Fletcher, Sugar* and *Dedert* decisions provide an extremely helpful resource for analysing any particular case that we as lawyers may be asked to consider concerning disputation over a bank guarantee in relation to a construction contract.

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18 July 2018