Considerations when converting a security bond

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A look at the relevance of bonds in contracts

CONSTRUCTION contracts often require the provision of security to protect and secure the performance of a contractor or subcontractor of its obligations under the contract and can include cash retention being withheld, bank guarantees and performance bonds.

In respect of bank guarantees and performance bonds, banks and insurers are required to secure or underwrite the performance of a party's obligations under the contract. This provides surety to the bond holder that the institution has the credit-worthiness to satisfy the security in the event of breach or default. Generally, bonds can either be on demand or conditional.

Conditional bonds place an obligation on the beneficiary to provide evidence that the party providing the bond has not performed its obligations under the contract, and that it has suffered a loss as a consequence of the other party's breach or default. This evidence would normally take the form of a claim made up of the facts and information relied upon to establish the causal link between an event and a default or breach (cause) setting out the defaulting party's culpability for the loss or damage (effect). The claim would traditionally set out the quantum (costs) sought by the party bringing the claim. Relevantly, Stephen J in *Wood Hall Limited v Pipeline Authority* (1979) 141 CLR 443 observed:

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

On-demand bonds tend to be more common in large international projects and often take the form of advance payment bonds, materials off-site bonds, tender bonds and warranty (defects liability) bonds. On-demand bonds are expressed to be irrevocable and unconditional and often described as being as good as cash.

That nature is reflected in what has become known as the autonomy principle, which means that a beneficiary is entitled to demand payment on the security, and the financial institution underwriting the bond is obliged to meet that demand. This obligation is mandatory upon the financial institution, regardless of whether or not the account party is in breach of the underlying contract. This allows for the cash to pass to the other party with any dispute between the parties being pursued retrospectively.

Consideration should be given to the collection of evidence that might be required in the event the bond call is challenged by an interim interlocutory injunction. In this instance, it is not uncommon for beneficiaries to provide information to the court in respect of the alleged breach and the grounds upon which the

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bond call is being made. If the bond call is challenged, evidence may be needed to show that the call is not fraudulent.

The autonomy principle allows banks and finance institutions to meet their obligations in a prompt manner so as to ensure that there is no effect on their *"reputation for financial and contractual probity."* [1] The underlying concept is that in the event of a dispute between the parties arising, the beneficiary of the bond may have recourse to the security whilst the dispute is being resolved. The parties have agreed that the financial burden incurred by one party whilst a dispute is resolved shall not lie with the beneficiary of the bond.

For a bank guarantee or unconditional performance bond to function as a risk allocation device (as well as a security), an intended beneficiary will need to routinely implement certain safeguards, rather than relying solely upon the autonomy principle. In Australia, this principle has been considered in many often cited authorities in this area of jurisprudence.[2]

On demand bonds do not require a party to provide proof or evidence of loss. Generally, a statement to the effect that an obligation in the underlying contract has been breached and that loss has been suffered by the beneficiary, without having to prove either, is sufficient to trigger payment. Due to the advantage that is provided to the beneficiary in respect of being able to swiftly convert an on demand bond to cash, it is not uncommon for a party to seek an urgent interim injunction restraining the beneficiary from converting the security.

Previous case law has shown that, save as to allegations of fraud, the courts would not normally grant an injunction preventing the beneficiary from converting the on-demand bond on the balance of convenience. The balance of convenience being to leave the bond intact until such time as the dispute is resolved. In Olex Focas Pty Ltd,[3] Charles JA said:

> *"The courts will intervene to prohibit a bank from paying under a performance guarantee in very limited circumstances. The wholly exceptional case in which an injunction might be granted at common law is where it is proved that the bank knows that any demand for payment already made, or which may thereafter be made, will clearly be fraudulent; Bolivinter Oil SA v Chase Manhattan Bank and Ors (1984) 1 Lloyds Rep 251, at 257 per Donaldson MR. Otherwise the whole commercial purpose of such guarantees (or, for that matter, irrevocable letters of credit) would be destroyed and the international reputation of a bank issuing such documents would be at risk of serious damage when the bank is caught between the competing demands of the guarantor (its customer) and the beneficiary of the guarantee. The bank is in no way concerned with any dispute the guarantor may have with the beneficiary; Power Curber International Ltd v National Bank of Kuwait (1981) 3 All ER 607 per Lord Denning MR at 612-613, and per Griffiths LJ at 614."*

In preparing to make a bond call, it is not uncommon for contracts to stipulate a notice period that must be given by the beneficiary as a condition precedent to the conversion of security. Failure to adhere to notification requirements in accordance with express contract provisions could result in a party bringing court proceedings seeking an injunction to restrain the other party from converting the bond.

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It is important for contractors and subcontractors to understand the importance of risk transfer when negotiating the terms of a bond, and any conditions precedent which must be met for a principal to be entitled to call on security. The expiry date of a bond should be considered in respect of the timing of a bond call and any benefits which may arise by renewing or extending the period of the bond. In addition, the wording of key contract clauses and bond wording should be carefully considered.

The reliance upon security bonds within the construction industry is widespread and with increased financial and commercial pressures, challenges to bond calls will be increasingly prevalent.

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[1] *Bolivinter Oil SA v Chase Manhattan Bank NA* (1984) 1 Lloyds' Rep 251, 257.
[2] *Wood Hall Ltd v The Pipeline Authority* (1979) 141 CLR 443; *Olex Focas Pty Ltd v Skoda Export Co Ltd* (1997) ATPR (Digest) [46-163]; *Reed Construction Services Pty Ltd v Kheng Seng (Australia) Pty Ltd* (1999) 15 BCL 158; *Bachmann Pty Ltd v BHP Power New Zealand Ltd* (1999) 1 VR 420 and *Fletcher Construction Australia Limited v Varnsdorf Pty Ltd* (1998) 3 VR 812; *Boral Formwork & Scaffolding Pty Ltd v Action Makers Ltd* (2003) NSWSC 713; *Vos Construction & Joinery Qld Pty Ltd v Sanctuary Properties Pty Ltd & Anor* [2007] QSC 332.
[3] *Olex Focas Pty Ltd v Skoda Export Co Ltd*, (unreported, Vic Sup Ct, CA, No 7050/1996, 17 September 1996 at pp2-4).