

The Insider

Unconditional bonds – are ‘clear words’ enough?

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As a general rule, a beneficiary of an unconditional undertaking is entitled to convert the security into cash, unless to do so would be fraudulent, unconscionable or in breach of a clear term of the contract restricting that ability. It requires ‘clear words’ to inhibit a beneficiary from calling on a performance guarantee where a breach is alleged in good faith i.e. non-fraudulently.

Last year the Supreme Court of NSW and the Court of Appeal was asked to consider whether ‘clear words’ are the only consideration for performance bonds.

The Facts

In April 2012, Laing O’Rourke Australia Construction Pty Ltd (**LORAC**) and Kawasaki Heavy Industries Ltd (**Kawasaki**) entered into a subcontract with JKC Australia LNG Pty Ltd (**the JKC Subcontract**). Pursuant to the terms of the JKC Subcontract, Kawasaki and LORAC were to jointly provide an unconditional and irrevocable bond to JKC. Kawasaki provided the bond to JKC on behalf of both LORAC and itself (**the Kawasaki Bond**).

The relationship between LORAC and Kawasaki was governed by a Consortium Agreement, which provided that if JKC made a call on the Kawasaki Bond, then both Kawasaki and LORAC would have to contribute to the call in proportion to their liability.

Separately, LORAC was required to provide 3 unconditional bonds to Kawasaki (**the LORAC Bonds**) under the Consortium Agreement. JKC asserted an entitlement to damages in excess of \$102M against LORAC and Kawasaki, but importantly, did not make a call on the Kawasaki Bond.

On 14 March 2017, Kawasaki called upon the LORAC Bonds. On 15 March 2017, Justice Ball granted LORAC an interim injunction restraining Kawasaki from calling on the LORAC Bonds. Following service of the interim injunction, Kawasaki agreed to withdraw its call on the LORAC Bonds pending a final determination of the injunctive relief sought by LORAC.

The Issue

Assuming a demand is valid, the issuer of an unconditional bond must pay the amount demanded to the principal (Kawasaki) without reference to the contractor (LORAC) and notwithstanding any notice given by the contractor to not pay the amount demanded.

LORAC’s application to the Court to restrain a call being made was not made on the basis that the call was fraudulent or unconscionable, but on the basis that on a proper construction of the Consortium Agreement, Kawasaki had agreed not to call on the LORAC Bonds until such time as JKC made a call on the Kawasaki Bond.

The Insider

The Outcome

The application for injunctive relief centred on whether LORAC could identify in the Consortium Agreement 'clear words' inhibiting Kawasaki from calling on the LORAC Bonds. Kawasaki submitted that 'clear words would be required to support a construction which inhibited from calling on the LORAC Bonds where a breach was alleged in good faith, that is, non-fraudulently'.

In Kawasaki's submission the Consortium Agreement did not include such clear words. Justice Stevenson determined that it is not necessary for express words of inhibition to be used, but it must clearly emerge that the parties intended there to be a constraint on the right to have recourse to the bonds.

Whilst His Honour could not find 'clear words' preventing Kawasaki from making a call, he determined that 'the structure of cl 14 [of the Consortium Agreement] suggests very strongly in my opinion, that it was the intention of the parties that Kawasaki could only call on the LORAC Bonds if a call had been made on it by JKC under the Kawasaki Bond'. The interim injunction was continued.

The Impact

Justice Stevenson's decision has already been the subject of an appeal to the Court of Appeal as well as the subject of comment in the Court of Appeal in Western Australia.

The Court of Appeal determined that no special rules of construction apply to performance bonds, rather the usual rules regarding the construction of contracts is applicable. That is, the proper construction of a contract or performance bond is to be determined by reference to its text, context and purpose.

It appears inevitable that this decision will be the subject of further comment by the Appeal Courts either in New South Wales or the other States if only to determine its limitations and its scope.

However, the two decisions are authority for the position that clear words are not the sole threshold. Text, conduct and purpose are all equally important. This is certainly of assistance to those who have provided bonds and who may want to restrict their call, and may impact on the way underlying contracts are drafted going forward. In the interim, the Courts can expect several more applications to be made relying on the decision.

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